

IN THE MATTER OF

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

BETWEEN

The Registrar of the Hong Kong Institute of
Certified Public Accountants COMPLAINANT

AND

Pan-China (HK) CPA Limited FIRST
Corporate Practice No. M268 RESPONDENT

Mr. Tsang Chiu Keung SECOND
Membership No. A25104 RESPONDENT

Mr. Chan Kin Wai THIRD
Membership No. A24477 RESPONDENT

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

Members: Ms. Lee Wai Yan Susanna (Chairman)
Ms. Cheng Wei Yan Vena
Ms. Tsui Pui Man Winnie
Mr. Guen Kin Shing Melvin
Mr. Chan Wai Man Raymond

ORDER & REASONS FOR DECISION

1. This is a complaint made by the Registrar of the Hong Kong Institute of Certified Public Accountants (the "**Institute**") against Pan-China (HK) CPA Limited, a corporate practice, Mr. Tsang Chiu Keung, a certified public accountant (practising) and Mr. Chan Kin Wai, a certified public accountant (practising) (collectively the "**Respondents**"). Section 34(1)(a)(vi) of the Professional Accountants Ordinance ("**PAO**") applied to the Respondents.
2. The Complaints as set out in a letter dated 1 September 2016 (the "**Complaint**") are as follows:-

Background

- (1) The Financial Reporting Council referred to the Institute a report of its Audit Investigation Board dated 19 August 2015 ("**AIB Report**") concerning the audits carried out by Pan China on the financial statements of a listed company, Polyard Petroleum International Group Limited ("**Company**") and its subsidiaries ("**Group**") for each of the years ended 31 December 2010 ("**2010 Audit**") and 31 December 2011 ("**2011 Audit**"). A copy of the Report is at **Attachment 1** to the Complaint Letter.
- (2) Pan China issued an unmodified audit report on the Group's financial statements for each of the two years. The audit reports were dated 21 March 2011 and 27 March 2012 respectively.
- (3) The Company's audited financial statements for the two years included two assets, namely an oil and gas project (Block M) in Brunei acquired in 2007 ("**Brunei Oil Project**") and a coal mining project in the Philippines acquired in 2008 ("**San Miguel Coal Mine Project**"), which were included respectively in the interests in a jointly controlled entity ("**JCE**") and interests in an associated company ("**Associate**").
- (4) For the purpose of impairment assessments, the Company engaged an independent professional valuer to provide valuations on the Brunei Oil Project and the San Miguel Coal Mine Project.
- (5) Pan China placed reliance on the above valuations in the audit of the impairment assessments of the Group's interests in the JCE and the Associate during the course of the 2010 and 2011 Audits.
- (6) The AIB Report found that Pan China, Tsang as the engagement director for the 2010 and 2011 Audits, and Chan as the engagement quality control reviewer ("**EQCR**") for the 2011 Audit, had violated section 34(1)(a)(vi) of the Professional Accountants Ordinance ("**PAO**") in that:
 - (a) Pan China and Tsang were in breach of a number of Hong Kong Standards on Auditing ("**HKSAs**") in conducting the impairment assessment of the interests in the JCE and Associate;
 - (b) Pan China and Tsang were in breach of the Code of Ethics for Professional Accountants ("**COE**") in failing to perform the audits with competence and due care in light of the findings in (a) above; and
 - (c) Chan was in breach of HKSA 220 (Clarified) *Quality Control for an Audit of Financial Statements* in conducting his review as an EQCR in the 2011 Audit.

Relevant Professional Accountants Ordinance (Cap. 50) ("**PAO**") provisions and professional standards

- (7) Section 34 of the PAO

"(1) A complaint that-

(a) a certified public accountant-

...

(vi) failed or neglected to observe, maintain or otherwise apply a professional standard;

...

shall be made to the Registrar who shall submit the complaint to the Council which may, in its discretion but subject to section 32D(7), refer the complaint to the Disciplinary Panels.

... "

(8) Section 34(1A) of the PAO

"Where the Registrar has reason to believe that subsection (1)(a) ... applies to a certified public accountant or a corporate practice, he shall submit the facts to the Council which may, in its discretion, refer the complaint to the Disciplinary Panels."

(9) The following professional standards are relevant:

- (a) HKSA 200 (Clarified) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing;*
- (b) HKSA 220 (Clarified) *Quality Control for an Audit of Financial Statements;*
- (c) HKSA 500 (Clarified) *Audit Evidence;*
- (d) HKSA 540 (Clarified) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures;*
- (e) HKSA 620 (Clarified) *Using the Work of an Auditor's Expert;* and
- (f) COE sections 100.5 and 130

(10) Relevant extracts of the above HKSAs and COE are set out at **Attachment 2** to the Complaint Letter.

