

Proceeding No.: D-17-1265F

IN THE MATTER OF

A Complaint made under sections 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 Chi Kei, Ronald (A18242) 1st RESPONDENT

Ho Yiu Hang, Ricky (A25768) 2nd RESPONDENT

Asian Alliance (HK) CPA Limited (M0331) 3rd RESPONDENT

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

Members: Mr. Wong Wing Yan, Kenneth (Chairman)
 Ms. Yu Ho Wun, Grace
 Mr. Lui Chi Ho
 Mr. Guen Kin Shing
 Mr. Martin Stuart Hills

ORDER AND REASONS FOR DECISION

(A) INTRODUCTION

1. This is the complaint made by the Acting Registrar of the Hong Kong Institute of Certified Public Accountants (the "Institute") against Mr. Chan Chi Kei, Ronald, a certified public accountant (practising) (the "1st Respondent"), Mr. Ho Yiu Hang, Ricky, a certified public accountant

(practising) (the “**2nd Respondent**”) and Asian Alliance (HK) CPA Limited, a corporate practice (the “**3rd Respondent**”) (collectively the “**Respondents**”).

2. By a letter dated 31 October 2018 to the Council of the Institute (the “**Complaint**”), the Acting Registrar (the “**Complainant**”) complained that the Respondents have failed or neglected to observe, maintain or otherwise apply professional standards under section 34(1)(a)(vi) of the Professional Accountants Ordinance (“**PAO**”).
3. On 15 January 2019, the Respondents provided their admission of the Complaint in writing to this Committee. The Complainant and the Respondents requested this Committee to dispense with the steps set out in Rules 17 to 30 of the Disciplinary Committee Proceedings Rules (the “**Rules**”). They also undertook to address this Committee in writing at a later stage as to the appropriate sanction to be imposed in light of their admission.
4. In light of the Respondents’ admission, this Committee agreed to the parties’ proposal to dispense with the steps set out in Rules 17 to 30 of the Rules and directed the parties to make written submissions as to sanctions and costs which should be imposed by the Committee pursuant to Rule 31 of the Rules.
5. On 4 April 2019, the Complainant filed his written submissions as to sanctions and costs.
6. On 9 April 2019, the Respondents filed their written submissions as to sanctions and costs.

(B) BACKGROUND

7. Natural Dairy (NZ) Holdings Limited (the “**Company**”), is incorporated in the Cayman Islands and its shares are listed on the Main Board (Stock code: 00462) of the Stock Exchange of Hong Kong Limited.
8. The financial statements for the Company and its subsidiaries (the “**Group**”) for the year ended 31 May 2011 (the “**2011 Financial**

Statements”) were stated to have been prepared in accordance with the Hong Kong Financial Reporting Standards (“**HKFRS**”) issued by the Institute.

9. The consolidated loss of the Group for the year ended 31 May 2011 was HK\$154 million and the consolidated net assets of the Group as at 31 May 2011 was HK\$1,252 million.
10. A material part of the consolidated net assets was the Company's right to its 20% equity interest in a New Zealand company (the “**Investee**”) which was classified as an available-for-sale financial asset (“**AFS Investment**”), with a carrying amount of HK\$367.2 million, as at 31 May 2011¹ and represented 29% of the Group's consolidated net assets.
11. The AFS Investment was the first step in a planned 100% acquisition by the Company of the Investee, which would be acquiring a further 16 dairy farms in New Zealand. The Investee had already acquired four dairy farms and these currently stood as its principal assets.
12. Under the Overseas Investment Act 2005 (the “**Overseas Investment Act**”), any acquisition of sensitive land and businesses in New Zealand by a foreign investor requires ministerial consent, following a recommendation from the Overseas Investment Office.
13. On 22 December 2010, an application for consent made by the Company to acquire the remaining 80% equity interest in the Investee, was declined. Consent was also declined for the Investee's proposed acquisition of 16 dairy farms and its retrospective application for consent for the acquisition of the current four dairy farms which it already held.
14. In respect of the current four dairy farms, the decision not to grant the retrospective consent to the Investee meant that those farms were, as at 31 May 2011, at risk of disposal by court order, pursuant to section 47 of the Overseas Investment Act.
15. The 2011 Financial Statements did not disclose this fact about the four dairy farms, which formed the principle assets of the Company's AFS

¹ The acquisition of the AFS Investment was completed on 10 February 2010

Investment.

