



Hong Kong Institute of Certified Public Accountants takes disciplinary action against a firm, a certified public accountant (practising) and a certified public accountant

(HONG KONG, 23 September 2021) A Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants reprimanded KPMG (0035), Ms. Yu Yuk Ping, June, certified public accountant (A27591) and Ms. Yu Wai Sum, certified public accountant (practising) (A18931) (respectively “1st, 2nd and 3rd Respondents”) on 12 August 2021 for their failure or neglect to observe, maintain or otherwise apply professional standards issued by the Institute. In addition, the Committee ordered the 1st, 2nd and 3rd Respondents to pay penalties of HK\$500,000, HK\$300,000 and HK\$200,000 respectively, and to pay costs of the Institute and the Financial Reporting Council (“FRC”) totalling HK\$5,000,000.

The 1st Respondent was the reporting accountant for the Hong Kong initial public offering of **China Forestry Holdings Co., Ltd.** (“Company”) in 2009, and in that capacity, audited the financial information of the Company and its subsidiaries (together “Group”) for the years ended 31 December 2006, 2007, 2008 and the six months ended 30 June 2009 (“IPO Engagement”). After the listing, the 1st Respondent audited the Group’s financial statements for the year ended 31 December 2009 (“2009 Audit”). Unmodified opinions were expressed in the accountant’s report of the IPO Engagement and the auditor’s report of the 2009 Audit. The 2nd and 3rd Respondents were the engagement partners for the IPO Engagement and the 2009 Audit respectively.

The Group was engaged in purchasing and planting forests, managing and harvesting forests, and selling harvested logs. It owned plantation assets in certain provinces of the People’s Republic of China.

The Institute received a referral from the FRC about audit irregularities in the IPO Engagement and the 2009 Audit, alleging that the audit team did not exercise sufficient professional scepticism in conducting audit procedures in a number of areas. As a result, there were **deficiencies in the evidence obtained and documentation compiled in the IPO Engagement in respect of the reliability of logging permits, existence of certain customers, completeness of sales, occurrence and completeness of expenses for logging activities, existence and ownership of the plantation assets, and effectiveness of the Group’s controls over cash and cash equivalents.** For the 2009 audit, deficiencies were found in the evidence obtained on the completeness of sales, and existence and ownership of the plantation assets.

After considering the information available, the Institute lodged complaints under section 34(1)(a)(vi) of the Professional Accountants Ordinance (Cap. 50).

The Disciplinary Committee found as follows:

- (i) The 1st and 2nd Respondents failed or neglected to observe, maintain or otherwise apply the following professional standards in the IPO Engagement:
- Hong Kong Standard on Auditing (“HKSA”) 200 *Objective and General Principles Governing an Audit of Financial Statements*;
 - HKSA 230 *Audit Documentation*;
 - HKSA 240 *The Auditor’s Responsibilities to Consider Fraud in an Audit of Financial Statements*;
 - HKSA 500 *Audit Evidence*;
 - HKSA 505 *External Confirmations*;
 - HKSA 520 *Analytical Procedures*; and
 - HKSA 530 *Audit Sampling and Other Means of Testing*.
- (ii) The 1st and 3rd Respondents failed or neglected to observe, maintain or otherwise apply the following professional standards in the 2009 Audit:
- HKSA 500 *Audit Evidence*;
 - HKSA 505 *External Confirmations*; and
 - HKSA 530 *Audit Sampling and Other Means of Testing*.

Having taken into account the circumstances of the case, the Disciplinary Committee considered that the breaches were not intentional, reckless or for improper motive. They noted that the sanctions should be proportionate to the nature of the failure, with the aim to protect public interest. The committee also noted the 1st Respondent’s disciplinary history and the 2nd and 3rd Respondents’ clear disciplinary records, and that the cost of HK\$ 5 million, as agreed by all the parties, was reasonable in light of the scale of the investigation and the amount of documents involved. Accordingly, the committee made the above order against the respondents under section 35(1) of the Ordinance.

About HKICPA Disciplinary Process

The Hong Kong Institute of Certified Public Accountants (“HKICPA”) enforces the highest professional and ethical standards in the accounting profession. Governed by the Professional Accountants Ordinance (Cap. 50) and the Disciplinary Committee Proceedings Rules, an independent Disciplinary Committee is convened to deal with a complaint referred by Council. If the charges against a member, member practice or registered student are proven, the Committee will make disciplinary orders setting out the sanctions it considers appropriate. Subject to any appeal by the respondent, the order and findings of the Disciplinary Committee will be published.

For more information, please see:

<http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/disciplinary/>

- End -

About HKICPA

The Hong Kong Institute of Certified Public Accountants ("HKICPA") is the statutory body established by the Professional Accountants Ordinance responsible for the professional training, development and regulation of certified public accountants in Hong Kong. The Institute has over 46,000 members and 17,000 registered students.

Our qualification programme assures the quality of entry into the profession, and we promulgate financial reporting, auditing and ethical standards that safeguard Hong Kong's leadership as an international financial centre.

The CPA designation is a top qualification recognised globally. The Institute is a member of and actively contributes to the work of the Global Accounting Alliance and International Federation of Accountants.

Hong Kong Institute of CPAs' contact information:

Dr Wendy Lam
Director of Corporate Communications
Phone: 2287-7209
Email: wendylam@hki CPA.org.hk



香港會計師公會對一間會計師事務所、一名執業會計師及一名會計師作出紀律處分

(香港，二零二一年九月二十三日) 香港會計師公會轄下紀律委員會，於二零二一年八月十二日就畢馬威會計師事務所(事務所編號：0035)、會計師余玉萍女士(會員編號：A27591)及執業會計師余慧心女士(會員編號：A18931)(分別稱為「第一、第二及第三答辯人」)沒有或忽略遵守、維持或以其他方式應用公會頒佈的專業準則，對他們予以譴責。此外，紀律委員會命令第一、第二及第三答辯人須分別繳付罰款 500,000 港元、300,000 港元及 200,000 港元，並須繳付公會及財務匯報局(「財匯局」)的費用合共 5,000,000 港元。

第一答辯人曾擔任中國森林控股有限公司(「該公司」)於二零零九年香港首次公開招股申報會計師，負責審計該公司及其附屬公司(統稱「該集團」)截至二零零六年、二零零七年及二零零八年十二月三十一日止年度和截至二零零九年六月三十日止六個月的財務資料(「公開招股審計」)。此外，第一答辯人於該公司上市後曾審計該集團截至二零零九年十二月三十一日止年度的財務報表(「二零零九年審計」)。第一答辯人於公開招股審計的會計師報告及二零零九年審計的核數師報告均發表了無保留意見。第二及第三答辯人分別是公開招股審計及二零零九年審計的審計項目合夥人。

該集團從事森林採購及種植、森林經營及採伐，以及原木銷售業務，並在中華人民共和國數個省份擁有林地資產。

公會收到財匯局的轉介，指公開招股審計及二零零九年審計有違規情況，審計團隊進行審計程序時在多個範疇欠缺充分的專業懷疑態度，在公開招股審計中就伐木許可證的可靠性、若干客戶的存在、銷售的完整性、伐木費用的產生及完整性、林地資產的存在及擁有權，以及該集團對現金及現金等價物的有效監控，均未有取得充分憑證及編備完備的紀錄。在二零零九年審計中，審計團隊亦未有就銷售的完整性以及林地資產的存在及擁有權取得充分憑證。

公會經考慮所得資料後，根據香港法例第 50 章《專業會計師條例》第 34(1)(a)(vi)條作出投訴。

紀律委員會裁定：

- (i) 第一及第二答辯人在公開招股審計中沒有或忽略遵守、維持或以其他方式應用以下的專業準則：
 - Hong Kong Standard on Auditing (「HKSA」) 200「Objective and General Principles Governing an Audit of Financial Statements」；

- HKSA 230 「Audit Documentation」；
- HKSA 240 「The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements」；
- HKSA 500 「Audit Evidence」；
- HKSA 505 「External Confirmations」；
- HKSA 520 「Analytical Procedures」；及
- HKSA 530 「Audit Sampling and Other Means of Testing」

(ii) 第一及第三答辯人在二零零九年審計中沒有或忽略遵守、維持或以其他方式應用以下的專業準則：

- HKSA 500 「Audit Evidence」；
- HKSA 505 「External Confirmations」；及
- HKSA 530 「Audit Sampling and Other Means of Testing」

經考慮有關情況後，紀律委員會認為該等違規並非故意、罔顧後果或出於不正當動機，並認為對答辯人的處分應相稱地反映違規的性質，以保障公眾利益。委員會同時注意到第一答辯人的紀律處分紀錄，以及第二和第三答辯人過往不曾被紀律處分。此外，委員會考慮到調查的規模及涉案的文件數量，認為 500 萬港元是合理的紀律程序費用，而此數額亦得各方同意。因此，紀律委員會根據《專業會計師條例》第 35(1)條向答辯人作出上述命令。

香港會計師公會的紀律處分程序

香港會計師公會致力維持會計界的最高專業和道德標準。公會根據香港法例第 50 章《專業會計師條例》及紀律委員會訴訟程序規則，成立獨立的紀律委員會，處理理事會轉介的投訴個案。委員會一旦證明對公會會員、執業會計師事務所會員或註冊學生的檢控屬實，將會作出適當懲處。若答辯人未有提出上訴，紀律委員會的裁判將會向外公佈。

詳情請參閱：

<http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/disciplinary/>

— 完 —

關於香港會計師公會

香港會計師公會是根據《專業會計師條例》成立的法定機構，負責培訓、發展和監管本港的會計專業。公會會員逾 46,000 名，學生人數逾 17,000。

公會開辦專業資格課程，確保會計師的入職質素，同時頒佈財務報告、審計及專業操守的準則，以鞏固香港作為國際金融中心的領導地位。

CPA 會計師是一個獲國際認可的頂尖專業資格。公會是全球會計聯盟及國際會計師聯合會的成員之一，積極推動國際專業發展。

香港會計師公會聯絡資料：

林婉梅博士

企業傳訊總監

電話號碼：2287-7209

電子郵箱：wendylam@hkipa.org.hk

IN THE MATTER OF

A complaint made under section 34(1A) of the Professional Accountants Ordinance (Cap. 50)

BETWEEN

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

AND

KPMG 1st RESPONDENT

Ms. Yu Yuk Ping, June 2nd RESPONDENT

Ms. Yu Wai Sum 3rd RESPONDENT

Decision of a Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants constituting

Members: Ms. LAU Shing Yan, Zabrina (Chairman)
Mr. LAM Yin Shing, Donald (Member)
Mr. MUI Arthur (Member)
Mr. CHAN Wai Tong, Christopher (Member)
Mr. TSAI Wing Chung, Philip (Member)

DECISION

A. INTRODUCTION AND BACKGROUND

1. The complaints in these disciplinary proceedings relate to the Respondents' engagement in the audits of China Forestry Holdings Co., Ltd (the "Company") from 2006 to 2009.

2. The 1st Respondent (“**KPMG**”) was:
 - (1) the reporting accountant who audited the financial information (the “**Financial Information**”) of the Company and its subsidiaries (collectively the “**Group**”) for the years ended 31 December 2006, 2007, 2008 and the six months ended 30 June 2009 (the “**IPO Period**”) (the “**IPO Engagement**”); and
 - (2) the auditor of the Group’s financial statements for the year ended 31 December 2009 (the “**2009 Audit**”).
3. The 2nd Respondent (“**R2**”) was the engagement partner for the IPO Engagement and the 3rd Respondent (“**R3**”) was the engagement partner for the 2009 Audit.
4. In the accountant’s report of the IPO Engagement and auditor’s report of the 2009 Audit, KPMG expressed an unmodified opinion and stated that the relevant audits were conducted in accordance with Hong Kong Standards on Auditing (“**HKSA**”) issued by the Hong Kong Institute of Certified Public Accountants (the “**Institute**”). The accountant’s report of the IPO Engagement was published as part of prospectus (the “**IPO Prospectus**”) issued by the Company in connection with its initial public offering on the Main Board of The Stock Exchange of Hong Kong Limited.
5. Subsequently, however, KPMG issued a disclaimer of opinion on the financial statements for the year ended 31 December 2010 as they were unable to obtain sufficient appropriate evidence to provide a basis for an

audit opinion. On 5 January 2012, KPMG resigned as the auditor of the Company.

6. On 11 May 2012, the Financial Reporting Council (“FRC”) received a complaint questioning whether KPMG met the relevant auditing and assurance standards in the IPO Engagement and the 2009 Audit. On 6 September 2012, the FRC directed the Audit Investigation Board (the “AIB”) to investigate possible relevant irregularities relating to these audits.
7. The AIB investigation took place between September 2012 and April 2016, during which the Respondents were requested to produce certain documents, provide explanations and responses on the issues under investigation, and to comment on the draft investigation report.
8. By a report dated 22 August 2016 (the “AIB Report”), the AIB found auditing irregularities in relation to the Respondents’ audits of the Financial Information in the IPO Engagement and the 2009 Audit. The AIB Report was adopted by the FRC on 8 September 2016. On 22 September 2016, the FRC referred the AIB Report to the Registrar of the Institute pursuant to section 9(f) of the FRC Ordinance, Cap. 588.
9. Meanwhile, the trading of the Company’s shares was suspended on 26 January 2011. The Company was wound up by a court order in June 2015 and subsequently delisted on 24 February 2017.

10. On 7 September 2017, the Registrar submitted to the Council of the Institute a formal complaint against the Respondents¹ which is based on the evidence and findings in the AIB Report.

B. THE GROUP'S BUSINESS

11. Before going into the details of the specific complaints, it is important to understand the nature of the Group's business which provides the context in which the relevant audit work was performed. The following is extracted from the Respondents' Amended Case and the Group's IPO Prospectus, and it is not disputed by the Complainant.
12. The Group's business consisted of the purchase or planting of forests, the management, operation and harvesting of those forests and the sale of harvested logs to third parties. The plantation assets owned by the Group were located in the Sichuan and Yunnan provinces in the PRC.
13. Prior to the reorganisation of the Group in April or around 2008, all of the Group's sales revenue was generated by Beijing Zhaolin Forestry Development Co., Ltd. After the reorganisation, the Group's plantation assets were transferred to Kunming Ultra Big Forestry Resources Development Co., Ltd ("KUB"), which in turn generated all of the Group's sales revenue from its principal activities.
14. The Group engaged third parties to carry out the harvesting activities. In Sichuan, the Group engaged villages located close to the forests to provide

¹ For convenience, the reference to the "Respondents" in this Decision may refer to (i) KPMG, R2 and R3 (in the context of the Complaints generally); (ii) KPMG and R2 (in the context of the IPO Engagement); or (iii) KPMG and R3 (in the context of the 2009 Audit).

simple harvesting services. According to the IPO Prospectus, the number of villages engaged ranged from 7 to 10 during the IPO Period. In Yunnan, where the forest areas were larger and logging conditions were more complex, the Group engaged a professional harvester (“**Dehong Hongda**”).

15. The Group entered into sales contracts with customers and only harvested timber after it received an order and partial payment from a customer. Sales were not made on credit terms and the Group typically did not maintain a large standing inventory of harvested logs.
16. According to the Respondents, the Group’s total number of customers increased from 10 for the year ended 31 December 2006 to 17 for the year ended 31 December 2009.
17. Upon receipt of an order and initial payment by the customer, the Group’s resources management department would:
 - (1) select a forest from which the timber would be harvested;
 - (2) apply for a logging permit from the local forestry bureau specifically for that customer order; and
 - (3) instruct the harvesting village or professional harvesting team to harvest the desired amount of timber by issuing a “logging confirmation” to the harvester specifying the harvest requirements.
18. Once the logs had been harvested, the Group would notify the customer, who would in turn arrange for the logs to be transported to the required destination and settle the balance of the payment. Transportation costs

were borne by the customer. On delivery of the logs, the Group issued a goods delivery note (“GDN”) to the customer confirming the volume and type of logs delivered.

