

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

Mr. Charles Pearson Fearn RESPONDENT  
Membership No. F00753

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

Members: Dr. Claire Wilson (Chairman).

Mr. Lee Tsung Wah Jonathan

Mr. Wan Chuck Fan David

Mr. Liu Yun Bonn

Mr. Espina Anthony Joseph

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**ORDER & REASONS FOR DECISION**

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1. This is a complaint made by the Registrar of the Hong Kong Institute of Certified Public Accountants (the "**Institute**") against Mr. Charles Pearson Fearn, certified public accountant (practising) (the "**Respondent**"). Sections 34(1)(a)(vi) and 34(1)(a)(viii) of the Professional Accountants Ordinance ("**PAO**") applied to the Respondent.
2. The Complaint as set out in a letter dated 28 November 2016 (the "**Complaint**") are as follows:-

**Background**

- (1) In October 2013, the Institute received an enquiry of possible non-compliance with audit standards in the performance of audits over a number of years. The complaint was prompted by a criminal case against Ms. Deborah Annells ("**Annells**") for her alleged improper conduct in handling client monies. Pearson Fearn & Co. ("**PFC**")

was the auditor for a number of companies owned or controlled by Annells, including AzureTrustees Limited ("**Company**"). Mr. Charles Pearson Fearn ("**Respondent**") was the sole proprietor of PFC.

- (2) The Company was registered and regulated under the Trustee Ordinance ("**Ordinance**"). Its audited financial statements were filed with the Companies Registry and accessible to the public<sup>1</sup>.
- (3) The Respondent issued unmodified audit opinions on the Company's financial statements for the period / year ended 30 June 2010 and 31 December 2010. For the years ended 31 December 2011 and 31 December 2012, the Respondent issued modified audit opinions that reflected the following.
  - (a) Limitation of audit scope leading to the auditor's inability to ascertain:
    - i) the status of all legal actions and criminal investigations against Annells and any possible effects on the financial statements (2011);
    - ii) the existence and valuation of other receivables of \$4,856,999 and other payables of \$5,095,548 (2011);
    - iii) the recoverability of two long outstanding accounts receivable amounts totaling \$719,770 (2011); and
    - iv) the recoverability of an outstanding accounts receivable amount of \$932,464 (2012).
  - (b) The Company's failure to comply with Hong Kong Accounting Standard 27<sup>2</sup> in not preparing consolidated financial statements (2011).
- (4) The Institute assessed the Respondent's audit work in light of the relevant auditing requirements<sup>3</sup>. In carrying out its investigation, the Institute found non-compliance with auditing standards relating to audit planning, audit evidence, and audit documentation.
- (5) On 15 April 2016, Respondent responded in a letter to the Institute indicating that he confirmed the factual accuracy of the Summary of Key Facts and Observations as set out in **Annex D12**.

#### **Relevant professional standards**

- (6) Extracts of the following relevant Hong Kong Standards on Auditing ("**HKSA**") and other professional standards are included at **Annex B**.
  - (a) HKSA 230 *Audit Documentation*
  - (b) HKSA 300 *Planning an Audit of Financial Statements*
  - (c) HKSA 500 *Audit Evidence*

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<sup>1</sup> **Annex C** includes audited financial statements of AzureTrustees for the period / years ended 30 June 2010, 31 December 2010, 31 December 2011 and 31 December 2012.

<sup>2</sup> Hong Kong Accounting Standard 27 (Revised) *Consolidated and Separate Financial Statements*

<sup>3</sup> **Annex E** contains a full set of the relevant audit working papers.

- (d) *Professional Competence and Due Care* set out in section 100.5(c)<sup>4</sup> and elaborated in section 130 of the Code of Ethics for Professional Accountants ("COE")

## **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 paragraphs 8, 9 and 13 of HKSA 300 (*Issued November 2004*) and paragraphs 7, 9 and 11 of HKSA 300 (*Issued June 2009; revised July 2010, December 2012*) in that there was insufficient planning conducted for the audits of the financial statements of the Company for each of the period or years ended 30 June 2010, 31 December 2010, 31 December 2011 and 31 December 2012.

