

IN THE MATTER OF

A Complaint made under Section 34(1A) of the Professional Accountants Ordinance (Cap.50) (“**the PAO**”)

BETWEEN

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

AND

Ms. Yuen Suk Ching (Membership no. A02183) 1st RESPONDENT

Mr. Leung Tai Keung (Membership no. A01132) 2nd RESPONDENT

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

Members: Mr. Kaung Wai Ming Alexander (Chairman)
Mr. Donowho Simon Christopher
Ms. Chan Yiting Bonnie
Mr. Copley Simon Charles
Mr. Doo William Junior Guilherme

Date of hearing: 16 and 17 October 2019

Date of Decision: 31 December 2019

REASONS FOR DECISION

1. These are complaints made by the Registrar of the Hong Kong Institute of Certified Public Accountants (the “**Institute**” or the “**Complainant**”) against Ms. Yuen Suk Ching and Mr. Leung Tai Keung (the “**1st Respondent**” and the “**2nd Respondent**” respectively, and the “**Respondents**” collectively).
2. The complaints arise in relation to the audit of a listed company which was formerly known as Blue Spa Holdings Limited (the “**Company**”), for the years ended 30 June 2007 to 30 June 2010.
3. The complaints are mainly concerned with alleged auditing irregularities relating to (i) prepayments to three suppliers and a major customer with respect to the audits of the Company’s financial statements for the years ended 30 June 2009 and 30 June 2010 (the “**2009 Audit**” and the “**2010 Audit**” respectively), and (ii) sales to and receivables from

the major customer with respect to the audits of the Company's financial statements for the year ended 30 June 2008 (the "2008 Audit"), the 2009 Audit and the 2010 Audit.

4. The three suppliers of the Company have been referred to (and will be referred to hereunder) as the "Three Suppliers" collectively.
5. The major customer of the Company has been referred to (and will be referred to hereunder) as the "Major Customer". It was the Company's single largest customer and sole distributor in the People's Republic of China ("PRC").
6. HLM & Co (the "Auditor") was the auditor of the relevant audits. The 1st Respondent was the engagement director of the relevant audits and the 2nd Respondent was the engagement quality control reviewer ("EQCR") of the relevant audits.
7. There are a total of 5 complaints against the Respondents. Complaints 1 to 3 are against the 1st Respondent. Complaints 4 and 5 are against the 2nd Respondent. In each case, the Complainant alleges that the relevant Respondent (i) failed or neglected to observe, maintain or otherwise apply a professional standard in breach of section 34(1)(a)(vi) of the PAO, and (ii) committed professional misconduct in breach of section 34(1)(a)(viii) of the PAO.
8. At its core, the Complainant's case is that there were numerous unusual risk factors in relation to the aforesaid prepayments and sales/receivables which the Auditor ought to have viewed as unusual and which should have prompted it to undertake additional audit procedures, but that it did not do so.
9. The Auditor resigned as auditors of the Company in March 2012, during the course of the audit of the Company's financial statements for the year ended 30 June 2011 (the "2011 Audit"), citing its inability to obtain sufficient and appropriate audit evidence in order to complete the audit and form an opinion, and an elevated level of professional risk associated with the audit, as its reasons for resignation. In the Company's announcement concerning the Auditor's resignation, the following reasons were those which the Auditor had asked to be brought to the attention of the Company's shareholders:-

"During the course of our audit, we have not been able to receive sufficient and appropriate evidence that we considered necessary for us to complete our audit and form an opinion. In view that the management of the Group had not been able to provide us with satisfactory explanations to certain issues noted during the audit, it has greatly elevated the level of professional risk associated with the audit."

"It came to our notice that a director of three subsidiaries of the Group is a supervisory board member of a major customer of the Group. The transactions between the Group and the customer were of a substantial amount and they had a material impact on the turnover of the Group for the year ended 30 June 2011. We believe such transactions should have been disclosed as "Related Parties Transactions" in accordance with Financial Reporting Standards HKAS24. We

have not been able to come to a consensus agreement with the management in relation to the disclosure of such transactions."

"After the year end date, certain amount of accounts receivables was reported to have been settled. However, a substantial portion of the money received was then paid out immediately to several entities ("Entities") for a purported project which the management had not been able to provide us with adequate satisfactory explanations. In addition, the former non-executive director/chairman of the Company is also the director/shareholder of those Entities just prior to the payments. Despite we have not been able to satisfy ourselves as to the validity of these transactions, we also believe that these transactions should be considered as material related party transactions."

"There were also certain occasions that there was a breakdown in audit trail of documentations for, including but not limited to, account receivables, deposit paid, loan receivable, prepayment and inventory."

10. The Complainant has also referred to following matters by way of factual background:-
 - (i) The new auditor performing the 2011 Audit in place of the Auditor expressed a disclaimer of opinion on the 2011 financial statements on the bases, inter alia, that they were unable to obtain sufficient appropriate audit evidence in relation to sales and trade receivables due from the Major Customer, the 2010 prepayments to the Three Suppliers, the 2010 prepayment to the Major Customer, and unable to verify the identities of the Major Customer and the Three Suppliers.
 - (ii) The Company subsequently engaged an independent forensic accountant to investigate the reasons for the resignation of the Auditor and the major findings included that (a) there were a number of indicators that the Major Customer was not an independent third party, and was related to some former senior management members of the Company, (b) there was a lack of arm's length commercial characteristics for the transactions with the Major Customer and the suppliers, (c) there was no documentary evidence to show that the Company had made any delivery of the goods sold to the Major Customer, (d) substantial prepayments to seven other suppliers also exhibited suspicious characteristics, and two of the seven suppliers confirmed that they had never received such prepayments, and (e) out of total sales of approximately HK\$223.1 million for the five years ended 30 June 2011, there were serious doubts as to the genuineness of sales totalling approximately HK\$204 million, being sales made to the Major Customer. The independent forensic accountant's report also indicated that a considerable number of past transactions may be fictitious and a number of falsified documents, forged signatures and chops were involved.
11. The Respondents say that the reference to the findings made by the independent forensic accountants after the audit years in question is prejudicial and cautioned the Disciplinary Committee against taking such matters into account.
12. The Disciplinary Committee has taken great care to focus only on the circumstances that existed, and what was known to the Respondents, during the 2008, 2009 and 2010 Audits.