16. The 3rd Respondent were the auditors of the 2011 Financial Statements and had expressed a qualified opinion because of scope limitations on *inter alia*, the opening balances and the corresponding figures of the AFS Investment in the 2011 Financial Statements.
17. On 8 May 2014, acting on a complaint received from a regulator on possible auditing irregularities in the audit of the 2011 Financial Statements regarding the AFS Investment, the Financial Reporting Council (the “FRC”) directed the Audit Investigation Board (the “AIB”) to investigate into the matter.
18. The FRC received a further complaint from another regulator on 5 November 2014 and directed the AIB to expand its investigations to include the audit work carried out on revenue recognition from the Group's trading of food and beverage and dairy related products for the year ended 31 May 2011.
19. Following a two-year investigation, the AIB submitted a draft report to the Respondents who provided their responses to the findings identified. These responses were detailed in the investigation report (the “AIB Report”) and considered before the investigation report was finalized and then submitted to and adopted by the FRC on 11 May 2017.
20. The AIB Report, together with annexures, was referred to the Institute pursuant to section 9(f) of the Financial Reporting Council Ordinance, Cap 588 on 12 May 2017. The AIB Report, which has been certified by the FRC as a true and complete copy, is admissible as evidence of the facts stated in that report².
21. In referring the AIB Report to the Institute, the FRC considered that, for the audit of the 2011 Financial Statements, the Respondents had failed or neglected to observe, maintain or otherwise apply professional standards under section 34(1)(a)(vi) of the PAO.
22. In the follow-up investigation of the matter by the Institute, the

² Section 35(7) of the Financial Reporting Council Ordinance

Respondents, in their letter dated 20 June 2017, have maintained the same representations that they had provided to the AIB with the additional criticism that the FRC had not given them the opportunity to explain the work that they had done through a face to face meeting.

23. On 17 August 2017, in response to a request from the Institute, the Respondents also provided two letters from the lawyers who had previously acted for both the Company and the Investee on *inter alia* the four dairy farms, and a copy of an announcement from the Overseas Investment Office issued on 25 March 2011, all of which they maintained were considered when carrying out their audit of the 2011 Financial Statements.

(C) THE COMPLAINTS

First Complaint

24. Section 34(1)(a)(vi) of the PAO applies to the 1st Respondent and the 3rd Respondent in that they have failed or neglected to observe, maintain or otherwise apply professional standards in their audit of the 2011 Financial Statements.

Second Complaint

25. Section 34(1)(a)(vi) of the PAO applies to the 2nd Respondent in that he had failed or neglected to observe, maintain or otherwise apply professional standards when acting as the Engagement Quality Control Reviewer during the audit of the 2011 Financial Statements.

(D) SUMMARY OF PRINCIPAL ISSUES

26. The principal issues focus on two key audit areas:
 - (a) The AFS Investment; and
 - (b) The Revenue Recognition.

D1. AFS Investment

27. This issue concerns the handling of the ministerial refusal to grant retrospective consent to the Investee's acquisition of the four dairy farms. With consent refused, the four dairy farms were at risk of being forcibly sold by the New Zealand government.
28. Given that the four dairy farms were the Investee's principal assets and were essential to its operations, a forced sale could have a significant effect to its financial affairs and, in turn, could financially impact the AFS Investment held by the Company. As the AFS Investment was material to the 2011 Financial Statements, there was a risk of a significant misstatement.

D1(a) Possession of four dairy farms and related Disclosure

29. In reviewing the working papers, the AIB found no evidence how the 1st Respondent and the 3rd Respondent (collectively the "**Auditor**") had addressed the potential impact that would arise as a result of the ministerial refusal to grant retrospective consent to the Investee's acquisition of the four dairy farms.
30. In representations to the AIB, the Auditor explained that, when carrying out a review of this issue, they had read the announcement from the Overseas Investment Office dated 25 March 2011 and had received two legal opinions which clarified that:
 - (a) The Investee retained legal title to the four dairy farms;
 - (b) Whilst the Investee retained title of the four dairy farms it could legitimately continue to use them;
 - (c) The Investee was currently free to sell the four dairy farms on the open market, if it so wished; and
 - (d) The refusal to grant consent was motivated for political reasons.
31. As a result, the Auditor accepted management's view that the Investee's

interest in the four dairy farms had not been adversely affected by the ministerial refusal to grant consent. None of these explanations or documents had been contained in the audit working papers and the Auditor acknowledged that they could have more comprehensively documented their work in the audit working papers.