### ***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 paragraph 2 of HKSA 500 (*Issued November 2004*) and paragraph 6 of HKSA 500 (*Issued July 2009; revised July 2010*) in gathering sufficient appropriate audit evidence to support the audit opinion expressed for the financial statements of the Company for each of the period or years ended 30 June 2010, 31 December 2010, 31 December 2011 and 31 December 2012.

### ***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 paragraph 2 of HKSA 230 (*Issued February 2006*) and paragraphs 7 and 8 of HKSA 230 (*Issued June 2009; revised July 2010*) in documenting matters relevant to the audits of the financial statements of the Company for each of the period or years ended 30 June 2010, 31 December 2010, 31 December 2011 and 31 December 2012.

### ***Complaint 4***

- (10) Section 34(1)(a)(vi) of the PAO applies to Respondent in that he failed or neglected to observe, maintain or otherwise apply the Fundamental Principle of *Professional Competence and Due Care* set out in sections 100.5(c) and 130 of the COE.

### ***Complaint 5***

- (11) Section 34(1)(a)(viii) of the PAO applies to Respondent in that he has been guilty of professional misconduct, as a result of multiple breaches of professional standards in the audits of the Company's financial statements for four consecutive periods or years, and failure to conduct those audits with competence and due care.

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<sup>4</sup> The same requirement was set out in 100.4(c) of the COE in the prevailing version that applied to the audit for the year ended 30 June 2010.

### **Facts and Circumstances in support of Complaint 1 – *Audit Planning***

- (12) An audit consists of systematic examinations of an entity's transactions, accounting records and other documents for the purpose of issuing an opinion on whether their financial statements are free from material misstatements and comply with the relevant financial reporting framework.
- (13) HKSA 300<sup>5</sup> requires an auditor to establish an audit strategy and develop an audit plan. Adequate planning benefits the audit process by maintaining a focus on important and potentially high risk areas.
- (14) HKSA 250<sup>6</sup> requires an auditor to obtain an understanding of the legal and regulatory framework applicable to the client and their compliance with that framework. The standard sets out audit procedures that may identify non-compliance with relevant laws and regulations that may materially affect the financial statements.
- (15) An auditor is also expected to obtain an understanding of relevant industry, regulatory, and other external factors in which the entity operates, as further elaborated in HKSA 315<sup>7</sup>, which are particularly pertinent to the planning process as they require an auditor to obtain an understanding of the entity and its environment, including its internal control structure. This understanding should guide the auditor in identifying and assessing the risks of fraud or error and allow him to design and conduct effective audit procedures.
- (16) There was no documentation on (i) the Respondent's general understanding of the legal and regulatory framework of the Company's trustee business and how the Company complied with the framework; and (ii) the review of the Company's internal controls, assessment of audit risk, consideration of fraud risk factors and performance of preliminary analytical procedures. The Respondent did not dispute that he did not establish an audit strategy and develop an effective audit plan.
- (17) The lack of audit strategy and effective audit plan had resulted in inadequate audit procedures performed to ascertain how client monies were accounted for in the Company's financial statements. Specifically, the working papers failed to reflect the following audit procedures which would have been expected under HKSA 315 when auditing a trustee company:
  - (a) obtaining an understanding of relevant industry, regulatory, and other external factors<sup>8</sup>;
  - (b) obtaining an understanding of the Company's internal controls<sup>9</sup>; and

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<sup>5</sup> HKSA 300 (Issued November 2004), paragraphs 8, 9 and 13; and HKSA 300 (Issued June 2009; revised July 2010, December 2012), paragraphs 7, 9 and 11.

<sup>6</sup> HKSA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* (Issued June 2005) and HKSA 250 (Issued July 2009; revised July 2010)

<sup>7</sup> HKSA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Issued November 2004) paragraph 22 and HKSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* (Issued June 2009; revised July 2010, July 2012) paragraph 11.

<sup>8</sup> HKSA 315 (Issued November 2004), paragraph 22; and HKSA 315 (Issued July 2009, revised July 2010, July 2012), paragraph 11.

<sup>9</sup> HKSA 315 (Issued November 2004), paragraph 41; and HKSA 315 (Issued July 2009, revised July 2010, July 2012), paragraph 12.