13. The main thrust of the Complainant's case is that there were a number of "red flags" or suspicious features that the Respondents should have identified as risk factors during the audit process, and that as a result they ought to have carried out additional audit steps and procedures, but that there was no evidence in the audit documentation that procedures to carry out such additional audit steps had been formulated or that such additional audit steps had been carried out. The Disciplinary Committee has considered the Complainant's case taking into account not only the audit documentation but also other evidence as to what happened during the 2008, 2009 and 2010 Audits.
14. The audit documentation shows that for the relevant audits, the Auditor adopted a "standard" audit program. Moreover, the Auditor documented in their audit planning that no significant events or unusual transactions were noted, and no risks were identified. The audit documentation indicated no issues or risks identified in relation to deposits, prepayments and other receivables, and in particular, the Fraud Risk Program reflected that the Respondents considered that there were zero fraud risk factors which they ought to look at during the course of those audits. This is the diametric opposite of what the Complainant says the Respondents should have done ie. there were a number of "red flags" or suspicious features which should have prompted the Respondent to carry out additional audit steps and procedures.
15. In terms of the lack of documentation which was found in the audit files, the point has been taken by the Respondents that they had available to them at the time of the audits documents which were not in the audit files but rather in general files called the Permanent File. Such documents included distributor agreements, franchise agreements, legal documents and the like. The Disciplinary Committee accepts that these documents had been available to the Respondents at the time. However, the Disciplinary Committee does not consider that this point takes the Respondents very far insofar as the Respondents seek to contend that reading these documents to understand the Company's business operations constituted adequate audit work on their part. It clearly did not.
16. The Disciplinary Committee does consider it material that trading in the shares of the Company had been suspended for some years prior to 2008, and that the Auditor had been involved in the resumption exercise which led to the eventual resumption of trading of the Company's shares in June 2008, and had also been involved in several prior unsuccessful resumption exercises. This was not disputed by the Respondents. The eventual resumption of trading of the Company's shares was made possible by the fact that the Company engaged as their sole distributor in China the Major Customer, which had a substantial sales network in China. Put another way, the Company's business was heavily reliant on the Major Customer, and this represented a significant change in the way in which the Company conducted their business.
17. Extensive written and oral submissions were made by both the Complainant and the Respondents. The Respondents had also made voluminous submissions during the prior investigation by the Audit Investigation Board ("AIB"). Although the Disciplinary Committee has considered all of the arguments raised by the Parties, it has in reaching its decision in relation to the 5 complaints focused on what it has considered to be the key facts and key issues.

18. The Disciplinary Committee has borne in mind that the standard of proof for disciplinary proceedings should be the civil standard, although the more serious the allegations, the more compelling the evidence which is required to prove the allegation (see Solicitor (24/7) v Law Society of Hong Kong (2008) 11 HKCFAR 117).

The 1st Respondent

19. The 1st Respondent faces Complaints 1, 2 and 3.

Complaint 1

20. Complaint 1 is concerned with alleged audited irregularities relating to prepayments to the Three Suppliers and the Major Customer. The prepayments to the Major Customer as at 30 June 2009 and the prepayments to the Three Suppliers and the Major Customer as at 30 June 2010 were greater than the materiality level for the 2009 Audit and the 2010 Audit respectively.
21. The Complainant says that the following "red flags" existed in relation to the prepayments:-
- (i) There were very significant increases in prepayments to the Major Customer from 2008 to 2009, and prepayments to the Three Suppliers from 2009 to 2010;
 - (ii) The prepayments represented a significant portion of the Company's total asset value (30% in 2009 and 55% in 2010);
 - (iii) Prepayments for supplies were made by cash cheques to the Major Customer, which would settle the payables to suppliers in the PRC;
 - (iv) Most prepayments were made in full and some prepayments had been prepaid for over half a year or even one full year.
22. The Complainant argues that risks relating to prepayments are higher than normal payments because the related liability has not yet been incurred when the company makes the payment, whereas in the case of normal payments to trade creditors and service providers there would be evidence showing that the company has acquired/consumed those goods and services. The Complainant also says that, if there was no proper checking of how the prepayments were utilised, there was a risk that the prepayments would result in a material misstatement of the financial statements ie. if the prepayments were not for a genuine purpose or were not utilised for the stated purpose.
23. It is noted that at a meeting with the management of the Company on 22 September 2010, the Auditor had stated concerns to the Company's management, and informed the Company's management that during the audit it could not confirm whether the prepayments had been received by the relevant suppliers, or that the goods supplied had been received by the Company.
24. It was recorded in a set of minutes of that meeting that the Company's management had given the following explanations:-

- (i) The prepayments to the Major Customer were in fact for purchases of supplies, and for reasons attributable to foreign exchange restrictions in the PRC, the Company would pay the Major Customer by cash cheques and the Major Customer would settle payments to the Company's suppliers in the PRC, including most purchases made from the Three Suppliers.
 - (ii) Prepayments had been made over half a year or even a year in advance in order to secure preferential pricing and to ensure the supply of products.
 - (iii) Purchase orders had been placed by the Company even before it had received sales orders, as those purchase orders had been placed based on anticipated sales.
25. However, there was nothing which showed what additional procedures the Auditor performed to verify the oral explanations given by the Company's management and how it was satisfied with those explanations.
26. On 27 September 2010, the Auditor issued a letter to the Independent Non-Executive Directors of the Company (the "INEDs") highlighting certain matters, including the following in relation to prepayments:-
- (i) At 30 June 2010, total prepayments of HK\$103,772,339 accounted for approximately 55% of the Company's net asset value.
 - (ii) The prepayments were approved by the CEO and the Chairman of the Company, and were made by cash cheques. The Auditor was unable to obtain a sufficient audit trail to verify who the recipients of the payments were.
 - (iii) Upon further discussion with management, the Auditor was eventually provided with more documentation and were satisfied that the prepayments had been made in relation to the purchase of products.
27. At the substantive hearing, the Respondents said that the documentation provided to them by Company's management upon further discussion was primarily in the nature of purchase orders and sales orders, some of which had contracts appended to them. The Complainant says that such documents would not have enabled the Respondents to resolve the concerns which they should have had about the prepayments, including whether they were for a genuine purposes and whether they were utilised for the stated purpose, and that the Respondents ought to have conducted additional audit procedures such as performing site visits, obtaining company searches and conducting interviews with the Major Customer and the Three Suppliers.
28. The Auditor signed off on the 2010 Audit on the same day (27 September 2010).
29. The Respondents also say that during the relevant audits, the Auditor had in fact tested samples covering between 95% to 100% of the account balance of the prepayments to the Three Suppliers and to the Major Customer. The Respondents say that the fact that this was done reflects the fact that the Auditor took a very conservative approach.
30. The Respondents consider that this, together with the fact that the Auditor had made enquiries with the Company's management to understand the commercial rationale for the prepayments and to assess the reasonableness of the prepayments, means that the

Auditor had taken sufficient steps to mitigate the risk of material misstatement of the financial statements.

31. As indicated above, for each of the 2009 and 2010 Audits, the Auditor documented in their audit planning that no significant events or unusual transactions were noted, and no issues or risks identified in relation to deposits, prepayments and other receivables.
32. On the other hand, what the Auditor actually did in relation to the prepayments was to conduct near 100% testing of the account balance of the prepayments. In the Disciplinary Committee's view, what the Auditor actually did shows that it clearly thought that there were high risks. When this was put to the Respondents during the course of the substantive hearing, the Respondents candidly accepted that they did in fact have significant concerns, but considered what they had done was sufficient to address those concerns.
33. In the Disciplinary Committee's view, the Auditor was clearly correct to have concerns about the prepayments, but the audit work which was actually done, and which can be shown to have been done, fell far short of what was required to properly address those concerns.
34. As indicated above, it is material that the Auditor was involved in the Company's resumption proposal and was aware of the heavy reliance of the Company on the Major Customer in the Company's new business model. The Auditor ought, in ascertaining and assessing the risks of fraud, to have been aware of the heightened risks of that business model and to have planned and taken additional steps when conducting their audits.
35. The Company had a business model involving selling their products through one distributor (the Major Customer). The significant amounts paid by the Company in cash to the Major Customer, which were described as prepayments, and which were also according to the Company's management prepayments paid by the Company to the Three Suppliers via the Major Customer, were clearly unusual to say the least.
36. The Disciplinary Committee considers that in such circumstances, there evidently were risks such that the Auditor ought to have undertaken additional audit procedures, including checking that the prepayments were for a genuine purpose, and checking that there was actual delivery of goods to the Company.
37. As indicated above, as at 22 September 2010, the Auditor was still expressing their concerns at a meeting with the Company's management that it could not confirm whether the prepayments had been received by the relevant suppliers, or that the goods supplied had been received by the Company. The Company's management provided certain oral explanations but there is no evidence in the audit documentation to indicate that the Auditor had performed any audit procedures to corroborate the oral explanations provided by the Company's management.
38. Thereafter, the Auditor indicated to the INEDs of the Company that they were satisfied by the documents which were provided thereafter by the Company's management that the prepayments had been made for the purchase of products. However, as stated above, those documents were merely purchase orders and sales orders. The Disciplinary Committee agrees with the Complainant that such documents would not have enabled

the Respondents to be satisfied that the prepayments were for a genuine purposes, and that there was actual delivery of goods to the Company.

