

IN THE MATTER OF

A Complaint made under section 34(1A) of the Professional
Accounts Ordinance, Cap. 50

BETWEEN

The Registrar of the Hong Kong Institute of
Certified Public Accounts

COMPLAINANT

AND

Ng Ka Hong (F07043)

RESPONDENT

REASONS FOR SANCTIONS & ORDER

1. The Respondent faces a complaint brought against him by the Registrar of the Hong Kong Institute of Certified Public Accountants under s.34(1)(a)(vi) of the Professional Accountants Ordinance (“PAO”) for failure and/or neglect to observe, maintain or otherwise apply a professional standard when carrying out his engagement quality control review for the audit of the financial statements of a client.
2. By a letter dated 22 December 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 30 of the Disciplinary Committee Proceedings Rules.

3. The Notice of Commencement of Proceedings was issued on 15 January 2021. Having considered the parties aforesaid 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 11 February 2021.
4. The Complainant provided the written submissions on sanction and costs on 10 February 2021. The Respondent elected not to make any submissions.

The Facts leading up to the Complaint

5. The audit in issue was performed by McMillan Woods SG CPA, a firm which had ceased practice and was re-registered on 1 December 2018, ("the Firm") for a company listed with the GEM Board of the Hong Kong Stock Exchange ("Listco") for the year ended 31 December 2014.
6. The financial statements were said to be prepared in accordance with Hong Kong Financial Reporting Standards, and the auditor's report stated that the audit was conducted in accordance with Hong Kong Standards on Auditing.
7. In the auditor's report issued for the said audit, the firm expressed an unmodified auditor's opinion on the Listco's financial statements and its balance sheet for the year ended 31 December 2014.

8. The Respondent was the engagement quality control reviewer (“EQCR”) of the said audit.
9. At the material time, the Listco and its subsidiaries (collectively called “the Group”) were principally engaged in the provision of internet platform for education on Chinese medicine and other advisory and training programs.
10. According to the complaint admitted by the Respondent, the said audit has fallen below the professional standard in 2 respects :
 - (a) the engagement team of the Firm had failed to obtain sufficient appropriate audit evidence to assess the impairment of the amounts due to the Listco from its subsidiaries (“Issue 1”);
 - (b) The engagement team of the Firm had further failed to properly evaluate the fair value of 2 convertible notes (“CNs”) issued by the Listco for a total principal amount of HK\$83.2 million for the purpose of fully settling certain existing liabilities of the Group, and the carrying amount of the extinguished liabilities to see if they had been appropriately calculated and recognized in the income statement of the Listco (“Issue 2”).
11. Dealing with Issue 1 first. As at 31 December 2014, the Listco had significant amounts (HK\$133.9 million) due from subsidiaries which amounted to 34.5% of the Listco’s net assets of HK\$388.1 million.

12. As the Group's net assets were in the region of HK\$312.9 million (as at 31 December 2014), this indicated that some of the Group's subsidiaries might be in a net liability position.
13. The amounts were mainly due from 4 subsidiaries, namely New Beida Business StudyNet Group Limited ("**New Beida**") of HK\$51.7 million, Best Boom Enterprises Limited ("**Best Boom**") of HK\$43.6 million, Beijing Hua Tuo Education Technology Company Limited ("**Beijing Hua Tuo**") of HK\$29.1 million and China E-Learning (Hong Kong) Limited ("**CELHK**") of HK\$9.2 million. There was no subsequent settlement from these subsidiaries as documented in the audit workpapers.
14. The engagement team identified the impairment on amounts due from subsidiaries as a key audit issue in the entity-level financial statements of the Company, which was considered to involve significant judgement about the ability of the subsidiaries to repay. But the engagement team concurred with Listco's Management that no impairment would be made for these amounts at the entity-level financial statements.
15. For New Beida and Beijing Hua Tuo, the engagement team documented its understanding from management that New Beida was searching opportunities for mergers and acquisitions, and it would develop a new business through its direct subsidiary (Beijing Hua Tuo) to generate cash flow. The engagement team also documented it had reviewed a memorandum of understanding in this respect.

