

review, which was concluded in April 2019.¹ During the practice review, the practice review team reviewed the Practice's audit of the consolidated financial statements of a Hong Kong listed company, "Client C" and its subsidiaries for the year ended 31 December 2017 ("2017 Financial Statements"). The Practice expressed an unmodified opinion on the 2017 Financial Statements on 28 March 2018. The Respondent was the engagement director of the audit.

4. Subsequent to the conclusion of the practice review visit, the Respondent submitted to the Institute his written representations on the dated draft report together with six memos prepared by an independent valuer engaged by Client C ("Valuer Memos") with reference to supporting files. However, none of the audit work as asserted in these representations was documented in the relevant audit working papers; nor were they mentioned at all during the practice review (Complaint 3).²
5. Significant deficiencies were also identified in the audit procedures conducted in respect of the 2017 Financial Statements concerning Client C's investment in an associate (Complaint 1) and convertible notes ("CNs") issued by Client C in relation to the investment (Complaint 2). In view of the public interest involved, the Practice Review Committee decided to initiate a complaint against the Respondent.
6. The extent of the audit deficiencies identified cast serious doubts on the Respondent's ability to maintain professional knowledge and skill at the level required to ensure his client received competent professional services (Complaint 4).

THE COMPLAINTS

Complaint 1

7. Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he failed or neglected to observe, maintain or otherwise apply professional standards in relation to the investment in an associate in the audit of Client C's financial statements for the year ended 31 December 2017.

Complaint 2

8. Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he failed or neglected to observe, maintain or otherwise apply professional standards in relation to convertible notes in the audit of Client C's financial statements for the year ended 31 December 2017.

¹ The Practice was deregistered from the Institute's register as a corporate practice in December 2018 and has been renamed as "McMillan Woods Strategic Advisory Limited" from March 2019.

² Section 6(c) of the Reviewer's Report

Complaint 3

9. Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he failed or neglected to observe, maintain or otherwise apply a professional standard in relation to audit documentation concerning the work done in relation to valuation(s) in the audit of Client C's financial statements for the year ended 31 December 2017.

Complaint 4

10. Section 34(1)(a)(vi) of the PAO applies to the Respondent in that he failed or neglected to observe, maintain or otherwise apply a professional standard for his failure to maintain professional knowledge and skill at the level required, and act diligently and in accordance with applicable professional standards, to ensure his client received competent professional services in the audit of Client C's financial statements for the year ended 31 December 2017.

FACTS AND CIRCUMSTANCES IN SUPPORT OF COMPLAINT 1³

11. An "Investment in an associate" of approximately HK\$102 million, representing a 49% equity interest in "Asso-B" in Mainland China, was recorded in the 2017 Financial Statements. The investment represented 50% of the net assets of Client C's group. Asso-B was a start-up retailer engaged in an e-commerce business of selling non-high-end watches with a track record of less than one and a half years.
12. Client C acquired the investment in April 2017 by issuing CNs valued at HK\$91.6 million at the time of the acquisition. The net assets acquired were valued at approximately HK\$6.3 million. After taking into account the contingent consideration receivable of HK\$1.7 million, the acquisition resulted in significant goodwill of approximately HK\$83.6 million⁴ (i.e. 13 times the net assets acquired) at the date of acquisition. Client C accounted for the investment using the equity method, under which the investment was initially recognized at cost, and the carrying amount would be subsequently adjusted to recognize its share of the profit or loss of Asso-B. The entire carrying amount including the goodwill arising on acquisition would be tested for impairment.
13. The acquisition was a material business transaction of Client C in 2017⁵ and gave rise to significant goodwill. The auditor failed to perform adequate work to support the year-end investment balance of HK\$102 million as recorded in the 2017 Financial Statements. They relied on the year-end valuation of the investment performed by an independent

³ Sections 4.2.1 and 4.2.2 of the Reviewer's Report

⁴ The goodwill was estimated to be around HK\$83.6 million derived from: Purchase Consideration of HK\$91.6 million minus fair value (FV) of net assets acquired of approximately HK\$6.3 million (RMB 5.2 million) minus FV of Contingent Consideration of HK\$1.7 million