39. It is alleged that the 1st Respondent was in breach of Section 34(1)(a)(vi) of the PAO in that, when carrying out the 2009 and 2010 Audits, she failed or neglected to observe, maintain or otherwise apply one or more of the following professional standards in relation to prepayments to the Three Suppliers and the Major Customer:-

- (i) Paragraph 15 of HKSA 200
- (ii) Paragraph 9 of HKSA 230
- (iii) Paragraphs 16 and 17 of HKSA 300
- (iv) Paragraphs 10, 55, 100 and 101 of HKSA 315
- (v) Paragraph 2 of HKSA 500
- (vi) Paragraph 8 of HKSA 520
- (vii) Paragraphs 11 and 13 of HKSA 700

40. Extracts of the relevant professional standards have been set out in a schedule provided by the Complainant, which is annexed hereto as **Attachment 1**.

Audit Planning

Paragraph 15 of HKSA 200

41. It is said that the Auditor failed to properly plan and update their audit strategy when appropriate in the 2009 and 2010 Audits with an attitude of professional scepticism, recognising that circumstances might exist that caused the financial statements to be materially misstated.
42. The Disciplinary Committee agrees that the Auditor should have been alert to heightened risks when it planned and conducted the 2009 and 2010 Audits in relation to prepayments.
43. As stated above, the Respondents accepted that they did in fact have significant concerns about the prepayments when they performed the 2009 and 2010 Audits. However, this was inconsistent with the documentation in the audit documentation, which did not show that the Auditor had considered there to be heightened risks and had planned and performed their audits in a way which would properly address the risks of material misstatement of the prepayments.
44. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraph 15 of HKSA 200.

Paragraphs 16 and 17 of HKSA 300

45. It is said that having encountered issues during the 2010 Audit which should have challenged the Auditor's original risk assessment, the Auditor failed to revise the planning decision and update the overall audit strategy and audit plan.
46. Earlier, during the course of the AIB's investigation, the Respondents had sought to maintain that nothing during the audit gave rise to a concern that the prepayments were

unusual. However, at the substantive hearing, the Respondents conceded that they had had significant concerns about the prepayments.

47. This is consistent with the fact that at a meeting with the management of the Company on 22 September 2010, the Auditor had stated their concerns to the Company's management, and informed the Company's management that during the audit it could not confirm whether the prepayments had been received by the relevant suppliers, or that the goods supplied had been received by the Company.
48. This is also consistent with the fact that thereafter, the Auditor issued a letter to the INEDs highlighting certain matters in relation to prepayments, including that the Auditor was unable to obtain a sufficient audit trail to verify who the recipients of the payments were.
49. The Respondents asserted that upon further discussion with management, they were eventually provided with more documentation and were satisfied that the prepayments had been made in relation to the purchase of products. However, as found above, the documentation provided to the Auditor, which was in the nature of purchase orders and sales orders, would not have enabled the Respondents to resolve the concerns which they should have had in relation to the prepayments.
50. The Disciplinary Committee agrees with the Complainant that the prepayments were unusual and there were risks arising therefrom which ought to have been addressed by the audit plan. In particular, the Auditor had raised concerns with the Company's management about their inability to confirm whether the prepayments had been received by the relevant suppliers, or that the goods supplied had been received by the Company. The Auditor ought to have updated and changed their audit plan, so as to check that the prepayments were for a genuine purpose, and checking that there was actual delivery of goods to the Company. However, the Auditor did not make any change to their overall audit strategy and audit plan. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraphs 16 and 17 of HKSA 300.

Paragraph 10 of HKSA 315 and Paragraph 8 of HKSA 520

51. It is said that the Auditor failed to properly use analytical procedures at the planning stage in accordance with paragraph 10 of HKSA 315 and paragraph 8 of HKSA 520, and specifically that the Auditor did not:-
 - (i) develop expectations based on historical data or other available information and compare the expectations with recorded amounts to identify that the significant increases in "Deposits and other receivable" might indicate the risks of unusual transactions and material misstatements to the relevant financial statements;
 - (ii) critically analyse the reasons for the significant increases in order to determine the nature, timing and extent of audit procedures;
 - (iii) properly assess the risks of material misstatement of the prepayments.
52. By reason of the matters set out above, the Disciplinary Committee agrees that the prepayments were unusual transactions and that there were material risks which warranted the Auditor taking steps during the planning of their audit to assess that risk,

however the Auditor did not do so. The Disciplinary Committee agrees that there was a higher level of audit significance and risk which simply was not addressed at the planning stage by the Auditor.

53. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraph 10 of HKSA 315 and Paragraph 8 of HKSA 520.

Paragraphs 55, 100 and 101 of HKSA 315

54. It is said that for the 2009 and 2010 Audits, the Auditor failed to properly assess the risk of the prepayments that could result in a material misstatement of the financial statements, and did not properly plan the relevant audit procedures, in accordance with paragraph 55, 100 and 101 of HKSA 315.

55. As indicated above, whilst the Respondents accepted that they did in fact have significant concerns about the prepayments, this contrasted with the Auditor's assessment of no risk or low risk which was reflected in the audit documentation.

56. The way that the prepayments had been made to the Major Customer was plainly unusual and warranted the Auditor taking steps during the planning of their audit to assess the risks flowing from those unusual transactions.

57. Given the Auditor's assessment of no risk or low risk assessment which was reflected by the audit documentation, there was unsurprisingly no evidence in the audit documentation that the design and implementation of controls over the prepayments to the Major Customer had been properly analysed and evaluated, or that appropriate risk assessment procedures had been planned or carried out. The Disciplinary Committee agrees that the Auditor failed to properly plan the relevant audit procedures for the purposes of assessing the risk of material misstatement of the financial statements by reason of the prepayments.

58. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraphs 55, 100 and 101 of HKSA 315.

Audit Evidence and Documentation

Paragraph 2 of HKSA 500

59. The Complainant made a number of complaints in respect of audit evidence and documentation for the 2009 and 2010 Audits. The most significant amongst them were that the Auditor:-

- (i) failed to obtain sufficient appropriate audit evidence to corroborate the oral explanations provided by management in relation to the significant increase in the prepayments;
- (ii) failed to test the utilisation of the prepayments to provide corroborative evidence on the significant prepayments; and
- (iii) failed to obtain sufficient appropriate audit evidence to ensure that the prepayments to the Three Suppliers were free from material misstatements when the purchases were not directly made by the Company.