19. Insofar as expenses are concerned, the Group recognised only two types of operating expenses for logging activities: costs of harvesting (logging) and forest maintenance fees associated with applying for logging permits. Costs of harvesting were the fees paid to the harvesters (Dehong Hongda in Yunnan and the local villages in Sichuan). Forest maintenance fees were paid to the PRC government when applying for a logging permit and were contributed to the forest maintenance fund maintained by the PRC government.
20. Given that the Group had only one principal business, less than 20 customers and a few suppliers of logging services in two provinces, the Group’s operations appeared to be relatively simple and straightforward. Notwithstanding, the Complainant’s case is that there are deficiencies in the audits relating to four major line items in the Financial Statements. In particular, the Complainant highlighted a number of anomalies or “red flags” in the audit evidence which are said to have been come across by the Respondents in the audits but the Respondents did not exercise sufficient professional skepticism by taking additional steps to address or resolve them.
21. Specifically, the complaints against R1 and R2 in respect of the IPO Engagement relate to the following accounts or line items in the Financial Information:
 - (1) turnover;

- (2) operating expenses for logging activities;
 - (3) plantation assets; and
 - (4) cash and cash equivalents.
22. The complaints against R1 and R3 in respect of the 2009 Audit relate to the following accounts or line items in the 2009 financial statements:
- (1) turnover;
 - (2) operating expenses for logging activities; and
 - (3) plantation assets.

C. THE RESPONDENTS' OVERARCHING SUBMISSIONS

23. The substantive hearing of these proceedings took place between 16 and 19 November 2020, during which the Committee heard detailed arguments in respect of the complaints. There were no witnesses called by any of the parties and the hearing proceeded purely on the basis of the documents produced and various submissions made on behalf of the parties.
24. The Complainant was represented by Ms Sara Tong leading Ms Esther Mak, and the Respondents were represented by Mr Paul Shieh SC leading Mr Byron Chiu. In the Respondents' opening submissions, they made a number of what they called "overarching submissions" regarding the nature and conduct of these proceedings. As those submissions concern the overall approach to the determination of the complaints, it is necessary for the Committee to deal with them at the outset.

C.1. Burden and standard of proof

25. The Complainant bears the initial burden of proof in respect of the complaints: rule 13 of the *Disciplinary Committee Proceedings Rules* (“**DCPR**”). The civil standard of proof (on the balance of probabilities) applies as suitably adjusted so that the more serious an allegation, the more compelling must be the evidence: §§17-19 of the Guidelines 1.101A – *Guidelines for the Chairman and the Committee on Administering the DCPR*. As far as we understand, the applicability of these rules and guidelines is not disputed by the Complainant.

C.2. De Novo Consideration of the Complaints

26. Second, the AIB Report is only admissible as to its facts. The Respondents urge the Committee to refrain from being influenced by the opinions and conclusions contained therein and should consider the complaints *de novo*. This is, again, not disputed. Indeed, the Committee has previously stated in correspondence that it is fully conscious that the ultimate issue of whether the Respondents have acted in compliance with the professional standards is strictly a matter for the Committee, and its determination will not be made by reference to the opinions in the AIB Report.

C.3. Complainant Not Contending that Respondents Ought to Have Detected Fraud

27. Third, the Respondents point out that the Complainant’s case is not premised on the allegation that the Respondents should/would have identified any systemic fraud that might have been perpetrated by the Group’s management, nor do the complaints allege that a fraud did or did

not exist at the material time. This has been confirmed by the Complainant, whose complaints are targeted at the quality and sufficiency of audit evidence obtained and the Respondents' alleged failure to exercise sufficient professional skepticism in carrying out their audit procedures and to resolve issues that went to the reliability of the evidence gathered and the basis upon which professional judgment was then exercised.

28. The Respondents then go further. They argue that the fact that the Complainant's case is not premised on the existence or otherwise of fraud means that the question of "what the additional crucial steps would have revealed" cannot be tested by reference to the actual facts. The Complainant's case would have to be "It does not matter whether it would have revealed anything. What matters is that you omitted a crucial step. The fact that it may have led to nothing is neither here nor there." In other words, the Respondents argue, in the absence of an actual scenario which can be shown to have been "discoverable", there is nothing concrete to test the utility and need for the alleged "crucial omitted steps" and thus the Complainant's case is based purely on an exercise of theoretical and abstract "box-ticking".
29. The Complainant's position is that auditing standards require an auditor to approach every audit with an attitude of professional skepticism, as circumstances may exist that cause the financial statements to be materially misstated. Whether or not there is any fraud or "discoverable scenario", the auditor is expected to be critical, to retain a questioning mind, and to be alert to the problems with the audit evidence obtained and respond accordingly. If there are indicators that bring into question the reliability of the audit evidence obtained, the auditor should carry out adequate alternative procedures.

30. The Complainant relies on a number of auditing standards to support these submissions, including:

(1) HKSA 200.15-16

Professional Skepticism

15. The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

16. An attitude of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. For example, an attitude of professional skepticism is necessary throughout the audit process for the auditor to reduce the risk of overlooking unusual circumstances, of over generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. When making inquiries and performing other audit procedures, the auditor is not satisfied with less than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
(emphasis added)

(2) HKSA 500.12

Sufficient Appropriate Audit Evidence

...

12. The auditor ordinarily obtains more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. ... Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional audit procedures are necessary to resolve the inconsistency.
-
31. Having considered these HKSAs, which are clearly applicable to the present case, we are unable to accept the Respondents' argument that the Complainant's case is purely theoretical. As we can see from HKSA 200.15-16 and HKSA 500.12, the need to maintain an attitude of professional skepticism is a general requirement throughout any audit, and is not conditional upon the existence, or a suspected existence, of fraud. This is consistent with HKSA 240, which specifically deals with the auditor's responsibilities to consider fraud in an audit of financial statements. Such responsibilities do not arise because fraud has been found. Rather, an attitude of professional skepticism is required for the possibility that a material statement due to fraud could exist: see HKSA 240.24, 55.
 32. Simply put, an auditor should critically assess the audit evidence he/she has received and if such evidence casts doubt on its reliability or appears to be inconsistent with the management's information, the auditor should determine what additional audit procedures are necessary to resolve the inconsistency. The reason for the apparent inconsistency in the audit evidence may or may not be fraud-related, and it may well be wholly innocuous (such as an inadvertent mistake by the preparer of the document). But it is incumbent upon the auditor to ascertain that reason as far as it is possible to do so, in particular when such audit evidence has a major impact

on certain line items in the accounts, so that the risk of material misstatement is reduced to an acceptably low level: HKSA 200.17, 24. Whether there is an actual “discoverable” scenario or “bad consequence” to test the utility of the additional or alternative audit procedure is, in our view, irrelevant and certainly does not affect an auditor’s responsibilities under these professional standards, which are in place regardless of fraud. For these reasons, the fact that the Complainant’s case is not premised on the existence or otherwise of fraud does not render the complaints purely theoretical, nor does it affect the Committee’s determination of the question whether the Respondents have failed to exercise sufficient professional skepticism.

C.4. Danger of Hindsight

33. Related to the previous point, the Respondents suggest that the question of what the Respondents failed or ought to have done should not be approached by using hindsight, i.e. with the likelihood that a substantial fraud has been perpetrated within the Company, and instead should be analysed on the basis of the audit teams’ knowledge as documented in their working papers, mindset and professional judgment at the material time.
34. The Respondents criticise the manner in which the complaints are formulated and presented as reflective of the application of hindsight, seeking to isolate the ostensibly weaker evidential aspects of the two subject audits from the totality of the audit evidence. The Complainant’s reference to the steps taken by KPMG in subsequent audit engagements for the purpose of demonstrating the alleged deficient nature of the earlier IPO Engagement and the 2009 Audit was cited by the Respondents as an example of evidential hindsight.

35. The Complainant reiterates that none of the complaints are based on subsequent events, as opposed to the circumstances reasonably known to the audit team at the time of the IPO Engagement and the 2009 Audit respectively. However, it is said that the marked differences in the approach adopted by the 2009 audit team in respect of the same type of evidence is indicative of whether the IPO Engagement was conducted in accordance with the standard expected of an ordinary and competent auditor.
36. We agree with the Respondents that each audit is different and must be considered in context with regard to the information available at the time. The fact that a point is spotted on a subsequent engagement does not mean that the absence of treatment of the point on an earlier occasion was, of itself, a departure from professional standards. The different treatment of a particular issue could be attributable to the fact that the circumstances of the subsequent audit are different, a possibility which the Committee cannot completely rule out. The Committee will therefore consider the IPO Engagement without regard to the 2009 and 2010 audits, and to consider the 2009 Audit without regard to the 2010 Audit.

C.5. A Holistic Approach to be Adopted

37. In addition to the above “overarching submissions”, a recurring theme in the Respondents’ case is that an audit is not a mechanical process whereby whenever an auditor comes across something that can be regarded as a “red flag”, then what would trigger off a requirement of “rebuttal” of those red flags as a stand-alone mandatory task in an audit. Rather, they argue that an audit is an exercise of holistic evaluation of all the audit evidence. The

Respondents criticise the Complainant for inviting the Committee to consider the audit evidence and procedures in isolation from the wider context. They argue that such an approach is inappropriate and unsatisfactory, as it divorces the assessment of whether the Respondents properly exercised their professional judgment from the context in which the totality of the audit evidence is considered and constitutes the basis for the Respondents' professional judgment call. Hence, the Committee is urged to consider the cumulative effect of all audit work performed in order to consider the sufficiency and adequacy of the audit evidence obtained.

38. The Complainant agrees that when assessing the sufficiency and adequacy of the audit evidence obtained, it is necessary to consider the cumulative effect of all audit work performed. The crux of the complaints, however, lies in the alleged deficiencies in pertinent aspects of the Respondents' audit work in the IPO Engagement and the 2009 Audit that the Complainant says cannot be, and have not been, compensated by the totality of the audit evidence, including all the additional or alternative audit procedures conducted by the Respondents.
39. As a matter of principle, the Committee agrees that an audit is an exercise of holistic evaluation of all the audit evidence. Therefore, while the complaints have been set out as separate issues for the purpose of these proceedings, they will not be considered in isolation. The Committee will take into account the cumulative effect of all audit procedures performed by the Respondents and the results of their work when determining the sufficiency and adequacy of the audit evidence obtained.
40. The Committee will also bear in mind that while an auditor is not expected to obtain absolute assurance because there are inherent limitations in an

audit, an auditor should obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether due to fraud, the lack of sufficient appropriate evidence, or error. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process and it is obtained when the auditor has reduced audit risk to an acceptably low level: HKSA 200.17, 18 & 24.

41. Having discussed the above points concerning the overall approach to these proceedings, we now turn to consider each of the complaints.

D. THE FIRST AND SECOND COMPLAINTS

42. The first and second complaints concern R1 and R2's audit work in relation to the Financial Information. These complaints are further divided under the headings of Turnover, Operating Expenses for Logging Activities, Plantation Assets, and Cash and Cash Equivalents.
43. The Committee has been provided with a List of Issues, which is agreed by the parties save that the Respondents object to the inclusion of certain words enclosed in square brackets. Having considered the issues, we do not think the disputed words are material to our determination. We will therefore disregard those words when we make a determination in respect of each of the issues.

D.1. Turnover

44. According to the Respondents, the Group's only source of turnover was the sale of timber logs to customers who were mainly manufacturers of furniture and paper in Sichuan or nearby provinces. Under PRC law, the Group must obtain a valid logging permit from the local forestry bureaus before each harvest.
45. At the audit planning stage, the audit team identified and assessed the risk in respect of turnover as follows:

Nature of risk	Years ended 31 December 2006 and 2007	Year ended 31 December 2008	6 months ended June 2009
Completeness	Inherent risk: Medium	Inherent risk: Low	Inherent risk: Medium
Existence	Inherent risk: Medium Risk of fraud	Inherent risk: Low (Fraud procedures conducted)	Inherent risk: Medium Risk of fraud
Accuracy	Inherent risk: Medium Risk of fraud	Inherent risk: Low (Fraud procedures conducted)	Inherent risk: Medium Risk of fraud

46. The audit team also identified a number of "significant risk points" in respect of turnover, including:
- (1) the risk that the timber might have been harvested without a logging permit; and
 - (2) the risk that sales were improperly recognised. For the years ended 31 December 2006, 2007 and 2008, the Group recognised sales upon the receipt of payment from customer (i.e. on a cash basis), instead

of upon the delivery of the timber logs to customers. This did not comply with IAS 18.

47. In KPMG's letter to the Company dated 15 October 2008, the audit team identified certain deficiencies in the Group's internal control and operation during the audit of the Financial Information:

- (1) The Group did not have any internal audit function.
- (2) The Group's revenue was not recognised in accordance with IAS 18 as the Group recognised sales upon the receipt of payment from customers (on a cash basis) instead of upon delivery of the timber logs.
- (3) The sales contracts and invoices were not issued in sequential order.
- (4) There were no inventory management policies and procedures and without detailed records for inventories receipts and dispatches in the financial records.
- (5) The Group's forestry management was considered relatively basic and not comprehensive enough.

48. The Complainant's case on turnover concerns the audit team's alleged failure to identify and/or address a number of anomalies or "red flags" that should have prompted the audit team to critically evaluate the evidence obtained and perform further procedures to address the anomalies. The alleged failure relates to the work performed in respect of:

- (1) the validity of logging permits;
 - (2) the existence of customers; and
 - (3) the completeness of turnover.
49. Each of these specific complaints will be discussed in detail below.
50. The Respondents' common defence against all the complaints in respect of turnover is that the audit team had performed a comprehensive range of audit procedures to obtain sufficient appropriate evidence of the Group's turnover during the IPO Engagement, including, *inter alia*:
- (1) Walkthrough tests (i.e. tests performed to understand the Company's business cycle and internal controls by selecting a sample transaction and walking through the company's systems and controls to check the process and confirm that they are consistent with management's explanation) on the sales process for each period during the IPO Period;
 - (2) Tests of controls (i.e. tests of effectiveness where the auditor selects a sample of transactions and tests that sample to confirm whether the controls operated effectively) to evaluate whether the Company had harvested forests legally by: (a) selecting 15 harvest samples from each audit period; and (b) checking that the relevant logging permits had been properly applied for prior to harvesting taking place.
51. In addition to these tests, the Respondents also rely on the following steps taken as substantive audit procedures:

- (1) Compared sales volume to logging volume. This involved (i) comparing 100% of the sales volume, as set out in the sales invoices, to the volume of timber permitted to be harvested pursuant to the logging permits and the corresponding inventory level; and (ii) checking information such as harvest location, permit date, harvest date, timber type, area harvested and volume harvested in the relevant logging permits.

- (2) Checked (i) the sales of harvested logs to the sales invoices for tax purposes issued to the Group's customers; (ii) the revenue generated from the sales of the harvested logs to the sales invoices for tax purposes issued to the Group's customers; (iii) the associated harvesting expenses incurred by the Group and (iv) the year-end balances in the Group's bank accounts and that those balances correlated with the records maintained by the Group.

- (3) Vouched 100% of the Group's sales transactions for the IPO Period by:
 - (a) obtaining all sales invoices for tax purposes issued by the Group and checking the identity of the customers, the gross sales price, merchandise, unit price and quantity of timber sold;

 - (b) obtaining all sales contracts entered into by the Group and its customers and checking that the sales price, merchandise, unit price and quantity of timber sold in the sales contract agreed with the sales invoice for tax purposes;

- (c) obtaining all bank-in slips (which evidenced that cash was transferred from the customer's bank account to the Group's bank account) and checking that the bank-in amount and identity of the customer agreed with the sales invoice for tax purposes; and
 - (d) obtaining all the GDNs (which would be issued to the customer confirming the volume and type of logs delivered) and checking that the goods (as set out in the sales contract) had been delivered to the customer.
- (4) Checked 100% of revenue receipt in the Group's bank statements to the bank-in slips. It is suggested by the Respondents that the Group did not receive revenue in the form of cash or banknotes, but solely in the form of bank transfers from customers.
- (5) Obtained third-party confirmations from the Group's customers:
 - (a) confirming the account balances with each customer for the years ended 31 December 2006 and 2007; and
 - (b) confirming the sales amount for the year ended 31 December 2008 and six months ended 30 June 2009 and account balance with each customer as at 31 December 2008 and 30 June 2009, which confirmations accounted for 92% and 100% of the sales transactions for the year / period respectively.