32. However, inadequate consideration appears to have been given to the fact that the four dairy farms were now at risk of being forcibly sold and the impact that would have on the Company's 20% investment in the Investee.
33. The legal opinions provided did not specifically address this issue. Even if the Investee could sell the four dairy farms on the restricted market³, there was no indication that this was what it planned to do. To the contrary, the Company's planned future in the Investee depended upon its continued ownership of the four dairy farms.
34. It was also noted by the AIB that the lawyers providing the opinion were not independent as they had advised on the acquisition of the four dairy farms, structured the Sale and Purchase Agreement ("SPA") to acquire 100% of the Investee and had represented the Company and the Investee in applying for the various approvals from the Overseas Investment Office, which were subsequently rejected.
35. In accepting these legal opinions, the Auditor demonstrated a lack of understanding of the Overseas Investment Act and an appreciation of the inconsistency between the Company's planned future and the legal advice received. The Auditor could have sought an independent opinion on the impact of the ministerial refusal on the Investee's continued ownership of the four dairy farms.
36. If it had done so, the Auditor may have appreciated the potential significant effect on the Company's AFS Investment of the ministerial refusal to grant consent of the acquisition of the four dairy farms.

³ The market was domestic with restricted access to overseas investors. Acquisition by any overseas investors required ministerial consent acting on recommendations from the Overseas Investment Office.

37. The 2011 Financial Statements did not disclose details of the ministerial refusal to grant consent to the acquisition of the four dairy farms. Given that the refusal to grant consent created uncertainty over the Investee's possession of the four dairy farms, proper disclosure should have been made in the 2011 Financial Statements which the Auditor failed to identify.
38. As a result of the above, there is no evidence that the Auditor had considered the following:
- (a) To obtain an adequate understanding of the relevant regulation in relation to the ministerial refusal in accordance with paragraph 18 of Hong Kong Standard on Auditing ("HKSA") 250; and/or
 - (b) To discuss with the lawyer who provided the legal opinions why they considered that the Investee's possession of the four dairy farms remained unaffected by the ministerial refusal, or to seek a second legal opinion, as required under paragraph 19 of HKSA 250 and paragraph 11 of HKSA 500; and/or
 - (c) To consider the possible effect of the ministerial refusal on the auditor's opinion, in accordance with paragraph 20 of HKSA 250; and/or
 - (d) To document how they justified that the Investee still legally possessed the four dairy farms, as at 31 May 2011 given the ministerial refusal and their consideration of the effect on the audit opinion if the issue could not be satisfactorily resolved in accordance with paragraph 27 of HKSA 250; and/or
 - (e) The potential disclosure deficiency, given the uncertainty caused by the ministerial refusal, which should have been disclosed in accordance with paragraph 112 of Hong Kong Accounting Standard ("HKAS") 1 and paragraphs 31 and B6 of HKFRS 7.
39. In their representations to the AIB and to the Institute, the Auditor acknowledged that they had not comprehensively documented all the procedures which they claim to have conducted, in the working papers.

In so far as the work had been carried out, it should have been documented, in accordance with paragraph 8 of HKSA 230.

40. However, the work, if carried out, was inadequate to address the deficiencies identified in paragraph 38 above.

D1(b) Impairment Assessment

41. In carrying out its impairment assessment of the AFS Investment, the Auditor relied on the conclusions of two valuers: Valuer A and Valuer B. Valuer A had been employed by the Company to value the AFS Investment as at 31 May 2011 (the "**Valuation Report**"). Valuer B was separately engaged by the Auditor to assess the work carried out by Valuer A.
42. In preparing the Valuation Report, Valuer A based its fair value calculations on two elements:
 - (a) A forecast of profits over four years up to December 2015 generated from the four dairy farms; and
 - (b) The profits generated by a manufacturing agreement signed between a related party of the Investee's and a subsidiary of the Company, of which 50% of the profits would be assigned to the Investee (the "**Assignment**").
43. Having arrived at a valuation based upon the above profit forecasts, a discount rate of 18% was applied to arrive at the figure of NZ\$74 million (HK\$470.7 million) for the AFS Investment. This final figure was higher than the carrying amount and no impairment was considered necessary.
44. Valuer B in their report dated 25 August 2011 concluded that "*the [adopted bases and valuation methodology utilised by Valuer A in the] valuation are fair and reasonable*".

D1(b)(i) The four dairy farms

45. As stated in the Valuation Report, the continued ownership of the four dairy farms was a significant assumption by Valuer A which, if it was not the case, would "*affect our conclusion in this report significantly...*".
46. Given the potential impact of the ministerial refusal to grant retrospective consent for the acquisition of the four dairy farms, further evidence should have been obtained by the Auditor to ascertain whether the assumptions underlying the profit forecasts remained sound.