60. It is said that by reason of the foregoing, the Auditor failed to obtain sufficient appropriate audit evidence in order to draw reasonable conclusions on which to base their audit opinion in relation to the 2009 and 2010 Audits of the prepayments, in accordance with paragraph 2 of HKSA 500.
61. The main failing of the Auditor, as contended by the Complainant, is that it failed to obtain supporting evidence to show how the Company monitored the utilisation of the prepayments, and to be satisfied that the prepayments had been utilised for the proper purposes of the Company's business. At the same time, the Auditor was also unable to obtain appropriate audit evidence showing that the goods which the payments were said to relate to were received.
62. What the Respondents were able to point to as having been done did not provide a complete answer. For example, it was said that at the meeting with the management of the Company on 22 September 2010, the Auditor had received oral explanations from the Company's management, but there is no evidence in the audit documentation to indicate that the Auditor had performed any audit procedures to corroborate the oral explanations provided by the Company's management.
63. Similarly, it was said that the Auditor had been satisfied by the documents provided after that meeting by the Company's management that the prepayments had been made for the purchase of products. However, as stated above, those documents were merely purchase orders and sales orders, and could not have constituted a sufficient audit trail to enable the Auditor to be satisfied as to who the recipients of the payments were.
64. It was accepted by the Complainant that the Auditor had obtained audit confirmations from the Three Suppliers. The Respondents also relied on the fact that they had obtained purchase orders and receipts issued by the Three Suppliers. But this was not sufficient. The Complainant says, and the Disciplinary Committee agrees, that given the unusual nature of the prepayments (which were first paid to the Major Customer by way of cash cheques, and thereafter paid over by the Major Customer to the Three Suppliers on behalf of the Company), the relevant audit risks ought to have been reassessed and additional audit procedures ought to have been performed, such as interviewing the Three Suppliers.
65. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraph 2 of HKSA 500.

Paragraph 9 of HKSA 230

66. It is said that the Auditor failed to prepare adequate documentation in relation to the 2010 Audit, in accordance with paragraph 9 of HKSA 230.
67. Paragraph 9 of HKSA 230 requires an auditor to prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand the nature of the audit procedure performed, the results of the audit procedures and the audit evidence obtained, and the conclusions reached on significant matters arising during the audit.

68. It was not seriously contended by the Respondents that the audit documentation contained in the audit files showed that sufficient audit work had been done. What the Respondents sought to rely on was that other things had been done, which were not reflected in the audit files.
69. As such, and given that on the face of it, the audit documentation shows that for the 2009 and 2010 Audits of the Company, the Auditor documented in their audit planning that no significant events or unusual transactions were noted, and no issues or risks identified in relation to deposits, prepayments and other receivables, it would follow that an experienced auditor having no previous connection with the audit would not have been able to understand what audit procedures had in fact been performed in relation to prepayments, and what audit evidence had been obtained, upon reviewing the documentation in the audit files.
70. That being the case, as the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraph 9 of HKSA 230.

Paragraphs 11 and 13 of HKSA 700

71. It is also alleged that, insofar as the basis of forming audit opinions is concerned, the Auditor failed to obtain sufficient appropriate audit evidence to support the conclusions which it reached in respect of the existence of and the reasons for the significant increase in the prepayments to the Major Customer (in the 2009 and 2010 Audits) and the prepayments to the Three Suppliers (in the 2010 Audit), thereby:-
- (i) failing to adequately evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements, in accordance with paragraph 11 of HKSA 700; and
 - (ii) failing to adequately evaluate whether the financial statements had been prepared and presented in accordance with the requirements of the applicable financial reporting framework when forming an opinion as to whether the financial statements were presented fairly in all material respects, in accordance with paragraph 13 of HKSA 700.
72. Thus, it is said, the Auditor failed to obtain sufficient appropriate audit evidence to support their audit opinions in the 2009 and 2010 Audits.
73. For the 2009 Audit, the Auditor issued an unqualified opinion.
74. For the 2010 Audit, the Auditor also issued an unqualified opinion, albeit with an emphasis of matter drawing attention to the Company's exposure to operation risk and credit risk attributable to the Company's heavy reliance on the Major Customer.
75. It is important to note that an emphasis of matter is only an explanation to enhance the user's understanding of the financial statements. It does not indicate that the Auditor's opinion has been modified with respect to the matter emphasised, and does not indicate that the Auditor considered that the matter had not been appropriately presented in the financial statements. In any event, the emphasis of matter related to the Company's heavy reliance on the Major Customer, which may be a matter which is relevant to

Complaint 2, but is not a matter which is relevant to Complaint 1, which is concerned with prepayments to the Major Customer and to the Three Suppliers.

76. As stated above, the first Respondent was in breach of Paragraph 2 of HKSA 500 in respect of the 2009 and 2010 Audits in that she:-
- (i) failed to obtain sufficient appropriate audit evidence to corroborate the oral explanations provided by management in relation to the significant increase in the prepayments;
 - (ii) failed to test the utilisation of the prepayments to provide corroborative evidence on the significant prepayments; and
 - (iii) failed to obtain sufficient appropriate audit evidence to ensure that the prepayments to the Three Suppliers were free from material misstatements when the purchases were not directly made by the Company.
77. These matters are highly relevant to whether there was compliance with Paragraphs 11 and 13 of HKSA 700.
78. Paragraph 11 of HKSA 700 requires that the Auditor's conclusion should take into account whether sufficient audit evidence has been obtained. For the reasons stated above, this clearly did not take place.
79. Paragraph 13 of HKSA 700 requires the Auditor to evaluate whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures, and specifically (amongst other things), whether:-
- (i) the accounting estimates made by management are reasonable;
 - (ii) the information presented in the financial statements is relevant, reliable, comparable, and understandable; and
 - (iii) the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events.

For the reasons set out above, for the 2009 and 2010 Audits, in respect of prepayments, the Auditor did not make the appropriate evaluation in accordance with Paragraph 13 of HKSA 700.

80. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraphs 11 and 13 of HKSA 700.

Conclusion

81. In conclusion, the Disciplinary Committee has found that the 1st Respondent had failed or neglected to observe, maintain or otherwise apply a number of professional standards in relation to prepayments to the Three Suppliers and the Major Customer. Section 34(1)(a)(vi) of the PAO applies to the 1st Respondent.

Complaint 2

82. Complaint 2 is mainly concerned with alleged audit irregularities relating to sales to and receivables from the Major Customer.
83. The Complainant says that the following "red flags" existed in relation to sales and receivables from the Major Customer:-
- (i) the Company relied heavily on the Major Customer;
 - (ii) by 2010, sales to the Major Customer accounted for approximately 97% of the Company's revenue, and the trade receivables due from the Major Customer of HK\$83.6 million as at 30 June 2010 was 45% of the Company's net asset value;
 - (iii) some receivables had been due for a long period, exceeding 180 days, but despite the long outstanding receivables, the Company still extended the credit period granted to the Major Customer;
 - (iv) when placing orders, the Major Customer did not follow the payment terms and no deposits were paid;
 - (v) receivables due from the Major Customer were settled in cash received from certain former directors of the Company, and by bank cheque issued by a former executive director of the Company;
 - (vi) payments from the Major Customer could not be matched with individual sales invoices as they did not specify which invoices were being settled when making payments; and
 - (vii) most of the control activities for revenue recognition relied on approval from one of the two key management personnel of the Company.
84. An issue which was ventilated before the Disciplinary Committee was whether the Major Customer was a related party during the 2008, 2009 and 2010 Audits. The Respondents accepted that they knew, at the time of the 2008, 2009 and 2010 Audits, that a Ms. Deng, who was the corporate supervisor of the Major Customer, had been made the legal representative of a PRC subsidiary of the Company. The Respondents said that this PRC subsidiary was dormant at the time and hence it was not considered that there was a related party relationship between the Company and the Major Customer until the 2011 Audit, by which time Ms. Deng had become the legal representative of 3 PRC subsidiaries of the Company, and at least one of them was active with substantial bank transactions, which caused the Auditor to consider that there had been a change in the nature of the relationship between the Company and the Major Customer.
85. In the Disciplinary Committee's view, this issue of related party distracted from the more fundamental question of what the Auditor knew about the Major Customer when performing the 2008, 2009 and 2010 Audits.
86. Having been involved in the prior resumption exercise, one would expect the Auditor to have detailed knowledge of the background of the Major Customer. Indeed, the

Respondents relied on their involvement in the resumption exercise to say that they had gained an understanding of the Major Customer.

