AFRC Accounting and Financial Reporting Council
會計及財務匯報局

10/F, Two Taikoo Place,
979 King's Road, Quarry Bay, Hong Kong
香港鰂魚涌英皇道 979 號太古坊二座 10 樓

T 電話 + 852 2810 6321
F 傳真 + 852 2810 6320
E 電郵 general@afrc.org.hk

afrc.org.hk

Press Release

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AFRC reprimands and fines Deloitte and two engagement partners over HK$1.9 million for multiple audit deficiencies in relation to two companies formerly listed in Hong Kong

The Accounting and Financial Reporting Council (**AFRC**) has sanctioned the following PIE audit firm and its two partners for multiple audit deficiencies related to revenue recognition and other breaches involving two companies formerly listed in Hong Kong:

(i) Deloitte Touche Tohmatsu (**Deloitte**), as the reporting accountants preparing the accountants' report of Tianhe Chemicals Group Limited[1] and its subsidiaries (**Tianhe Group**) for the years ended 31 December 2011, 2012 and 2013 included in the prospectus for the company's initial public offering (**IPO**), and the auditor of Sound Global Limited[2] and its subsidiaries (**Sound Global Group**) for the years ended 31 December 2012 and 2013;

(ii) Mr Wong Tin Chak Samuel (**Wong**), engagement partner for the 2011, 2012 and 2013 audits of the Tianhe Group; and

(iii) Mr Mak Chi Lung (**Mak**), engagement partner for the 2012 and 2013 audits of the Sound Global Group.

The AFRC has issued a public reprimand to each of Deloitte, Wong and Mak (collectively, **Regulatees**), and imposed pecuniary penalties totalling HK$1,912,000, comprising penalties of HK$1,160,000 for Deloitte,[3] HK$416,000 for Wong and HK$336,000 for Mak.

This is the first batch of completed disciplinary cases involving Mainland audit working papers obtained through cross-boundary regulatory collaboration with the support of the Ministry of Finance of the People's Republic of China (**MoF**).

In the audits of both companies formerly listed in Hong Kong, the AFRC identified multiple deficiencies in the audit procedures concerning revenue recognition and external confirmations. These deficiencies resulted in failures to obtain sufficient

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[1] Previous stock code: 01619, now delisted.
[2] Previous stock code: 00967, now delisted.
[3] The pecuniary penalties of HK$1,160,000 for Deloitte comprises of: (i) a pecuniary penalty of HK$592,000 for audit deficiencies in the Tianhe Group case involving three audit years (2011, 2012 and 2013); and (ii) a pecuniary penalty of HK$568,000 for audit deficiencies in the Sound Global Group case involving two audit years (2012 and 2013).

appropriate audit evidence and indicated a lack of professional skepticism to address the assessed risk of material misstatement of revenue.

The Regulatees accepted their breaches and proactively engaged in settlement negotiation and reached an early settlement with the AFRC. In light of the Regulatees' cooperative attitude, the AFRC has exercised its discretion under the Guidance Note on Cooperation with the AFRC and reduced the pecuniary penalties by 20% in each case.

Disciplinary decision regarding the audits of Tianhe Group

The core business of the Tianhe Group was the manufacturing and sale of fine chemical products. In 2014, the company sought a listing on the Main Board of the Hong Kong Stock Exchange. Revenue from the sales of fine chemical products was mainly generated by a subsidiary. The subsidiary's sales amounted to RMB3.2 billion, RMB4.1 billion and RMB4.8 billion for the financial years 2011, 2012 and 2013 respectively, representing 95.3%, 97.5% and 96.1% of the respective consolidated sales of the Tianhe Group.

Deloitte and Wong were the reporting accountants for the IPO in 2014, and in that capacity, audited the financial information of the Tianhe Group for the financial years 2011, 2012 and 2013. Revenue was identified as a significant risk area and where potential risk of material misstatement due to fraud existed.