16. For Best Boom, the engagement team documented management’s explanation that a subsidiary contributed profit of over HK\$9 million to the Group in the past three years, and the engagement team “believed” that Best Boom could require that subsidiary to declare dividend.
17. For CELHK, the engagement team understood from management that it had provided management services to the Group but no related management fee had been charged by CELHK. Management would consider booking such fees in the books and if so, CELHK would have net cash inflow and be able to make repayment.
18. The engagement team further said it understood from management that the abovementioned subsidiaries acted as “special purpose vehicles” within the Group for future M&A purposes. The team considered the recoverability of the amounts due should be considered from a “single economic entity” perspective, and that the Company would be able to allocate funds within the Group to satisfy any intercompany indebtedness. The team thus considered there was no objective evidence of impairment and therefore concurred that no impairment loss be recognised.
19. But as mentioned in paragraphs 11 and 12 above, the Listco’s net assets were larger than the Group’s net assets and this would indicate that some of the Company’s subsidiaries might be in net liability positions.
20. In addition the Group incurred losses for the years 2013 (HK\$86.1 million) and 2014 (HK\$47.4 million), and the net cash flows from operating activities

deteriorated from a net cash inflow of HK\$24.2 million in 2013 to a net cash outflow of HK\$53.0 million in 2014.

21. Also, the fact that there was no subsequent settlement of the amounts due from subsidiaries should have raised doubts as to the recoverability of those amounts, from the Company's perspective.
22. All these would have indicated possible impairment of the amounts due, and would require the auditor to perform further procedures to confirm whether there was in fact impairment of the receivables.
23. Just as importantly, the engagement team had not evaluated the financial positions of the subsidiaries in question. Also, evidence obtained by the engagement team in this connection was largely limited to management's representations which the team had not obtained any corroborative evidence to substantiate or verify. The engagement team had not evaluated the nature and status of any of the purported M&A projects and/or management fee arrangements, and how such projects and arrangements would generate sufficient cash flows for the subsidiaries to repay the Company.
24. There is no evidence of the engagement team performing an evaluation of management's claim that it could allocate funds within the Group to enable the subsidiaries to repay the amounts due, including how the fund allocation would be conducted and how such an exercise would impact the cash position of each subsidiary and its ability to repay the amount due.

25. On the basis of the aforesaid, there can be no question that the Firm had obtained sufficient appropriate audit evidence to assess the impairment of the amounts due from the Listco's subsidiaries. The failure on Issue 1 is obvious and disturbing.
26. Turning to Issue 2. During the year, the Listco issued two convertible notes (CN2016 and CN2016A) with a total principal amount of HK\$83.2 million to fully settle certain existing liabilities of the Group carried at HK\$83.2 million. The two CNs were fully converted as at the year-end date.
27. The engagement team identified the risk of material misstatement of the CNs as high and they involved judgement and estimates but concurred with the Listco's Management on the way they were being dealt with in the Financial Statements.
28. Management engaged a valuation expert ("**Management Expert**") to perform valuations of the two CNs on the date of issuance, but it did not fully adopt the valuations as calculated by the expert.
29. Management determined that the total fair value of the two CNs at initial recognition was HK\$83.2 million, being the same as the carrying amount of the liabilities extinguished. The two CNs were recognised at HK\$82.3 million after deduction of total issuance costs of HK\$0.9 million (see consolidated statement of cash flow of the Financial Statements).