Complaint 1

- (11) Section 34(1)(a)(vi) of the PAO applies to Pan China and Tsang in that they failed or neglected to observe, maintain or otherwise apply one or more auditing standards, namely HKSAs 200, 500, 540 and 620, as a result of deficiencies in the audit procedures they performed during the 2010 Audit in relation to impairment assessment of the interest in the JCE and the Associate.

Complaint 2

- (12) Section 34(1)(a)(vi) of the PAO applies to Pan China and Tsang in that they failed or neglected to observe, maintain or otherwise apply one or more auditing standards, namely HKSAs 200, 500, 540 and 620, as a result of deficiencies in the audit procedures they performed during the 2011 Audit in relation to impairment assessment of the interest in the JCE and the Associate.

Facts and circumstances in support of Complaints 1 and 2

- (13) The carrying values of the Brunei Oil Project and San Miguel Coal Mine Project were determined by professional valuers. For the Brunei Oil Project, there were significant impairment losses recognized in the years up to 2010 and the losses recognized were reversed in 2011. For the San Miguel Coal Mine Project, there were significant impairment losses recognized in 2009 and the losses recognized were reversed in 2010

and 2011. Details are as follows:

	2011	2010	2009
	HK\$'000	HK\$'000	HK\$'000
<i>Interest in Jointly Controlled Entities</i>			
<u>Brunei Oil Project (or JCE)</u>			
At the beginning of the year	866,382	858,151	856,118
Additional investments	1,940	49,367	23,604
Impairment loss recognized	-	(41,136)	(21,571)
Reversal of impairment loss	215,077	-	-
At the end of the year	<u>1,083,399</u>	<u>866,382</u>	<u>858,151</u>
	2011	2010	2009
	HK\$'000	HK\$'000	HK\$'000
<i>Interest in an Associate</i>			
<u>San Miguel Coal Mine Project (or Associate)</u>			
At the beginning of the year	74,478	47,645	81,915
Share of loss of associate	(2)	(10)	(5)
Impairment loss written back / (recognized)	7,422	26,843	(34,265)
At the end of the year	<u>81,898</u>	<u>74,478</u>	<u>47,645</u>

(14) Disclosures in the Company's annual reports suggested that there were delays in the projects:

- (a) Brunei Oil Project – It was initially expected to commence production in 2007. However, the expected commencement dates were delayed to 2010 as disclosed in the 2008 and 2009 annual reports and were not even specified in the 2010 and 2011 annual reports.
- (b) San Miguel Coal Mine Project – The 2009, 2010 and 2011 annual reports disclosed that there was delay of construction of a road that gave access to the mining area due to heavy rain, flood and environment protection issues.

(15) Delays in the projects could have a significant impact on assessment of the valuation of the projects. There were time limitations imposed by the relevant governments / local authorities to explore and operate the oil field / coal mine as noted below:

- (a) Brunei Oil Project – exploration of Block M expired on 27 August 2012 (i.e. 6 years from 28 August 2006), which was only 5 months subsequent to the 2011 audit report, and production of oil and/or gas would be allowed for a period of 24 years¹.
- (b) San Miguel Coal Mine Project – exploration of the coal mine expired on 16 November 2010 and development of the coal mine would be allowed for a period of five years².

(16) The Company's interests in the projects were material to the Group's financial position:

¹ Disclosed in page 18 of the Company's circular dated 6 August 2007. (Annex 1F of Attachment 1)

² Disclosed in page 174 of the Company's circular dated 31 October 2008. (Annex 1G of Attachment 1)

	31 December 2011	31 December 2010
<u>Group</u>		
Total assets	HK\$1,532,798,000	HK\$983,113,000
Net assets	HK\$1,372,482,000	HK\$662,337,000
<u>Brunei Oil Project</u>		
Interest	HK\$1,083,339,000	HK\$866,382,000
% of Group's total assets	71%	88%
% of Group's net assets	79%	131%
<u>San Miguel Coal Mine Project</u>		
Interest	HK\$81,898,000	HK\$74,478,000
% of Group's total assets	5.3%	7.5%
% of Group's net assets	6%	12%

- (17) According to the working papers for the 2010 and 2011 Audits, the valuation reports were reviewed by the auditor. The basis of valuation was value in use and the method applied was the income approach. The key assumptions were set out in sections 3.1.2.4 and 4.1.2.2 of the AIB Report (**Attachment 1**). The audit work performed in assessing the work of the valuers was set out in sections 3.1.3 and 4.1.3 of the AIB Report.