⁵ The overall materiality set by the auditor was HK\$3 million

valuer engaged by Client C to obtain reasonable assurance on the investment in the associate. Based on the audit working papers and information stated, there was no evidence that the auditor had adequately reviewed / assessed:

- (a) Client C's determination of the recoverable amount in relation to the investment; and
 - (b) the assumptions and significant data used in the underlying management forecast adopted in the valuation.
14. With respect to 13(a), the 2017 Financial Statements stated that impairment of Client C's investment in the associate would be the excess of the carrying amount over the recoverable amount of the investment⁶. Under HKAS 36 *Impairment of Assets*, the recoverable amount is defined as the higher of an asset's fair value less costs of disposal and its value in use; and it is stated in paragraph 53A of HKAS 36 that "*fair value differs from value in use*".
 15. Therefore, in order for Client C to assess impairment of its investment in Asso-B, they needed to determine the investment's fair value (less costs of disposal) and value-in-use in order to establish its recoverable amount.
 16. The associated valuation report stated that Client C had instructed a value-in-use valuation to be performed; and the valuer reported a value-in-use of Client C's 49% interest in the investment at 31 December 2017 of HK\$102 million. However, the same valuation report was inconsistent in stating the valuation was carried out "based on fair value" in accordance with HKFRS 13 *Fair Value Measurement*. The auditor documented in their working papers that they had reviewed the valuer's method of using the DCF (discounted cash flow) and concluded it "*acceptable as per HKFRS 13*".
 17. The auditor clearly failed to identify the inconsistencies evident in Client C's determination of the recoverable amount of the investment. Based on this, it was unclear whether the valuer had in reality reported the investment's value-in-use or its fair value less costs of disposal (which are clearly distinguished as two different amounts and subject to different measurement requirements in HKAS 36), and whether, in assessing impairment of the investment, the recoverable amount of HK\$102 million was determined to be value-in-use or fair value less costs of disposal.
 18. Moreover, with respect to 13(b) above, the auditor failed to address the apparent unreasonableness of a critical element in the management forecast – the sales growth rate. Management used a growth rate of 28% for 2018, 39% in 2019, 77% in 2020, 30% in 2021, 16% in 2022 and 10% in 2023. The valuer cited three reports to support the revenue growth rates. However, those documents, together with their discussion with

⁶ Note 4 to 2017 Financial Statements

management as documented in the Valuer Memos still failed to support how the auditor had considered the relevance, reliability and quality of these reports in their supposedly independent assessment. The unsupported, unduly optimistic management projection significantly impacted the valuation; and yet, there was no evidence of the auditor questioning management or the valuer about the reasonableness of the sales growth rates used.

19. Further, there was no evidence that the auditor had performed adequate procedures to assess other key elements of the forecast including the gross profit margin, total expenses, changes in net working capital, and capital expenditures. The valuer supported the appropriateness of some of those elements, including the 5-year average gross profit margin, earnings before interest and tax margin, and capital expenditure ratio used by establishing that they fell within the range of data of eight "comparable" companies, which was very wide. There was no evidence of the auditor questioning the comparability of those "comparable" companies, including some carried on totally different businesses such as real estate and automobile marketing and of different sizes and conditions. Moreover, in the assessment of the gross profit margin of 30% used by the valuer, the auditor documented in the working paper that references were made to five other selected companies, there was no information as to the relevance and accuracy of the percentages cited; and how these five companies were comparable to the eight comparable selected by the valuer; and they could all be used as comparable to Client C.
20. In addition, the auditor filed in the working papers a "Discount Rate" table which listed data for eight comparable companies, as well as cost of debt, cost of equity and the weighted cost of capital. However, there was no evidence of any procedures performed by the auditor on the relevance or accuracy of these information in assessing the appropriateness of the discount rate adopted by the valuer.
21. Notwithstanding the Respondent had subsequently submitted to the Institute the Valuer Memos and elaborated on the procedures performed, none of those addresses the audit deficiencies identified above, as explained in detail in sections 4.2.2(c) to (i) of the Reviewer's Report.
22. As such, in respect of the "Investment in an associate" as recorded in the 2017 Financial Statements, the Respondent failed to comply with:
 - (a) paragraph 8 of HKSA 500 in that he did not adequately evaluate the appropriateness of the valuer's work;
 - (b) paragraph 6 of HKSA 500 in that he did not obtain sufficient appropriate audit evidence in relation to the year-end account balance; and
 - (c) paragraphs 15, 17 and 18 of HKSA 540 in that he failed to perform a proper evaluation of the accounting estimates which gave rise to significant risks in the valuation of the investment.

