Proceedings No.: D-19-1514 F

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 ("**HKICPA**")	COMPLAINANT
AND	
ZHONGHUI ANDA CPA Limited (M0282)	FIRST RESPONDENT
Mr. Sze Lin Tang, CPA (A14573)	SECOND RESPONDENT

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

Members: Ms. DOE, Julianne Pearl (Chairman)
Mr. CHU, Kin Wing
Mr. FAN, Hoi Kit
Mr. IP, Chiu Yin
Mr. BAO, King To, Raymond

Date of Hearing: 14 June 2022

REASONS FOR DECISION

1. These Reasons for Decision refer to a complaint made by the Registrar of the Hong Kong Institute of Certified Public Accountants as Complainant (the "**Institute**" or "**Complainant**") against ZHONGHUI ANDA CPA Limited (the "**First Respondent**") and Mr. Sze Lin Tang, a certified public accountant (the "**Second Respondent**" and together with the First Respondent, the "**Respondents**"). Section 34(1)(a)(vi) of the PAO applied to the Respondents for their failure or neglect to observe, maintain or otherwise apply professional standards.

2. The particulars of the complaint are set out in a letter from the Registrar of the Institute dated 7 September 2020 addressed to the Council of the Institute (the "**Complaint**").

BACKGROUND

3. The First and Second Respondent were the auditor and the engagement quality control reviewer ("**EQCR**") respectively for the audit of the consolidated financial statements of Ko Yo Chemical (Group) Limited (a company whose shares are listed on The Stock Exchange of Hong Kong Limited (stock code: 00827) (the "**Company**") and its subsidiaries (collectively the "**Group**") for the year ended 31 December 2015 ("**2015 Financial Statements**"). The Group incurred a loss of RMB 106.3 million for the year 2015. As the auditor (at the time) of the Company, the First Respondent issued an unmodified audit opinion on the 2015 Financial Statements with an emphasis on matter on the existence of a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern. Mr. Ng Ka Lok[1] was the engagement director and the Second Respondent was the engagement quality control reviewer ("**EQCR**").

[1] Mr. Ng Ka Lok passed away in November 2019.

4. On 4 July 2019, the Financial Reporting Council referred to the Complainant an Investigation Report of the Audit Investigation Board ("**AIB**") concerning the audit of the **2015 Financial Statements** of the Group.

The AIB found the First Respondent to have failed a number of Hong Kong Standards on Auditing ("**HKSA**") in relation to:

(a) the initial recognition and subsequent measurement of a put option granted to the Company by a substantial shareholder ("**Put Option**"); and

(b) the impairment assessments of two cash-generating units ("**CGUs**").

5. The Group's main business was the manufacturing and sale of chemical products and chemical fertilizers. The plants (the Dazhou Plant and Guangan Plant, collectively as the "Plants") for manufacturing these products were the two CGUs of the Group. The First Respondent performed impairment assessment on them during the audit. The two plants were the only source of income of the Group. The Chairman of the Company stated, inter alia, in the 2015 Financial Statements as follows: -

"In 2015, the economic growth of China continued to slow down. The problem of overcapacity of the chemicals and chemical fertilizer industries in China has not yet been improved while the costs of raw materials remained high. Both sale volumes and selling prices of products dropped to a level that the selling prices were significantly lower than the costs of raw materials.....

During the period of review, the ammonia and urea synthesis facilities of Dazhou Plant of the Group maintained stable operation. The unit energy consumption of ammonia synthesis facilities of Dazhou Plant in the first half of the year decreased by 15kg standard coals on average, a new record low. The methanol and purge gas facilities of Gaungan Plant reached their designed production capacity within a relatively short period. Sales revenue from OEM and trading business increased by 15% as compared to last year in line with business growth. However, product costs further increased due to high natural gas price and the restoration of VAT of 13% on urea effective from 1st September 2015. In order to minimize the losses, the Company mitigated the market risk by temporary suspension of production, resulting in a serious low utilization of Dazhou Plant and Guangan Plant.

In addition, the market and demand for all the downstream market were weak and both sale volumes and selling prices of products fell when international crude oil price plunged and excessive supply in the industry and other unfavourable economic factors remained. The selling prices of liquid ammonia, urea and methanol for the year decreased by approximately RMB 450 per tonne, RMB 250 per tonne and RMB 800 per tonne respectively, resulting in a significant decrease in the operating results of the Company with substantial losses, which fell short of the operation targets.

During the period of review, due to the unfavourable economic conditions, prolonged weak chemical fertilizer and chemical markets and delayed funding arrangement, the Group slowed down the progress of new projects. Installation of facilities of new projects was yet to complete.....

[...] Suspension of the 2nd Phase of the Project of Urea and Melamine Dazhou

Due to high raw materials costs and suppressed selling prices of urea and melamine, the Group has suspended the construction of the project. Administrative approval of the project has been completed and construction of such project will resume when market conditions improve."

(Hereinafter called **"Statements"** collectively)

Based on the Statements, the Complainant embarked on an investigation of the conduct of the Respondents.

THE PROCEEDINGS

6. A Disciplinary Committee was constituted under section 33 (3) of the PAO and a Notice of Commencement of Proceedings was issued on 5 November 2020.

On 9 November 2020, the Complainant sought an extension of time of approximately one month to file its Case. The extension of time was granted on 13 November 2020 and the Complainant filed its Case on 14 January 2021.

On 5 February 2021, the Respondents sought a seven-week extension of time to file their Case. The extension of time was granted on 11 February 2021 and the Respondents filed their Case on 8 April 2021.

The Complainant and the Respondents filed their Reply on 30 April 2021 and 21 May 2021 respectively.

During the course of the proceedings, one of the members of the Disciplinary Committee, Mr. Chu Kin-wing, has stepped down from the Committee and re-joined the Committee on 15 July 2021. Another Disciplinary Committee member, Mr. Chiu Ling Cheong, Anthony has stepped down and Mr. Fan Hoi Kit was appointed as a Committee member as a replacement on 15 July 2021.

The parties were directed to attend the substantive hearing on 11 and 12 January 2022.

On 11 January 2022, the substantive hearing was adjourned because the Second Respondent did not attend due to medical reasons. The 2nd day of the hearing scheduled on 12 January 2022 was also vacated. A full-day hearing was then fixed to be held on 9 February 2022, with the morning of 12 February 2022 reserved.

The hearing was subsequently adjourned to 14 June 2022 due to severe outbreak of COVID. The hearing was held on 14 June 2022.

On 31 January 2023, the term of office of Mr. Chu Kin-wing as a Disciplinary Panel member expired.