- (6) Obtained third-party confirmations from the Group's banks and reviewed the bank reconciliations at year / period end to ensure the appropriate treatment of reconciling items for the IPO Period, which is said to provide evidence that the transactions and balances recorded in the Group's books were accurate and complete.
 - (7) Arranged company searches on the Group's customers despite being able to locate only a relatively small proportion of the Group's customers through those searches; made enquiries with the Group's management and obtained an explanation for the company search results; and obtained the due diligence reports prepared by the IPO sponsors and their lawyers in respect of the Group's customers in Sichuan (including notes of site visits to the customers).
 - (8) Obtained and inspected copies of: (i) the business licences of the Group's customers in Sichuan for the year ended 31 December 2008; and (ii) the business licenses for all of the Group's customers for the six months ended 30 June 2009.
52. The Respondents argue that these tests and procedures are extensive and comprehensive and the totality of audit evidence obtained by the audit team strongly outweighs the alleged red flags (if there were any), and justifies the opinion which the Respondents had expressed in the accountant's report.
53. The Respondents' responses to the specific complaints will be discussed below.

D.1.1 Validity of Logging Permits

The Complaint

54. As mentioned above, the Group was not authorised to carry out any legal logging activities without first obtaining a logging permit from the local forestry bureaus. The validity of logging permits would not only provide evidence on the completeness, existence and accuracy of the Group's turnover, but also evidence on the existence of Group's ownership of the plantation assets. As part of the substantive procedure, the Respondents in the IPO Engagement checked the recorded sales to the logging permits. The audit team inspected the logging permits held by the Group and did not identify any issue.
55. The Complainant, however, criticises the Respondents for failing to identify a number of "red flags" in the logging permits.
56. First, it is said that a substantial number of the logging permits were identical looking except for the serial number. They were all handwritten, the handwriting on those identical looking permits was the same, and the chops of the relevant government authorities and officials were stamped in the same position and orientation on each permit. For example, for the 6 months ended 30 June 2009, the audit team inspected a total of 2,361 logging permits. Amongst those permits, there were only 218 unique documents and the remaining 2,143 permits were all identical to the other permits in the file except for their serial number.
57. The second alleged "red flag" is that the contents of the logging permits did not accord with the audit team's understanding of the Group's business

process. It was the Respondents' understanding at the time that the Group's resources management department would apply for a logging permit specifically for each customer order². However, the audit team's work in reconciling the logging permits to sales order showed that the customer orders were supported by multiple logging permits which were largely identical in terms of contents, and some of the logging permits were used for multiple and different customer orders.

58. According to the Complainant, the identical appearance of a substantial number of the handwritten logging permits was highly unusual and should have caused a reasonable auditor to question whether the logging permits were authentic or reliable as audit evidence, and also question the propriety of the logging permit application and approval process claimed by the Respondent to have been conducted with the local forestry bureaus. The Complainant therefore submits that in view of these "red flags" and the significance of the logging permits in the logging process, the audit team should have (i) performed a critical assessment of whether the logging permits were reliable or authentic, (ii) obtained a legal opinion to confirm the validity of the logging permits; and/or (iii) obtained direct confirmations from the forestry bureaus which issued the logging permits for each of the relevant periods. But the audit team did not carry out any of these steps.

² This was set out in the Company's IPO Prospectus and referred to in §87.2 of the Respondents' Amended Case.

59. The Complainant therefore argues that the Respondents had failed to:
- (1) exercise sufficient professional skepticism to question the validity of the logging permits in accordance with HKSA 200.15 (to be read with HKSA 200.16);
 - (2) consider whether the identical-looking, handwritten logging permits indicated a risk of material misstatement due to fraud in accordance with HKSA 240.55;
 - (3) perform additional audit procedures to enable them to obtain sufficient appropriate evidence in respect of the validity and reliability of the logging permits in accordance with HKSA 500.2 (to be read with HKSA 500.7).

The Defence

60. The Respondents deny the existence of any of the alleged “red flags”. First, the Respondents argue that it is not part of their duty to subject the permits to minute examination with a view to checking whether they appeared “identical”. Second, in the absence of any evidence that handwritten or identically printed logging permits on the Mainland are unusual to the knowledge of Hong Kong auditors, there is no basis to say that the Respondents ought to have acted upon this fact. The Respondents further suggest that there could be perfectly innocuous reasons why they were “identical” in the sense of being pro forma.
61. In response to the Complainant’s case that the way in which the logging permits were used was inconsistent with the Respondents’ understanding

of the Group's business process, Mr Shieh submits that one must not treat the Company's statement (that it would apply for a logging permit specifically for each customer order) as an "immutable biblical rule" that there is a singular logging permit for one singular contract; and even if one were to treat it as a rule there was no material deviation and there might have been innocuous reasons for the inconsistency. In any event, as mentioned above, the Respondents rely on the wide range of tests and substantive procedures which they say have enabled the audit team to obtain sufficient appropriate audit evidence on the validity of the logging permits.

Discussion

Issue 1: In respect of the validity of the logging permits, whether the Respondents have failed to:-

- (1) exercise sufficient professional skepticism to question the validity of the logging permits in accordance with HKSA 200.15;
- (2) consider whether the handwritten logging permits indicated a risk of material misstatement due to fraud in accordance with HKSA 240.55;
- (3) perform additional audit procedures to enable them to obtain sufficient appropriate evidence in respect of the reliability of the logging permits in accordance with HKSA 500.2.

62. We have considered the logging permits (which are photocopies in the hearing bundles) and we share the Complainant's observation that a vast majority of the permits in the audit files look identical except for their serial numbers. Many of the permits contain exactly the same contents (e.g.

logging volume, type of wood, location), with the same or even identical looking signatures and chops affixed in exactly the same place of the documents. While we are fully aware that an auditor is not trained or expected to be an expert in the authentication of documents (HKSA 240.26 and HKSA 500.10), in our view the identical (or close-to-identical) appearance of the logging permits is fairly obvious and, contrary to Mr Shieh's submissions, does not require a forensic study of the documents to be spotted.

63. We have also considered whether, in the course of performing the audit, it was reasonable for the audit team to have noticed that the logging permits looked identical. In this connection, we note that the audit team performed the walk-through tests (where they tried to match a particular sale with the logging permits) and tests of control (where they checked if particular harvest samples were supported by logging permits). In performing these tests, the audit team would have to closely examine and record the contents of the permits (such as type of wood, volume of wood permitted to be harvested, serial numbers of the permit, etc). In the test samples we were given, multiple identical-looking permits were used for the purpose of the same customer order, while the same logging permit was used for different orders. In our view, in the course of performing these tests, it would have been obvious to a reasonable auditor that the logging permits appeared to be identical and that the use of the permits was inconsistent with the Respondents' understanding of the Group's business at the time.
64. As we see it, given that the forest industry in the PRC was still relatively rudimentary at the time, the fact that the logging permits were handwritten is not, *per se*, necessarily a cause of concern. However, it would be reasonable to expect the audit team to raise questions about the identical

appearance of the permits and to seek management's explanations and other collaborative evidence that would confirm that they are genuine. Such a suspicion is exacerbated by the Respondents' understanding given by the Group that it would apply for a logging permit specifically for each customer order. If the Respondents' understanding of the Group business process was correct, then one would expect the majority or possibly all of the logging permits prepared and issued pursuant to different customer orders to be different, and they would only be the same if the customer orders were exactly the same (which was not the case). In addition, as mentioned above, the way the logging permits were allocated to the sales contracts (i.e. multiple permits for the same customer order and the same permit for multiple orders) is also inconsistent with the Respondent's understanding.

65. Mr Shieh argues that it is not an immutable rule that a logging permit is to be applied for a specific customer order. We agree that it is not an immutable rule in the sense that the Group was not permitted to depart from it. However, if the audit evidence did not support the Respondents' understanding of the Group's business process, additional steps should be taken by the auditor to ascertain why there was such an inconsistency.
66. As for Mr Shieh's submissions that even if there was any inconsistency, it was immaterial and there might have been innocuous reasons, such as the logging permits were pre-filled for administrative convenience, and that the logging permits were issued in identical denominations of 225 cubic metres and multiple permits were used to make up for the balance, etc.
67. We are unable to accept such submissions. First, the inconsistency is material. The logging permits constituted one of the primary audit

evidence and their reliability is material to many line items in the Company's accounts. If the forestry bureaus only issued unique logging permits but a vast majority of the Group's logging permits were identical looking with identical contents, one would reasonably question the authenticity of those logging permits provided to the auditors, and this would in turn bring into question whether there is sufficient appropriate audit evidence obtained by the audit team. Moreover, since the audit team used the logging permits for a number of audit procedures (such as test of control and comparing sales volume to logging volume), the reliability of all these procedures would hinge on the validity of the logging permits. Secondly, the suggested "innocuous reasons" are postulations which are not mentioned in any of the audit working papers, the AIB Report or the Respondents' Amended Case and, more importantly, no audit work was performed to confirm the existence of those purported "innocuous reasons". In any event, it is also possible that the identical appearance of the logging permits was due to human error or even fraud, in particular when a medium-level inherent risk and a risk of fraud in terms of existence and accuracy of turnover had been expressly identified at the audit planning stage.

68. HKSA 200.15 and 16 require an auditor to plan and perform an audit with an attitude of professional skepticism, i.e. the auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of information obtained from management.
69. HKSA 240.55 states that when obtaining an understanding of the entity and its environment, including its internal control, the auditor should

consider whether other information obtained indicates risks of material misstatement due to fraud.

70. For the reasons we have discussed above, we accept the Complainant's submissions that there are material anomalies which bring into question the reliability of the logging permits as audit evidence, and those anomalies also indicate risks of material misstatements due to fraud.
71. The question that follows is whether the Respondents planned and performed the audit in the IPO Engagement in response to these risks of material misstatements. There is no suggestion that the audit team raised any questions or carried out any steps or procedures to specifically address the identical appearance of the logging permits. What the Committee needs to consider, therefore, is whether the tests and the substantive audit procedures performed by the audit team, taken as a whole, nonetheless enabled them to obtain sufficient appropriate evidence in respect of the reliability of the logging permits in accordance with HKSA 500.2.
72. HKSA 500.7 – 14 provide the relevant guidance on what constitutes sufficient appropriate audit evidence.

“Sufficient Appropriate Audit Evidence

7. Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality.

8. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. ...

9. The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of audit evidence can be made; however, such generalizations are subject to important exceptions. Even when audit evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable.

...

11. When information produced by the entity is used by the auditor to perform audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information. In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate...

12. The auditor ordinarily obtains more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. In addition, obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from a management representation. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional audit procedures are necessary to resolve the inconsistency." (emphasis added)

73. We have carefully considered all the relevant audit procedures and tests performed by the audit team, and our overall conclusion is that these procedures and tests, whether taken individually or collectively, did not address the validity or the reliability of the logging permits.

(1) While some of these procedures (e.g. walkthrough test on the sales process, obtaining bank confirmations and reviewed bank reconciliations, vouching the recorded sales to sales invoices, sales contracts, bank slips and GDNs, checking the revenue receipts, vouching the recorded expenses to payment receipts and bank slips)

may support the assertion that certain sale transactions or business operations took place, they cannot address the issue of whether the logging permits were valid and properly issued by the forestry bureaus (HKSA 500.8).

- (2) We notice that some of these procedures or tests (e.g. test of control and comparing sales volume to logging volume stated on the logging permits) were performed on the very assumption that the logging permits were authentic. But this assumption was never verified to be accurate (HKSA 500.11).

74. Under HKSA 240.26, if conditions identified during the audit cause the auditor to believe that a document may not be authentic, the auditor should investigate further, for example by confirming directly with the third party or considering using the work of an expert to assess the document's authenticity. Notwithstanding the matters raised in paragraphs 62 to 64 above, the audit team did not take any step to investigate further or verify the validity of the logging permits.
75. In view of the above reasons, we have found on the evidence that the three questions under Issue 1 are to be answered in the affirmative.

D.1.2 Existence of Customers

The Complaint

76. The audit team carried out a number of audit procedures to verify the existence of the Group's customers, including (i) performing company searches on the Group's customers; and (ii) sending confirmation requests

to the Group's customers (using the names and addresses provided by the Group) and asking them to confirm the sales figures.

77. The audit team instructed third party search agents to perform company searches on the Group's customers in January 2008 and April 2009. The results indicated that the registration, contact or information of a majority of the Group's customers could not be found in the industrial, commercial or public domain (i.e. negative results).
78. In addition to checking the relevant company's registration at the relevant State Administration for Industry and Commerce ("AIC") branch, the search agent also:
 - (1) made enquiries with local authorities (including local tax bureaus and the AIC) to enquire about the customers;
 - (2) making enquiries with other companies located in the same area; and/or
 - (3) conducting searches on the Internet and on local yellow pages.
79. Despite these efforts, the audit team obtained negative search results in respect of:
 - (1) 9 out of 10 customers for the year ended 31 December 2006;
 - (2) 13 out of 16 customers for the year ended 31 December 2007; and
 - (3) 15 out of 17 customers for the year ended 31 December 2008.

80. The Complainant argues that the negative search results for the vast majority of the Group's customers represent an obvious anomaly which should have prompted the audit team to at least investigate into the cause of the anomaly and obtain further evidence to dispel the concerns. However, there is no evidence in the working papers that the audit team had taken any steps to address the anomaly, and thus the Respondents failed to obtain sufficient appropriate audit evidence in accordance with HKSA 500.2 (to be read together with HKSA 500.7).
81. Another procedure conducted by the audit team was to obtain confirmations from all of the Group's customers to confirm the account balance and sales amounts for (i) 1 April 2008 to 31 December 2008; and (ii) the 6 months ended 30 June 2009.
82. According to the Complainant, the returned customer confirmations contained a number of anomalies or "red flags":
- (1) The confirmation requests were sent using the same contact information and addresses of the customers used for the company searches. While the search results for a number of customers were negative, the confirmation requests sent to those customers were returned.
 - (2) 7 of the returned confirmations for the 6 months ended 30 June 2009 had sequential mail codes on the envelope despite being sent from different addresses.

83. At the hearing, Ms Tong explained that the sequential mail codes were indicative of the confirmations being sent together in one batch and processed by the same postal office at the same time.
84. The Complainant argues that these “red flags” suggest that the returned confirmations might not be reliable or at least required obtaining valid explanation, but there is no evidence in the working papers that the audit team had identified or addressed these issues. The Respondents’ alleged failure to ascertain the reliability of the confirmations received and resolve the anomalies is said to be in breach of HKSA 200.15 (to be read together with HKSA 200.16) and HKSA 505.33.

The Defence

85. The Respondents’ overall response to this complaint is that the negative search results were inconclusive, as there is no specific requirement under the HKSA to carry out company searches, and under Mainland regulatory regime there was no mandatory requirement for registration which was invariably adhered to. Further, while positive company search results can add to the pool of knowledge of an auditor, a negative company search does not mean that a company or the item of sales does not exist.
86. Secondly, the identification of the sequential mail codes involved a forensic exercise (in the sense of requiring a mind which is determined to spot or focus on a particular feature). The standard procedure for checking the customer confirmations did not require scrutinising the mail codes, and the Complainant gives no explanation for how and why the sequencing would become “blatantly obvious” in the course of this process.