- (c) identifying and assessing the risks of material misstatements in the financial statements<sup>10</sup>.
- (18) HKSA 240<sup>11</sup> requires an auditor to, inter alia, perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud; to address the assessed risks of material misstatement due to fraud<sup>12</sup> and to design and perform audit procedures to respond to the risk of management override of controls. The Respondent's working papers do not appear to address any of these issues, or that the audit was planned with them in mind.
- (19) Given that client monies it managed might have a material impact on the Company's financial statements<sup>13</sup>, the auditor should have gained a better understanding of the following issues during the audits:
- (a) potential impact of apparent breaches of trust (Ordinance section 90);
  - (b) method of segregating trust funds from Company assets (Ordinance section 89); and
  - (c) potential misappropriation of client monies as loans to the Company's directors or officers or to any company of which any director or officer is actively engaged (Ordinance section 92).
- (20) Proper planning procedures would assist the auditor to establish whether management maintained adequate custody of client monies and properly accounted for them in the Company's financial statements. Without proper planning, the risk of material misstatements pertaining to misappropriation of funds may go undetected.
- (21) For example, the Respondent should have been aware that the Company accounted for client monies received as accounts payable\* in the Company's financial statements. At some point, these funds would be payable to the trust client or designated investment instruments so one would expect an equal amount to be reflected in a corresponding asset account to represent the item of value that is being held (e.g. cash) on behalf of the client. On the contrary, the only item on the asset side of the statement of financial position that might explain where the money from trust clients had gone was receivables due from related parties. Below are extracts of material balances from the Company's statements of financial position as at the relevant period or year ends:

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<sup>10</sup> HKSA 315 (Issued November 2004), paragraph 100; and HKSA 315 (Issued July 2009, revised July 2010, July 2012), paragraphs 25 and 26.

<sup>11</sup> HKSA 240 *The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements* (Issued October 2004) paragraphs 3, 43 and 57 and HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (Issued July 2009; revised July 2010) paragraphs 16, 17, 22 and 24.

<sup>12</sup> HKSA 240 (Issued October 2004), paragraphs 3, 43 and 57; and HKSA 240 (Issued July 2009, revised July 2010), paragraphs 16, 17, 22 and 24.

<sup>13</sup> Please refer to paragraphs 9, 15, 24 and 32 of Annex D12 for details of the relevant material balances on the balance sheets; extracts are in paragraph 21 below.

	<u>30.6.2010</u>	<u>31.12.2010</u>	<u>31.12.2011</u>	<u>31.12.2012</u>
	HK\$	HK\$	HK\$	HK\$
Amount due from related companies	13,678,436	18,129,822	1,924,191	3,389,928
Other receivables	4,048,168	1,420,864	4,856,999	116,368
Cash and cash equivalents	1,878,622	8,729,952	1,846,447	1,270,794
Accounts payables*	15,634,080	30,672,295	-	5,035,432
Amount due to related companies	2,511,566	1,176,178	1,552,282	134,477
Other payables*	-	-	5,095,548	2,374,570

\* The Company accounted for client monies received as other payables in its financial statements for the year ended 31 December 2011. For 2012, client monies received were included in accounts payables and other payables.

- (22) Ordinance section 92 prohibits loans to related parties; therefore, the Respondent should have performed further procedures to ascertain the propriety of the arrangement involving related parties. Furthermore, the comparatively higher accounts payable balances and receivables from related parties balances seem to suggest that the trust funds may have been used for purposes other than clients' benefit.
- (23) In this regard, it appears the Respondent failed to exercise adequate professional skepticism<sup>14</sup> during the planning stage<sup>15</sup>. The Respondent's lack of skepticism was demonstrated by the following gaps in planning for:
- (a) determining whether client monies were kept separate from the Company's funds;
  - (b) assessing whether there was any misappropriation of client monies when loans had been made to the Company's officers or related companies; and
  - (c) inquiring of management whether the entity had complied with laws and regulations relevant to a trustee company.
- (24) During the audits for each of the period or years ended 31 December 2010, 31 December 2011 and 31 December 2012, the Respondent completed certain audit planning checklists and approved the related planning memorandums. However, it appears that the Respondent did not actually perform all of the audit procedures reflected in the planning working papers. For example, certain audit schedules referred to in the checklists were not found in the working papers<sup>16</sup>.