D1(b)(ii) The Assignment

47. Whilst the Assignment accounted for 95% of the forecasted profit before tax in the Valuation Report, there was no evidence that the Auditor had considered the background and business rationale of the Assignment, the basis for determining the assignment percentage of 50%, and whether the assigned amount should be recognized by the Investee as revenue/income.
48. In fact, there was no evidence that the Auditor had obtained sufficient appropriate audit evidence on certain key assumptions relevant to the Assignment, in the Valuation Report: the milk production capacity; the forecasted period; the growth rate of the milk production; the unit cost used; the 11 listed companies used as proxy companies for the valuation; and the capital expenditure, depreciation and other facts adopted in the profit forecast and discounted cash flows.

D1(b)(iii) The Discount Rate

49. There was no evidence in the working papers to demonstrate how the Auditor had adequately assessed the reasonableness of the discount factor of 18% as the current market rate of return for a similar financial asset, as required under paragraph 66 of HKAS 39.

D1(b)(iv) The Auditor's Failures and Response

50. As a result, in respect of the three issues identified in paragraphs 45-49

above, the Auditor had failed:

- (a) To exercise sufficient professional skepticism in considering the background and business rationale of the Assignment, the basis in determining the assignment percentage of 50% and whether the assigned amount constituted revenue/income of the Investee, in accordance with paragraph 15 of HKSA 200; and/or
 - (b) To perform audit procedures necessary to obtain sufficient appropriate audit evidence as to whether the work of the valuers could be relied on for the impairment assessment of the AFS Investment as at 31 May 2011, in accordance with paragraphs 6, 8, 11 and A48 of HKSA 500 and paragraphs 12 and A35 of HKSA 620; and/or
 - (c) To obtain sufficient audit evidence to evaluate whether the accounting estimates for the impairment assessment of the AFS Investment were reasonable, in accordance with paragraph 18 of HKSA 540; and/or
 - (d) To obtain sufficient appropriate audit evidence to support the conclusion reached in relation to the impairment assessment of the AFS Investment and the unmodified audit opinion expressed in this respect in the 2011 Financial Statements, in accordance with paragraphs 12 and 13 of HKSA 700.
51. The Auditor sought to defend its audit work by claiming to have carried out additional inquiries not documented in the working papers, which they suggest were adequate to satisfy themselves that an impairment of the AFS Investment was unnecessary.
52. Particular reliance was said to have been placed on certain clauses that were present in the SPA which governed the Company's 20% acquisition of the shares in the Investee with a further option to purchase the remaining 80%.
53. These clauses entitled the Company to terminate the SPA in the event that consent from the Overseas Investment Office for its acquisition of the

remaining 80% of the Investee's shares could not be obtained whereupon the vendor was required to buy back the shares it had sold to the Company.

54. In addition, the SPA provided for a profit guarantee which if not met would require the vendor and/or warrantor to pay a refund equivalent to 14 times the shortfall.
55. Such reliance would have been misconceived, given the available information. There was no indication that the Company planned to terminate the SPA, such that the termination clause would be triggered. Even if it did, no assessment was carried out on the ability of the vendor to refund the purchase price. Equally, there was no similar assessment on the financial ability of the vendor and/or warrantor to meet the penalty provision of 14 times equivalent of any shortfall.
56. This, as well as the other inquiries that were alleged to have been conducted, has not been documented in the working papers. In so far as the work had been carried out, it should have been documented, in accordance with paragraph 8 of HKSA 230.
57. Nevertheless, even if the work had been carried out, it was insufficient to address the deficiencies identified above. It is not sufficient to restrict procedures to inquiry alone. Paragraph A2 of HKSA 500 reminds all practitioners of the necessity to obtain sufficient appropriate audit evidence to support that inquiry.

D2. Revenue Recognition

58. In the 2011 Financial Statements, the Group recognized external sales revenues from the trading of food and beverage and dairy related products of approximately HK\$49 million, accounting for 84% of the Group's total revenue for the period ended 31 May 2011.
59. It was not evident from the working papers if and how the Auditor had considered the terms of the relevant distribution agreements concerning the exchange of perished products.

60. In its representation to the AIB and the Institute, the Auditor maintains that it had read the relevant agreements and discussed the issue with the management.
61. This audit work should have been documented, in accordance with paragraph 8 of HKSA 230.

D3. Engagement Partner

62. The audit deficiencies identified above demonstrate that the 1st Respondent had failed to act diligently in accordance with the applicable technical and professional standards when providing professional services on the audit of the 2011 Financial Statements, as required under sections 100.5(c) and 130.1 of the Code of Ethics for Professional Accountants - *Professional Competence and Due Care*.