30. In the initial recognition, management adopted only the Management Expert's calculation of the fair value of the debt component as HK\$72.4 million (less issuance costs of HK\$0.8 million), but not the fair value of the embedded derivative component and the total fair value of the CNs as determined by the Management Expert (ie. HK\$27.5 million & HK\$99.9 million respectively). Management then deducted the recognised value of the debt component from the total recognised value of the two CNs to arrive at the recognised residual value of the equity component.
31. Also, curiously, while the CNs were recognised at the amount calculated by management per above (HK\$82.3 million), note 30 to the Financial Statements stated their respective fair values at issuance dates as those calculated by the Management Expert (i.e. HK\$53.1 million and HK\$46.8 million, totalling HK\$99.9 million). This discrepancy was not explained in the Financial Statements.
32. In concurring with management's initial recognition, the engagement team considered the following :
- (a) the extinguishment constituted an orderly transaction, and if the extinguished liabilities were to be settled by cash then HK\$83.2 million of cash would be paid. Therefore such an amount would represent the fair value of the two CNs;
 - (b) the embedded derivatives as identified in the Management Expert's valuation should not be included in the debt component, as the derivatives were "*closely related*" to the debt host contracts;

(c) the fair value of HK\$99.9 million as disclosed in the Financial Statements “*was not a good place for disclosure*” and the engagement team had “*an inadvertent oversight*” in this matter.

33. But, clearly, the engagement team had failed to sufficiently evaluate the initial recognition of fair value of the two CNs and the disclosure of them in the Financial Statements, and consequently whether any profit or loss on extinguishment of liabilities had been appropriately recognised.

34. The engagement team failed to adequately evaluate the appropriateness of management’s equating the fair value of the two CNs to the carrying amount of the liabilities extinguished (i.e. HK\$83.2 million) when :

(a) there was no evidence to support that the extinguishment of liabilities was indeed an “orderly transaction” as defined under HKFRS 13 *Fair Value Measurement*. An orderly transaction is defined as one which assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving assets or liabilities; it is not a forced transaction (eg a forced liquidation or distress sale);

(b) as a result of (a) above, there would be a question of whether the carrying amount of the liabilities appropriately represented the fair value of the CNs;

- (c) the fair value of the two CNs thus recognised was the same as their principal amount, which was highly unusual given the existence of the equity-conversion and optional early-redemption features of the CNs; and
- (d) the Management Expert had determined the total fair value of the two CNs differently at HK\$99.9 million.

- 35. Also, the engagement team failed to sufficiently challenge management's selective adoption of the valuation by the Management Expert by only taking account of the fair value of the liability component of the two CNs as calculated by the Management Expert, and disregarding the fair value of the embedded derivative component (i.e. the call option) of the CNs.
- 36. In this respect, management's calculations apparently did not take account of the fair value of the embedded derivative at all, which is in breach of Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement*. This observation applies regardless of whether the derivative was "closely related" to the host contract in terms of economic characteristics and risks and so should be accounted for with the host contract, or the derivative was not "closely related" to the host contract and should be accounted for separately.
- 37. Indeed, the engagement team had failed to properly evaluate the work of the Management Expert in determining the fair value of the CNs (which was partly adopted by management in recognising the CNs in the Financial Statements. In this regard, there is no evidence that the engagement team had assessed whether the valuation by the Management Expert had been correctly

performed, in particular, as regards the treatment of the embedded call option and the absence of residual equity value for the CNs in the valuation.

38. And, of course, the engagement team failed also to identify the discrepancy between the fair value at which the CNs were recognised in the Financial Statements disclosure and the CN's fair value per the Management Expert.
39. As a result of the above deficiencies in the audit of the two CNs, the engagement team failed to properly evaluate whether any difference between the fair value of the CNs and the carrying amount of extinguished liabilities had been appropriately calculated and recognised in the income statement. The Firm's failure on Issue 2 is likewise obvious and significant.

The Respondent's Role as EQCR

40. In the audit, the Respondent signed off an "Engagement Quality Control Review Worksheet" which signified that he, as the EQCR was satisfied that the auditor's report could be released on the basis that there was adequate audit work and documentation on significant financial statements areas and management estimates, and that significant matters had been addressed and resolved.
41. However, in light of the audit deficiencies discussed above, it is clear that the Respondent had not properly performed his engagement quality control review by adequately challenging the judgments made, and conclusions reached, on the abovementioned significant judgemental issues by the

engagement team. As a result, he failed to comply with paragraph 20 of HKSA 220 *Quality Control for an Audit of Financial Statements*.