THE COMPLAINTS

7. There are three complaints. The main complaint in the case is that the Respondents placed unreasonable reliance on the representation of the client's management without making sufficient inquiry into the basis of such representations as an ordinary auditor.

   a) **First Complaint ("Complaint 1")** - By section 34(1AA) of the PAO, section 34(1)(a)(vi) applies to the First Respondent for their failure or neglect to observe, maintain or otherwise apply professional standards in the audit of the 2015 Financial Statements in respect of the Put Option.

   b) **Second Complaint ("Complaint 2")** - By section 34(1AA) of the PAO, section 34(1)(a)(vi) applies to the First Respondent for their failure or neglect to observe, maintain or otherwise apply professional standards in the audit of the 2015 Financial Statements in respect of the impairment assessments.

   c) **Third Complaint ("Complaint 3")** - Section 34(1)(a)(vi) of the PAO applies to the Second Respondent because he, as the EQCR, failed or neglected to observe, maintain or otherwise apply a professional standard in the audit of the 2015 Financial Statements.

Complaint 1 relates to the accounting treatment and audit procedures with respect to Put Option. Complaint 2 concerns whether sufficient appropriate audit evidence was obtained for impairment assessment of the Plants. Complaint 3 concerns the Second Respondent's EQC Review.

THE COMPLAINANT'S CASE RELATING TO COMPLAINT 1

8. After investigation, the Complainant concluded the following with regard to the First Respondent: -

The First Respondent failed to comply with a number of HKSAs regarding the initial recognition and subsequent measurement of the Put Option by the Put Option Agreement dated 18 January 2015 at a consideration of HK$1. Under the Agreement, the Company was entitled to require the substantial shareholder to subscribe on one or more occasions during the period of three years for the convertible bonds ("**CBs**") with an aggregate principal amount of up to HK$ 1,440 million. The Put Option was classified by the Company as a "derivative financial asset" with a carrying amount of RMB 214.8 million based on a valuation at the year-end date. The Company recognised the entire amount of difference between the price of the Put Option i.e. HK$1 and its fair value of RMB 214.8 million as at 31 December 2015 in its profit or loss.

(A) Risk Assessment

The First Respondent failed to identify any specific risk arising from the Put Option in accordance with paragraph 25 of Hong Kong Standards on Auditing ("HKSA") 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.* It therefore failed to properly design and implement responses to address any risks of material misstatement relating to the Put Option at the financial statement and assertion levels, in breach of paragraphs 5 and 6 of HKSA 330 *The Auditor's Responses to Assessed Risks.*

Particulars

Procedures performed by the First Respondent including requesting the Company to engage an external valuer were insufficient. Such procedures only comprised the valuer's representations. There was no evidence that the representations were looked at.

(B) Initial and year-end assessment

According to paragraphs 43, 46 and 55 of Hong Kong Accounting Standard ("HKAS") 39 *Financial Instruments: Recognition and Measurement*, the Put Option should be measured at fair value at initial recognition and any subsequent changes in fair value in profit or loss. The First Respondent was in breach of paragraph 15 of HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* and paragraph 18 of HKSA 540 *Auditing Accounting Estimates and Related Disclosures* relating to planning and performing audit work with professional scepticism and evaluation of whether the accounting estimates were reasonable.

Particulars

The Respondents took HK$1 as the fair value at initial recognition rather than by a valuation technique. They have argued that the issue relates to whether the initial fair value gain should be recognised in the profit or loss, but have not addressed the need to make an initial recognition clearly.

(C) Inadequate work regarding year-end valuation of the Put Option at RMB 214.8 million

Inadequate work was carried out regarding year-end valuation of the Put Option at RMB 214.8 million. There were breaches of paragraph 8 of HKSA 500 *Audit Evidence*, paragraph 18 of HKSA 540, and paragraph 15 of HKSA 200.

Particulars

The CBs were treated as a single convertible bond. There was no evidence that multiple issuance was considered. The valuation was based on historical volatility. There is no evidence of the basis of adopting historical volatility for assessing future volatility, nor that the First Respondent had considered the dilution effect on the share price upon conversion of the CBs. There was no evaluation on the financial capability of the Subscriber. The Respondents' case is that the engagement team had properly assessed the valuation report and had properly performed certain audit procedures, but none of the explanations were documented in any of the audit working papers.

(D) Failure to disclose information
Under Hong Kong Financial Reporting Standard ("HKFRS") 7 *Financial Instruments: Disclosures* and 13 *Fair Value Measurement*, certain items of information are required to be disclosed where certain assets are classified for level 2 and level 3 measurement. Changes from level 3 to level 2 illustrate the Respondents' problematic performance, and irrespective of being level 2 or 3, the Respondents needed to make disclosure under professional standards. There were breaches of paragraph 20 of HKSA 540 and paragraph 13 of HKSA 700 *Forming an Opinion and Reporting on Financial Statements*.

Particulars
In the 2015 Financial Statements, the derivative financial assets balance including the Put Option was categorised as level 3. Under HKFRS 7 and 13, certain items of information were required to be disclosed for level 3. There was no such disclosure of such items. The carrying amount of the Put Option as at 31 December 2015 and the difference of RMB 214.8 million represented a significant portion of the Group's net assets and significantly reduced the net loss for the year. Such non-disclosure would significantly affect the ability of users to understand and appraised the financial position of the Group. The Respondents acted that the Put Option should have been stated as level 2 and certain disclosures should have been expressly made in the 2015 Financial Statement, but that their omissions were minor and did not affect the Respondent's audit opinion.

(E) Documentation
The Respondents had not documented, or insufficiently documented two types of information relating to the Put Option, in breach of paragraph 8 of HKSA 230 *Audit Documentation*.

THE COMPLAINANT'S CASE RELATING TO COMPLAINT 2

9. After investigation, the Complainant concluded the following in relation to the impairment assessment with regard to the First Respondent: -

(A) Risk Assessment
The First Respondent had not properly identified and assessed, or failed to identify and assess the risk of material misstatements at the financial statement and assertion levels from the Statements, in breach of paragraph 25 of HKSA 315. Because of this failure or improper identification or assessment, it follows that the First Respondent had failed to properly design and implement responses to address the assessed risk of material misstatement at the financial statement and assertion levels, in breach of paragraphs 5 & 6 of HKSA 330.

Particulars
In the First Respondent's Detailed Risk Assessment checklist, the risk assessment of the business operations of the Company which heavily relied on particular products or services was identified as low. Also identified as low risk therein was related to the determining of fraud and error of account balances with high degree of judgement.

(B) Lack of Sufficient Evidence of Profit Forecast Periods
The First Respondent had not critically or adequately assessed the reasonableness of the profit forecast periods of 15 years for the Dazhou Plant and 21 years for the Guangan Plant with supportable evidence, including evidence of a proper evaluation of the remaining estimated useful lives of these two plants.

Particulars
The assessments made by the First Respondent lacks evidence to indicate or tell whether the forecast periods of 15 years for the Dazhou Plant is appropriate. It is also uncertain if it had inappropriately included the estimated cash in-or-out flows of the replacement of new plant for Dazhou Plant, which is prohibited under paragraph 44 of HKAS 36 *Impairment of Assets*, or whether the First Respondent had taken account of the estimated cash flows by constructing new plant for Dazhou Plant in their assessments.

Regarding the useful life of 21 years for the Guangan Plant, the First Respondent's assessment was based on the fact that the plant was a new plant and also that a site visit was carried out by its engagement director. It was argued that such assessment was therefore reasonable. The Complainant asserts that such basis of assessment is insufficient and inadequate.