The AFRC found a multitude of deficiencies in the reporting accountants' work in the area of revenue recognition in relation to that subsidiary, including:

- failure to properly evaluate the design and implementation of internal controls in relation to the revenue cycle and obtain sufficient appropriate audit evidence as to their operating effectiveness, and wrongful conclusion that such controls were effective and reliable;

- failure to ensure the completeness of sales in the tests of controls and substantive procedures; and

- regarding the testing of the occurrence of revenue, (i) failure to obtain critical evidence of goods delivery and customers' acceptance; (ii) failure to properly design and perform audit procedures resulting in the overlooking of certain inconsistencies between the transaction amounts stated on some value-added tax invoices and other records; and (iii) failure to identify that revenue from the sales of goods was recognised in advance of the delivery of goods, which deviated from the Tianhe Group's accounting policy.

Disciplinary decision regarding the audits of Sound Global Group

The Sound Global Group was principally engaged in turnkey water and wastewater treatment. According to the consolidated financial statements for the financial years 2012 and 2013, revenue from turnkey projects and services amounted to RMB2.4 billion and RMB2.9 billion, representing 92.2% and 91.8% of the total revenue of the Sound Global Group respectively.

Deloitte and Mak audited the financial information of the Sound Global Group for the financial years 2012 and 2013. The auditors had identified that there were risks of material misstatement in relation to revenue and bank balances for both the 2012 and 2013 audits.

The AFRC found multiple deficiencies in the auditors' work concerning (i) revenue from turnkey services and sales of equipment; and (ii) external confirmations relating to bank balances and trade receivables, including:

- failure to obtain sufficient appropriate audit evidence to corroborate revenue recognition in respect of turnkey projects;
- failure to properly determine the sample size for testing the completeness and occurrence of revenue from sales of equipment; and
- failure to identify and verify that some confirmations were returned from Sound Global subsidiaries, rather than from the banks or from the customer to which the external confirmations were addressed.

In deciding the appropriate disciplinary sanctions in each case, the AFRC has considered all the relevant circumstances, including the nature, seriousness, duration, frequency and impact of the misconduct. In particular, the AFRC has taken into account the following factors in these two cases:

- the conduct involved multiple breaches of auditing standards involving multiple audit years;
- there was no finding of intentional, dishonest or deliberate misconduct;
- as the subject companies were listed, or sought to be listed, on the Main Board at the material times, and the Tianhe Group case involved the initial public offering of shares, significant public interest was at stake. Deficiencies in the audit work could undermine public confidence in the audit quality;
- Deloitte's history of non-compliance with the Hong Kong Institute of Certified Public Accountants as at the time of the misconduct;
- the clean disciplinary records of Wong and Mak; and

- the Regulatees' cooperation with the AFRC, acceptance of the AFRC's findings and disciplinary action, which facilitated an early resolution of the matter.

Ms Hester Leung, Head of Discipline, stated, "Revenue is a key performance indicator in financial reporting and can be prone to manipulation by management. Deficient audit work in this critical area can increase the risk of undetected material misstatements of revenue or financial statement fraud, threatening investor interests. Further, the use of external confirmations is a critical audit procedure for verifying the financial information provided by the audited entity. External confirmations must be returned directly from the requested third parties to the auditors to ensure their reliability as audit evidence. The AFRC emphasises that auditors must maintain professional skepticism while performing audit procedures relating to revenue and external confirmations."

Ms Janey Lai, CEO of the AFRC, remarked, "The successful completion of these disciplinary cases attests to the effectiveness of the Memorandum of Understanding signed between the MoF and AFRC in 2019 in strengthening public trust in financial reporting and investor confidence. Given that a large proportion of listed companies in Hong Kong are based in Mainland China, accessing the relevant audit working papers from the Mainland is vital for our investigative and disciplinary work. The AFRC will continue to work closely with relevant authorities to enhance cross-boundary audit supervision."

For details of the decision regarding the audits of Tianhe Group, please refer to the Statement of Disciplinary Action.

For details of the decision regarding the audits of Sound Global Group, please refer to the Statement of Disciplinary Action.

End

About the Accounting and Financial Reporting Council

The Accounting and Financial Reporting Council (**AFRC**) is an independent body established under the Accounting and Financial Reporting Council Ordinance. As an independent regulator, the AFRC leads the accounting profession by upholding professional standards, safeguarding the public interest, and promoting the profession's healthy development.