Brunei Oil Project

- (18) For the Brunei Oil Project, Pan China placed reliance on 2010 and 2011 valuations done by an independent professional valuer in the audit of impairment assessment. The valuations were based on estimates and assumptions provided by the management of the Company, including the production plan and schedules and forecasted expenditures. Pan China failed to perform necessary procedures to obtain sufficient appropriate audit evidence on these estimates and assumptions.
- (19) Details of AIB's findings are set out in section 3 of the AIB Report. A summary is as follows.

Brunei Oil Project – forecast production plan and schedule

- (20) With regard to the 2010 valuation, Pan China failed to obtain sufficient appropriate evidence to evaluate the reasonableness of the forecast production plan and schedule to ensure that the Company and the valuer had duly considered the effect of deferral in production, when there were clear indications of production deferral as follows:
- Anticipated commencement of production in the third quarter of 2010, as stated in the Company's 2009 annual report, did not take place in 2010;
 - Three wells were still in the exploration stage in 2010;
 - The Company was required, under a production sharing agreement, to submit various plans when a significant accumulation of crude oil or natural gas was identified or the discovered petroleum field became commercial, but no such plans were submitted in 2010;
 - No feasibility study was prepared for the oil and gas project; and
 - The expenditure incurred for the oil and gas project in 2010 of HK\$2 million

was substantially less than the forecast expenditure of US\$12 million.

- (21) With regard to the 2011 valuation, Pan China again failed to obtain sufficient appropriate evidence to evaluate the reasonableness of the forecast production plan and schedule to ensure that the Company and the valuer had duly considered the effect of deferral in production, when there were clear indications of production deferral and expiry of the exploration period in the near future as follows:
- (a) Production did not take place in 2011 contrary to the anticipation in 2010, and drilling of the remaining three wells had not commenced; and
 - (b) The exploration period would expire within four months from the date when the 2011 financial statements were authorised for issue.
- (22) The above shows that Pan China failed to critically evaluate the status of the project, the reasonableness of the production plan and schedule which are critical to the valuation of the Brunei Oil Project, and hence the interests in the JCE. There were non-compliances with §15 of HKSA 200, and/or §§6, 8, 9 of HKSA 500, and/or §18 of HKSA 540, and/or §7 of HKSA 620.

Brunei Oil Project – forecast field cost

- (23) There was no evidence in the audit working papers supporting that Pan China had obtained corroborative evidence to support the reasonableness of the assumption that the forecast field costs would not be affected by other market price adjustments throughout the forecast periods. There were non-compliances with §§6 and 9 of HKSA500, and/or §18 of HKSA540.
- (24) The production projections for the 2010 and 2011 valuations were prepared by the chief operating officer. Pan China did not assess whether any safeguards were imposed by the Company to reduce possible threats to the objectivity of the chief operating officer in accordance with paragraphs 8, A37 and A41 of HKSA 500.

San Miguel Coal Mine Project

- (25) For the San Miguel Coal Mine Project, Pan China placed reliance on 2010 and 2011 valuations done by an independent professional valuer in the audit of impairment assessment. The valuations were based on estimates and assumptions provided by the management of the Company, including the coal production schedule which was prepared by the project engineer of the Associate and the forecast of revenue and costs. Pan China failed to perform necessary procedures to obtain sufficient appropriate audit evidence on these estimates and assumptions.
- (26) Details of AIB's findings are set out in section 4 of the AIB Report. A summary is as follows.

San Miguel Coal Mine Project – forecast production plan and schedule

- (27) With regard to the 2010 valuation, Pan China failed to:
- (a) ascertain the progress of a road construction and to challenge the reliability of the production schedule prepared by management when there were circumstances indicating production deferral, including the fact that no production took place in 2010 contrary to previous year's expectation and a suspension of road construction; and

- (b) obtain sufficient appropriate evidence to ensure the effect of deferral in production had been duly considered by the Company and the valuer.

(28) With regard to the 2011 valuation, Pan China again failed to:

- (a) ascertain the status of government approval and progress of road construction, and to challenge the reliability of the production schedule prepared by management when there were circumstances indicating production deferral as follows: (i) no production took place in 2010 contrary to previous year's expectation; (ii) the Company was still working on applications for certain permits essential for enabling production to proceed further; and (iii) road construction was resumed but suspended again, pending approval from government; and
- (b) obtain sufficient appropriate evidence to ensure the effect of deferral in production had been duly considered by the Company and the valuer.