(C) Lack of Sufficient Audit Evidence of Re-commencement of Production
The First Respondent had not questioned what actions the Company might have taken following the temporary suspension of the Plants and the basis of their expectation of why and when they would re-commence production, in light of the asserted statements of the Company that the suspension was due to weak economy and decrease in demand of the Group's products; and that the drop in the price of natural gas and increase in oil price were unrelated to the recovery of economy or increase in the demand of the Group's products.

Particulars
The First Respondent should have sought audit evidence to support or verify the Company's statement that the Company expected increase in selling price and demand of the Group's products.

(D) Lack of Sufficient Audit Evidence of Profit Estimations
The First Respondent had not considered actual product demand. Accordingly, the profit estimations for the periods from 2016 to 2018 and from 2019 onwards, and the profit ratios from 23% to 31.5% for the Dazhou Plant and 26.4% to 37.5% for the Guangan Plant (based on their annual compound growth rates of 4% and 3% respectively), were not reasonable because the Company incurred loss in the 2015 Financial Statement (but not previously). This is especially so since previously, the historical profit ratios had been declining (from 24% in 2012 to 0.9% in 2014), and also given the unfavourable economic conditions revealed in the 2015 Financial Statement.

Particulars
The profit margin was estimated at 23% for Dazhou Plant in the forecast from May 2016 to 2018 and at 26.4% for Guangan Plant from June 2016 to 2018, despite the actual market demand represented by the Company's management that it was declining.

The First Respondent should have questioned this area. Instead, it only searched the internet to find the market prices, but failed to seek any signed or negotiated future sales contracts regarding the selling prices.

The profit margin was estimated at 23.8% to 31.5% for Dazhou Plant in the forecast from 2019 to 2030/2035 and at 27% to 37.5% for Guangan Plant from 2019 to 2030/2035. Such growth rates had not been displayed historically. In 2014, the gross profit was RMB11.8M and the gross profit ratio was 0.9%. In 2013, the gross profit was RMB137M and the gross profit ratio was 10%. In 2012, the gross profit was RMB327.2M and the gross profit ratio was 24% (NB: in 2015, it was RMB(27.4)M with the gross profit ratio being inapplicable). Hence, the First Respondent failed to perform critical independent analysis and evaluation of the reasonableness of the expected growth rate and profit margins.

(E) Lack of Sufficient Audit Evidence of Construction in Progress
The First Respondent had not obtained audit evidence supporting the conclusion that the construction in progress of the new Dazhou Plant was not impaired when the construction had been suspended, in breach of paragraphs 9 & 12 of HKSA 36 where the need for impairment assessment arose when there is an indication that an asset may be impaired.

(F) Lack of Sufficient Audit Evidence of Discount Rate of 12% adopted by the First Respondent's appointed Expert Valuer
The First Respondent had not considered whether the five listed companies compared by the First Respondent's expert valuer were indeed comparable to the Company in terms of their size, business nature and related operations, thus appropriate (or not appropriate) to determine the debt and equity weighting (cost of debt and costs of equity), or thus suitable for use as reference.

Particulars
Only 4 ticks were made in the discount rate calculation worksheet without any explanation. Only one comment was recorded as follows: "As per Elvis, the director of Access Partner, the WACC is post-tax." It is not known as to what matters had been checked or what exactly had been done.

The First Respondent had not considered the relevance, completeness and accuracy of the source data adopted by the First Respondent's expert valuer in arriving at the costs of debt and costs of equity, and had not considered the date of the annual financial statement in 2015 (year ended 31 December 2015) and the date of valuation with calculation worksheet (dated 30 March 2016), thus calling into question the accuracy and reliability of the use of the data and values opined by its expert valuer.

There is no evidence of noting or considering of the discrepancies between 31 December 2015 and 30 March 2016 and of relying on the expert's valuation report and opinion.

There is no evidence of proper evaluation of the work of the First Respondent's expert's opinion deriving the 12% discount rate, in breach of paragraph 12 of HKSA 620 *Using the Work of an Auditor's Expert.*

10. After receiving responses from the First Respondent, the Complainant further alleged that there was lack of audit documentation on the part of the First Respondent, in particular the First Respondent's failure to prepare sufficient audit documentation regarding the First Respondent's checklist and calculation worksheet on their audit work done (if any).

11. As regards the Complainant's allegation of the First Respondent's lack of sufficient appropriate evidence stated in the above paragraphs 9(B) to (F), the Complainant says that overall speaking, the First Respondent has breached the following standards:

(i) Paragraph 15 of HKSA 200 (professional skepticism);
(ii) Paragraphs 6 & 7 of HKSA 500;
(iii) Paragraphs 15, 17 & 18 of HKSA 540; and
(iv) Paragraphs 12 & 13 of HKSA 700 *Forming an Opinion and Reporting on Financial Statements.*

THE COMPLAINANT'S CASE RELATING TO COMPLAINT 3

12. The issues identified under Complaints 1 and 2 involved significant judgement, and were in fact identified as issues concerned in the audit planning memorandum and discussed in the audit kick-off meeting attended by the Second Respondent. It was reasonable to assume that the Second Respondent would have reviewed these issues with care. However, there is no evidence as to what the Second Respondent did to discharge his duties as EQCR or what he discussed with the engagement team, in breach of paragraph 20 of HKSA 220 *Quality Control for an Audit of Financial Statements.*

THE FIRST RESPONDENT'S CASE IN RELATION TO COMPLAINT 1

13. (A) Risk Assessment
The accuracy and appropriateness of the Put Option was identified as one of the accounting and audit issues. The procedures performed were proportionate to a "high risk" area.

(B) Initial and year-end assessment
All fair value gain must be recognised in the profit or loss.

(C) Inadequate work regarding year-end valuation of the Put Option at RMB 214.8 million
The expert valuer is a reputable valuer and the valuation methodologies are entirely reasonable. From an auditor's perspective, there is no basis to challenge the valuer's methodologies, which are consistent with the First Respondent's understanding of standard valuation principles. The Complainant has not adduced authorities to support its criticisms.

(D) Failure to Disclose information

The Respondents accept that level 2 disclosures should have been made (disclosing descriptions of the valuation techniques and inputs used, and the nature and extent of risks associated with the Put Option), but such omission is a minor issue as it does not affect the audit opinion and the true and fair view on the 2015 Financial Statements as a whole.

(E) Documentation

Other than the admitted omission of the level 2 disclosure, the Complainant has not established any other deficiency of the Respondents' documentation. The Respondents could not have foreshadowed all of the Complainant's allegations and documented their responses.

THE FIRST RESPONDENT'S CASE IN RELATION TO COMPLAINT 2

14. The First Respondent asserts that it had conducted the impairment assessments on the Dazhou Plant and Guangan Plant, and that such assessments were appropriate and supported by sufficient appropriate audit evidence particularly in relation to the forecast period, profit estimates and discount rate. In gist: -

(A) Risk Assessment

a) The risk assessment is supported by audit planning memorandum, audit kickoff meeting minutes, and a detailed risk assessment checklist in which the valuation of the two plants were assessed as high risk.

b) Detailed and comprehensive substantive audit procedures were performed by the First Respondent, who had treated impairment assessment as a significant audit issue and as of "high risk".