For more information about the statutory functions of the AFRC, please visit www.afrc.org.hk

For media enquiries:

Joyce Mak
Manager, Corporate and Public Affairs
Tel: +852 3586 7889
Email: joycemak@afrc.org.hk

Chelsy Chan
Senior Officer, Corporate and Public Affairs
Tel: +852 2236 6066
Email: chelsychan@afrc.org.hk

STATEMENT OF DISCIPLINARY ACTION

A. The Disciplinary Action

1. Pursuant to sections 37CA and 37I(1A) of the Accounting and Financial Reporting Council Ordinance (Cap. 588) (**AFRCO**), the Accounting and Financial Reporting Council (**AFRC**) has:

    1.1. publicly reprimanded each of Deloitte Touche Tohmatsu (**Deloitte**) and Wong Tin Chak Samuel (**Wong**);

    1.2. imposed a pecuniary penalty of **HK$592,000** against Deloitte; and

    1.3. imposed a pecuniary penalty of **HK$416,000** against Wong,

    (collectively, **Disciplinary Sanctions**).

2. The Disciplinary Sanctions were imposed in relation to the preparation of the Accountants' Report (**Accountants' Report**) for Tianhe Chemicals Group Limited (**Company**) (previous stock code: 01619, now delisted) and its subsidiaries (collectively, **Group**) for the years ended 31 December 2011, 31 December 2012 and 31 December 2013 (**2011, 2012 and 2013 Audits** respectively) included in the Company's prospectus dated 9 June 2014 (**Prospectus**).

3. Deloitte[1] was the reporting accountant preparing the Accountants' Report, and Wong[2] was the engagement partner responsible for the engagement, including its performance and the preparation of the Accountants' Report. Unless otherwise stated, **Auditor** refers to both Deloitte and Wong.

4. The AFRC found multiple audit deficiencies in the 2011, 2012 and 2013 Audits regarding revenue and related cost of sales. As a result, the AFRC found that the Auditor failed or neglected to observe, maintain or otherwise apply the professional standards and guideline below in the Accountants' Report in the relevant years of audits:

    4.1. in each of 2011 Audit, 2012 Audit and 2013 Audit:

        4.1.1. paragraph 15 of the applicable version of ISA 200 *Overall Objectives of* the *Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing* (**ISA 200**);

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1 Deloitte is registered as a CPA firm and a public interest entity auditor with the AFRC (registration number 0166).

2 Wong was at all material times a member of the HKICPA (number A06178), a practising certificate holder (number P03848) and a practising partner of Deloitte. He was also a registered engagement partner and a registered engagement quality control reviewer of Deloitte. Currently, he is not a HKICPA member and does not hold any practising certificate.

4.1.2. paragraph 12 of the applicable version of ISA 240 *The Auditor's* Responsibilities *relating to Fraud in an Audit of Financial Statements* (**ISA 240**);

4.1.3. paragraph 13 of the applicable version of ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* (**ISA 315**);

4.1.4. paragraphs 6 and 8 of the applicable version of ISA 330 *The Auditor's Responses to Assessed Risks* (**ISA 330**);

4.1.5. paragraphs 6 and 9 of the applicable version of ISA 500 *Audit Evidence* (**ISA 500**);

4.1.6. paragraphs 28 and 37 of the applicable version of Statement 3.340 *Auditing Guideline Prospectuses and the Reporting Accountant* (**AG 3.340**);

4.1.7. paragraphs 100.5(c) and 130.1 of the applicable versions of the Code of Ethics for Professional Accountants (**COE**); and

4.2. in each of 2011 Audit and 2012 Audit:

4.2.1. paragraph 12 of the applicable version of ISA 505 *External Confirmations* (**ISA 505**).

5. By failing or neglecting to observe, maintain or otherwise apply the PAO professional standards in the relevant years of audits, each of Deloitte and Wong committed professional irregularities under section 3B(1)(c) of the AFRCO, and is guilty of CPA misconduct pursuant to section 37AA(1)(a) of the AFRCO and section 71 of the Accounting and Financial Reporting Council (Transitional and Saving Provisions and Consequential Amendments) Regulation (Cap. 588B).