D4. Engagement Quality Control Review

63. There is no evidence in the working papers which demonstrate if or how the 2nd Respondent had reviewed or discussed with the audit team the impact of the refusal of consent to the acquisition of the four dairy farms, and the assumptions adopted for the impairment assessment exercise with the engagement team.
64. These two areas were significant risk areas which the 2nd Respondent was expected to properly discuss and evaluate in accordance with paragraphs 20 and 21 of HKSA 220. His review, if carried out, was required to be adequately documented in accordance with paragraph 25 of HKSA 220.
65. The absence of any critical review of the work carried out by the audit team on the four dairy farms and the AFS Investment demonstrated the 2nd Respondent's failure to act diligently in accordance with the applicable technical and professional standards as the Engagement Quality Control Reviewer of the audit of the 2011 Financial Statements, as required under sections 100.5(c) and 130.1 of the Code of Ethics for Professional Accountants - *Professional Competence and Due Care*.

(E) DECISION AND ORDER

66. This Committee notes that it has a wide discretion on the sanctions it might impose. Each case is fact sensitive and this Committee is not bound by the decision of the previous committees.
67. This Committee takes consideration of the various cases referred by the Complainant. This Committee considers that the nature of the Respondents' failures in this case involved a possible misleading of the investing public in the Company. This Committee further considers that the public are entitled to expect that practicing accountants and corporate entities discharge their duties and carry out their work to the highest standards of probity, independence and competence. If public confidence is shaken then the price to be paid by the entire accountancy profession will be very high.
68. Therefore, this Committee believes that it is important that public confidence in the accountancy profession is maintained and that any sanctions imposed by this Committee should also act as deterrence to others that non-compliance by accountancy professionals to the high standards expected of them would be viewed seriously and would exact suitably severe sanctions.
69. This Committee agrees with the following submissions of the Complainant:
 - (a) There was no element of dishonesty or lack of integrity on the part of the Respondents.
 - (b) The present case concerns a lack of diligence on the part of the 1st and 2nd Respondents, and thereby the 3rd Respondent, in failing to comply with relevant auditing standards.
 - (c) The failures of the Respondents fall within the "Serious" spectrum.
70. This Committee has taken consideration of all of the Respondents' submissions. Particularly, this Committee has taken consideration the following matters:

- (a) The Respondents admitted the Complaint at the early stage of these proceedings.
- (b) The Respondents have not been the subject of any disciplinary order or sanction.
- (c) The Respondents were co-operative with the AIB's investigation.
- (d) The Respondents regret the instances of non-compliance with the relevant auditing standards.
- (e) The 3rd Respondent has implemented the following measures in attempting to prevent future breach and ensure compliance with the relevant auditing standards:
 - (i) Training sessions have been held for its staff in relation to identifying and assessing issues arising out of impairment assessments;
 - (ii) Training sessions have been held for its staff on the procedures required under the 3rd Respondent's filing and referencing system and the importance of adhering to the same; and
 - (iii) The practice of engaging external technical reviewers has been adopted to assist with identifying and reviewing audit issues arising out of engagements which involve complex accounting issues.

71. This Committee notes that the audit fee paid by the Company for the relevant year totalled HK\$700,000.
72. Having considered the afore-mentioned, all relevant facts of the Complaint, the parties' submissions, the Respondents' conduct throughout the proceedings and their personal circumstances, the Committee considers that a financial penalty of **HK\$150,000** as sanction against the Respondents jointly and severally are appropriate.

73. It is also considered that a reprimand against each Respondent will be a proper sanction to signify this Committee's disapproval of their failures.
74. As for costs, this Committee considers that the sum of **HK\$221,501** was incurred reasonably and should be borne by the Respondents.
75. This Committee makes the following ORDERS:
- i) The Respondents be reprimanded under section 35(1)(b) of the PAO;
 - ii) The Respondents do pay jointly and severally a penalty of **HK\$150,000** pursuant to section 35 (1)(c) of the PAO; and
 - iii) The Respondents do pay jointly and severally (i) the costs and expenses of **HK\$89,209** in relation to or incidental to the investigation incurred by the FRC under section 35(1)(d)(ii) of the PAO and (ii) the costs and expenses of and incidental to the proceedings of the Complainant in the sum of **HK\$132,292** under section 35(1)(iii) of the PAO, in the total sum of **HK\$221,501**.

Dated the 25th day of June 2019.

Mr. Wong Wing Yan, Kenneth
Chairman

Ms. Yu Ho Wun, Grace
Member

Mr. Lui Chi Ho
Member

Mr. Guen Kin Shing
Member

Mr. Martin Stuart Hills
Member