(B) Forecast Periods/useful lives

c) The First Respondent had used professional judgment, experience and understanding about the Group's business. It had performed audit procedures and site visit in order to check production capacity and the plants' conditions, review the status of construction project in Dazhou. The First Respondent then concluded that the estimated useful lives were appropriate.

d) The Dazhou project was related to construction of new plant, not replacement of old plant. The existing plant had been used for 10 years. So the remaining useful life of 15 years after completion of construction was reasonable, as it would enhance productivity and improve equipment and extend useful life of the existing plant.

e) The Guangan Plant was a new plant and reasonably expected to last longer with longer remaining useful life.

f) Due to the discount rate of 12%, the length of the forecast period does not materially change the valuation and affect the impairment assessment.

(C) Re-commencement of Production

g) The Group incurred a loss in 2015. Suspension of production was due to the high price of natural gas. However, both plants were operational and incurred no further or additional costs in order to resume operation.

h) Audit procedures were performed including performing research on natural gas prices and reviewing underlying supporting documents.

i) Invoices issued by suppliers were considered. They showed that natural gas price had dropped before March 2016. A draft agreement showed that the agreed natural gas price from May 2016 would continue to drop.

j) Further independent research shows that the PRC government had at the time made substantial investments in natural gas, namely construction of the West-East Gas Pipeline. It would result in supply, and hence, was expected to have an effect of decreasing the price of natural gas.

k) The First Respondent thus agreed with the management that natural gas price would likely drop. It was dropping at the time when the audit was being signed by the First Respondent.

l) The First Respondent did not agree that suspension of production was due to the weak economy and reducing demand of the Group's products, but rather due to high costs of raw materials (natural gas) in 2015. External research was conducted on the expected increase in demand and selling prices of the products by reviewing authoritative reports such as publications by the International Energy Agency and industry analysis reports. The market size of the chemical fertilisers' products was expected to increase by more than 3%. Hence, the First Respondent believed the two plants would resume operation after a decrease in natural gas prices and accordingly, the Company's profit estimate/profit forecast was made based on this assumption. The assumed operations in 2016 did in fact occur in 2016.

(D) Profit Estimate

m) The forecast for profit for next three years (2016-2018) that assumed no changes to underlying prices and costs and 4% growth on sales and 3% on costs was not ambitious and did not look unreasonable to the First Respondent.

n) The forecast percentages were reasonable because natural gas prices were likely to drop according to the PRC government policies on natural gas (including the West-East Pipeline Plan) and draft agreement between the Company and a supplier of natural gas, and review of the latest invoices issued by suppliers of natural gas. As regards the forecasted increase in selling prices, the First Respondent conducted and reviewed research materials including that of the International Energy Agency and review of the industry analysis reports (expected increase in the market size of chemical fertilizers products). The expected and forecasted selling prices of urea (RMB 1450), ammonia (RMB 2400), methanol (RMB 1880) and ammonia (RMB 1966) were all in line with the research material conducted by the First Respondent.

o) The forecast was for medium to long term while the suspension of two plants was for short term only. The suspension did not affect the long term forecast.

p) The municipal government approval documentation inspected by the First Respondent was supportive of the forecast of the management about claimed production capacity of the two plants with expected production volumes.

q) The historical profit ratios in the Company's yearly financial statements are not comparable as they involved factors of depreciation and other businesses of the Group. The gross profit ratios if considering depreciation for Dazhou Plant should be 12.3% (2016) and 15.9% (2017 and 2018); and for Guangan Plant should be 19.6% (for 2016 to 2018).

r) The gross profit ratio of the Group was 24% in 2012 (depreciation factor considered). In 2013 and 2014, natural gas prices increased and affected profit ratios. Thus, in 2015, the Company incurred a loss notwithstanding an increase in revenue by 40%.

s) A profit forecast or valuation is a forward looking exercise. As it is not possible to verify or calculate future projections precisely, nor to guarantee its accuracy, the First Respondent had evaluated and assessed the management's estimates by reviewing independent objective evidence and applying common sense and professional judgment.

Forecast from 2016 to 2018

t) The forecast was based on market prices of the products and costs. The First Respondent had checked the market prices and considered them as reasonable.

u) Total sales for 2016 were low because the plants were to resume operation in mid-2016. Subsequently in 2017 sales volumes were significantly higher because the Group would be able to produce for a full year. All other items such as selling prices, costs etc., were assumed to stay constant for 2016 to 2018. External research conducted by the First Respondent supported an increase in demand of the chemical fertilisers products. The market size was expected to rise by more than 3%.

v) As regards the failure to consider whether there were any signed future sales contracts, the Group's major customers were wholesalers who placed orders and then sold products to industrial users. These wholesalers placed sales orders depending on market prices fluctuating, and would not sign contracts fixing long-term prices in advance. Therefore, the estimated selling prices were consistent with market prices for 2016 – 2018.

w) Natural gas price was estimated to drop, thus expecting increase in gross profit margin in 2016 to 2018.

<u>2019 onwards</u>

x) The 4% growth on sales and 3% growth on costs were supported by the First Respondent's independent research.

y) The First Respondent assessed the management's estimate of 4% long term growth rate of sales by conducting research and reviewing reports. The First Respondent compared highest estimated inflation rate in China (3% as per International Monetary Fund) and performed news searches to understand PRC government policies on natural gas for 3% long term growth rate on costs.

(E) <u>Construction in Progress of Dazhou Plant</u>

z) Construction would continue immediately once natural gas price dropped back to a reasonable level. The First Respondent's own research supported an expected drop in natural gas price and increase in market demand for the Group's products.

(F) <u>Discount Rate (12%)</u>

za) The discount rate was reasonably determined using a weighted average cost of capital (WACC) which is a generally accepted valuation approach and methodology.

zb) The First Respondent performed audit procedures by checking and evaluating the comparable companies selected by Access Partner Consultancy & Appraisals ("**AP**") and the source data used. The five companies are HK listed companies producing fertiliser products. The First Respondent discussed these companies with AP (its expert) and considered them as comparable and appropriate.

zc) As regards source data, the First Respondent's engagement team attended AP's office and checked the same for WACC calculation, including checking Bloomberg data. The First Respondent made manuscript notes and tick marks.

zd) As regards valuation date, 31 December 2015 was the appropriate date, not 30 March 2016, because AP was engaged to perform a valuation for year-end impairment assessment. The final version of the valuation report might have been provided on 30 March 2016, but clearly the relevant issues were discussed and considered throughout the audit procedures.

<u>Lack of Documentation</u>

ze) The First Respondent relied on their risk assessment checklist, detailed, comprehensive and substantive procedures performed by their engagement team. They also checked and verified the source data including checking Bloomberg data evidenced by their manuscript notes.