<sup>14</sup> HKSA 250 (Issued June 2005), paragraphs 2, 13, 18(a) and 19; HKSA 315 (Issued November 2004), paragraphs 100 and 108; HKSA 250 (Issued July 2009; revised July 2010), paragraphs 12 to 15; and HKSA 315 (Issued July 2009, revised July 2010, July 2012), paragraphs 25 and 26.

<sup>15</sup> An auditor is expected to maintain an attitude of professional skepticism throughout the audit, regardless of the auditor's experience with the entity about the honesty and integrity of management.

<sup>16</sup> For example, audit objective summary sheets, permanent audit file, Commercial Observations Procedures on clients' business (B11) and an assessment on anti-money laundering procedures referred to in steps 2, 8, 16 and 25 in the File Completion Checklist (B4) were not found. Other completed audit schedules referred to in Checklists C2 and C8, such as schedules C2.1, C2.2, C5.1, C8.1, C8.2 and C8.3, are not found.

- (25) In summary, the working papers did not reveal the Respondent's general understanding of the legal and regulatory framework of the Company's trustee business and how the Company complied with the applicable regulatory framework<sup>17</sup>. They reveal that the following issues were not properly addressed in the planning phase of the audit:
- (a) obtaining a general understanding of the legal and regulatory framework of the Ordinance as it applied to the Company;
  - (b) exercising professional skepticism to ascertain the nature of significant sums of receivables due from, and payables due to, companies apparently related to Anells; and
  - (c) assessing the implications arising from a significant portion of the client money received being held somewhere other than a bank.

The audit documentation did not support that an audit strategy and an audit plan were properly established and developed according to the requirements of HKSA 300.

**Facts and Circumstances in support of Complaint 2 – *Audit Evidence***

- (26) Audit evidence is all of the information used by an auditor in arriving at the conclusions on which an audit is based. An auditor should verify management's assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion<sup>18</sup>.
- (27) It appears that various audit procedures reflected in the audit programs were not actually performed as relevant audit evidence expected to have been obtained was not found in the corresponding audit schedules. For example, copies of confirmations to confirm trade receivable and trade payable balances returned from debtors and creditors were not found in the working papers despite documentation in the audit programs suggesting that circularisation was performed<sup>19</sup>. Further to this point, the working papers did not contain audit evidence reflecting the following or any acceptable alternative tests:
- (a) testing of source documents supporting proper accounting and disclosure of various receivable and payable balances that were material to the financial statements; and
  - (b) searches for unrecorded and other contingent liabilities.

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<sup>17</sup> HKSA 250 (Issued June 2005), paragraph 15; and HKSA 250 (Issued July 2009; revised July 2010), paragraph 12.

<sup>18</sup> HKSA 500 (Issued November 2004), paragraph 2; and HKSA 500 (Issued July 2009; revised July 2010), paragraph 6.

<sup>19</sup> Please refer to paragraphs 12, 21 and 29 of Annex D12 for details of audit evidence not found in the working papers despite indication documented on the audit programs that the evidence was obtained.

- (28) Review of the working papers also revealed account balances with related companies. However, the working papers did not contain any assessment of those balances, or any consideration of whether they should be disclosed in the financial statements as related party transactions in accordance with paragraph 17 of HKAS 24<sup>20</sup> (*Issued November 2004*) and paragraph 18 of HKAS 24 (*Issued November 2009*).
- (29) As at 31 December 2010, despite an amount due from a director of \$5,180,361, there was no disclosure of loans to director as required by section 161B of the Companies Ordinance in the Company's financial statements. The working papers did not contain any assessment to determine if the amount represented loans advanced to director as defined in the Companies Ordinance.
- (30) In addition to the deficiencies listed above, the working papers for the December 2011 audit did not explain the circumstances which led to a modified audit report in respect of the limitation of audit scope on:
- i) other receivables of \$4,856,999; and
  - ii) other payables of \$5,095,548.
- (31) Although the modified audit report stated that existence and valuation of other receivables and other payables could not be ascertained, evidence gathered to arrive at this conclusion was inadequate. The working papers did not reflect the information requested, the unavailable information, or the reasons for unavailability. The documentation merely indicated that other receivables were '*payment paid on [behalf] of client*'. However, this is inadequate and reflects a basic lack of understanding regarding the nature of 'other payables'. It further leads to suspicion regarding the use of trust funds for purposes other than clients' benefit.