87. The Respondents further say that, in any event, the sequential nature of the mail codes is susceptible to innocuous explanations (e.g. the registration records might be held with another AIC branch or the customer might not be properly registered) which do not detract from the ultimate conclusion to be tested, namely the existence and genuineness of the sales items, and the broader range of audit procedures performed by the audit team on the Group's turnover, taken together, provided sufficient appropriate evidence of the existence of the Group's turnover and customers.

Discussion

Issue 2: In respect of the existence of customers, whether the Respondents have failed to:-

- (1) obtain sufficient appropriate audit evidence when the result of the company searches identified exceptions in accordance with HKSA 500.2;
- (2) exercise sufficient professional skepticism in identifying factors that gave rise to doubts on the reliability of the returned customer confirmations and obtaining further audit evidence to resolve these doubts, in accordance HKSA 200.15 and HKSA 505.33.

88. There can be no question that the existence of the Group's customers was important as it affected whether the recorded sales attributable to them could be properly verified, which could then confirm the existence and accuracy of the turnover.

89. The company searches served an important purpose of confirming or corroborating the existence of the Group's customers and it was by no

means auxiliary or merely “nice-to-have” in the IPO Engagement. The negative search results in respect of a large majority of the customers should draw the attention of a reasonable auditor who would raise questions and conduct follow up procedures. It is therefore wholly unacceptable for the Respondents to say that the negative search results were “inconclusive” as to the existence of the customers, for that excuse defeats the very purpose of the company searches. In our view, the negative search results using information provided by the Company for a vast majority of the customers is a material inconsistency within the meaning of HKSA 500.12. The audit team should have been prompted to (i) inquire further on the existence of those customers and (ii) resolve why the contact information provided by the Company could not be found in the industrial, commercial or public domain.

90. With regard to the returned customer confirmations, we accept the Respondents’ submissions that the sequential mail codes might not have been obvious to the audit team, as it was not part of the standard procedure to check the mail codes on the returned confirmations. However, the fact that the confirmation requests were all returned, despite the negative search results using the same contact information, would appear to be an anomaly or questionable to a reasonable auditor, as it brings into question the reliability of the contact information provided by the Group, and/or the existence of the customers.
91. The Respondents put forward a number of “innocuous reasons” for the inconsistency but none of them had been articulated in the audit working papers and tested by the audit team to be the real reasons or explanations. Moreover, it does not appear that they had performed any additional steps to specifically address the negative search results.

92. With regard to the substantive audit procedures, we agree with the Complainant's submissions that while most of those audit procedures were related to turnover, they were not designed to address the specific issue of whether the Group's customers actually existed and could not provide sufficient appropriate evidence as to the existence of the Group's customers and turnover. For example, the walkthrough test served to understand the Group's sales process and the test of control was to check if the Group had obtained a logging permit before each harvest, but neither of them addressed the issue relating to the existence of customers. Similarly, the bank confirmations were not designed to and could not verify the existence of customers.
93. The Respondents also rely on the fact that the audit team obtained and inspected the customers' business licences. However, as the Complainant points out, this procedure raised even more questions as some of the information shown on the business licenses conflicted with the results of the company searches.
94. The Respondents further contended that they obtained all bank-in slips and checked that the bank-in amount and identity of the customers agreed with the sales invoice for tax purposes. Insofar as the bank-in slips are concerned, the Committee has a number of reservations. First, it is unclear whether the bank-in slips were prepared by the relevant banks or the Company, and under what circumstances they were prepared. Secondly, as the Complainant has pointed out, if the Respondents' contention is that the bank-in slips evidenced that funds were being transferred to the Group from a bank account held in the customers' name, this was not recorded in the working papers (which only stated that the audit team had checked if

the “*proceeds have been deposited into the client’s bank accounts from the client’s customers*”). In any event, the procedure was not carried out for the purposes of verifying the existence of the customers and the corroborative value of such evidence is limited in light of the red flags identified.

95. In conclusion, we find that the Respondents have failed to comply with HKSA 500.2 and 505.33 in respect of the existence of customers, and the two questions under Issue 2 are to be answered in the affirmative.

D.1.3 Completeness of Sales

The Complaint

96. This complaint relates to the audit team’s alleged failure to address the risk of understatement of sales. According to the Complainant, the risk of understatement arises from the following deficiencies in the Group’s internal controls:

- (1) the audit team had identified a number of material internal control deficiencies which might have an impact on the completeness of the sales transactions recorded by the Group, meaning that the Group’s controls over the completeness of sales were unreliable;
- (2) the completeness of turnover was identified as one of the inherent risks in the audit, with a “medium” risk rating (apart for the year ended 31 December 2008, where the risk rating was “low”); and

- (3) the issues concerning the validity of the logging permits, the existence of customers and logging expenses raised questions about the reliability and accuracy of the Group's records for turnover.
97. While the Complainant accepts that the audit team had performed a number of substantive audit procedures to test the Group's turnover, the Complainant submits that none of those procedures could properly test for sales transactions which had not been recorded by the Group (i.e. understatement of sales). The complaint focuses on the alleged deficiencies in respect of (i) two substantive procedures relied on by the audit team; and (ii) the reasonableness test.
98. First, in the vouching of sales transactions and sales cut-off tests, the audit team tested sales transactions selected from a population of the Group's recorded sales. It is said that the work itself cannot detect if there were any "missing" or "unrecorded" transactions which had not been recorded by the Group, and hence could not address the risk of understatement of sales.
99. In respect to the Respondents' suggestion that they had obtained all sales invoices, sales agreements, bank-in slips and GDNs from the Group (which tallied with the Group's sales record and hence supported completeness), the Complainant criticises the audit team for omitting to test the completeness of the documents provided or any system of control over the maintenance of the completeness of such information and documentation, even though the audit team was aware that the Group's sales documents were not numbered in sequence, and the audit team could not rely on the Group's sales documentation to determine whether a complete set of documents had been provided.

100. The Complainant argues that in order to properly test for understatement of sales, the correct population should have been the complete population of delivery or goods receipts by customers or other appropriate evidence of dispatch (such as confirmations obtained directly from relevant forestry bureaus as to the volume of logs harvested). There is no indication in the working papers that the audit team had ascertained whether the population used was appropriate and complete. For these reasons, the Complainant submits that the Respondents failed to select test samples from an appropriate and complete population in accordance with HKSA 530.35 and 530.35a.
101. Second, in relation to the reasonableness test, the objective as stated in the working papers was to substantiate that sales revenue was not materially misstated. The audit team developed an expected amount of turnover and compared that with the amount of turnover actually recorded by the Group. The expected amount of turnover was determined by applying (i) the average contract sales price to (ii) the sales volume data extracted from the Group's sales ledger (i.e. the Group's recorded sales). According to the Complainant, the deficiency of this procedure lies in the fact that the audit team did not properly evaluate the reliability and accuracy of the Group's recorded sales (which formed the benchmark of comparison) and hence in breach of HKSA 520.12 (to be read with HKSA 520.12c).
102. In light of the above circumstances, the Complainant argues that the Respondents had failed to:
- (1) adequately consider the reliability of evidence provided by the Group (including the Group's sales records and the completeness of

the underlying sales documentation provided) in performing the audit tests; and

- (2) obtain sufficient appropriate audit evidence on the completeness of the Group's turnover,

in accordance with HKSA 500.2 (to be read together with HKSA 500.7) and 500.11.

The Defence

103. In the Respondents' Amended Case, their primary defence is that the audit team had performed a comprehensive range of audit procedures and obtained sufficient appropriate audit evidence which addressed both the risk of overstatement and understatement of sales. The audit team was aware that the Group's sales documentation was not sequentially numbered and they carried out the following audit procedures which did not rely on the numbering of the documents:

- (1) walkthrough tests to understand the sales process;
- (2) for the 6 months ended 30 June 2009, tests of control to evaluate whether sales had been properly recognised;
- (3) vouched 100% of the Group's recorded transactions to a number of underlying supporting documents and checked 100% of the revenue receipts in the Group's bank statements to the bank-in slips;

- (4) obtained confirmations directly from the Group's customers of the total sales amount (for the year ended 31 December 2008 and the 6 months ended 30 June 2009) and end of period account balances (for each of the audit periods);
 - (5) obtained bank confirmations for all of the Group's bank balances and reviewed the bank reconciliation at year/period end, with no exceptions noted;
 - (6) compared 100% of the sales volume set out in the sales invoices to (i) the volume of timber permitted to be logged pursuant to the logging permits; and (ii) the transfer of inventory due to harvesting, with no exception noted. The work papers expressly acknowledge that this test was designed to detect understatement of sales.
104. The Respondents further deny the Complainant's allegation that they had failed to evaluate the reliability of the sales volume data used in the reasonableness test on turnover. It is said that the reasonableness test was to assess the accuracy of turnover rather than to address its completeness. In any event, the Respondents say that the completeness and accuracy of the sales volume data was assessed through the comprehensive procedures mentioned above.
105. According to the Respondents, the only transactions which the above procedures could not detect were sales that were entirely off-book, i.e. those which were (i) not recorded in the Group's books and records; (ii) made to customers which had not been disclosed to the audit team (and therefore no confirmations were sent); and (iii) paid for in cash or into bank account which had not been disclosed to the audit team. In the context of

the fact that the Company was at the material time contemplating an IPO and the exhaustive tests that KPMG had conducted on the reported sales of the Company, the possibility of understatement of sales which are “off-book” cannot be regarded as sufficiently significant to compel a test for understatement. In any event, the Respondents criticise that even on the Complainant’s own case, the Company’s GDN system was inadequate (in particular, the GDNs were not issued in sequential order) and if so, it is questionable how the Complainant’s proposed test can be said to reliably detect the risk of understatement.

Discussion

Issue 3: In respect of the completeness of sales, whether the Respondents have failed:-

- (1) in relation to substantive procedures, i.e. vouching of sales transactions and sales cut-off tests, to select test samples from an appropriate and complete population in accordance with HKSA 530.35 and 530.35a;
- (2) in relation to the reasonableness test, to evaluate the reliability and completeness of the sales volume data used in the 1st Respondent’s analytical procedures, in accordance with HKSA 520.12;
- (3) to adequately consider the reliability of evidence provided by the Group in performing the audit tests, and obtain sufficient appropriate audit evidence on the completeness of the Group’s turnover, in accordance with HKSA 500.2 and 500.11.

106. HKSA 530.35 requires an auditor to ensure that the population is:

- (1) *appropriate* to the objective of the audit procedure, which will include consideration of the direction of testing. For example, if the auditor's objective is to test for overstatement of accounts payable, the population could be defined as the accounts payable listing. On the other hand, when testing for understatement of accounts payable, the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports or other populations that provide audit evidence of understatement of accounts payable; and
- (2) *complete*. For example, if the auditor intends to select payment vouchers from a file, conclusions cannot be drawn about all vouchers for the period unless the auditor is satisfied that all vouchers have in fact been filed. Similarly, if the auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period.

107. HKSA 530.35a provides that the auditor is required to obtain audit evidence about the accuracy and completeness of information produced by the entity's information system when that information is used in performing audit procedures. When performing audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate. As we see it, this requirement to test for completeness and

accuracy is to address both the risk of understatement and overstatement of a particular account and is a basic requirement in any audit.

108. In relation to the vouching of sales transactions, we note that the transactions were checked from the recorded sales but this testing procedure was not adequate for the audit team to ensure that the recorded sales was the complete population. To address the risk of understatement of sales, the auditor should have first ascertained the completeness and accuracy of various sets of supporting business documents such as inventory records, GDNs and sales invoices and matched the details in those documents with the Group's recorded sales transactions to see if there were any missing sales. For the same reasons, we also take the view that in the sales cut-off tests (which involved selecting samples from the Group's sales ledger and matching the recorded sales with various supporting documents), the Respondents did not select test samples from an appropriate and complete population and the tests were unable to address of the risk of understatement of sales.
109. As for the reasonableness test, a primary purpose of the test is to identify any unexplained fluctuations in sales and unusual movements. It is a form of analytical procedure which may highlight anomalies in the sales data where further audit procedures can be considered and conducted. In this connection, HKSA 520.12 requires the auditor to consider the reliability of the data with which the expectation is developed when designing and performing analytical procedures as substantive procedures.
110. The Respondents argue that the completeness and accuracy of the sales volume data was assessed through the comprehensive procedures that the audit team had carried out. However, having considered each of these tests

in detail, we are not satisfied that these tests were effective for the purpose of evaluating the reliability and completeness of the Company's sales volume data. For example, the comparing of sales volume as stated in the sales invoices to logging volume, which involved inspection of logging permits and the corresponding inventory level, was expressly stated to detect understatement of sales. However, the test suffered a few material deficiencies. Firstly, the reliability of the logging permits is questionable for the reasons we discussed above. Secondly, there is no suggestion that the sales invoices provided by the Group were checked to be complete for the auditor to ensure that the sales volume as recorded in the sales invoices was also complete. Thirdly, the test would only be workable if sufficient appropriate audit evidence on the actual logging volume was obtained by the auditor and adequate verification work was carried out. However, it is not suggested that the audit team had carried out such verification. On the whole, we accept the Complainant's submission that the Respondents failed to evaluate the reliability and completeness of the sales volume data under the sales analytical procedures.

111. The Respondents argue that since the Company was planning for an IPO and the audit team had performed a whole host of procedures on the recorded sales of the Company, the risk of understatement of sales which are "off-book" cannot be regarded as sufficiently significant to warrant a test for understatement. We disagree. First, an auditor should plan and execute its auditing procedures to deal with the risks of both understatement and overstatement of sales. Second, the approach adopted by the Respondents, which was based on an assumption that the risk of understatement of sales might be insignificant due to the Company's intended IPO, is unacceptable in any audit under HKSA. The Respondents did not identify any audit evidence which supported this assumption, and

there are no supporting documents in the audit files which show that the audit team had verified the reasonableness of the above assumption during the IPO Engagement. Thirdly, since the audit team had identified a number of internal control deficiencies (mentioned above) which affected the completeness, existence and accuracy of turnover, and the completeness of turnover was identified as one of the inherent risks in the audit with a “medium” level except for the year ended 31 December 2008, the Respondents had no basis to assert that the risk of understatement “cannot be regarded as sufficiently significant” without having properly tested for understatement.

112. The remaining issue is whether the tests and substantive procedures taken as a whole were nonetheless effective to address the risk of understatement, hence the Respondents obtained sufficient appropriate audit evidence on the completeness of the Group’s turnover. In the course of the discussion above, we have set out our views on why certain tests were deficient and unable to address the risk of understatement and we need not repeat the same views here. As for the other tests and procedures, we have considered them in detail. Suffice it to note that they either did not address the risk of understatement or the source data used in such tests and procedure were unreliable or possibly incomplete. In this regard, we accept the Complainant’s comments and submissions on completeness of turnover as set out in Appendix 1 to the Complainant’s Written Submissions.
113. In conclusion, we have found on the evidence that the three questions under Issue 3 are to be answered in the affirmative.

D.2. Operating Expenses for Logging Activities

114. The Group's logging expenses comprised the cost of harvesting and forest maintenance fees. At the audit planning stage, the audit team assessed the risks in relation to logging expenses as follows:

Nature of risk	Years ended 31 December 2006 and 2007	Year ended 31 December 2008	6 months ended June 2009
Completeness	Inherent risk: Medium	Working paper not provided	Inherent risk (no rating given)
Existence	Inherent risk: Medium	Working paper not provided	Inherent risk (no rating given)
Accuracy	Inherent risk: Medium	Working paper not provided	Inherent risk (no rating given)

115. The Group recognised logging expenses on a cash basis (i.e. when such expenses were paid) instead of an accrual basis (i.e. when such activities took place). This was not in compliance with IFRS. The complaints under this heading relate to the completeness and accuracy of logging expenses and the company search results obtained in respect of Dehong Hongda, the Group's sole logging service provider in Yunnan.