<u>THE FIRST RESPONDENT'S CASE IN RELATION TO COMPLAINT 3</u>

15. The EQCR's role is to review selected audit documentation relating to significant judgments made and conclusions reached by the engagement team. The Second Respondent had sufficient basis to come to the view that the audit work performed by the engagement team in relation to the Put Option and the impairment assessment on the Plants looked sufficient. In relation to the level 2 fair value disclosure with respect to the Put Option, it was not a significant issue which an EQCR was expected to identify. In any event, the effect of the omission was insignificant. The Complainant has not particularized or articulated any specific failures of the Second Respondent. Even if an engagement team's work may be deficient, it does not necessarily mean that the EQCR must also have failed his duties.

APPLICABLE STANDARDS AND RULES

16. The Complainant alleges that the First Respondent had breached the following rules and standards:

Paragraph 15 of HKSA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing"

15 (Professional Skepticism) The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

Paragraph 8 (Documentation of the Audit Procedures Performed and Audit Evidence Obtained) of HKSA 230 "Audit Documentation"

8 (Form, Content and Extent of Audit Documentation): The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

(a) The nature, timing and extent of the audit procedures performed to comply with the HKSAs and applicable legal and regulatory requirements;
(b) The results of the audit procedures performed, and the audit evidence obtained; and
(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

Paragraph 25 of HKSA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment"

25 (Identifying and Assessing the Risks of Material Misstatement): The auditor shall identify and assess the risks of material misstatement at:
(a) the financial statement level; and
(b) the assertion level for classes of transactions, account balances, and disclosures,
to provide a basis for designing and performing further audit procedures.

Paragraphs 5 & 6 of HKSA 330 "The Auditor's Responses to Assessed Risks"

5 (Overall Responses): The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.

6 (Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level): The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

Paragraphs 6 ,7 & 8 of HKSA 500 "Audit Evidence"

6 (Sufficient Appropriate Audit Evidence): The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

7 (Information to Be Used as Audit Evidence): When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence.

8 (Information to Be Used as Audit Evidence): If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:
(a) Evaluate the competence, capabilities and objectivity of that expert;
(b) Obtain an understanding of the work of that expert; and
(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Paragraphs 15, 17 (Further Substantive Procedures to Respond to Significant Risks), 18 (Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements) & 20 *(Disclosures Related to Accounting Estimates)* of HKSA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

15 (Estimation Uncertainty): For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of HKSA 330, the auditor shall evaluate the following:

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
(b) Whether the significant assumptions used by management are reasonable.
(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

17 (Recognition and Measurement Criteria): For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:

(a) Management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and
(b) The selected measurement basis for the accounting estimates,

are in accordance with the requirements of the applicable financial reporting framework.

18 The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.

20 For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

Paragraph 12 of HKSA 620 "Using the Work of an Auditor's Expert"

12 (Evaluating the Adequacy of the Auditor's Expert's Work): The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

(a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;
(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and
(c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source date.

Paragraphs 12 & 13 (Forming an Opinion on the Financial Statements) of HKSA 700 "Forming an Opinion and Reporting on Financial Statements"

12 The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

13 In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

(a) *The financial statements adequately disclose the significant accounting policies selected and applied;*

(b) *The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;*

(c) *The accounting estimates made by management are reasonable;*

(d) *The information presented in the financial statements is relevant, reliable, comparable and understandable;*

(e) *The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and*

(f) *The terminology used in the financial statements, including the title of each financial statement, is appropriate.*

ANALYSIS OF COMPLAINT 1

17. (A) Risk Assessment

Whilst it is true that the First Respondent requested the Company to engage an external valuer, given that the accuracy and appropriateness of the Put Option was identified as a "high risk" area for this audit, it was necessary for the First Respondent to identify any specific risk arising from the Put Option.

(B) Initial and year-end assessment

The initial recognition needs to be measured clearly, as well as any subsequent changes in fair value. The First Respondent failed to apply professional standards relating to planning and performing audit work in this regard.

(C) Inadequate work regarding year-end valuation of the Put Option at RMB 214.8 million

There is no evidence of sufficient work carried out by the First Respondent in its consideration of the valuation of the Put Option. Even if, as the First Respondent asserts, the option holder would exercise the Put Option at the best price rather than at different times, this is not necessarily a given, and this and other factors which could affect the valuation should be adequately documented in the audit working papers.

(D) Failure to Disclose information

The Respondents accept that level 2 disclosures should have been made. Given the significance of the carrying amount of the Put Option as at 31 December 2015 and of the impact of the difference of RMB 214.8 million on the net loss of the Group, irrespective of being level 2 or 3, the Respondents needed to perform and document the work on assessing whether sufficient and appropriate disclosure had been made in accordance with professional standards in order to allow users to understand the financial position of the Group.

The complaint is that there is no evidence that the auditor had identified that the 2015 Financial Statements did not disclose the relevant information associated with the Put Option, showing the auditor's failure to:

(a) perform audit procedures with professional skepticism in accordance with paragraph 15 of HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*; and

(b) evaluate whether the 2015 Financial Statements provided adequate disclosures in relation to the Put Option, in accordance with paragraph 13 of HKSA 700 *Forming an Opinion and Reporting on Financial Statements*.

(E) Documentation

Following from the analysis in (C) and (D) above, the Respondents had not sufficiently documented factors which could affect the valuation of the Put Option.

18. Accordingly, the complaint is found proven.

ANALYSIS OF COMPLAINT 2

19. Risk Assessment
It is noted that several statements at the beginning of the 2015 Financial Statement appeared to support the pessimistic views of the Company's performance in both financial and operational aspects for the year of 2015, such as:

- the overcapacity of chemicals and chemical fertilizer industries;
- the continuing high cost of the raw materials throughout 2015;
- the drop in both sales volumes and selling prices and the same being lower than the costs of raw materials;
- the decrease in demand of ammonia synthesis facilities of Dazhou Plant by 15kg standard coals on average;
- the increased costs due to high natural gas price and restoration of VAT of 13% on urea;
- the decrease in sale volumes and selling prices due to the plunge in crude oil price worldwide, excessive supply; and
- other continuing unfavourable economic factors.

Furthermore, selling prices of the liquid ammonia, urea and methanol decreased by about RMB450 per tonne, RMB 250 per tonne and RMB 800 per tonne respectively, resulting in substantial loss. This led to the Company's slowing down of the progress of its new project installation of facilities, suspension of the 2nd Phase of the Project of Urea and Melamine Dazhou, and suspension of construction of its project. Construction of such projects would resume when market conditions improved.

20. In the Detailed Risk Assessment Checklist ("**DRAC**"), the First Respondent assessed the risk of misstating the operational business nature of the Company as contained in the Statements as generally low. It assessed the risk of misstating the valuation of the two plants and their impairment as high. The First Respondent appeared to have a good understanding of the operational business nature of the Company regarding its environment, types of finances, investments, classes of transactions, account balances and disclosures expected in the financial statements, in compliance of para. 25 of HKSA 315. The First Respondent may also be said to have properly assessed the risk of material misstatement relating to the downgrade assessment of its business performance by the Company made in the Statements.