The Respondent's Disciplinary Records

42. The Respondent has 2 previous records. The case **D-19-1520C** (October 2020) is a recent disciplinary decision involving the Respondent himself. The decision involves exactly the same kind of issues as that of the present case, namely impairment assessment, and the accounting treatment of CNs including failure to recognize their correct fair values. In that case the impairment assessment of an investment in an associate was inadequately performed, in the determination of the recoverable amount in relation to the investment, and the assumptions and significant data used in the underlying management forecast. For the CNs, there were inadequate assessment of the accounting treatment, the fair value of a call option embedded, and the appropriateness of the discount rate used. The Respondent therefore failed to perform the review adequately, in breach of §20 & 21 of HKSA 220, and he also failed to maintain his professional competence under the COE. He was reprimanded and a penalty of HK\$120,000 was imposed.
43. Apart from the case of D-19-1520C referred to above, the Respondent has another regulatory record in **C-19-1513F** (January 2020) in which the complaint against him was resolved through Resolution by Agreement (“RBA”). That case concerned deficiencies in the impairment assessment and the valuation of biological assets, and the Respondent was also the EQCR. For impairment assessment of the intangible assets, the engagement team did not perform audit procedures to assess the relevance and reasonableness of the valuation method, key input data and assumptions used in the valuation.

As for the valuation of biological assets, the engagement team did not perform adequate audit procedures to evaluate the relevance and reasonableness of the key assumptions and data used in the valuation, and assess the competence, capabilities and objectivity of the consultant and research company before relying on the data they provided for the valuation. The Respondent was again in breach of §20 of HKSA 220, for which he was reprimanded and paid a penalty of HK\$20,000.

The Sanctions

44. In considering the question of sanctions, one of the key factors must be the damage the Respondent's failure has done to the integrity and reputation of the profession. As stated by the Disciplinary Committee in the Reason for Decision given in the Respondent's last case (D-19-1520C) :

“30 ... 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 and maintained”.

45. We echoed the sentiment expressed therein. And in our view there are clearly merits in what the Complainant has said in paragraph 11 of their submission's on sanctions :

“11. The fact that the Respondent was committing the same or similar mistakes in case after case is worrying. All of his regulatory cases, including the present one, concern listed audits and public interest is involved. The repeated offences and the public interest are material factors in which the

Committee should consider increasing the level of sanctions so as to send a clear message both to the Respondent and the wider profession and the public that the highest standard is expected from members of the profession practising public accountancy.”

(Note: As both the present case and the RBA Case C-19-1513F concern audits for the year ended 31 December 2014, whereas D-19-1520C concerns an audit for the year ended 31 December 2017, the Respondent was, strictly speaking, not a “repeat offender” and is not treated as such).

46. Taking into account the nature of the complaint, the Respondent’s previous disciplinary records, and the public interest at stake, we have come to the decision that the following sanctions are called for in the circumstances of the case :

(a) the Respondent be reprimanded under s.35(1)(b), of the PAO;

(b) the Respondent pay a penalty of HK\$150,000 under s.35(1)(c) of the PAO.

And we so order.

Costs

47. In the absence of any special reason to the contrary, we consider that costs should follow the event. Accordingly we further order the Respondent to pay

the cost and expenses of and incidental to the proceedings of the Complainant
in the sum of HK\$100,222.

The above shall take effect on the 42nd day from the date of this Order.

Mr. Newman Wong
Chairman
Disciplinary Panel A

Mr. Conrad Chan
Member
Disciplinary Panel A

Ms. Fung Suet Ngan Gladys
Member
Disciplinary Panel B

Ms. Lau Yuk Kuen
Member
Disciplinary Panel A

Mr. So Kwok Kay
Member
Disciplinary Panel B

Dated 11 May 2021