D.2.1. Completeness of logging expenses

The Complaint

116. This complaint relates to the audit team's alleged failure to address the risk of understatement of logging expenses by obtaining sufficient appropriate evidence on the reliability and completeness of logging expenses. The complaint focuses on the alleged deficiencies in respect of (i) the

reasonableness test; and (ii) two substantive procedures relied on by the audit team.

117. First, in undertaking the reasonableness test, the audit team compared the trend in logging expenses with turnover in order to consider their reasonableness in the overall review at the end of the audit. The reliability of the reasonableness test is affected by the completeness and accuracy of the turnover figures used for the comparison. The Complainant argues that given the issues concerning the reliability of the turnover figures, the reasonableness test could not provide sufficient appropriate evidence as to the completeness of logging expenses with reference to HKSA 520.12 (to be read with HKSA 520.12c).
118. Secondly, in the following substantive procedures mentioned below, the audit team tested transactions selected from a population of the Group's recorded expenses. According to the Complainant, however, the work could not detect if there were any "missing" expenses which had not been recorded by the Group, and hence could not address the risk of understatement of operating expenses for logging activities.
 - (1) Vouching of logging expenses involved the Group's recorded logging expenses to receipts and bank-in slips; and
 - (2) Search for unrecorded liabilities involved vouching selected transactions recorded in the Group's expenses ledger for a period immediately following the end of the relevant audit period to the supporting documentation to check if they had been booked in the correct accounting period.

119. The Complainant says that in order to properly test for understatement of logging expenses, the correct population should have been the complete set of subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, etc. There is no indication in the working papers that the audit team had ascertained whether the population used was appropriate and complete in accordance with HKSA 500.11 and HKSA 530.35.
120. The Complainant further submits that, in light of the above, the Respondents had also failed to adequately consider the reliability of evidence provided by the Group, and to obtain sufficient appropriate audit evidence on the completeness of the operating expenses for logging activities in accordance with HKSA 500.2 (to be read with HKSA 500.7).

The Defence

121. The Respondents explained to the AIB that they identified the risk in this account as primarily one of overstatement, rather than understatement. This is because the Group had to pay logging expenses to third party harvesters *before* they rendered the logging activities, and since the Group recognised expenses upon payment, this would lead to the premature recognition of expenses.
122. In any event, the Respondents' defence is that they had performed a wide range of audit procedures and obtained sufficient appropriate audit evidence to ascertain the completeness of the Group's logging expenses. The cumulative effect of those procedures was to test for both overstatement and understatement. The substantive procedures are:

- (1) a vouching exercise on harvesting fees, which involved (i) obtaining a breakdown of harvesting fees; (ii) matching the fees to receipts issued by Dehong Honda for Yunnan and the local villages for Sichuan; and (iii) matching the receipts to the corresponding bank payment slips issued by a number of different banks to the Group;
- (2) a vouching exercise on forest maintenance fees, which involved (i) obtaining a breakdown of forest maintenance fees; (ii) matching the fees to receipts issued by the relevant forestry bureaus; and (iii) matching the receipts to the corresponding bank payment slips issued by several banks to the Group.

123. The Respondents further rely on the following steps which they say substantiated that there were no material unrecorded liabilities at the end of the year:

- (1) The audit team performed a test involving (i) obtaining the expense ledger for the months immediately before and following the period end and selecting expenses greater than the 'audit difference posting threshold'; (ii) for all expenses selected, vouching the supporting documents and investigating the nature of the expenses to ensure that it was properly accrued in the correct financial period; and (iii) recording the vouchers checked and the results. For each period, the audit team concluded that there were no material unrecorded liabilities.
- (2) For the IPO Period, the audit team performed an analytical review and found that the increase in logging expenses between periods

correlated to the increase in the volume of logs harvested (i.e. what the Complainant refers to as the reasonableness test).

- (3) The audit team obtained confirmations from the Group's banks of the period end account balances which correlated with the records maintained by the Group, providing evidence that the transactions and balances recorded in the Group's books were accurate and complete.

Discussion

Issue 4: In respect of the completeness of logging expenses, whether the Respondents have failed:-

- (1) in relation to the reasonableness test, to evaluate the reliability and completeness of the evidence provided by the Group, in accordance with HKSA 520.12;
- (2) in relation to substantive procedures, i.e. vouching of logging expenses and search for unrecorded liabilities, to adequately consider the appropriateness and completeness of the population used for testing understatement of liabilities in accordance with HKSA 500.11 and HKSA 530.35;
- (3) to adequately consider the reliability of evidence provided by the Group in performing the audit tests, and to obtain sufficient appropriate audit evidence on completeness of the operating expenses for logging activities, in accordance with HKSA 500.2.

124. While the Respondents had maintained their position that the risk in respect of logging expenses is primarily one of overstatement, we do not think it

can be seriously disputed that there was a risk of understatement, as the completeness, existence and accuracy of logging expenses were identified as inherent risks in the audit. Indeed, in paragraph 162 of their Amended Case, the Respondents expressly acknowledge that there was a risk of unrecorded transactions. What the Committee needs to consider then is whether the range of audit procedures effectively addressed such a risk and enabled the audit team to obtain sufficient appropriate audit evidence on the completeness of the operating expenses for logging activities.

125. In relation to the reasonableness test, we have concluded above that the Respondents had failed to evaluate the reliability and completeness of the sales volume data used in the test. Since the sales volume data and turnover figures were used as a benchmark in the reasonableness test to compare the trend in the Group's logging expenses, the reliability of the audit team's conclusion based on the test results (i.e. that the increase in logging expenses between periods correlated to the increase in the volume of logs harvested) is questionable. In the premises, we take the view that the Respondents had failed to evaluate the reliability and completeness of the evidence provided by the Group and the Respondents cannot rely on the reasonableness test for the purpose of obtaining sufficient appropriate audit evidence on the completeness of the Company's logging expenses.

126. As regards the vouching of logging expenses and search for unrecorded liabilities, these exercises suffer the fundamental problem of selecting the expense items from the Group's recorded expenses or expenses ledger. Therefore, they were not sufficient to detect if there were any logging expenses which had not been recorded by the Group, and hence could not address the risk of understatement. We agree with the Complainant's submission that in order to properly test for understatement of logging

expenses, the correct population should have been the complete set of subsequent disbursements, unpaid invoices, suppliers' statements, unmatched payment receipts, etc. There is no indication in the working papers that the audit team had ascertained whether the population used was appropriate and complete. In the premises, we hold that the Respondents had failed to adequately consider the appropriateness and completeness of the population used in these exercises in accordance with HKSA 500.11 and HKSA 530.35.

127. With regard to the other procedures carried out by the audit team, we have considered them in detail. However, we take the view that they could not be relied upon by the auditor to detect unrecorded expenses or liabilities which had been incurred but remained unpaid. In this connection, we accept the Complainant's submissions under items 1 and 4 of Appendix 4 to the Complainant's Written Submissions.
128. For these reasons, it is our view that the three questions under Issue 4 are to be answered in the affirmative.

D.2.2. Company search

129. In March 2009, the audit team engaged a search agent to perform a company search on Dehong Hongda, the Group's only logging service provider in Yunnan. The company search report dated 3 April 2009 indicated that the name of the Dehong Honda could not be found on the internet and the registration of the logging company could not be found from the official records. The search agent also conducted enquiries using key words from the company's name but could not locate a similar company.

The Complaint

130. This complaint relates to the audit team's alleged failure to critically evaluate the company search result, carry out follow-up work and properly document their conclusions on the negative search result.
131. In the Complainant's submissions, the negative search result should have caused a reasonable auditor to question whether the logging company existed and to perform additional audit procedures to address the anomaly or "red flag". This is particularly the case given the importance of Dehong Hongda to the Group's operations – Dehong Hongda was the Group's only logging service provider in the Yunnan province. If Dehong Hongda did not exist, this would cast doubt on the reliability of not only the Group's expenses but also the turnover generated in Yunnan, which accounted for a significant part of the Group's income.
132. The Complainant also criticises that there is no documentation in the working papers as to the audit team's evaluation of the company search result, or how the team had addressed the negative search result. It is said that the audit team could have visited Dehong Hongda or made enquiries with third parties to verify its existence.
133. Accordingly, the Complainant submits, the Respondents failed to:
- (1) critically evaluate the results of the company search and perform any additional procedures in accordance with HKSA 500.2 (to be read with HKSA 500.7); and

- (2) adequately document their conclusions reached on the company search results in accordance with HKSA 230.9.

The Defence

134. Similar to their defence in respect of the negative customer search results, the Respondents' position is that a negative result in the PRC was not unusual at the time and while a positive result would provide useful audit evidence, a negative result was not conclusive.
135. The Respondents say that the audit team had, in any event, further relied on other audit procedures and evidence including the vouching of, in particular, all harvest fees paid to Dehong Hongda to receipts issued by Dehong Hongda and bank-payment slips issued by the bank. In addition, the audit team reviewed two agreements between the Group and Dehong Hongda, both bearing the chop of Dehong Hongda. They also relied on the audit evidence evidencing harvesting activities in Yunnan, which included (i) the logging permits and forest maintenance fees paid; (ii) the sales of harvested wood logs to customers in Yunnan; (iii) the revenue generated from the Yunnan sales and paid to the Group's bank accounts; and (iv) the confirmation of the Group's bank accounts' period end balances.

Discussion

- Issue 5: In respect of the company search, whether the Respondents have failed to:-

- (1) critically evaluate the results of the company search and perform any additional procedures in accordance with HKSA 500.2;
- (2) adequately document their conclusions reached on the company search results in accordance with HKSA 230.9.

136. As discussed above, a purpose of the company search is to ascertain or corroborate the existence of the entity in question. It would be completely futile if the search results are merely inconclusive and the auditor does not carry out any follow-up procedures. Given the significance of Dehong Hongda – being the Group’s only logging service provider in the Yunnan province – the confirmation of its existence was particularly important as directly affected the reliability of the Group’s turnover and expenses in Yunnan. The fact that the search agent used the contact information supplied by the Group and obtained a negative search result on Dehong Hongda is a major audit inconsistency within the meaning of HKSA 500.12, and additional audit procedure should be determined for the purpose of resolving that inconsistency. The audit team should have (i) inquired further on the existence of Dehong Hongda, such as conducting a site visit and (ii) resolved why the contact information provided by the Company could not be found in the industrial, commercial or public domain.

137. The Respondents rely on the other audit procedures but since those procedures were carried out on the assumption that Dehong Hongda existed, they could not be used to verify the existence of the company. For example, although the audit team reviewed two agreements between Dehong Hongda and the Group, the agreements did not contain any signature of Dehong Hongda’s representative or its address. This might indicate that the agreements were only draft agreements which, if true,

could not be regarded as valid audit evidence. As regards the vouching of all harvest fees paid to Dehong Hongda to receipts issued by Dehong Hongda and payment slips issued by the bank, it is unclear from the working papers how or on what basis such procedures could verify the existence of Dehong Hongda. It is also not recorded in the working papers that the audit team had checked that the Group's funds were paid into a bank account held in Dehong Hongda's name. Moreover, while the other audit procedures and evidence may be used to evidence that certain logging activities in Yunnan took place, it did not necessarily mean that the work was carried out by Dehong Hongda. In short, on the basis of the evidence before us, we are not satisfied that the other procedures and evidence can effectively address this complaint and the Respondents have failed to critically evaluate the results of the company search and perform any additional procedures in accordance with HKSA 500.2.

138. HKSA 230.9 requires the auditor to prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

- (1) The nature, timing, and extent of the audit procedures performed to comply with HKSAs and applicable legal and regulatory requirements;
- (2) The result of the audit procedures and the audit evidence obtained;
and
- (3) Significant matters arising during the audit and the conclusions reached thereon.

139. HKSA 230.11 further states that oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.
140. In our view, it was a significant matter that the company search results in respect of Dehong Hongda were negative. There is no dispute that the audit team did not document their conclusion reached on those results and the oral explanations now provided by the Respondents do not suffice. In the premises, the Respondents had failed to adequately document their conclusions in accordance with HKSA 230.9.

D.3. Plantation Assets

141. At the audit planning stage, the audit team identified and assessed the risks in relation to plantation assets as follows:

Nature of risk	Years ended 31 December 2006 and 2007	Year ended 31 December 2008	6 months ended June 2009
Completeness	Inherent risk: Medium	Inherent risk: Medium	Inherent risk: Medium
Existence	Inherent risk: Medium	Inherent risk: Medium	Inherent risk: Medium
Accuracy	Inherent risk: Medium	Inherent risk: Medium	Inherent risk: Medium
Valuation	Inherent risk: Medium Risk of fraud	Inherent risk: Medium Risk of fraud	Inherent risk: Medium Risk of fraud
Ownership	Inherent risk: Medium	Inherent risk: Medium	Inherent risk: Medium
Presentation	Inherent risk: Medium	Inherent risk: Medium	Inherent risk: Medium

142. In KPMG's letter to the Company dated 15 October 2008, the audit team identified, among other things, the following internal control deficiencies,

which might lead to material misstatements in the Group's financial statements and/or the Group's internal records as regards its plantation assets:

- (1) the Group did not have any internal audit function; and
- (2) the Group's plantation assets management (including records of forestry acquisitions) was relatively basic and not comprehensive.

The Complaint

143. The complaint under this head relates to the audit team's alleged failure to obtain sufficient appropriate audit evidence to support the existence and completeness of the Group's plantation assets.
144. In particular, it is said that the audit team ought to have obtained reliable corroborative evidence from independent sources in respect of the Group's plantation assets. However, the audit team did not (i) obtain direct confirmation from the respective forestry right certificate issuing authorities; (ii) perform search on forestry rights; and/or (iii) visit the appropriate forestry bureaus. Accordingly, the Complainant submits, the Respondents have failed to obtain sufficient appropriate audit evidence of the Group's plantation assets in accordance with HKSA 500.2 (to be read with HKSA 500.7).

The Defence

145. The Respondents have put forward a number of defences against this complaint.

146. First, the Respondents argue that the auditing standards did not require the audit team to obtain direct confirmation of the Group's plantation rights from the relevant forestry bureaus.
147. In any event, the Respondents rely on the following procedures which are said to have enabled the audit team to obtain sufficient appropriate audit evidence as regards the existence and completeness of the Group's assets:
- (1) walkthrough tests to evaluate the Group's internal controls in respect of its acquisition, monitoring and harvesting of plantation assets;
 - (2) tests of control to address the risk points identified during the walkthrough tests, including the risks that (i) the Group's acquisition of plantation assets were not properly reviewed, (ii) the plantation assets were not closely monitored by the Group, and (iii) the plantation assets were harvested illegally. The Group's internal control were determined to be effective and it is said that the deficiencies identified by the audit team referred to the Group's inventory management system, not its plantation asset management system.
 - (3) substantive procedures:
 - (a) checking all sale and purchase agreements in respect of the Group's acquisition of plantation assets and the corresponding forestry rights certificates against the Group's plantation assets register;
 - (b) obtaining and evaluating the valuation reports of the plantation assets prepared by Chandler Fraser Keating

- (“CFK”), an external valuer engaged by the Group to value its plantation assets for the purposes of the IPO;
- (c) obtaining and checking the Group’s “forest log volume form” against the “small parcel survey forms” obtained from the local forestry bureaus;
 - (d) confirming that the records of CFK, the forestry bureaus and the Group’s forest investigation team were all consistent in terms of the volume of forests acquired;
 - (e) reviewing the original forestry rights certificates for the Group’s entire forest estate;
 - (f) reviewing a legal opinion prepared by the Group’s PRC legal counsel, Commerce and Finance Law Offices (“CF Law”) as to the Group’s rights over its plantation assets. Although the legal opinion included a standard warranty as to the veracity of the documentary materials provided by the Group, CF Law had reviewed the forestry rights certificates and it is inherently unlikely that they would have proceeded to give the opinion if they suspected there to be anything wrong with them.