21. However, two significant features need to be addressed.

Firstly, it is noted that in the First Respondent's DRAC, the parameter for measuring and assessing the risk of misstatement is different from the HKSA. Paragraph 25 of HKSA 315 required the assessment of risks of material misstatement, whether due to fraud or error. It does not, unlike DRAC, limit the assessment of risks of material misstatement only due to fraud.

DRAC states as follows: "When completing this checklist, it is important that an attitude of professional skepticism be maintained throughout, recognizing the possibility that a material misstatement due to fraud could exist, ...".

The First Respondent was dealing with the Company, a public listed company, with shareholders and stakeholders with different interests and perspectives. Regardless of its accuracy, the Statements were made by the chairman of the Company. It is thus possible that the risk of material misstatement due to the factors mentioned above than fraud may be assessed as low in DRAC, and therefore undetectable. This may naturally have explained why the assessment of the First Respondent was made as a low risk of misstatement of the Statements in relation to the Company's heavy reliance on its particular products or services (questionnaire 5.2, DRAC). This would have a knock-on effect on how responses were then formulated to tackle the risk of misstatement by the First Respondent. Responses may have been in fact formulated by the First Respondent to address the risk of misstatement due to fraud. But the formula/responses adopted by the First Respondent may not have sufficiently detected the misstatement of facts or by misrepresentation due to negligible statements, omissions of facts, inclusions of irrelevant factors etc.

Secondly, another part of the Statements involved a representation of the Company's intention to restore its business performance - an aspiration giving a rosy future. Assessment of the risk of misstatement of optimistic statements needs more care than for pessimistic statements and should be specially addressed at the outset of the design stage. When one deals with the rosy picture as forecast of a company, one should naturally need to be more critical than with the conservative views. That said, here, the assessment of the risk of misstatement regarding the two plants due to fraud by the First Respondent as high risk is noted and appropriate.

22. The audit engagement agreement between the First Respondent and the Company was dated 16 March 2016. The audit kick-off meeting minutes of the First Respondent were recorded on 24 February 2016 and 22 March 2016. The DRAC was dated 24 February 2016. Two typed-up meeting notes for visit sites with forecast tables were dated 23 March 2016. The closing date of the financial reporting period for the Company was 31 March 2016.

23. The time needed to consider the Company, the Group, its business and financial statements and then verify the Statements depends on a number of relevant factors, one of which must be that historically, the data or information were consistently demonstrating the same or familiar pattern, and the other of which is the same team of auditors who had been previously engaged and familiar with its structures and business nature, performance etc. Here, the financial statement and performance in year 2015 was notably different than that of the previous years 2012 to 2014. Of those years, only 2015 was reported as loss in profit with explanations given in the Statement. A different team of auditors were engaged. That is, the First Respondent was newly on board in 2015. All those factors would require a prudent auditor to approach the Statements with great caution when considering and formulating an audit plan in order to safe guard against any possible risk of misstatement. Prior to the DRAC, dated 24 February 2016, the First Respondent may be said to have performed some acts to understand the nature and business of the Company. However, it is not clear as to what and how much it had done to afford the answers of DRAC assessments. For example, it is not known whether there was any evidence (such as emails and written communications of any form) showing lists of questions being raised by the First Respondent to that effect, or any answers provided by the Company.

24. The First Respondent should be given a benefit of the doubt and hence is not in breach of para. 25 of HKSA 315. However, on a balance of possibilities, the First Respondent has failed to sufficiently design and implement overall responses to the assessed risks of material misstatement at the financial statement level, in breach of paragraph 5 (Overall Responses) of, HKSA 330. The failure to "implement" on the part of the First Respondent is dealt with paragraphs below. Further, as analysed above, the timing and nature and extent to respond to the assessed risks of material misstatement at the assertion level falls short of the standards for the design and the performance of further audit procedures, thus breaching paragraph 6 (audit procedures responsive to the assessed risks of material misstatement at the assertion level) of HKSA 330.

25. Lack of Sufficient Audit Evidence of Profit Forecast Periods
Paragraph 44 (impairment of assets) of HKAS 36 is quite clear that in estimating future cash flows, the First Respondent should not take into account of two factors: a future restructuring of an entity to which that entity is not yet committed; or improvement or enhancement of the asset's performance. To consider either factor would be in violation of this standard.

26. In general, the replacement of a plant, be it new or old, would vary the asset performance and affect the future in-or-out flows of capitals. If the result of the replacement enhances or improves the asset performance, any estimate for the part of future performance should be disregarded. In the present case, the First Respondent's assertion of evidence of due consideration of production capacity, plants' conditions, review of construction project in Dazhou, site visit, and of due performance of audit procedures before having concluded the useful lives of two plants, 15 years and 20 years, does not imply or explicitly confirm that it had given due consideration or discount to remove that factor of replacement of plant, nor present any evidence to show that it had raised questions to the Company- that replacement of plants if enhancing or improving the plant's performance should not be taken into account for estimate- thus such failure is in violation of paragraph 44 of HKSA 36.

It is not sufficient for the First Respondent to just state that the discount rate of 12% had sufficiently catered for the forecast period and for the valuation.

27. Lack of Sufficient Audit Evidence of Re-commencement of Production
When a company estimates and concludes a restoration of business performance like the present case, the auditor of the company should be cautious and critical of the company's estimates. An assessment regarding the re-commencement of production should be a sensitive and critical exercise since misstatement of such kind by giving an otherwise rosy future of a company's performance could profoundly affect the shareholders' and stakeholders' interests.

28. Here, according to the Statement, a number of factors could materially affect the decision to re-commence production. They can be grouped into sales and costs factors, namely price of natural gas and oil, reduction of global demands of products.

29. The First Respondent's audit evidence were limited to the following:-

i. Research on natural gas prices and review of underlying supporting documents.

ii. Invoices issued by the Company's suppliers which showed a dropped gas price before March 2016. A draft agreement showed natural gas price continued to drop from May 2016.

iii. External and independent research from the PRC government which made substantial investments in natural gas, resulting in decrease in its price.

Based on the above, the First Respondent agreed with the Company that natural gas price would drop. As suspension of production was due to high natural gas price, that natural gas price decreases would trigger the decision of the Company to re-commence production. Apart from the costs of the natural gas price, the First Respondent did not agree the suspension was due to a weak economy and reduction of the products demand. International Energy Agency and industry analysis reports were reviewed to support this notion.

30. Audit evidence by definition of paragraphs 6 & 7 of HKSA 500 refers to and includes minutes of meetings, confirmations from third parties, analyst's reports, comparable data about competitors (benchmarking), controls manuals, information obtained by the auditor from such audit procedures as inquiry, observation, and inspection, and other information developed by the auditor that permits the auditor to reach conclusions through valid reasoning.

31. The evidence obtained by the First Respondent as stated in paragraph 28 is no doubt audit evidence. What the Complainant is challenging is its sufficiency.