(29) The above shows that Pan China failed to adequately evaluate the reasonableness of the production plan and schedule which are critical to the valuation of the San Miguel Coal Mine Project, and hence the interest in the Associate. There were non-compliances with §15 of HKSA 200, and/or §§6, 8, 9 of HKSA 500, and/or §18 of HKSA 540, and/or §7 of HKSA 620.

San Miguel Coal Mine Project – forecast revenue

(30) With regard to the 2010 and 2011 valuations, Pan China failed to:

- (a) obtain an explanation to ascertain why the contracted coal price was significantly higher than the market price;
- (b) obtain sufficient appropriate audit evidence to evaluate whether a sales contract – which provided audit evidence of the contracted price but was only effective for one year – would be renewed, and whether applying a price which was contracted by the Company and a third party for one year only, to the remaining period of the cash flow projections up to 2018 was reasonable;
- (c) obtain an explanation to ascertain whether the production plan could fulfill the obligation under the contract given that the contract was entered into before the commencement of production, and the forecast production volume was much less than the contracted amount; and
- (d) assess whether the repeated delays in coal production had any impact on the execution of the sales contract.

Hence, there were non-compliances with §§6, 8, 9 of HKSA 500 and/or §18 of HKSA 540.

San Miguel Coal Mine Project – forecast operating cost and capital expenditure

(31) With regard to the 2010 and 2011 valuations, Pan China failed to:

- (a) obtain corroborative evidence to justify the reasonableness of management's estimation of unit cost and explanation of the correlation between coal price and unit operating cost; and
- (b) obtain sufficient appropriate evidence to evaluate the reasonableness of the forecast capital expenditure, when the expenditure incurred in 2010 and 2011 was significantly less than that forecast, and there were differences between the forecast capital expenditure used in the cash flow projections and in a feasibility study report prepared in 2008,

Hence there were non-compliances with §§6, 8, 9 of HKSA 500 and/or §18 of HKSA 540.

- (32) The production projections for the 2010 and 2011 valuations were prepared by the project engineer of the Associate. Pan China did not assess whether any safeguards were imposed by the Company to reduce possible threats to the objectivity of the chief operating officer in accordance with paragraphs 8, A37 and A41 of HKSA 500.
- (33) Based on the foregoing, Pan China and Tsang as the engagement director were in breach of the following auditing standards in conducting the 2010 and 2011 Audits:
 - HKSA 200 paragraph 15,
 - HKSA 500 paragraphs 6, 8, 9, A37, A41 and A48,
 - HKSA 540 paragraph 18, and
 - HKSA 620 paragraph 7.

Complaint 3

- (34) Section 34(1)(a)(vi) of the PAO applies to Tsang in that he failed or neglected to observe, maintain or otherwise apply paragraph 19(a) of HKSA 220 in the 2010 Audit, in that he failed to ensure that someone with sufficient and appropriate experience and authority to act as the EQCR had been appointed in that audit.

Facts and circumstances in support of Complaint 3

- (35) Paragraphs 19 and 20 of HKSA 220 require an EQCR to be appointed for audits of financial statements of listed companies, who must perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report.
- (36) Paragraph 7(c) of HKSA 220 defines an "engagement quality control *reviewer*" to mean "*a partner, other person in the firm,.....with sufficient and appropriate experience and authority to objectively evaluate the significant judgements the engagement team made and the conclusions if reached in formulating the auditor's report.*"
- (37) Although HKSA 220 does not further elaborate on what constitutes "sufficient and appropriate experience and authority" for an EQCR, §A47 of HKSQC 1 provides some indication of what this might entail for listed audits. It states:

"What constitutes sufficient and appropriate technical expertise, experience and

authority depends on the circumstances of the engagement. For example, the engagement quality control reviewer for an audit of the financial statements of a listed entity is likely to be an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities."