148. The Respondents also rely on the following evidence which is said to have corroborated the Group’s ownership of plantation assets and their existence:

- (1) the audit evidence obtained by the audit team in respect of harvesting, sales, revenue and cash balances;

- (2) the logging permits issued by the forestry bureaus which recorded the Group as the owner of the plantation assets for which the permits were issued; and
- (3) the views of the Company's sponsors and their legal advisers who were engaged for the IPO.

Discussion

Issue 6: Whether the Respondents have failed to obtain sufficient appropriate audit evidence of the Group's plantation assets in accordance with HKSA 500.2.

149. The Group's principal assets were the trees acquired, planted and managed by the Group in the PRC. The rights to own and use the trees were granted under the forestry rights certificates which were issued by various PRC forestry bureaus. It can be hardly disputed that the verification of the Group's ownership of its plantation assets constituted an important part of the IPO Engagement. A direct and reliable procedure would have been to seek confirmation from all the relevant forestry bureaus as to the Group's ownership of the forests and their respective volumes. But the audit team did not do so. Instead, they relied on a number of audit procedures and indirect audit evidence to confirm the existence and completeness of the Group's plantation assets.

150. Having considered such procedures and audit evidence, we are unable to accept the Respondents' submission that they are sufficient to address this complaint. The audit team had checked the forestry right certificates

against the Group's plantation assets register but there is no suggestion that they had verified the validity of the forestry rights certificates in the first place. As for the valuation report of CFK, it cannot be relied upon for the purpose of confirming the Group's ownership of its plantation assets. This is because, as Ms Tong rightly points out, the report contained extensive disclaimers and reservations such that it was inappropriate for the audit team to rely on it (which was prepared in respect of the issue of valuation) without conducting their own verification on the existence and completeness of the forests. Similarly, the legal opinion of CF Law was prepared on a number of assumptions (such as documents provided by the Company being complete, true and effective, and all representations made by the Company to CF Law did not contain any falsehoods, or concealment or omission of facts and/or document) and hence cannot constitute reliable audit evidence on the Group's ownership of the forests.

151. The audit team also checked the forest log volume form against the "small parcel survey forms" obtained from the local forestry bureaus. However, the working papers of the actual test had not been provided and there is no suggestion that the "small parcel survey forms" contained any evidence of ownership.
152. With regard to the walkthrough tests, they are in our view insufficient as their purpose was to understand the business process from the acquisition of forests to harvesting and they cannot address the existence and completeness of the Group's assets. Similarly, the tests of control were to test certain risk points identified in the walkthrough tests and again they cannot be used to verify the Group's ownership of assets. Moreover, the reliability of the logging permits was also questionable. In any event, the Group possessed a number of internal control deficiencies, e.g. it did not

have any internal audit function and its plantation asset management was relatively basic and incomprehensive. It is doubtful if the Group's internal records used in these tests were accurate and complete for the purpose of these tests.

153. For these reasons, we take the view that the Respondents have failed to obtain sufficient appropriate audit evidence of the Group's plantation assets in accordance with HKSA 500.2 and this Issue 6 is to be answered in the affirmative.

D.4. Cash and Cash Equivalents

154. The account of cash and cash equivalents consisted primarily of funds held in the Group's bank accounts. At the audit planning stage, the audit team identified and assessed the risks in relation to cash and cash equivalents as follows:

Nature of risk	Years ended 31 December 2006 and 2007	Year ended 31 December 2008	6 months ended June 2009
Completeness	Inherent risk: Low	Inherent risk: Low	Inherent risk: Low
Existence	Inherent risk: Low	Inherent risk: Low	Inherent risk: Low
Accuracy	Inherent risk: Low	Inherent risk: Low	Inherent risk: Low
Ownership	Inherent risk: Low	/	/
Valuation	/	Inherent risk: Low	Inherent risk: Low

D.4.1. Assessment of Internal Controls

The Complaint

155. This complaint concerns the audit team's alleged failure to properly document their understanding and testing of the Group's controls to monitor cash payments and receipts, in particular on the detection of possible unrecorded transactions. It is said that the documentation was important for an experienced auditor, without previous connection with the audit, to understand the nature, timing and extent of the audit procedures performed to comply with HKSA's and the results of the audit procedures and the audit evidence obtained.
156. The documentation relied upon by the Respondents as documenting their understanding of the Group's controls was the walkthrough tests but the Complainant criticises those tests as relating to the Group's turnover, not cash payments and receipts. Also, the Complainant argues that the relevant controls identified by the audit team related to the correct recording of sales transactions in the general ledger, not the monitoring of cash payments and receipts. There is no record in the working papers as to what controls the Group actually had in place over payments made by the Group to third parties, and there is no documentation in respect of any evaluation of the design and implementation of the Group's controls as required under HKSA 315.3 and 315.54.
157. The Complainant argues that the Respondents have therefore failed to document or sufficiently document their understanding of the Group's controls to monitor cash payments and receipts, and their evaluation of the

relevant controls' design and implementation over the payment cycle in accordance with HKSA 230.9.

The Defence

158. The Respondent's response is that their understanding of the Group's business model (with respect to cash) was set out in each of the walkthrough tests on the sales process for the IPO Period. In particular, the audit team recorded in the audit working papers for the six months ended 30 June 2009 that:

- (1) "The customer has to pay in advance as stated in the sales contract (clause 3) and send the bank-in slip ... to the client";
- (2) "Upon receipt of cash, sales invoices...will be issued to customer and the sale will record at batch basis in General Ledger"; and
- (3) "The posting of sale to general ledger is prepared a [by] staff in Accounting Department, reviewed by another staff and approved by Account Manager".

159. According to the Respondents, although the audit team identified the above controls, they did not rely on those controls to reduce the substantive audit procedures carried out to verify the Group's handling of cash payments and, consistent with this approach, the audit documentation focused on the following substantive procedures carried out rather than the reliance on the Group's controls:

- (1) the audit team vouched 100% of the revenue receipts against the bank-in slips, with no exceptions noted;
- (2) the audit team vouched the logging expenses recorded in the Group's ledger to the payment transfer slips issued by the bank (which showed that cash was transferred from the Group's bank account to the logging company/logging village), with no exceptions noted;
- (3) the audit team obtained bank confirmations for all of the Group's bank balances, with no exceptions noted; and
- (4) the audit team reviewed the bank reconciliation at year/period end to ensure the appropriate treatment of reconciling items, with no exceptions noted.

Discussion

Issue 7: In respect of the assessment of internal controls, whether the Respondents have failed to document or sufficiently document their understanding of the Group's controls to monitor cash payments and receipts, and their evaluation of the relevant controls' design and implementation over the payment cycle, in accordance with HKSA 230.9.

160. We share the Complainant's observation that the walkthrough tests only related to the correct recording of sales transactions in the general ledger and not the monitoring of cash payments and receipts. Although the Respondents argue that they did not rely on those controls to reduce the

substantive audit procedures for the purpose of verifying the Group's handling of cash payments, it cannot be reasonably disputed that there is no documentation in respect of the Respondents' understanding and evaluation of the design and implementation of the Group's controls to monitor cash payments and receipts. In the circumstances, we find that the Respondents have failed to comply with HKSA 230.9 in respect of assessment of internal controls.

D.4.2. Return of Bank Confirmations

The Complaint

161. The audit team sent out requests to the Group's bankers to confirm the year/period end balances. Amongst the confirmations received, the envelope of two confirmations returned by Huaxia Bank, the principal banker of the Group's main operating subsidiary (KUB) for the 6 months ended 30 June 2009, recorded that the confirmations had been mailed by KUB to KPMG (instead of being mailed directly from Huaxia Bank). The Complainant criticises the audit team for failing to:

- (1) consider whether the relevant bank confirmations had come from Huaxia Bank and whether there was any indication that the confirmations received might not be reliable (for example, by reason of management interception); and
- (2) perform additional audit procedures to dispel the concern on the responses' authenticity by (for example) making a telephone call to Huaxia Bank or asking for a direct resend by Huaxia Bank;

thereby failing to comply with HKSA 505.33.

The Defence

162. The Respondents' defence is that the audit team had maintained "sufficient and appropriate controls" over the issuance of the confirmations and exercised professional skepticism in evaluating the reliability of the returned confirmations.
163. The Respondents say that the audit team was aware that the two bank confirmations had not been returned directly from Huaxia Bank, and the audit team therefore performed the following additional audit procedures which did not reveal any inconsistency:
- (1) The audit team checked the bank chop on the two confirmations against the bank chop in a confirmation mailed directly from the bank for the year ended 31 December 2008. No discrepancies were noted.
 - (2) The audit team checked the two returned confirmations against photocopies of the original confirmations (which the audit team had made prior to sending the confirmations to the bank). The audit team found that KPMG's identification chop and other details on the confirmation were the same.
 - (3) The audit team checked the bank balances set out in the two returned confirmations against original bank statements. No discrepancies were noted.

Discussion

Issue 8: In respect of the return of bank confirmations, whether the Respondents have failed to (a) consider whether the relevant bank confirmations had come from Huaxia Bank and whether there was any indication that the confirmations received might not be reliable; or (b) perform additional audit procedures to dispel the concern on the responses' authenticity, in accordance with HKSA 505.33.

164. Audit evidence is more reliable when it is obtained from independent sources outside the entity. Similarly, audit evidence obtained directly by the auditor is more reliable than that obtained indirectly or by inference: HKSA 505.3. Confirmations from bankers are frequently used as one of the most important pieces of audit evidence in relation to a particular entity's account balances and their components, which in turn impact upon the entity's major accounts including turnover, expenses, and cash and cash equivalents.

165. In order to obtain reliable confirmations, the auditor should maintain control over the entire external confirmation process by (i) minimising the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or response; (ii) ensuring that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the auditor; and (iii) considering whether replies have come from the purported senders: HKSA 505.30.

166. HKSA 505.33 further requires the auditor to consider whether there is any indication that external confirmations received may not be reliable and the

response's authenticity and performs audit procedures to dispel any concern. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor should request the purported sender to mail the original confirmation directly to the auditor.

167. As one can see, the importance that external confirmations are returned directly to the auditor is repeatedly emphasised throughout HKSA 505, for the simple yet fundamental reason that external confirmations should be free from interception or alteration, so that the auditor can safely rely on such confirmations in the rest of the audit procedures and reduce the audit risks to an acceptably low level.
168. The Complainant made the observation that there is no indication in the working papers that the audit team had identified the issue concerning the two bank confirmations. The Respondents do not seem to deny this, but they make a general submission that the lack of any indication in the working papers does not necessarily mean that the audit team did not consider a particular issue – it may well be that the matter was simply not significant enough to warrant any written record of such consideration in the working papers. In their written submissions, the Respondents further criticise this complaint as being a “microscopic challenge”, for it “disregards the bigger picture that substantive procedures were performed”, and the fact that the bank confirmations were returned through KUB might have only been an inconsistency in “granular details”.
169. In our view, the Respondents’ criticism is a mischaracterisation of this complaint – it is inappropriate and it underrates the fundamental importance that replies should be sent directly to the auditor. The auditor’s

responsibility to maintain proper control over the external confirmation process is a basic standalone duty regardless of whether substantive procedures are performed to corroborate the information contained in the confirmations. Thus, where external confirmations are returned from entities other than the original recipients, it is a significant anomaly and it is not an inconsistency in “granular details”.

170. In any event, even if the audit team did consider whether the relevant bank confirmations had come from Huaxia Bank and carried out additional audit procedures in response, those procedures are insufficient to dispel the concern on the authenticity of the returned confirmations. In particular, those procedures cannot explain why KUB was the one who returned the confirmations when the requests for confirmations were sent by KPMG to Huaxia Bank directly and they should not have been in the Group’s possession. Indeed, if the audit team was aware that the two bank confirmations had not been returned directly from Huaxia Bank and thought fit to take additional steps in response, it is rather curious that the team did not inquire with the bank directly with a simple telephone call (which would have been straightforward) but instead checked the bank chops and bank balances which did not really address the issue and yet more time-consuming. In conclusion, we consider that the complaint is made out and the Respondents have failed to comply with HKSA 505.33.

E. THE THIRD AND FOURTH COMPLAINTS

171. These complaints concern the 2009 Audit which was stated to have been conducted in accordance with HKSA. By the time of the 2009 Audit, the Company had been listed on the Main Board of the Stock Exchange and

KPMG expressed an unmodified opinion in respect of the 2009 Financial Statements.

E.1. Turnover

172. Similar to the IPO Engagement, the audit team assessed the risk in relation to turnover for the 2009 Audit as follows:

Nature of risk	Risk assessment
Completeness	Inherent risk: Medium
Existence	Inherent risk: Medium Risk of fraud
Accuracy	Inherent risk: Medium Risk of fraud

173. During the audit planning stage, the audit team identified similar “significant risk points” including the risk that timber might be harvested without a logging permit and the risk that sales were not properly recognised in accordance with IAS 18.

174. In the 2009 Audit, the team conducted a review of the Group’s progress in addressing the internal control deficiencies identified during the IPO Engagement. The Group was at the time still “in progress” in their response to the internal controls deficiencies of (i) lack of an internal audit function, (ii) non-sequential numbering of sales documentation, (iii) lack of inventory management policies and records for inventories movement, and (iv) basic forestry management.

E.1.1. Forestry Bureau Confirmations

The Complaint

175. The audit team sought to confirm the total volume of timber logged by the Group with two local forestry bureaus, the Mabian Yi Autonomous Prefecture Forestry Bureau (for Sichuan province) (the “**Mabian Forestry Bureau**”) and the Dehong Dai and Jingpo Autonomous Prefecture Luxi Country Forestry Bureau (for Yunnan province) (the “**Luxi Forestry Bureau**”).
176. The Mabian Forestry Bureau stated that the Group’s total volume of timber harvested in Sichuan was 150,800 m³, and the Luxi Forestry Bureau stated that the Group’s total volume of timber harvested in Yunnan was 475,690 m³. The Complainant points out that the two forestry bureaus only issued part of the logging permits in question. In particular, the logging permits issued by Mabian Forestry Bureau accounted for only 13,800 m³ while the Luxi Forestry Bureau accounted for only 369,075 m³. The rest of the logging permits were issued by four other forestry bureaus in Sichuan and Yunnan. It is unclear why these two forestry bureaus were chosen for the purpose of the confirmations and there is no documentation as to how the audit team had assessed the authority and ability of the two forestry bureaus to confirm the logging permits which were not issued by them.
177. The Complainant therefore criticises the Respondents for failing to comply with HKSA 505.28 and adequately assess and document the authority and ability of the two forestry bureaus to confirm or provide information relating to logging permits issued by other forestry bureaus.

The Defence

178. The Respondents deny this complaint. They argue that the confirmations provided express written confirmations of the total volume of timber harvested by the Group, and were original documentary evidence which the audit team collected by hand directly from the bureaus and on which the Respondents properly relied.
179. The Respondents also contend that the total volume of timber harvested was closely linked with the total sales receipts, logging expenses and end-of-period cash balances. The two confirmations were supported by the substantial volume of other audit evidence relating to turnover, including:
- (1) Confirmations obtained directly from the Group's customers confirming total sales for the year ended 31 December 2009.
 - (2) Confirmation of revenue obtained directly from the tax bureau.
 - (3) Confirmation of the total volume of timber harvested in Yunnan, provided to the audit team directly by Dehong Hongda.
 - (4) The end of year bank balance confirmations provided directly by the Group's banks, which reconciled with the records maintained by the Group.
 - (5) The substantive vouching of the Group's sales transactions.
 - (6) The logging permits themselves, which set out the volume of timber permitted to be harvested.