23. As HKSAs are professional standards referred to in the PAO, section 34(1)(a)(vi) of the PAO applies to the Respondent.

FACTS AND CIRCUMSTANCES IN SUPPORT OF COMPLAINT 2

24. As consideration for acquisition of the 49% interest in Asso-B, Client C issued CNs with an aggregate principal amount of HK\$91.6 million on 25 April 2017. Client C engaged the same valuer to perform a valuation of the CNs and determined the fair value of the CNs to be the same as their principal amount at the date of acquisition. Based on the valuation, the CNs were recorded in the 2017 Financial Statements with the following breakdown: a net liability component of HK\$32.1 million (after deducting the call option of HK\$37.7 million)⁷ and an equity component of HK\$59.5 million. It is also disclosed in the financial statements that the fair value of the liability component was calculated using binomial tree models based on a discount rate of 9.46%.
25. The audit working papers included inter alia, the valuation report and three tables which showed the binomial calculations. The Valuer Memos summarized procedures performed by the valuer with reference to supporting documents; whereas the Respondent asserted that the auditor had assessed the reasonableness of the key parameters used in the calculation of fair value of CNs during meetings with the valuer.
26. However, available evidence does not support the performance of any procedures by the auditor in this area. In particular, there was no evidence to show the auditor had reviewed or assessed the:
- (a) Client C's accounting treatment of the CNs;
 - (b) fair value of a call option in the CNs (HK\$37.7 million), which represented 54% of the debt component and effectively reduced the liability component by more than half; and
 - (c) appropriateness of the discount rate (9.46%) used in the valuation.
27. In respect of 26(a) above, the auditor failed to perform an adequate assessment to support his concurrence with Client C's accounting treatment of the CNs. This deficiency was demonstrated by the lack of evidence to support the auditor's consideration of specific terms and conditions of the CNs, which would be a prerequisite for such an assessment. For example, the auditor did not make any reference to the adjustment clauses which would affect the conversion price of the CNs. In other words, there was no evidence that the auditor had assessed or adequately assessed whether the fixed-for-fixed condition under paragraph 11 of HKAS 32 *Financial Instruments: Presentation* had been met to allow the recognition of an equity component; or whether the entire CNs should be accounted for as a financial liability.

⁷ Debt component of HK\$69.8 million minus call option of HK\$37.7 million = HK\$32.1 million

28. There was also no evidence to support that the auditor had properly reviewed and assessed Client C's valuation of the call option (26(b) above). In this area, it was simply stated in the working paper that the call option was "calculated by reference to the conversion price and stock price". There was no other information to show how the auditor had audited this material amount.
29. With respect to 26(c) above, the Valuer Memos documented that the discount rate was derived based on the valuer's research on Client C's credit rating and market average bond yield; and the auditor had inspected the relevant screen shots. However, such documentation still revealed nothing to support how the auditor had assessed the appropriateness of the discount rate used by the valuer.
30. Based on the above, in respect of the CNs in relation to the acquisition of Asso-B as recorded in the 2017 Financial Statements, the Respondent failed to comply with:
 - (a) paragraph 8 of HKSA 500 in that he did not adequately evaluate the appropriateness of the valuer's work;
 - (b) paragraph 6 of HKSA 500 in that he did not obtain sufficient appropriate audit evidence in relation to the account; and
 - (c) paragraphs 15, 17 and 18 of HKSA 540 in that he failed to perform a proper evaluation of the accounting estimates which gave rise to significant risks in their valuation.
31. As HKSAs are professional standards referred to in the PAO, section 34(1)(a)(vi) of the PAO applies to the Respondent.