87. The Auditor clearly did know about Ms. Deng's connection to the Major Customer. But it appears that the Auditor knew little about, and had done little to find out about, the Major Customer's shareholders, its business operations, its financial position etc.
88. The Complainant alleges, even by the time of the meeting which the Auditor had with the Company's management in September 2010, the Auditor still did not know much about the Major Customer. It was common ground that at that meeting, the Auditor requested various types of information from the Company about the Major Customer, such as information about its shareholders, its business licence and its financial statements, but that none of the requested information was provided other than the business licence.
89. When asked about the fact that the Auditor had not received any documents about the Major Customer other than the business licence, the Respondents argued that the Auditor did not actually need the financial statements of the Major Customer or the other requested information.
90. The Respondents relied on the fact that during the resumption exercise, they had sent staff to visit a few of the Major Customer's shops in Beijing and Shenzhen, from which they had observed that the Major Customer was doing good business. However, other than these cursory visits, which did not involve interviewing the staff of the Major Customer or looking at any financial data of the Major Customer, nothing else was done. The Respondents were unable to address questions such as what steps they had taken to verify what had been said in the Company's business plan about how many outlets the Major Customer had in the PRC, or how they could ascertain the creditworthiness of the Major Customer without having its financial statements or any other form of financial information about it.
91. The Respondents also sought to rely on the fact that in 2011, they had taken the initiative to obtain a company search of the Major Customer, purportedly prompted by concerns arising from Ms. Deng's relationship with the Company in 2011, but this was clearly too little, too late.
92. The Auditor raised their concerns about the Major Customer with the Company's management at the meeting on 22 September 2010. According to the minutes of the meeting:-
 - (i) The Company's sales for the financial period were HK\$99.66 million, and the Company's receivables for the financial period were HK\$83.74 million, meaning that most of the revenues generated by the sales had not yet been received.
 - (ii) The receivables due from the Major Customer was HK\$83.59 million, and as at 30 June 2010, HK\$35.81 million of this sum had been outstanding far beyond the agreed payment date.

- (iii) The Company's management made oral representations that they understood the Major Customer's mode of operation and believed that it had the ability to pay. The Company's management also made oral representations that as the Major Customer settled the receivables through non-bank channels, and the PRC government's crackdown on those non-bank channels had slowed the payment process, the Company would consider extending the credit period granted to the Major Customer.
93. The minutes also recorded that the Auditor told the Company's management that it did not know much about the background of the Major Customer, and had requested the provision of more information about the Major Customer.
94. As indicated above, what was requested included information about the Major Customer's shareholders, its business licence and its financial statements, but the Auditor only received the Major Customer's business licence.
95. In the letter from the Auditor to the INEDs of the Company dated 27 September 2010, the Auditor stated: "*As at 30 June 2010, an aggregate amount of HK\$83,587,229 was due from [the Major Customer]. The amount due from [the Major Customer] was equivalent to 45% of the Company's net asset value at the end of the reporting period. Subsequent to the end of the reporting period and up to the date of this letter, only HK\$840,000 of the outstanding balance at 30 June 2010 was settled. Certain amount has been past due for more than 180 days, which has violated the agreement signed between the Company and [the Major Customer]. In addition, we noted that when placing orders for purchase of goods, [the Major Customer] had not followed the payment terms and no deposits were paid as agreed ...*"
96. The Complainant says that unlike the issue over the prepayments, on this issue the letter did not state that the Auditor was eventually provided with more documentation or evidence that gave them the comfort to sign off on the auditor's report, or how the above issues were eventually resolved to the Auditor's satisfaction. The Auditor issued an unqualified opinion on 27 September 2010 albeit with an emphasis of matter drawing attention to the Company's exposure to operation risk and credit risk attributable to the Company's heavy reliance on the Major Customer.
97. As already observed above, an emphasis of matter is only an explanation to enhance the user's understanding of the financial statements, and is not a modification of the Auditor's opinion with respect to the matter emphasised, and does not indicate that the Auditor considered that the matter had not been appropriately presented in the financial statements.
98. More importantly, an emphasis of matter did not mean that the Auditor had conducted their audit of sales to and receivables from the Major Customer properly, and cannot be a substitute for audit procedures that the Auditor should have performed in view of the Company's heavy reliance on the Major Customer and the existence of the aforementioned "red flags".
99. In the Disciplinary Committee's view, the Auditor simply did not know enough about the Major Customer, and did little, if not nothing, to find out more about the Major Customer so as to enable it to properly discharge their audit responsibilities.

100. For each of the 2008, 2009 and 2010 Audits, the Auditor adopted a "standard" audit program and documented in their audit planning that no significant events or unusual transactions were noted, nor any significant risks. The audit documentation reflected an assessment of no risk or low risk. In particular, the Fraud Risk Programs stated on their face that the Auditor considered that there were zero fraud risk factors which it ought to look at during the course of those audits. On the other hand, the Respondents said that what the Auditor actually did was to perform substantive tests of samples covering more than 90% of the sales to the Major Customer. Again, in the Disciplinary Committee's view, this showed that the Auditor actually did appreciate that there were risk factors, but as the substantive tests performed did not effectively address the "red flags" that existed, took inadequate steps to plan and to carry out their audits to address those risks.
101. The fact that the Auditor appreciated that there were risk factors also sits uncomfortably with the explanations which the Respondents sought to advance. For example, the Respondents said that the Company's management had explained that it had confidence that the Major Customer would be able to repay the long outstanding balance, and as such, given that the Company "was agreeable to accept the slow payment of trade receivables", and "had assessed and had confidence in the recoverability of the trade receivables", it was simply a commercial decision of the Company to waive compliance with the payment terms and to grant a longer credit period. The Respondents also said that the explanations provided to them by the Company's management appeared reasonable under the circumstances and was in line with their understanding of the Company's business.
102. The Disciplinary Committee considers that in accepting such rationales, the Auditor did not demonstrate the requisite level of professional scepticism. It was clear that the Company was exposed to the risks of over-reliance on the Major Customer. This was not disputed by the Respondents. But the fact that (i) the Auditor brought the issues to the attention of the INEDs, and (ii) the Auditor included an emphasis of matter in their auditor's report for the 2010 Audit, does not mean that it had done sufficient audit work in relation to assessing the risks of material misstatement of the financial statements.
103. A point was taken by the Respondents that during the 2011 Audit, they became aware that outstanding receivables due from the Major Customer of around HK\$68 million, which had been outstanding as at 30 June 2010, were settled in September 2011. However, as this was not something that occurred during the 2010 Audit, the Disciplinary Committee does not consider that it has any material bearing as to what audit work ought to have been done during the 2010 Audit.
104. It is alleged that the 1st Respondent was in breach of Section 34(1)(a)(vi) of the PAO in that, when carrying out the 2008, 2009 and 2010 Audits, she failed or neglected to observe, maintain or otherwise apply one or more of the following professional standards in relation to revenue and accounts receivables of the Company:-
- (i) Paragraph 15 of HKSA 200
 - (ii) Paragraphs 57, 60 and 110 of HKSA 240
 - (iii) Paragraphs 10, 100 and 101 of HKSA 315