180. The Respondents further deny any omission to assess the ability of the two forestry bureaus to provide the confirmations and refer to the following evidence:

- (1) The logging confirmations bear the chops of the Mabian and Luxi Forestry Bureaus, confirming that those bureaus considered they had the authority and ability to confirm the information stated. Both confirmations were filed with the audit work papers.
- (2) The logging confirmations record that they were collected by the audit team from the bureaus directly by hand, limiting any risk of management interference and providing additional evidence that the confirmations were genuine and reliable.
- (3) The detailed file notes of the site visits to the forestry bureaus as prepared by the audit team.
- (4) The “summary of audit issues” documents the purpose of the confirmations, namely that the confirmations were obtained as part of the broader additional audit procedures relating to customers and turnover.
- (5) The forestry bureaus were government organisations responsible for issuing logging permits. They were independent of the Group and self-evidently had the competence, independence and authority to provide the confirmations. There is no reason why an independent government organisation would provide such confirmation if it was

unable to do so. All of this would be readily apparent to an experienced auditor from a review of the audit work papers.

Discussion

Issue 9: In respect of forestry bureau confirmations, whether the Respondents have failed to adequately assess and document the authority and ability of the Mabian and Luxi Forestry Bureaus to confirm the logging permits issued by other forestry bureaus, in accordance with HKSA 505.28.

181. HKSA 505.28 states:

“The reliability of audit evidence provided by a confirmation is affected by the respondent’s competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity’s long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.”

182. The Respondents argue that the audit team had assessed the ability of the forestry bureaus to provide the confirmations in respect of the total volume of timber logged and they refer to certain documented evidence (e.g. that they bear the chops of the two forestry bureaus and they were collected by the audit team by hand). In our view, however, such evidence only goes to support the assertion that the two confirmations are genuine (as opposed to counterfeit) documents, but it does not address the issue concerning the competence, independence, authority of the two forestry bureaus to provide information relating to the logging permits issued by other forestry

bureaus. It is unsatisfactory for the Respondents to assume, without verification, that the forestry bureaus had no reason to provide such information if they were unable to do so.

183. Moreover, we note that all the logging permits at the time were manually prepared. A reasonable auditor would have questioned how the Mabian and Luxi Forestry Bureaus pulled together all the relevant logging permits from the other forestry bureaus in preparing the confirmations. However, there is no suggestion that the audit team had done so.
184. As regards the other audit evidence which is said to support the two confirmations, we are not satisfied that it can address this complaint. Again, while the other audit evidence may corroborate the figures stated in the two confirmation, they go nowhere to verifying the two forestry bureaus' competence and authority to represent the other four forestry bureaus.
185. In short, we are of the view that the Respondents have failed to act in accordance with HKSA 505.28 and Issue 9 is to be answered in the affirmative.

E.1.1.2 Completeness of Sales

The Complaint

186. This complaint is similar to the one discussed in Section D.1.3 above and it concerns the audit team's alleged failure to address the risk of understatement of sales by obtaining appropriate evidence on the completeness of sales transactions recorded by the Group. While the Complainant accepts that the audit team had performed a number of

substantive audit procedures to test the Group's turnover, it is said that none of those procedures could properly test for sales transactions which had not been recorded by the Group.

187. The complaint focuses on two substantive procedures in which the audit team tested sales transactions selected from a population of the Group's recorded sales. The Complainant argues that the work therefore could not detect if there were any "missing" transactions which had not been recorded by the Group and hence could not address the risk of understatement of sales:

(1) Vouching of sales transactions which involved checking the information relating to all of the Group's recorded sales transactions to the sales invoices, sales contracts, bank-in-slips and GDNs; and

(2) Sales cut-off tests which involved selecting samples from the sales ledger and matching the recorded sales with various supporting documents such as sales invoices, sales contracts, GDNs and bank-in slips to test if the samples had been recorded in the correct financial period.

188. In response to the Respondents' suggestion that they had obtained all sales invoices, sales agreements, bank-in slips and GDNs from the Group, the Complainant argues that the audit team did not test the completeness of the documents provided or any system of control over the maintenance of the completeness of such information and documentation, despite that the audit team was aware that the Group's sales documentation was not numbered in sequence and could not rely on the numbering of the

documentation to determine whether a full set of the documentation had been provided.

189. The Complainant therefore submits that the Respondents have failed to (i) select test samples from an appropriate and complete population in accordance with HKSA 530.35 and 530.35a; and (ii) obtain sufficient appropriate audit evidence on the completeness of the Group's turnover in accordance with HKSA 500.2 (to be read with HKSA 500.7) and 500.11.

The Defence

190. The Respondents contend that the audit team had planned and performed a comprehensive range of audit procedures (which did not rely on the numbering of sales documentation) to verify the Group's turnover, including:

- (1) Walkthrough tests on the sales process to understand the sales process and tested the effectiveness of the Group's internal controls.
- (2) A test of control to evaluate whether sales were properly recognised by: (i) selecting 15 samples of monthly sales during 2009 and obtaining the relevant sales contracts, sales invoices and GDNs; (ii) for each sample, checking that the sales were properly supported by GDNs; and (iii) for each sample, checking that sales vouchers were reviewed by the accounting manager before being posted to the general ledger. The conclusion was that this control was effective.
- (3) Planning and performing procedures with a greater emphasis on the risk of overstatement since the risk of overstatement of sales is

naturally greater than the risk of understatement in context of a listed company.

- (4) Vouching 100% of the Group's sales transactions to a number of underlying supporting documents (including the sales invoices, sales contracts, bank-in slips and GDNs), with no exceptions noted.
- (5) Sending confirmations to all of the Group's customers to confirm the total sales amount for the year ended 31 December 2009 and the end of year account balances for each customer. The confirmations were returned by five of the Group's 17 customers, with no exceptions noted.
- (6) Obtaining bank confirmations for all of the Group's bank balances and reviewed the bank reconciliations at year-end to ensure the appropriate treatment of reconciling items, with no exceptions noted. It is said that this provided evidence that the transactions and balances recorded in the Group's books were accurate and complete and reduced the risk of both overstatement and understatement.
- (7) Comparing 100% of the sales volume set out in the sales invoices to the volume of timber permitted to be logged pursuant to the logging permits and the inventory level for the year ended 31 December 2009, with no exception noted. It is also said that this provided evidence of completeness (both understatement and overstatement) of the Group's turnover.

191. In addition, since the Respondents identified certain audit issues during the 2009 Audit, the Respondents carried out the following additional audit procedures on turnover. These included:

- (1) Conducting site visits to the operating addresses for 16 of the Group's 17 customers and taking photos of their premises and/or operations. The audit team obtained further confirmations by hand directly from the 16 customers visited.
- (2) Obtaining confirmations from Mabian and Luxi Forestry Bureaus confirming the entire volume of timber harvested by the Group in the Sichuan and Yunnan provinces respectively during 2009.
- (3) Obtaining a confirmation directly by hand from the Kunming Economic and Technological Development Zone State Taxation Bureau for KUB's total revenue for 2009.
- (4) Obtaining directly from the Huaxia Bank (being the bank at which the Group's principal bank account was opened): (i) a list of bank accounts opened for the Group at the Huaxia Bank; (ii) monthly bank statements for the year ended 31 December 2009; and (iii) bank advice slips for certain transactions which had occurred between July and December 2009.
- (5) Conducting a cash transaction test to evaluate whether the cash transactions in the Huaxia Bank statements provided by the Group were consistent with the Huaxia Bank records. This involved: (i) obtaining the bank ledger from the Group; (ii) selecting samples from the bank ledger based on "monetary unit sampling"; and (iii)

for each sample, checking the details in the bank slips provided by the Group against the bank slips provided by the Huaxia Bank. It was concluded that the objective of this test was achieved.

- (6) Obtaining management representation as to the completeness of the financial information provided to KPMG.

192. The Respondents argue that the cumulative effect of these procedures was to test the accuracy and completeness of the Group's sales, for both overstatement and understatement. The only transactions which the above tests could not detect were sales that were entirely off-book and such risk was said to be sufficiently remote to be justifiable.

Discussion

Issue 10: In respect of completeness of sales, whether the Respondents have failed:-

- (1) in respect of the vouching of sales transactions and sales cut-off tests, to select test samples from an appropriate and complete population in accordance with HKSA 530.35 and 530.35a;
- (2) to obtain sufficient appropriate audit evidence on the completeness of the Group's turnover, in accordance with HKSA 500.2 and 500.11.

193. The vouching of sales transactions and sales cut-off tests are essentially the same as those conducted in the IPO Engagement. We have discussed in Section D.1.3 above why those procedures were in our view ineffective to address the risk of understatement of sales. The same reasons are apposite

for these two procedures conducted in the 2009 Audit and we need not repeat them here. Suffice it to say that both the population and direction of testing were inappropriate. The audit team should have tested for understatement by obtaining a complete population of business documents (such as reliable confirmations obtained directly from the relevant forestry bureaus as to the volume of logs harvested in each county, GDNs and goods receipts, receipts by the logging service providers, and inventory records, etc.) and checking those documents against the Group's recorded sales transactions and sales ledger for understatement. In our view, therefore, Respondents failed to select test samples from an appropriate and complete population in accordance with HKSA 530.35 and 530.35a.

194. In respect of the Respondents' allegation that the risk of understatement was remote, again we adopt the same reasons as those discussed in the context of the IPO Engagement and we do not think the Respondents has any reasonable basis to make such an allegation.

195. As to whether the other tests and substantive procedures were effective to address the risk of understatement, we accept the Complainant's comments as stated in Appendix 7 attached to the Complainant's Written Submissions. Those tests and procedures either cannot, by their nature, address the issue relating to the risk of understatement of sales (e.g. walkthrough test, obtaining various documents from Huaxia Bank, cash transaction test, obtaining confirmation from tax bureau and management representations), or the source information/documents in the procedures had not been verified to be complete or reliable (e.g. obtaining confirmations from only two forestry bureaus, obtaining customers' confirmations, comparing sales volume to logging volume). Moreover, the stated objective of the cash transaction test was to ensure the cash transactions on the bank statements

provided by the Group were consistent with the bank records. As the Committee observes, the audit team obtained matching documents from the bank in respect of only a very small portion of the transactions but nonetheless made the conclusion that the stated objective was achieved. In short, despite that the completeness of turnover was identified as one of the inherent risks with a medium level and the Group was still in the process of addressing the internal control deficiencies identified in the IPO Engagement, the audit team failed to obtain sufficient appropriate audit evidence on the completeness of the Group's turnover, in accordance with HKSAAs 500.2 and 500.11.

196. The answers to the two questions under this Issue 10 are therefore in the affirmative.

E.2. Operating Expenses for Logging Activities

The Complaint

197. This complaint relates to the audit team's alleged failure to properly identify and address the risk that Dehong Hongda might be a related party of the Group. The Complainant relies on the following matters.

- (1) Dehong Hongda was the sole harvester of the Group's forests in Yunnan. It only provided logging services to the Group and had no other customers. Dehong Honda also provided various other services to the Group, including consultancy and site investigation services for forests located in Sichuan and road repairing services.

(2) In the year 2009, in addition to logging expenses incurred during the year the Group paid a further sum of around RMB 42.8 million to Dehong Hongda for consultancy, site investigation services, road repairing services and prepayment for logging expenses for the year 2010.

198. The Complainant submits that the exclusive relationship between Dehong Honda and the Group, together with the substantial amounts paid to it for various services, should have caused a reasonable auditor to question the substance of the transactions and whether there were indications of a previously unidentified related party. However, there is no indication in the working papers that the audit team had identified the risk that Dehong Hongda might be a related party and the Complainant therefore argues that the Respondents had failed to exercise sufficient professional skepticism in accordance with HKSA 200.15 (to be read with HKSA 200.16) and to be alert to transactions which appeared unusual in the circumstances and might indicate the existence of previously unidentified related parties in accordance with HKSA 550.9.

The Defence

199. The Respondents have three defences to this complaint.

200. First, in the 2009 Audit, the Respondents reviewed a number of agreements between the Group and Dehong Hongda and critically considered the various payments made to Dehong Hongda under those agreements.

201. Secondly, in respect of whether Dehong Hongda was a related party, the Respondents rely on the following:

- (1) In planning for the 2009 Audit, the audit team obtained an understanding of the Group's related party relationship and transactions, including by making enquiries with the Chief Operating Officer and Chief Financial Officer in relation to (i) policies, procedures and control concerning related parties and related party transactions; and (ii) any identified related parties and/or related party transactions.
- (2) The Respondents obtained written confirmation from the Board that all related party transactions had been disclosed.
- (3) The Respondents conducted a site visit to the operating premises of Dehong Hongda and discussed the relationship between Dehong Hongda and the Group with Mr Lai (the logging supervisor of Dehong Hongda). During the site visit, Mr Lai confirmed that the Chairman of Dehong Hongda was Mr Li Chaole. Neither Mr Lai nor Mr Li were listed among the directors or senior management of the Group. The file note of the site visit was filed in the working papers.
- (4) The Respondents obtained the business licence of Dehong Hongda directly from Mr Lai, which stated that it was a sole proprietorship of Mr Li Chaole.
- (5) The Respondents also verified 100% of the harvesting fees paid to Dehong Hongda recorded in the ledger to receipts issued by Dehong Hongda as well as bank payment transfer slips which verified the identity of the payee.

202. Thirdly, the Respondents rely on paragraph 11(d) of IAS 24, which states that a supplier with “whom an entity transacts a significant volume of business, merely by virtue of the resulting economic dependence” is not necessarily a related party.

Discussion

Issue 11: Whether the Respondents failed to exercise sufficient professional skepticism in auditing the relationship between the Group and Dehong Hongda in accordance with HKSA 200.15.

Issue 12: Whether the Respondents failed to be alert to transactions which appeared unusual in the circumstances and might indicate the existence of previously unidentified related parties in accordance with HKSA 550.9.

203. HKSA 550.9 states that the auditor should review information provided by those charged with governance and management in identifying related party transactions and should be alert for other material related party transactions.

204. During the course of the audit, the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. An example of such transactions is high volume or significant transactions with certain suppliers as compared with others: HKSA 550.11. On the other hand, a supplier with whom an entity transacts a significant volume of business is not necessarily a related party merely by virtue of the resulting economic dependence: IAS

24 paragraph 11(d). Thus, when the auditor comes across an entity which transacts a significantly higher volume with a particular supplier, the auditor should be alert to the possibility that the supplier may be a previously unidentified related party and review information from the entity to assess the nature of the relationship. However, the auditor should not hastily conclude that such a supplier is a related party solely on the basis of the high volume of business.

205. In the context of this case, there is no question that Dehong Hongda, being the Group's sole harvester in Yunnan, played a significant role in the Group's business and transacted a significant volume of business with the Group. However, the significance of such relationship and volume of business transacted between the two entities does not necessary mean that they were related parties.

206. At the substantive hearing, the Committee's attention was brought to the meeting notes between the audit team and representatives of Dehong Hongda. Various questions were raised by the audit team about the business of Dehong Hongda and its management. Meanwhile, the audit team obtained the business licence of Dehong Hongda, which stated that it was a sole proprietorship of Mr Li Chaole, who was neither a director nor shareholder of the Company. In addition to these, the audit team also obtained a written confirmation from the Board that all related party transactions had been disclosed. On the basis of such information available to the audit team at the time, the relationship between the Company and Dehong Hongda did not appear to be unusual or suspicious as being related parties. While the audit team could have asked more questions concerning the nature of relationship between the Company and Dehong Hongda, the Committee is of the view that the Respondents had exercised sufficient

professional skepticism in auditing the relationship between the Group and Dehong Hongda and therefore they are not liable under Issues 11 and 12.

E.3. Plantation Assets

The Complaint

207. This Complaint relates to the audit team’s alleged failure to critically assess and document the competence, knowledge and ability of the three forestry bureaus to confirm the forestry right certificates which were not issued by them.
208. At the audit planning stage, the audit team identified and assessed the risks in relation to plantation assets as follows:

Nature of risk	Risk assessment
Completeness	Inherent risk: Medium
Existence	Inherent risk: Medium
Accuracy	Inherent risk: Medium
Valuation	Inherent risk: Medium Risk of fraud identified
Ownership	Inherent risk: Medium
Presentation	Inherent risk: Medium

209. During the audit, the audit team instructed a search agent to conduct searches on the Group’s forest ownership certificates. It was recorded in the working papers that the search agent made inquiries with local forestry bureaus and were told that the forestry rights certificates were fabricated. In response, the audit team carried out additional procedures to confirm

their validity, including obtaining confirmation of all of the forestry right certificates held by the Group as at 31 December 2009 from three local forestry bureaus.