#### **Facts and Circumstances in support of Complaint 3 – *Audit Documentation***

- (32) HKSA 230 requires that audit documentation reflect the evidence that was gathered to form the auditor's basis for conclusion regarding an entity's financial statements. It should also reflect evidence that the audit was planned and performed in accordance with the relevant auditing standards and applicable legal and regulatory requirements. Respondent's failure to document exceptions related to planning procedures (matters in paragraph 25 above) and audit evidence (matters in paragraph 27 to 31 above) reflect a lack of audit documentation as required by HKSA 230.

#### **Facts and Circumstances in support of Complaint 4 – *Professional Competence and Due Care***

- (33) The severity and continuity of the failures clearly shows that the Respondent lacked competence and diligence in conducting the relevant audits for a trustee company in breach of the Fundamental Principle of *Professional Competence and Due Care*.

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<sup>20</sup> Hong Kong Accounting Standard 24 *Related Parties Disclosures* (December 2004) and HKAS 24 (*Issued November 2009*)



### **Facts and Circumstances in support of Complaint 5 – Professional Misconduct**

- (34) The non-compliance with numerous professional standards set out in the above Complaints were serious and fundamental mistakes either when viewed individually or when considered collectively. They demonstrate that the Respondent conducted the audits with a minimal regard to audit implications presented by the Company's handling of trust assets, and by the fact (known to the Respondent at the time of the 2011 and 2012 audits) that the Company's owner/controller, Annells, was facing civil claims and criminal investigation in relation to her running of the Company.
- (35) In the premises, the Respondent has been guilty of professional misconduct.

### **Conclusion**

- (36) On the basis of the Institute's analysis of the Respondent's relevant audit working papers as summarised above, the Respondent was found to have failed to comply with HKSA's 230, 300, and 500 in the audits of the financial statements of the Company for each of the period or years ended 30 June 2010, 31 December 2010, 31 December 2011 and 31 December 2012. His repeated failure to conduct audits in accordance with auditing standards for the 4 period or years under the Institute's review also demonstrates a breach of Professional Competence and Due Care. Further, the repeated audit failure over the period / years demonstrates a minimal regard to audit implications presented by the Company's trust business and civil and criminal proceedings on foot against the Company's owner/controller at the time, and accordingly the Respondent has been guilty of professional misconduct.
3. The Respondent admitted the complaints against him. He did not dispute the facts as set out in the complaints. On 17 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 Respondent provided their first round of submissions on sanctions and costs on 17 and 15 March 2017 respectively. At the request of the Committee, the Complainant provided further information on 20 April 2017 and the Respondent provided his reply on the Complainant's additional submissions on 11 May 2017.
  6. The complaint was found proved on the basis of the admission by the Respondent.
  7. In considering the proper order to be made in this case, the Disciplinary Committee has had regard to all the relevant matters, including the particulars in support of the Complaints, the Respondent's personal circumstances, and the conduct of the Respondent throughout the proceedings. The Committee considers the present case serious, but notes that the Respondent has taken some remedial actions in his practice which is a mitigating factor to the severity of the matter.

8. The Disciplinary Committee orders that:-
- (a) the practising certificate issued to the Respondent in 2017 be cancelled under Section 35(1)(da) of the PAO;
  - (b) a practising certificate shall not be issued to the Respondent for 12 months under section 35(1)(db) of the PAO;
  - (c) the Respondent do pay the costs and expenses of and incidental to the proceedings of the Complainant in the sum of HK\$60,069 under Section 35(1)(iii) of the PAO.

The above order shall take effect on the 40<sup>th</sup> day from the date of this order.

Dated the 6th day of July 2017