32. The First Respondent disagreed with the Company that suspension was due to weak economy but rather due to high natural gas price. With respect, there are two different and distinct aspects here. The first aspect is that the First Respondent's disagreement seems to go to supporting or justifying its audit work, as opposed to justifying what the Company represented in the Statements.

33. In the Statement there appear various factors about the macro environment in China towards the globe in 2015 that were relevant and affecting the operations of the Company and its decision to suspend production: overcapacity of chemicals, fertilizer industries, high costs of raw materials, drop in sale volumes and selling prices which are lower than costs. To be more specific, the Company stated that consumption of ammonia synthesis facilities of Dazhou Plant decreased by 15kg standard coals on average, a new record low. The methanol and purge gas facilities of Guangan Plant reached their production capacity within a short time period. After stating these various factors above, the Company then started to state "...However, product costs further increased due to high natural gas price and the restoration of VAT of 13% on urea effective from 1st September 2015." The ordinary meaning of the words "However" and "further" connote natural gas price as not being the single factor affecting the decision to suspend production. If the First Respondent did not agree with the Statements, as opposed to disagreeing with the Complainant's allegation in this aspect, the First Respondent should have confronted with and made direct inquiry to the Company to confirm its view, i.e. natural gas price being the only factor of product costs. This inquiry if raised and documented would become an audit evidence, and answers to this inquiry would have bearing on the assessment of material risk of misstatement.

Had the First Respondent made any Inquiry or Confrontation to the Company about natural gas price as the only Factor of Product Costs?

34. From the First Respondent's audit evidence, there is no specific or concrete evidence addressing this area nor inquiries made to the Company, or revealing any answers/replies from the Company. Neither is shown any external source of evidence about the overcapacity of chemicals, fertilizer industries, high costs of raw materials. In case of doubt about the meaning of "raw materials" mentioned in the Statements, a prudent auditor would without doubt come forth, make inquiries and clarify with the Company as to its meaning(s), and then depending on the answers, embark on further inquiries if necessary and/or the external research on the raw materials if applicable. Especially here, the word "materials" were used as plural, indicative of more than one type of raw material. The First Respondent should have inquired what types and whether they only referred to natural gas.

35. The First Respondent's minutes of closing meeting dated 22 March 2016 (which was 30 minutes in duration, from 14:00 to 14:30 hours), paragraph 2(i), stated that: *"Alan mentioned... (i) Under the section of sales, costs of goods sold and gross profit, the Group has a gross loss in 2015. This is due to decrease of market price of chemical products followed to the decrease of market price of crude oil. The client is bargaining to China National Petroleum Corporation and China Petroleum and Chemical Corporation to push down the price of natural gas which is the main raw material of the production of the Group, in order to improve the gross profit rate. In the opinion of the client, the space of decrease of crude oil is limited now. Therefore, the selling price of the product will not have much place to decrease. The gross profit will be improved in coming year."*

36. The above quoted part merely cites the Company's opinions or positions at the time. There is no mention whether the First Respondent had verified and then agreed to it. If the First Respondent had done so, there is no mention whether such opinions were in congruence with the Statements. If there was no such congruence, the First Respondent should have confronted the Company with the Statement in order to safeguard against the risks of material misstatement as such.

37. Paragraph 7 of HKSA 500 states the auditor shall consider the relevance and reliability of the information to be used as audit evidence. Paragraph 5(e) of HKSA 500 states that sufficiency of audit evidence means the measure of the quantity of audit evidence, while paragraph 5(b) states that appropriateness is the measure of the quality of audit evidence. Both sufficiency and appropriateness are needed to support or detect misstatements. The amount of quantity needed is affected by the risk of misstatement. The greater the risk the more audit evidence is likely to be required. It follows that:-

    i. Failure to accurately identify the risk of misstatement would lead to failure to obtain audit evidence to support or detect misstatements.

    ii. Having identified the risk of misstatement but failed to appropriately design and obtain audit evidence would equally result in undermining the risk of misstatements. Sufficiency and appropriateness of audit evidence are interrelated, for merely obtaining more audit evidence does not compensate for its poor quality.

    iii. Audit evidence which was obtained and insufficient would include not having obtained appropriate evidence to support for or detect the risk of misstatement.

38. The present case falls into these areas (i) to (iii). The allegation of the Complainant that the First Respondent had not questioned the basis of the Company's expectation of why and when they re-commenced production, or had not sought audit evidence to verify the Statements of that part is therefore substantiated.

39. Lack of Sufficient Audit Evidence of Profit Estimations
The Complainant's allegations are contained in paragraph 9(D) above. That is, the First Respondent should have questioned the Company about the declining market demand.

40. The First Respondent in response has stated that it had considered natural gas price according to the PRC polices including the West-East Pipeline Plan and draft agreement between the Company and a supplier of natural gas, review of latest invoices issued by suppliers of natural gas. The First

Respondent also considered selling prices and reviewed materials including that of the International Energy Agency and industry analysis reports saying about the increase in market size of the chemical fertilizers products. It had inspected and considered municipal government approval documentation about production capacity of two plants. In gist, The First Respondent had assessed and evaluated the Company's estimates by reviewing independent objective evidence and applying common sense and its professional judgement.

41. The Statements had stated the problem of overcapacity of the chemicals and chemical fertilizer industries in China. The problem of overcapacity or excessive supply of products continues to be suggested with the Statements referring to the decrease in consumption of products for Dazhou Plant, the weak market and demand for all of the downstream markets, the fall in price of sale volumes and selling prices of products where oil price dropped, excessive supply and the continuation of other unfavourable economic factors. Apart from the First Respondent's own supporting search to try and correspond with the profit estimation of the Company, the First Respondent could have questioned the Company directly (and then documented) in the following areas in order to verify whether some statements were misstated:-

   i. Meaning(s) of other unfavourable economic factors referred to, with supporting documents or pointers to sources relied upon by the Company rather than those relied upon by the First Respondent;

   ii. Meaning(s) of the weak market and the weak demand for all the downstream market, with supporting documents or pointer(s) to sources relied upon by the Company rather than those relied upon by the First Respondent. Note that the Statements separates the concepts of market and demand while the First Respondent considered them as the market demand as a whole;

   iii. Meaning(s) of excessive supply in the industry, with supporting documents or pointer to sources relied upon by the Company. There is no evidence showing the First Respondent had raised questions and considered possible competitor(s) in the same industry. The market shares and the demand for the Company's products would vary greatly as a result of competitor(s) and its/their competitiveness. Wholesalers as its customer make no differences. The external sources of reference or research conducted or verified by the First Respondent at most may not present a true picture, fair or accurate views of whether the statements made in the Statements were indeed misstated. The proper approach was to ask the Company why it made those relevant parts of the statements as it did with supporting information or pointers to the data source. Then it was the First Respondent's duty to consider the same and determine whether they were misstated. If needed, to conduct external source to verify or disprove the same.