210. Although the three forestry bureaus only issued certificates in respect of 730,040 mu of forests, they provided the audit team with confirmations of the Group's entire forestry right certificates for a total forest area of 2,534,178 mu. The remainder of the certificates were issued by 10 other forestry bureaus in Sichuan and Yunnan, but the audit team did not seek confirmation from those 10 forestry bureaus.
211. The Complainant points out that there is no record in the working papers as to why the three forestry bureaus were chosen, or how the audit team had assessed the competence, knowledge and ability of the three forestry bureaus to confirm the forestry right certificates which were not issued by them. It is argued that the audit team should have ensured that the confirmation requests were directed to an appropriate entity / individual, e.g. by making inquiries with the remaining 10 forestry bureaus to confirm whether the three bureaus had authority to provide a confirmation on their behalf, or visiting those 10 bureaus directly in respect of the certificates issued by them, but the audit team did not do so. The Complainant therefore submits that the Respondents had failed to comply with HKSA 505.28.

The Defence

212. The Respondents deny this complaint and contend that the audit team did assess the authority and ability of the forestry bureaus to provide the

requested confirmations and they refer to the documentary evidence similar to those mentioned in paragraph 180 above.

213. The Respondents contend that the forestry bureau confirmations were not relied upon in isolation and should be considered in their proper context, in particular the following steps taken by the audit team in respect of the Group's plantation assets:

- (1) Took into account the work that the audit team had undertaken on the Group's plantation assets during the IPO Engagement, noting that no additional plantation assets were acquired between the end of the IPO Period and 31 December 2009.
- (2) Evaluated the Group's internal controls in respect of its rights over plantation assets and tested the effectiveness of those controls.
- (3) Obtained all sales and purchase agreements in respect of the acquisition of the Group's plantation assets, along with copies of the corresponding forestry right certificates, and checked these documents against the Group's plantation assets register.
- (4) Reviewed copies of the forestry right certificates for the entirety of the Group's forest estate as provided by the Group and compared them to the copies of the original forestry right certificates prepared by the Respondents during the IPO Engagement. The Respondents also inspected the original forestry right certificates again prior to issuing the 2009 Audit Report.

- (5) Obtained third party confirmations directly from PICC of the Group's insurance coverage for its entire forest estate.
- (6) Performed a site visit to one of the Group's forests in Yunnan and prepared a detailed note of that site visit.
- (7) Conducted site visits to three forestry bureaus, and sought and obtained oral and written confirmations directly.
- (8) Took into account the site visits performed by CFK and its review of market information and the Group's forestry data.
- (9) Obtained a legal opinion from CF Law confirming the Group's legal title to the entirety of its plantation assets.
- (10) In response to the search agent's comment that the forestry right certificates were fabricated, raised the issue with the management and obtained two written confirmations from the Funing County Forestry Bureau confirming the Group's ownership of the forest covered by that certificate. The Respondents also raised the issue with CF Law which confirmed that the matter did not alter their opinion on ownership.

Discussion

Issue 13: Whether the Respondents have failed to adequately assess and document the competence, knowledge and ability of the three forestry bureaus to confirm forestry rights certificates issued by other forestry bureaus, in accordance with HKSA 505.28.

214. We have considered each of the Respondents' defences to this complaint and, similar to our views expressed in respect of Issue 9 above, we are not satisfied that the steps taken by the audit team (whether individually or collectively) addressed the issue of whether the three forestry bureaus had the competence, knowledge and ability to confirm the forestry rights certificates which were not issued by them. The Respondents seem to have placed particular reliance on CF Law's legal opinion as reliable third-party corroborative evidence of the Group's forestry rights. But as the Complainant has rightly pointed out, CF Law did not appear to have undertaken independent inquiry as to the veracity of the forestry certificates issued by the 13 forestry bureaus and assumed the authenticity of the same. This rendered the audit team's reliance on CF Law's legal opinion inappropriate.
215. The Respondents contend that the forestry bureau confirmations were not relied upon in isolation. We disagree. The audit team sought the confirmations in response to the search agent's report that the Group's forestry right certificates were fabricated. The forestry bureau confirmations were clearly relied upon by the team to verify the authenticity of the Group's forestry rights certificates.
216. It is also no answer for the Respondents to say that they had obtained sufficient appropriate audit evidence even without relying on the forestry bureau confirmations. As we see it, the other audit procedures are not sufficient to provide reliable evidence to confirm the Group's ownership of its forests. For example, performing a site visit to only one of the Group's forests in Yunnan, checking the sale and purchase agreements in respect of the Group's forests and getting confirmation from PICC that the

Group's entire forest estate was covered by insurance cannot serve as independent third-party corroborative evidence of the Group's ownership over the entirety of its forests. Likewise, as mentioned above, the audit team's reliance on the other experts' reports might have been misplaced because such experts simply assumed the forestry rights certificates to have been authentic, or the reports contained extensive reservations and disclaimers such that it was inappropriate to rely on them without first verifying the contents. **Moreover, in view of the search agent's that the Group's forestry rights certificates were fabricated, it was crucial for the audit team to verify the Group's ownership of the forests by obtaining a valid confirmation directly from each of the issuing authorities.**

217. In light of the above discussion, we consider that the Respondents had failed to comply with HKSA 505.28 and Issue 13 is to be answered in the affirmative.

F. CONCLUSION AND FURTHER DIRECTIONS

218. We have reached the above unanimous determination in respect of each of the issues after we have carefully considered the parties' submissions and all the relevant professional standards, case law and documents that were drawn to our attention. Lest there be any doubt, the fact that we have not set out in detail all of what has been addressed to us does not mean that we have not taken it into account when determining the issues before us.

219. For the further conduct of these proceedings, we make the following directions:

- (1) The Complainant should file and serve its submissions on sanctions and costs within 28 days of this decision; and
- (2) The Respondents should file and serve their submissions in reply within 28 days thereafter.

220. Finally, we would like to express our gratitude to the parties' respective legal teams for their invaluable assistance, which has greatly facilitated the conduct of this case.

DATED the 29th day of April 2021

Ms. LAU Shing Yan, Zabrina
Chairman

Mr. LAM Yin Shing, Donald
Member

Mr. CHAN Wai Tong, Christopher
Member

Mr. MUI Arthur
Member

Mr. TSAI Wing Chung, Philip
Member

IN THE MATTER OF

A complaint made under section 34(1A) of the Professional Accountants Ordinance (Cap. 50)

BETWEEN

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

AND

KPMG (0035) 1st RESPONDENT

YU Yuk Ping, June (A27591) 2nd RESPONDENT

YU Wai Sum (A18931) 3rd RESPONDENT

Decision of a Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants constituting

Members: Ms. LAU Shing Yan, Zabrina (Chairman)
Mr. LAM Yin Shing, Donald (Member)
Mr. MUI Arthur (Member)
Mr. CHAN Wai Tong, Christopher (Member)
Mr. TSAI Wing Chung, Philip (Member)

DECISION ON SANCTIONS AND COSTS

Introduction

1. By a decision dated 29 April 2021 (the “**Decision**”), this Committee gave decision on the Respondents’ substantive liability in respect of the

complaints made in these disciplinary proceedings. Parties were then directed to file submissions on sanctions and costs, and they did so on 1 June 2021 (for the Complainant) and 16 June 2021 (for the Respondents) respectively. This is the Committee's decision on sanctions and costs. Unless otherwise stated, we adopt the same abbreviations used in the Decision.

2. The Complainant has proposed the following orders as to sanctions and costs:
 - (1) the Respondents be reprimanded under section 35(1)(b) of the PAO;
 - (2) KPMG do pay a penalty of \$500,000 (for the first and third complaints), R2 do pay a penalty of \$300,000 (for the second complaint), and R3 do pay a penalty of \$200,000 (for the fourth complaint) under section 35(1)(c) of the PAO; and
 - (3) the Respondents do pay, on a joint and several basis, the costs and expenses in relation or incidental to the investigation reasonably incurred by the FRC under section 35(1)(d)(ii) of the PAO and the costs and expenses of and incidental to the proceedings of the Complainant (including the costs and expenses of the Disciplinary Committee) under section 35(1)(iii) of the PAO, agreed at \$5,000,000.
3. The Respondents have indicated that they do not intend to contest the quantum of the financial penalty proposed by the Complainant.

4. The Respondents have also confirmed that the costs order referred to at paragraph 2(3) above is agreed by the Complainant and the Respondents to be appropriate in the circumstances of the case.
5. In these circumstances, what remains to be considered by the Committee is whether the proposed orders are reasonable and appropriate in light of the circumstances of this case.

Discussion

6. The relevant factors for a Disciplinary Committee's consideration of its order for sanctions are found in the Guideline to Disciplinary Committee for Determining Disciplinary Orders (the "**Guideline**").
7. In considering the appropriate disciplinary orders to be imposed, the Disciplinary Committee will have in mind the objects of the Institute as set out in section 7 of the PAO. The sanctions should not only be proportionate to the nature of the failure and the harm or potential harm caused by the breach, but also with the aim to protect public interest, deter non-compliance with professional standards, maintain and promote public confidence in the profession and declare and uphold proper standards of conduct and performance: see sections 1.3 and 1.4 of the Guideline.
8. The Disciplinary Committee is recommended to take a three-stage approach under sections 4 – 7 of the Guideline in determining the appropriate disciplinary order.

- (1) To determine the seriousness of the offence, including reviewing the circumstances of the case and determining the seriousness of the breach.
 - (2) To determine the appropriate sanctions based on case severity before considering other factors. Different sanctions are suggested as starting points for consideration for the three different levels of severity, namely moderately serious, serious and very serious.
 - (3) The Disciplinary Committee is then to consider the impact of other factors (i.e. previous disciplinary records, aggravating and/or mitigating factors, and past similar cases) in finalising its disciplinary order.
9. We adopt this three-stage approach and consider the relevant factors as set out in the Guideline.
10. Stage 1: In respect of the seriousness of the offence, we agree with the Complainant that the offences in the present case are properly considered to fall within the “serious” category for the following reasons.
- (1) As mentioned in the Decision, the audit deficiencies related to major line items in the Financial Information and the 2009 Financial Statements, and they could have a material impact on the assessments of findings in the audits by the auditors in accordance with relevant professional standards.
 - (2) Secondly, the breaches were not isolated events but they involved non-compliance of multiple professional standards over 2 audits.

- (3) Moreover, given the IPO Engagement related to the listing of the Company's shares on the Main Board of the Hong Kong Stock Exchange, and the 2009 Audit was the first year audit of the Company after it became listed, substantial public interest was at stake and it was imperative that the Financial Information and the 2009 Financial Statements present a true and complete picture of the Company's financial position to the investing public.
 - (4) The deficiencies in the Respondents' audit work in relation to a listed company could undermine public confidence in the standards of the profession and have a detrimental effect on the reputation of the profession. The sanction imposed should adequately reflect that breaches of professional standards will not be condoned, and the sanctions imposed should provide a deterrence against deficiencies in order to maintain and promote public confidence in the profession.
 - (5) However, there is nothing in the conduct of the Respondents, and the audit evidence made available by the Respondents to the investigating team of AIB, which suggests that their breaches were intentional or reckless or otherwise for improper motive. The complaints do not cast doubt on the Respondents' integrity.
11. Stage 2: As we have taken the view that the offences in the present case fall into the "serious" category, under section 6 of the Guideline the starting point for sanctions includes a reprimand, financial penalty, cancellation of practising certificate (not to be reissued for up to 1 year), temporary removal from the register and/or payment of costs and incidentals.

12. Stage 3: We then consider other factors such as past disciplinary record, aggravating and/or mitigating factors and the sanctions imposed in past similar cases.

(1) KPMG has in its past disciplinary history one disciplinary order and one resolution by agreement. The former concerned KPMG's audit of a listed company and there were deficiencies and non-compliance of professional standards. Whilst there was no dishonesty, deliberate misconduct or concealment, the Committee in that case considered the breaches to be serious. Taking into account the respondents' early admission, KPMG was reprimanded, ordered to pay a penalty of \$400,000 and to pay costs jointly and severally. Separately, the resolution by agreement concerned KPMG's audits of a listed company and its subsidiaries for 3 financial years. KPMG and the other respondents were reprimanded and jointly fined \$35,000, with costs to the Institute and the FRC.

(2) R2 and R3 have clear disciplinary records.

(3) The Complainant acknowledges, and the Respondents agree, that there are a number of mitigating factors in favour of the Respondents:

(a) The Respondents had cooperated fully with the FRC and the AIB's investigation.

(b) The relevant audits took place more than 11 years ago and the Complainant is not aware of any other audit issues involving R2 and R3.

(c) R2 is in private practice and does not currently hold a practising certificate.

- (d) The complaints in these proceedings did not involve issues of professional competence, dishonesty, deliberate misconduct or concealment, nor the receipt of inappropriate benefits on the part of the Respondents.
 - (e) Although they fell short of the required standards, the Respondents had carried out a considerable amount of work in the IPO Engagement and the 2009 Audit.
 - (4) The Complainant has cited two past disciplinary orders (being D-05-IC22Q and D-16-1181F) involving audits of listed companies but in those cases the respondents admitted liability at the outset. The respondents were reprimanded, fined in the range of \$100,000 to \$350,000 and ordered to pay costs.
13. After taking into account the seriousness of the breaches, the circumstances of this case as well as all the mitigating factors, we agree with the Complainant that the sanctions to be imposed should be confined to those suggested sanctions for “moderately serious” breaches as listed in section 6 of the Guidelines, i.e. reprimand, financial penalty and/or payment of costs and incidentals.
14. Moreover, whilst this Committee is not bound by the decision of a previous Committee, we note that there are similarities in terms of the nature of the complaints in the present case and that in the two precedents cited to us. Having considered the amount of financial penalties imposed in those cases, we consider the quantum of the Complainant’s proposed penalties reasonable and appropriate in the circumstances of this case.

15. As for costs, since the Complainant is successful in all of the complaints against KPMG and R2 in respect of the IPO Engagement and all the complaints against KPMG and R3 in respect of the 2009 Audit (except for those relating to operating expenses for logging activities), the Respondents have fairly agreed to pay, on a joint and several basis, the costs and expenses in relation to or incidental to the investigation reasonably incurred by the FRC and the costs and expenses of and incidental to the proceedings of the Complainant (including those of the Committee). The agreed sum of \$5,000,000 is in all respects reasonable in the light of the scale of investigation and the voluminous amount of documents involved.

Conclusion

16. The Committee makes the following order:
 - (1) the Respondents be reprimanded under section 35(1)(b) of the PAO;
 - (2) KPMG do pay a penalty of \$500,000 (for the first and third complaints), R2 do pay a penalty of \$300,000 (for the second complaint), and R3 do pay a penalty of \$200,000 (for the fourth complaint) under section 35(1)(c) of the PAO; and
 - (3) the Respondents do pay, on a joint and several basis, the costs and expenses in relation or incidental to the investigation reasonably incurred by the FRC under section 35(1)(d)(ii) of the PAO and the costs and expenses of and incidental to the proceedings of the Complainant (including the costs and expenses of the Disciplinary

Committee) under section 35(1)(iii) of the PAO, agreed at \$5,000,000.

DATED the 12th day of August 2021

Ms. LAU Shing Yan, Zabrina
Chairman

Mr. LAM Yin Shing, Donald
Member

Mr. CHAN Wai Tong, Christopher
Member

Mr. MUI Arthur
Member

Mr. TSAI Wing Chung, Philip
Member