

# **Executive summary of the Investigation Report by the Audit Investigation Board dated 4 January 2012 on [the Auditor] in relation to the audits of the accounts of a listed company and its subsidiaries for the years ended 31 March 2001 and 2002**

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## **Introduction**

This report is prepared pursuant to section 35 of the FRC Ordinance and contains the findings of the investigation conducted by the AIB pursuant to section 23(1)(b) of the FRC Ordinance into the 2001 Audit and the 2002 Audit by [the Auditor].

## **Background information**

[The Company] was incorporated in Bermuda and was listed on the main board of SEHK. It was delisted on [date] in 2006 and was then put into liquidation.

The results of the Group, after taxation, for the years ended 31 March 2001 and 31 March 2002 were a loss of HK\$92.3 million and a profit of HK\$0.3 million respectively. The consolidated net assets of the Group at 31 March 2001 and 31 March 2002 were HK\$827 million and HK\$828 million respectively.

According to note 2 to the 2001 Accounts and note 3 to the 2002 Accounts, the respective accounts were prepared in accordance with accounting principles generally accepted in Hong Kong. The 2001 Accounts and the 2002 Accounts were audited by [the Auditor]. The auditor's reports issued by [the Auditor] stated that its audits were conducted in accordance with the SASs. The audit opinions expressed by [the Auditor] on the 2001 Accounts and the 2002 Accounts were unmodified.

## **Initiation of investigation**

The Council received a complaint of a potential auditing irregularity in relation to the 2001 Audit and the 2002 Audit by [the Auditor] on 25 August 2009. Upon receiving the complaint, the secretariat of the Council reviewed the accounts concerned and the information provided by the complainant.

Having considered all the information available, the Council, on 5 November 2009, directed the AIB, in accordance with section 23(1)(b) of the FRC Ordinance, to investigate the 2001 Audit and the 2002 Audit by [the Auditor] to ascertain whether an auditing irregularity had occurred.

### **Scope of investigation**

The investigation was to collect information and evidence relating to the question whether or not there is an auditing irregularity in relation to the 2001 Audit and the 2002 Audit in respect of the following areas:

- (a) the PUD of [the Subsidiary A] and [Subsidiary B] at 31 March 2001 and 31 March 2002; and
- (b) the loan to the Debtor from [the Subsidiary C] at 31 March 2001 and 31 March 2002.

### **Relevant auditing, accounting and professional ethics requirements**

The auditing, accounting and professional ethics requirements applicable at the time of the 2001 Audit and the 2002 Audit and relevant to the findings on the question whether or not there is an auditing irregularity in this report are set out below:

SAS 100	<i>Objective and general principles governing an audit of financial statements</i>
SAS 200	<i>Planning</i>
SAS 230	<i>Documentation</i>
SSAP 22	<i>Inventories</i>
Statement 1.200	<i>Professional ethics explanatory foreword</i>

### **Views of the AIB**

#### *Audit documentation*

Based on the results of the investigation, the AIB considers that [the Auditor] did not sufficiently document the nature, timing and extent of the audit procedures performed and the conclusion reached in the 2001 Audit and the 2002 Audit in accordance with paragraphs 2, 5, 6 and 7 of SAS 230 in relation to the following:

- (a) the results, findings (if any) and conclusion of control tests of the inventory management business cycle in the 2001 Audit;
- (b) the analysis on the exception of a HK\$8.7 million invoice dated 28 December 1999 but recorded in the 2001 Accounts found in the “Overstatement test on additions to PUD”, and the audit procedures performed and the results thereof in respect of the review on the reasonableness of the assumptions underlying “other costs to completion” used in “Review of profit forecast analysis” of [the Subsidiary A] in the 2001 Audit; and the results and conclusion of the “Cutoff test on PUD” of [the Subsidiary A] in the 2002 Audit; and
- (c) the reason for the increase in the principal amount of the loan over the amount as stated in the loan agreement and the basis of conclusion in assessing the recoverability of the loan to the Debtor of [the Subsidiary C] in the 2001 Audit and the 2002 Audit.

*Professional scepticism*

Based on the results of the investigation, the AIB considers that [the Auditor] had not exercised sufficient professional scepticism in accordance with paragraphs 9 and 10 of SAS 100 in the 2001 Audit and the 2002 Audit in respect of the following:

- (a) the analysis of the exception of that HK\$8.7 million invoice dated 28 December 1999 but recorded in the 2001 Accounts in the “Overstatement test on additions to PUD” of [the Subsidiary A] in the 2001 Audit;
- (b) the assessment of the reliability of payment certificates issued by the Project Architect of [the Residential Project], a related party of the Group, as an audit evidence in the “Overstatement test on additions to PUD” of [the Subsidiary A] in the 2002 Audit; and
- (c) the identification of potential non-compliance with paragraphs 6 and 12 of SSAP 22 and the accounting policy in respect of the capitalization of costs in the “Overstatement test on additions to PUD” of [the Subsidiary A] in the 2002 Audit.

In conclusion, based on the findings of the investigation, the AIB considers that [the Auditor] did not fully comply with paragraph 2 of Statement 1.200, which requires an auditor to carry out its

professional work with a proper regard for the technical and professional standards expected of it in performing the 2001 Audit and the 2002 Audit.