- (38) The review conducted by the EQCR in the 2010 Audit was deficient. The "Engagement Quality Control Review Worksheet" did not contain any reference to audit working papers that had been reviewed or any comments made by the EQCR, nor was there any reference to discussion with the engagement team on the impairment assessment of the interests in JCE and the Associate. Had the EQCR performed a diligent and competent review, she should have identified the audit deficiencies as set out above.
- (39) According to the audit planning memorandum for the 2010 Audit, the individual acting as EQCR, one Ms. Chan Ka Man ("**Ms. Chan**"), was only an assistant audit manager of Pan China at the time. According to the Institute's records, Ms. Chan qualified as a CPA in early 2008 and she had never been issued with any practising certificate from the time of her becoming a CPA to the time of the 2010 Audit.
- (40) In the above circumstances, Ms. Chan was clearly not someone with "sufficient and appropriate experience and authority" to act as EQCR. Tsang should not have assigned Ms. Chan to be the EQCR for the 2010 Audit. Such an assignment would not achieve effective audit quality control, since there was a real risk that given her inadequate experience, Ms. Chan was unable to undertake an objective evaluation of the significant judgments made by the engagement team and the conclusions reached. The audit documentation of the engagement quality control review work in the 2010 Audit, and the audit deficiencies identified above in relation to the 2010 Audit, supported that Ms. Chan as the EQCR did not adequately perform her review.
- (41) Based on the foregoing, Tsang was in breach of paragraph 19(a) of HKSA 220 in that he failed to ensure that someone with sufficient and appropriate experience and authority to act as the EQCR had been appointed for the 2010 Audit.

Complaint 4

- (42) Section 34(1)(a)(vi) of the PAO applies to Chan in that he failed or neglected to observe, maintain or otherwise apply §20 of HKSA 220, as a result of his failure in the 2011 Audit to perform the engagement quality control review adequately in accordance with the requirements of that auditing standard.

Facts and circumstances in support of Complaint 4

- (43) The AIB found that the engagement quality control review conducted by the Chan in the 2011 Audit was deficient. Details are set out in section 5 of the AIB Report.
- (44) Specifically, as the Group's interests in JCE and the Associate were material, Chan was expected to carry out a review of the relevant audit working papers and assess the appropriateness of the estimates, judgements and assumptions adopted in the valuation reports. Had he performed a diligent and competent review, he should have identified the audit deficiencies as set out above.

(45) The audit documentation of the engagement quality control review work in the 2011 Audit, and the audit deficiencies identified above in relation to the 2011 Audit, clearly show that Chan as the EQCR failed to perform an objective evaluation of the significant judgments made by the engagement team and the conclusions reached, and to discuss significant matters arising during the audit engagement with the engagement director.

(46) Based on the foregoing, Chan was in breach of paragraph 20 of HKSA 220.

Complaint 5

(47) Section 34(1)(a)(vi) of the PAO applies to Pan China and Tsang in that they failed or neglected to observe, maintain or otherwise apply the Fundamental Principle of *Professional Competence and Due Care* set out in §§100.5(c) and 130 of the COE in their conduct of the 2010 and 2011 Audits.

Facts and circumstances in support of Complaint 5

(48) The significant audit deficiencies found in the 2010 and 2011 Audits, as noted above, clearly show that Pan China and Tsang failed to conduct their professional work with competence and due care, in breach of §§100.5(c) and 130 of the COE.

3. The Respondents admitted the complaints against them. They did not dispute the facts as set out in the complaints. On 9 November 2016, the parties agreed that the steps set out in paragraphs 17 to 30 of the Disciplinary Committee Proceedings Rules ("**DCPR**") be dispensed with.
4. The Disciplinary Committee agreed to the parties' joint application to dispense with the steps set out in Rule 17 to 30 of the DCPR in light of the admission made by the Respondent and directed the parties to make written submissions on sanctions and costs.
5. The Complainant and Respondents provided their submissions on sanctions and costs on 1 February 2017. The complaints were all found proved on the basis of the admission by the Respondents.
6. In considering the proper order to be made in this case, the Disciplinary Committee has had regard to all the aforesaid matters, including the particulars in support of the Complaints, the Respondents' personal circumstances, and the conduct of the Respondents throughout the proceedings.
7. The Disciplinary Committee, by a majority view, orders that:-
 - (a) all three Respondents be reprimanded under Section 35(1)(b) of the PAO;
 - (b) the First Respondent, Pan-China (HK) CPA Limited, pay a penalty of HK\$80,000 under Section 35(1)(c) of the PAO;

- (c) the Second Respondent, Tsang Chiu Keung, pay a penalty of HK\$50,000 under Section 35(1)(c) of the PAO;
- (d) the Third Respondent, Chan Kin Wai, pay a penalty of HK\$60,000 under Section 35(1)(c) of the PAO;
- (e) the Respondents do pay the costs and expenses of and incidental to the proceedings of the HKICPA in the sum of HK\$42,580; and that of the Financial Reporting Council in the sum of HK\$82,805.30 under Section 35(1)(iii) of the PAO. The costs and expenses shall be shared equally by the Respondents.

Dated the 17th day of May 2017