- (iv) Paragraph 23 of HKSA 330
 - (v) Paragraph 2 of HKSA 500
 - (vi) Paragraphs 8 and 17 of HKSA 520
 - (vii) Paragraph 11 of HKSA 500
 - (viii) Paragraphs 11 and 13 of HKSA 700
105. Extracts of the relevant professional standards have been set out in Attachment 1.
- Audit Planning
- Paragraph 15 of HKSA 200
106. Paragraph 15 of HKSA 200 requires an auditor to plan and perform an audit with an attitude of professional scepticism, to avoid the risk of material misstatement to the financial statements.
107. Here, there were clearly risk factors arising from the way in which the Company received orders and payments from the Major Customer which ought to have been addressed in the audit planning.
108. However, as found above, for each of the 2008, 2009 and 2010 Audits, the Auditor adopted a "standard" audit program and documented in their audit planning that no significant events or unusual transactions were noted, nor any significant risks. The audit documentation reflected an assessment of no risk or low risk. In particular, the Fraud Risk Programs stated on their face that the Auditor considered that there were zero fraud risk factors which it ought to look at during the course of those audits.
109. The Disciplinary Committee finds that the Auditor should have been alert to heightened risks when it planned and conducted the 2008, 2009 and 2010 Audits in relation to sales to and receivables from the Major Customer, but failed to plan and perform their audits in a way which would address the risk of material misstatement of the financial statements.
110. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraph 15 of HKSA 200.
- Paragraph 10 of HKSA 315 and Paragraph 8 of HKSA 520
111. It is said that the Auditor failed to properly use analytical procedures at the planning stage in accordance with Paragraph 10 of HKSA 315 and Paragraph 8 of HKSA 520, and specifically that the Auditor did not:-
- (i) develop expectations of the sales to the Major Customer and compare them with the recorded amounts to identify unusual transactions; and
 - (ii) critically analyse the reasons for the significant increases in order to determine the nature, timing and extent of audit procedures.
112. The explanation given by the Respondents was that their expectation of the sales to the Major Customer derived from their understanding of the Company's business model, which explained the significant increase in sales in 2008, 2009 and 2010. However, the Complainant was unable to locate any evidence in the planning section of the audit documentation to indicate that the Auditor had developed their own expectation of the sales to the Major Customer based on their understanding.

113. The Respondents also contended that the significant increase in sales could easily be explained by the commitment of the Major Customer to place purchase orders of HK\$100 million each year. However, it is not plausible that the Auditor would simply base their expectations on the contractual commitment, and actual sales to the Major Customer never reached HK\$100 million in each of the three audit years in question. Actual sales to the Major Customer for the year ended 30 June 2008 (HK\$14.9 million) and for the year ended 30 June 2009 (HK\$47.2 million) were far less than HK\$100 million. Actual sales for the year ended 30 June 2010 were HK\$96.5 million.
114. The Complainant says that the Auditor did not perform audit procedures to investigate why the sales to the Major Customer did not reach the minimum purchase order and whether the minimum purchase order was the valid reason for the significant increase in sales to the Major Customer, and that the Auditor did not take steps during the planning of their audit to assess the risk of material misstatement for revenue.
115. The Disciplinary Committee agrees that the audit procedures adopted by the Auditor were inappropriate given the difference between the minimum purchase order and the actual sales to the Major Customer recorded. The Auditor ought to have developed their own expectations of the sales to the Major Customer with the use of independent data, compared those expectations with the actual sales to the Major Customer recorded, and critically analysed the reasons for the significant increases, so as to verify the veracity of the receivables and the accuracy of the sales figures. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraph 10 of HKSA 315 and Paragraph 8 of HKSA 520.

Paragraphs 100 and 101 of HKSA 315

116. Paragraph 100 of HKSA 315 states that an auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures.
117. Paragraph 101 of HKSA 315 relates to the use of information gathered by the auditor by performing risk assessment procedures as audit evidence to support the risk assessment, and the use of the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.
118. The Complainant says that the Auditor failed to justify the risk of material misstatement for revenue being "low" in the 2008 Audit and the assertion level risk for revenue being "medium" in the 2009 Audit and the 2010 Audit. Specifically, there was insufficient evidence in the audit documentation to support that the "standard" audit program was appropriate to address the significant increases in sales and receivables, and to show that the following factors which could increase the risks of material misstatements at the financial statement level and at the assertion level had been assessed:-
- (i) the revenue from the sales to the Major Customer accounted for over 90% of the Company's revenue, and the significant increases in sales to the Major Customer;
 - (ii) during the years ended 30 June 2009 and 30 June 2010, the trade receivables due from the Major Customer were settled by cash which was directly received by the former directors of the Company or settle by bank cheque issued by a former executive director of the Company;
 - (iii) the trend of the long outstanding trade receivables due from the Major Customer and the Company's extension of the credit period granted to the Major Customer from 60 days to 180 days during the year ended 30 June 2010;

- (iv) during the year ended 30 June 2010, the Major Customer settled the trade receivables without specifying what the settlement was for, and the payments could not be matched with individual sales invoices; and
 - (v) most of the control activities identified by the Auditor for revenue recognition relied on the approval from one of the two key management personnel of the Company.
119. At the AIB investigation stage, an attempt had been made to assert that the Auditor had in fact revised the risk of material misstatement for revenue in the 2008 Audit to "high", and revised the assertion risk for revenue in the 2009 Audit and the 2010 Audit to "high". However, as the Complainant pointed out, this was flatly contradicted by what was stated in the audit documentation. For example, the planning decisions in "Assertion risk and response summary" for the 2009 Audit and the 2010 Audit stated that "*I am satisfied that the planned audit will produce sufficient appropriate audit evidence. In response to the assessed risk of assertion level of revenue is medium and need to reduce the risk to acceptable low level, we assign more experience staff to handle the audit of the assertion of revenue and more supervision of the audit works*" and that "*I have reconsidered specific risks and: no changes are needed.*"
120. The Complainant also says that there was no evidence in the audit documentation that the Auditor had designed and performed audit procedures whose nature, timing and extent were responsive to the "high" risk level.
121. The Respondents sought to maintain that there was nothing unusual or that everything was within their expectation, and that there was no material risk of misstatement in the sales to the Major Customer and the related trade receivables. However, against the background described above, this is simply untenable.
122. In view of the significant concentration of sales to the Major Customer, the unusual method of settlement of trade receivables by the Major Customer, the tenor of the receivables and the extension of the credit period given by the Company to the Major Customer, the Disciplinary Committee agrees that the Auditor ought to have designed and performed additional audit procedures to address the risks of material misstatement in relation to revenue recognition.
123. For example, the Auditor should have performed procedures to develop their own expectation of the sales to the Major Customer and compared that with the recorded amounts, to investigate why the sales to the Major Customer did not reach the minimum purchase amounts, and to address the failure by the Major Customer to follow payment terms, the reasons for slow repayment of the receivables, and the failure by the Major Customer to specify which invoice was being settled when making payment. The Auditor did not do so and thus conducted their audits without adequate audit procedures.
124. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraphs 100 and 101 of HKSA 315.