### **Comments from [the Auditor] on the draft investigation report**

The relevant sections of the draft investigation report were sent to [the Auditor] for comments on 24 October 2011 and 28 November 2011. In its reply letters dated 4 November 2011 and 16 December 2011, [the Auditor] reiterated its comments made in its previous letters to the AIB dated 30 June 2010, 2 November 2010 and 15 September 2011 that its responses to the AIB's requirements have been substantially constrained by the passage of time, the absence of key audit personnel who worked on the 2001 Audit and the 2002 Audit, and the absence of some important working papers seized by a specified enforcement agency. [The Auditor] further commented that the auditing standard recognized that a discussion with the audit team represents an important step in the process of obtaining a comprehensive understanding of all aspects of the audit. Because of the absence of key audit team members and the lapse of time, [the Auditor] considered the FRC does not appear to have a proper basis to draw any definitive conclusion on the issues of audit documentation.

Owing to the inherent limitations of an audit, [the Auditor] emphasized that there was an unavoidable risk that some material misstatements of the 2001 Accounts and the 2002 Accounts might not have been detected, even though the 2001 Audit and the 2002 Audit had been properly planned and performed.

In respect of the AIB's findings on inventory management internal control, overstatement test on PUD and review of profit forecast analysis, [the Auditor] reiterated its comments that the audit working papers concluded and documented that no revision of the control reliance strategy was necessary and the audit documentation was sufficient. With regard to the cutoff test on PUD, [the Auditor] mentioned that the relevant audit working paper might have been seized by a specified enforcement agency. In respect of the appropriateness of capitalization of advertising and promotion expenses and sales commission in PUD, [the Auditor] commented that there was divergent market practice at that time.

### **Response of the AIB to comments from [the Auditor]**

The AIB acknowledged that [the Auditor]'s responses to the requirements have been constrained by the passage of time, the absence of key audit personnel who worked on the relevant audits and the absence of some important working papers. However, the AIB considers that (a) audit working papers when prepared should be sufficiently complete and detailed to provide an overall understanding of the audit to another experienced auditor; (b) audit working papers should record the planning, the nature, timing and extent of procedures performed, the results thereof, and the conclusion drawn from the audit evidence obtained; and (c) auditors should document matters that are important in providing evidence to support the audit opinion, which inevitably, were the basic principles and essential procedures as specified in the auditing standard concerning audit documentation. Despite the inherent limitations of an audit, the AIB considers that [the Auditor] should have planned and performed the 2001 Audit and the 2002 Audit with an attitude of professional scepticism. [The Auditor] should have made a critical assessment of the validity of audit evidence obtained and alerted to audit evidence that contradicted or brought into question the reliability of documents or management representation. Based on the findings of this investigation, the AIB upholds its view and considers that [the Auditor] did not sufficiently document certain audit procedures, results and conclusions, and had not exercised sufficient professional scepticism in certain aspects of the audits.

### **Comments from [the Company] on the draft investigation report**

The relevant sections of the draft investigation report were sent to [the Company] for comments on 24 October 2011. In its reply letter dated 11 November 2011, [the Company] commented that the scope of the investigation is not wide enough to cover the misuse of the property pre-sale proceeds and the misappropriation of funds. [The Company] further commented that [the Auditor] had not given a fair assessment on the multiple conflicting roles taken up by the managing director and the company secretary, failed to detect the violation of pre-sale agreements, loan agreements and subordination agreements, failed to review journal entries, irregular set-off transactions and inter-company transactions, and questioned the appropriateness of the audit approach in the 2001 Audit and the 2002 Audit.

## **Response of the AIB to comments from [the Company]**

The AIB noted the comments from [the Company] but emphasizes that the Council did consider the auditor's responsibility in relation to fraud, other irregularities and error in determining the scope of this investigation.

In respect of [the Company]'s other comments, the AIB considers that they related to the legality of usage of pre-sale proceeds, misappropriation of funds, fraud investigation, irregular set-off transactions and inter-company transactions, which are not within the remit of the FRC or the scope of this investigation. The AIB considers that it is not in a position to comment on the appropriateness of the audit approach adopted by [the Auditor].

## Abbreviations used in the Executive Summary

AIB	Audit Investigation Board
[Auditor]	The auditor for the 2001 Accounts and 2002 Accounts
Council / FRC	Financial Reporting Council
Debtor	An individual debtor of the Group (whose name is not disclosed in this report)
FRC Ordinance	Financial Reporting Council Ordinance (Cap. 588)
Group	[The Company] and its subsidiaries
Project Architect	Project architect of the Residential Project, a related party of the Group
PUD	Property under development
[Residential Project]	Residential project developed by [Subsidiary A], which is located in Hong Kong
SAS	Statement of Auditing Standards issued by the then Hong Kong Society of Accountants (now renamed Hong Kong Institute of Certified Public Accountants)
SEHK	The Stock Exchange of Hong Kong Limited
SSAP	Statement of Standard Accounting Practice issued by the then Hong Kong Society of Accountants (now renamed Hong Kong Institute of Certified Public Accountants)
[Subsidiary A]	A wholly-owned subsidiary of [the Company]
[Subsidiary B]	A wholly-owned subsidiary of [the Company]
[Subsidiary C]	A wholly-owned subsidiary of [the Company]
[The Company]	The listed company concerned in this investigation
2001 Accounts	Accounts of the Group for the year ended 31 March 2001
2002 Accounts	Accounts of the Group for the year ended 31 March 2002
2001 Audit	Audit of the 2001 Accounts
2002 Audit	Audit of the 2002 Accounts

**Notes concerning this executive summary**

This executive summary relates to the possible occurrence of an auditing irregularity in respect of the audits of the accounts of a listed entity under the Financial Reporting Council Ordinance (Cap.588).

Any references in this executive summary to breaches of any law, regulation, standards of accounting, auditing, assurance and professional ethics, practice or principle, or the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited should be understood in the context of that Ordinance only and pursuant to which this executive summary was prepared.

This executive summary, whenever it relates to the private rights of third parties between themselves, makes and implies no comment as to the rights and obligations, and the merits of the conduct, of these third parties as between themselves.