FACTS AND CIRCUMSTANCES IN SUPPORT OF COMPLAINT 3

32. On 17 May 2017, Client C granted 330 million share options; and a valuer engaged by Client C determined the fair value of the share options at HK\$28.9 million on the grant date. The relevant audit working papers included a copy of the valuation report, a summary schedule which listed the key parameters used in the valuation, and a working paper titled "Evaluating the working papers provided by valuer". In the latter working paper, the auditor stated that they had "reviewed the valuation report and working papers" of the valuer and commented that the method used by the valuer was acceptable, and the major assumptions and significant data were reasonable.⁸
33. However, there was no documentation in the working papers to show how the auditor had assessed the basis and assumptions in the valuation. Although the Respondent subsequently provided more information about how the key parameters used in the valuation were obtained as well as supporting documents, none of those information was documented in the working papers.

⁸Note 34 to 2017 Financial Statements

34. Paragraph 32 above applies to all “supplementary” information submitted by the Respondent on 20 May 2019 by way of the Valuer Memos (concerning Client C’s investment in Asso-B, CNs, and share options) and their supporting files. The Respondent asserted that these information supported the work performed in his audit of the 2017 Financial Statements. However, none of those information was included in the audit working papers which only days before, the Respondent himself had confirmed their completeness.
35. On the above facts and based on the working papers, it is found that the Respondent failed to prepare adequate audit documentation in his audit of the 2017 Financial Statements and thereby breached paragraph 8 of HKSA 230.
36. As HKSA is a professional standard referred to in the PAO, section 34(1)(a)(vi) of the PAO applies to the Respondent.

FACTS AND CIRCUMSTANCES IN SUPPORT OF COMPLAINT 4

37. Complaints 1 to 3 above demonstrate the auditor had breached a number of professional standards in the audit of Client C. These deficiencies are significant in that the accounts involved were all material to the 2017 Financial Statements.
38. On that basis, as engagement director, it is found that the Respondent also failed to comply with the fundamental principle of professional competence and due care in that he failed to maintain professional knowledge and skill at the level required to ensure his client received competent professional services and act diligently and in accordance with applicable technical and professional standards, and thereby breached sections 100.5(c) and 130.1 of the *Code of Ethics for Professional Accountants*.
39. As the Code is a professional standard referred to in the PAO, section 34(1)(a)(vi) of the PAO also applies to the Respondent.

THE PROCEEDINGS

39. By a letter dated 11 May 2020, the parties jointly informed the Committee that the Respondent had admitted the complaint against him. They also suggested that it is no longer necessary for the parties to follow the steps set out in paragraphs 17 to 20 of the Disciplinary Committee Proceedings Rules.
40. The Notice of Commencement of Proceedings was issued on 20 July 2020. Having considered the parties aforementioned joint letter and the Respondent’s admission of the complaint, the Committee approved the parties’ proposal and directed that they made submissions on sanctions by 17 August 2020.

41. The Complainant and Respondent provided their written submission on sanctions and costs on 17 August 2020 and 18 August 2020 respectively.

CONSIDERATIONS

42. The Committee has considered the facts of the case and notes that the complaints concerned a public listed company and the nature of the failures involved the possibility of misleading the public. It is important that public confidence in the accounting profession be maintained and any sanctions imposed by the Committee should aim to ensure that high standards of the profession are maintained.
43. The Committee has also carefully considered the submissions advanced by the parties and in particular the mitigation by the Respondent in his email of 17 August 2020. It is noted that the Respondent admitted the complaints thereby obviating the need for a full hearing which acknowledges his responsibility for the failures.

SANCTIONS

44. The Disciplinary Committee orders that:-
- (a) the Respondent be reprimanded under Section 35(1)(b) of the PAO;
 - (b) the Respondent pay a penalty of HK\$80,000.00 under Section 35(1)(c) of the PAO;

COSTS

- (c) the Respondent pay the costs and expenses of and incidental to the proceedings of the Complainant and that of the Clerk totalling HK\$89,386 under Section 35(1)(iii) of the PAO.

The above shall take effect on the 40th day from the date of this Order.

Dated: 27 October 2020

Mr. Malcolm Lim
Chairman
Disciplinary Panel A

Ms. Chan Lai Yee
Member
Disciplinary Panel A

Ms. Tang Yuen Yee Loren
Gertrud
Member
Disciplinary Panel B

Ms. Chan See Mun Lily
Member
Disciplinary Panel A

Ms. Woo King Wa
Member
Disciplinary Panel B