Consideration of Fraud in Revenue Recognition

Paragraphs 57, 60 and 110 of HKSA 240

125. Paragraph 57 of HKSA 240 requires an Auditor to identify and assess the risks of material misstatement due to fraud.
126. Paragraph 60 of HKSA 240 requires an Auditor to presume that there are risks of fraud in revenue recognition and to assess the risks of material misstatement due to fraud related to revenue recognition.

127. Paragraph 110 of HKSA 240 requires an Auditor to document the reasons for any conclusion that the presumption of risk of fraud in revenue recognition is not applicable.
128. As found above, the Fraud Risk Programs for each of the 2008, 2009 and 2010 Audits stated that the Auditor considered that there were zero fraud risk factors.
129. The Disciplinary Committee has found that the Auditor ought to have been alert to heightened risks when it planned and conducted the 2008, 2009 and 2010 Audits in relation to sales to and receivables from the Major Customer, but failed to plan and perform their audits in a way which would address the risk of material misstatement.
130. For these reasons, as the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraphs 57, 60 and 110 of HKSA 240.

Tests of Controls

Paragraph 23 of HKSA 330

131. Paragraph 23 of HKSA 330 states that an auditor should perform tests of controls where their assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, to obtain sufficient appropriate audit evidence that the controls are operating effectively.
132. The Respondents said that Auditor had checked the Company's vouchers, which attached the sales invoices and the goods delivery notes bearing the chop of the Major Customer acknowledging receipt of goods, as the control activity in relation to sales. The Disciplinary Committee accepts what the Respondents have said in this regard, and does not consider that it has been proven that the Auditor failed to perform tests of controls to check that the controls were operating effectively.
133. Accordingly, there was no breach of Paragraph 23 of HKSA 330 by the 1st Respondent.
134. That having been said, it should be emphasised that the Auditor's checking of the Company's vouchers was only a validation of a particular control activity in relation to sales, which was not a control for assessing recoverability of the receivables due from the Major Customer from a credit control perspective.

Substantive Procedures

Paragraph 2 of HKSA 500, Paragraph 17 of HKSA 520 and Paragraph 11 of HKSA 550

135. Paragraph 2 of HKSA 500 states that an auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
136. Paragraph 17 of HKSA 520 states that when analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative audit evidence.
137. Paragraph 11 of HKSA 550 states that the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties.
138. The Complainant says that the Auditor:-
 - (i) did not follow the procedures stated in the "Sales – Model Audit Program" for the 2008, 2009 and 2010 Audits;

- (ii) did not follow the procedure set out in the audit programs to "agree the sales invoice prices to a price list" for the audit samples selected;
- (iii) did not verify, for the audit samples selected, whether the corresponding goods delivery notes were signed by the Major Customer to acknowledge the receipt of goods;
- (iv) did not perform audit procedures to verify the accuracy of the aging analysis of trade receivables as at 30 June 2008, 2009 and 2010;
- (v) did not state in the audit working papers what documents they had checked for the subsequent settlements of trade receivables from the Major Customer in the 2008 Audit and the 2009 Audit;
- (vi) should have been aware that certain settlements of trade receivables due from the Major Customer of HK\$22.4 million were made by a former executive director of the Company during the year ended 30 June 2010, which indicated an unusual relationship between the Company and the Major Customer, but no additional audit procedures were performed to address this issue;
- (vii) failed to obtain sufficient appropriate audit evidence in the 2008, 2009 and 2010 Audits to support the revenue recognition in respect of sales of goods to the Major Customer and the recognition of related trade receivables;
- (viii) failed to perform the analytical review with an attitude of professional scepticism to verify the unusual fluctuation of sales to the Major Customer and the relationship between the Company and the Major Customer, in light of the trend of long outstanding receivables and the extension of the credit period to the Major Customer against the increase in sales to the Major Customer
- (ix) failed to perform audit procedures to support that the Major Customer was not a related party of the Company; and
- (x) failed to obtain, other than the business licence of the Major Customer, information relating to the Major Customer from the Company's management during the 2010 Audit, or to perform alternative audit procedures to resolve the issue.

139. Based on the evidence before it, the Disciplinary Committee considers that:-

- (i) the allegations summarised in paragraph 138(iii) and (iv) above were not proved, as the Disciplinary Committee accepted that (a) the Auditor had verified that the sampled goods delivery notes were signed by the Major Customer to acknowledge the receipt of goods, and (b) the Auditor prepared the aging analysis of trade receivables as at 30 June 2008, 2009 and 2010; and
- (ii) the remaining allegations summarised in paragraph 138 have been proved.

140. In respect of the allegation referred to in paragraph 138(iv), the Respondents explained in their oral submission that the aging analysis had been prepared by their staff during their audits and consequently did not need to be tested (as would have been the case had it been a document prepared by the Company). This was accepted by the Complainant.

141. The Disciplinary Committee agreed with the Complainant in respect of the other allegations set out in paragraph 138. Although the Respondents provided additional explanations of audit work papers and drew the attention of the Disciplinary Committee to audit work papers which they said provided additional substantive evidence, the

Disciplinary Committee concluded that the Auditor failed to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinions. The Disciplinary Committee also agreed with the Complainant that, because of the deficiencies noted in paragraph 138, the Auditor failed to investigate and obtain adequate explanations and appropriate corroborative audit evidence for significant fluctuations or relationships identified by analytical procedures and failed to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties.

142. The Auditor committed breaches of Paragraph 2 of HKSA 500, Paragraph 17 of HKSA 520 and Paragraph 11 of HKSA 550. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraph 2 of HKSA 500, Paragraph 17 of HKSA 520 and Paragraph 11 of HKSA 550.

Basis of Forming An Opinion

Paragraphs 11 and 13 of HKSA 700

143. It is alleged that the Auditor failed to obtain sufficient appropriate audit evidence to support the conclusions reached in respect of sales to the Major Customer and the related trade receivables in the 2008, 2009 and 2010 financial statements.
144. Paragraph 11 of HKSA 700 requires an auditor to evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion of the financial statements. Given that the Disciplinary Committee has already found, as stated above, that the Auditor had not obtained sufficient audit evidence in many areas of the audits, it follows that the Disciplinary Committee is satisfied that there has been a breach of Paragraph 11 of HKSA 700.
145. Paragraph 13 of HKSA 700 says that forming an opinion as to whether the financial statements give a true and fair view involves evaluating whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures.
146. In addition, paragraph 13 of HKSA 700 requires the auditor to evaluate whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures, and specifically (amongst other things), whether
- (i) the accounting estimates made by management are reasonable;
 - (ii) the information presented in the financial statements is relevant, reliable, comparable, and understandable; and
 - (iii) the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events.
147. For the reasons stated above, in respect of the sales to the Major Customer and related trade receivables in 2009 and 2010, the Auditor did not make the appropriate evaluation of one or more of the requirements under Paragraph 13 of HKSA 700.
148. As the engagement director of the relevant audits, the 1st Respondent was in breach of Paragraphs 11 and 13 of HKSA 700.

Conclusion

149. In conclusion, the Disciplinary Committee has found that the 1st Respondent had failed or neglected to observe, maintain or otherwise apply a number of professional standards in relation to sales to and receivables from the Major Customer. The 1st Respondent has breached Section 34(1)(a)(vi) of the PAO.