42. <u>Standard Guidelines on Estimating Future Cash Flows</u>
The prescribed accounting standard for estimates of future cash flows in measuring value in use is contained in paragraph 33 of HKAS 36. Sub-paragraph (a) states that essentially, greater weigh shall be given to the external evidence. Was it the external evidence of the Company or the First Respondent here? The standard must refer to the company's assumption while in the present case, the First Respondent relies on its own external evidence to tally with that of the Company.

43. Repeatedly, sub-paragraph (b) states that cash flow projection should exclude enhancement of the asset's performance.

44. The First Respondent repeatedly submitted at the hearing that profit forecast or valuation is a forward looking exercise. Its own forecast with own audit evidence supported the forecast of the Company. On balance, in a nutshell, the First Respondent's case in this category of allegation is marginally and barely made out and given a benefit of the doubt.

45. <u>Lack of Sufficient Audit Evidence of Construction in Progress of Dazhou Plant</u>
Had the First Respondent performed sufficient and adequate audit procedures to access the estimated recoverable amount of the asset following the suspension of construction in progress and the Company's market capitalization in compliance of paragraph 9 of HKAS 36? The requirement of estimating recoverable amount is triggered when there is an indication of impairment of asset. The

Company had considered the likelihood of impairment and concluded that impairment was unnecessary. Paragraph 9 of HKAS 36 states "An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset." Does Company need to estimate recoverable amount given its decision not to impair assets? Does the First Respondent also need to do so instead?

46. It is noted that it was the Company's project of construction of new Dazhou Plant, not replacement of old Dazhou Plant. The existing Plants were both in use albeit suspended temporarily. Its remaining useful lives were also considered by the Company and the First Respondent.

47. the First Respondent found impairment unnecessary and claimed that it had done the external research on the natural gas price which would drop and the increase in market demand of the Group's products, purportedly in support of the Company's decision not to impair assets.

48. There are requirements for the internal sources of information under paragraph 12 of HKAS 36. It may be said to have been complied with and relied upon by the First Respondent since the two existing plants and construction of new plants were commented, considered and assessed by the Company and the First Respondent. The result was that they were far from being closed to obsolescence or physical damage, hence did not afford to any significant changes with an adverse effect taken place during 2015, or expected to take place in the near future. Changes with adverse effect, as guided under paragraph 12 of HKAS 36 include assets becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plants to dispose of an asset before the previously expected date, and reassessing the useful lives of two plants as finite rather than indefinite. All the evidence claimed by the First Respondent together with the Statements does not point to worsening economic performance of the plants of the Company in future, or suggest adverse effect. Thus, Complainant's complaint against the First Respondent in respect of its failure to obtain audit evidence supporting construction of new plant was not impaired is not made out.

49. <u>Lack of Sufficient Audit Evidence of Discounted Rate of 12% adopted by the First Respondent's appointed Expert Valuer</u>
The Weighted Average Cost of Capital (WACC) was assessed by the First Respondent via appointment of an external expert valuer, i.e. AP, so was the discount rate assessment. the First Respondent claimed that the 5 listed companies adopted by AP were comparable source of data, as they were in the same business of the Company. The First Respondent also claimed to have checked WACC calculation of AP and checked Bloomberg data. The First Respondent then made manuscript notes and tick marks.

50. Paragraph 12 of HKSA 620 requires the First Respondent to evaluate AP's findings and give consideration of source data, assumptions and methods used and their consistency with prior periods; and AP's works result. The result of AP's assessment reveals that the discount rate in relation to the assets impairment test of the Company as of the Date of Valuation was reasonably stated as 12%, thus in both AP and the First Respondent's opinions, properly reflecting the financial statements of the Company that supports the discount rate of 12% in the discounted cash flow calculations of the recoverable amounts of both plants.

51. In respect of the date of valuation, the First Respondent claimed that it must be 31 December 2015 rather than 31 March 2016 because AP was engaged to perform a valuation for year-end impairment assessment.

52. It is noted that 30 March 2016 was shown in AP's report and calculation worksheet, rather than 31 December 2015. The discrepancies were not shown in the First Respondent's audit evidence that it had raised and discussed the issue of discrepancies between the two dates adopted for the valuation. Despite what the First Respondent's legal representatives had submitted, the differences are material albeit the duration was short according to the First Respondent (i.e. 3 months from December to March). AP based its analysis quite significantly on the data and information between the omitted period of 31 December 2015 and 30 March 2016 and derived their valuation. For instances, AP had taken account of (i) the shareholding of a shareholder of the Company as at 22 March 2016, (ii) the liability due to debt under the heading "Cash and cash equivalents decreased approximately RMB 5 million compared with 2015", namely as at 23 March 2016, cash was mainly to repay debt in order to

save finance cost. Anything that was stated in the valuation report is and should be relevant to towards the valuation. If what the First Respondent said that there is no difference between the two dates, it should have verified its own view by raising questions to AP for an answer, rather than making its own conclusion and relying upon it without questioning the works of AP.

53. In fact, AP's report had made assumptions "...We have not verified the accuracy of the information provided and have assumed that the aforesaid information is accurate. We have not conducted any investigations concerning whether all data have been provided to us for our assessment and we have no reason to believe that any material data have been withheld from us." and "our valuation was based on the information of the Target Company provided to us." Did the First Respondent make any inquiry about the assumptions of AP, and document it? It does not appear from any audit evidence that it did.

54. Hence, the standard adopted by the First Respondent in hiring and using AP as its expert is below the standard prescribed under para. 12 of HKSA 620. That is, an auditor should evaluate the appropriateness of the expert's works as audit evidence regarding the assertion being considered. This will involve evaluation of whether the substance of the findings is properly reflected in the financial statements or supports the assertions, and consideration of, amongst others, source data, assumptions and methods used and their consistency with prior periods.

55. For the reasons above, the First Respondent has been lacking in the audit evidence and Complaint 2 is found proven.

ANALYSIS OF COMPLAINT 3

56. We have considered the EQCR's role and the assertion of the Second Respondent that it had sufficient basis to come to the view that the audit work performed by the engagement team in relation to the Put Option and the impairment assessment on the Plants looked sufficient. We have also considered the evidence including the EQCR worksheet checklist. In our view, the completion of such checklist did not adequately evidence the actual work done by the Second Respondent in performing his duties as EQCR. We would have expected a record of the procedures and considerations carried out by the Second Respondent to substantiate his views regarding the work done by the engagement team.

57. Accordingly, the Complaint is found proven.

CONCLUSION AND FURHTER DIRECTIONS

58. In the circumstances we find that the First Respondent is guilty of Complaint 1 and 2. The Second Respondent is guilty of Complaint 3.

59. The Committee makes the following directions:

(1) The Complainant shall file and serve its written submission on sanctions and costs within 21 days of the service of this decision; and

(2) The Respondents shall file and serve their written submission on sanctions and costs within 21 days thereafter.

Dated the 5th day of January 2024

Ms. DOE, Julianne Pearl (Chairman)

Mr. FAN, Hoi Kit (Member)

Mr. IP, Chiu Yin (Member)

Mr. BAO, King To, Raymond (Member)