Complaint 3

150. Professional misconduct can arise in many different ways and there is no exhaustive definition of what conduct would constitute professional misconduct.
151. The Complainant says that on the authorities, the term simply means any act which has fallen below the standard of conduct which is expected of members of the profession.
152. It is alleged that the 1st Respondent's multiple audit failures constituted professional misconduct under Section 34(1)(a)(viii) of the PAO.
153. The Complainant says that during the 2008, 2009 and 2010 Audits, there were many "red flags" which would have prompted any reasonable auditor to view the risk factors as unusual.
154. The Disciplinary Committee has found that the 1st Respondent has committed multiple breaches of professional standards under Complaints 1 and 2, involving at the audit planning stage a lack of proper assessment of the risk factors that could increase the risks of material misstatements, and, in carrying out substantive audit procedures, the failure to carry out appropriate and sufficient audit procedures which could address the specific audit risks in this case.
155. The Disciplinary Committee has in particular borne in mind the fact that the risk indicators were present throughout the 2008, 2009 and 2010 Audits, and that in addition to performing inadequate work in various aspects of those audits, and despite the unsatisfactory responses received by the Auditor when it raised their concerns with the Company's management towards the tail-end of the 2010 Audit, the Auditor still did not perform additional procedures to address the risks thrown up by those concerns, but proceeded to issue an unqualified opinion on the 2010 financial statements with only an emphasis of matter paragraph added. Such conduct, in the Disciplinary Committee's view, clearly did fall below the standard of conduct which is expected of members of the profession.
156. The 1st Respondent was the engagement director of the relevant audits, and the Disciplinary Committee finds that the 1st Respondent's conduct did amount to professional misconduct under Section 34(1)(a)(viii) of the PAO.

The 2nd Respondent

157. The 2nd Respondent faces Complaints 4 and 5.

Complaint 4

158. An engagement quality control review is an important required component of an audit firm's overall audit process. The purpose is to provide an objective evaluation of the

significant judgments made, and of the conclusions reached by the auditor, so as to ensure overall audit quality.

159. Complaint 4 is concerned with the role of the 2nd Respondent as the EQCR for the 2008, 2009 and 2010 Audits. It is alleged that the 2nd Respondent was in breach of Section 34(1)(a)(vi) of the PAO in that, as EQCR of the 2008, 2009 and 2010 Audits, he failed or neglected to observe, maintain or otherwise apply the following professional standards:-
- (i) Paragraph 23 of HKSA 230; and
 - (ii) Paragraphs 38 and/or 39 of HKSA 220.
160. Much of the factual background and the findings of fact set out above are relevant to Complaint 4, and as such will not be repeated.
161. The Complainant says that the 2nd Respondent did not sign or date the Engagement Quality Control Review Worksheet for any of the 3 audit years, and did not sign or date the Engagement Quality Control Review Risk Tolerance Worksheet for the 2008 and 2009 Audits. It was acknowledged by the 2nd Respondent that he had not signed the worksheets.
162. The Complainant says that given the 2nd Respondent failed to record his performance of his reviews and the completion dates of his reviews, he was in breach of Paragraph 23 of HKSA 230. The Disciplinary Committee agrees, and finds that the 2nd Respondent was in breach of Paragraph 23 of HKSA 230.
163. The Complainant also says that there was no evidence in the worksheets to show that the 2nd Respondent had selected the relevant audit documentation to review and assess whether the work performed by the engagement team in relation to the significant issues on prepayments and sales/trade receivables was sufficient and appropriate to support the conclusions reached.
164. In particular, it was said that the EQCR had failed to identify the significant increase in the prepayments to the Major Customer and the Three Suppliers, the sales to the Major Customer and the related trade receivables as risky areas at the planning stage of the 2008, 2009 and 2010 Audits in the Engagement Quality Control Review Worksheet, which stated that there was no risk of material misstatement and that potential fraud risks had been identified. The Complainant says that this adversely impacted on the design of the audit procedures to be responsive to the risks of material misstatement.
165. The Complainant also says that during his engagement quality control review, the 2nd Respondent should have, in light of the significant increase in trade receivables from the Major Customer coupled with the significant increase in sales to the Major Customer, requested the audit team to perform additional audit procedures to obtain adequate explanations and appropriate corroborative audit evidence to support the sales transactions with the Major Customer. The Disciplinary Committee has already found above that no such additional audit procedures were performed by the Auditor.
166. It is said that consequently, the 2nd Respondent failed to perform an objective evaluation of the significant judgments made by the audit team and their conclusion that there was

no significant risk of material misstatements in relation to prepayments and sales/trade receivables, and did not properly perform the engagement quality control reviews for the 2008, 2009 and 2010 Audits, in breach of Paragraphs 38 and 39 of HKSA 220.

167. The only answer which the 2nd Respondent was able to give was to assert that he sat closely to the audit team and was in constant communication with them in relation to audit issues, such that his comments and concerns had been addressed by the audit team and any audit work required would have been reflected in the audit working papers.
168. The Disciplinary Committee has already found above that there were a significant number of failings in the 2008, 2009 and 2010 Audits, both in terms of the planning of the audits and the way in which the audits were carried out and documented. These failings showed that the Auditor failed to recognise the risk of material misstatement and potential fraud risks, and to design and carry out audit procedures to be responsive to those risks.
169. That being the case, the Disciplinary Committee has little hesitation in finding that the 2nd Respondent did not properly perform the engagement quality control reviews for the 2008, 2009 and 2010 Audits, which contributed to the significant number of failings in the 2008, 2009 and 2010 Audits in terms of the planning of the audits and the way in which the audits were carried out and documented, and that the 2nd Respondent was in breach of Paragraphs 38 and 39 of HKSA 220.

Complaint 5

170. Relying on the same matters as alleged against the 1st Respondent, the Complainant alleges that the 2nd Respondent's multiple failures constituted professional misconduct under Section 34(1)(a)(viii) of the PAO.
171. The Disciplinary Committee has found that the 2nd Respondent has committed multiple breaches of professional standards in relation to his role as EQCR, which contributed to the significant number of failings in the 2008, 2009 and 2010 Audits in terms of the planning of the audits and the way in which the audits were carried out and documented.
172. Those failings involved at the audit planning stage a lack of proper assessment of the risk factors that could increase the risks of material misstatements, and in carrying out substantive audit procedures, the failure to carry out appropriate and sufficient audit procedures which could address the specific audit risks in this case. The risk indicators were present throughout the 2008, 2009 and 2010 Audits, but the Auditor issued unqualified opinions in each of those audit years.
173. The 2nd Respondent was the EQCR of the relevant audits and served an important function in the audit process to ensure overall audit quality. However, the 2nd Respondent did not properly perform the engagement quality control reviews for the 2008, 2009 and 2010 Audits, which as indicated above contributed to the significant number of audit failures found.
174. The 2nd Respondent's conduct, in the Disciplinary Committee's view, did fall below the standard of conduct which is expected of members of the profession.

175. Accordingly, the Disciplinary Committee finds that the 2nd Respondent did commit professional misconduct under Section 34(1)(a)(viii) of the PAO.

Directions

176. The Complainant shall file written submissions on the appropriate sanctions and costs within 28 days of service of this Decision.
177. The Respondents shall file written submissions in response to the Complainant's submissions on sanctions and costs within 28 days of service of the Complainant's submissions.
178. The parties are at liberty to apply for any further directions in writing to the Disciplinary Committee within 14 days of service of the Respondents' submissions.

Mr. Kaung Wai Ming Alexander

Chairman

Mr. Donowho Simon Christopher

Member

Ms. Chan Yiting Bonnie

Member

Mr. Copley Simon Charles

Member

Mr. Doo William Junior Guilherme

Member