B. Summary of Facts

6. The Group was principally engaged in manufacturing and sale of fine chemical products. The two major product groups were (i) lubricant additives; and (ii) specialty fluorochemicals.

7. On 9 June 2014, the Company issued the Prospectus for its initial public offering (**IPO**) in Hong Kong and raised net proceeds of approximately HK$3.52 billion. On 20 June 2014, the Company was listed on the Main Board of the Stock Exchange of Hong Kong Limited.

8. On 2 September 2014, a short-seller issued a research report alleging that the Group's revenue and profitability were significantly inflated. Trading of the Company's shares was suspended on the same day. On 10 September 2014

and 8 October 2014, the Company issued clarification announcements to rebut the allegations made by the short-seller. Trading of the Company's shares subsequently resumed on 9 October 2014.

9. On 26 March 2015, trading of the Company's shares was suspended at the Company's request, as the Company required additional time to provide further information to the Company's then auditor, Deloitte, for auditing the consolidated financial statements of the Group for the year ended 31 December 2014. This led to a delay in publishing its annual results.

10. On 16 September 2015, Deloitte resigned as the Company's auditor after the board decided not to accept Deloitte's draft auditor's report, which contained a disclaimer of opinion on the consolidated financial statements of the Group for the year ended 31 December 2014.

11. On 11 June 2020, the listing of the Company's shares was cancelled.

12. On 19 June 2020, the Securities and Futures Commission commenced proceedings in the Market Misconduct Tribunal (**MMT**) against the Company and its executive director for allegedly issuing the Prospectus which overstated about 54% of the Group's track record revenue totalling RMB12.6 billion. On 25 January 2022, the MMT found them culpable of market misconduct for issuing a false or misleading IPO prospectus to overstate the Company's revenue.

C. Summary of Findings

13. The audit work conducted in respect of revenue and related cost of sales in the 2011, 2012 and 2013 Audits is the subject of an investigation (**Investigation**) conducted by the Audit Investigation Board pursuant to section 23(3) of the then Financial Reporting Council Ordinance (Cap. 588).

14. The Group's sales were generated mainly through two of the Company's key subsidiaries in Mainland China, Jinzhou DPF-TH Chemicals Co., Ltd., (**Jinzhou DPF-TH**) and Fuxin Hengtong Fluoride Chemicals Co., Ltd. The sales generated by Jinzhou DPF-TH for the years ended 31 December 2011, 2012 and 2013 were RMB3,202 million, RMB4,086 million and RMB4,840 million respectively, which accounted for 95%, 97% and 96% of the consolidated sales. Hence, the Investigation focused on the domestic sales and the related cost of sales of Jinzhou DPF-TH.

15. The AFRC found that the Auditor's work in respect of revenue and related cost of sales suffered from a range of deficiencies, including those summarised below.

16. In the audit working paper, the Auditor documented that cut-off, accuracy, completeness and occurrence of revenue were identified as "significant risks", and considered that there was risk of material misstatement due to fraud. However, multiple audit deficiencies in respect of revenue and related cost of sales were identified during the Investigation.

Verification of the Authenticity of the Value-added Tax (VAT) Invoices

17. During audit planning and risk assessment, the Auditor documented that the specialty fluorochemicals products were mainly sold through distributors rather than directly to end customers, and therefore there was a greater risk associated with the genuineness of revenue from these products, and identified it as a "significant matter".

18. To test the occurrence and genuineness of revenue from the sales of specialty fluorochemical products, one of the Auditor's planned audit procedures was to verify the authenticity of the selected samples of VAT invoices issued by the Group through internet or telephone inquiry.

19. It was stated in an audit working paper that some of the VAT invoices could not be retrieved through the State Taxation Administration's website. For a majority of the verifications performed, the Auditor instead relied on screenshots of VAT inquiry results provided by the Group. Further, it was found that a number of the sampled transactions were not supported by the screenshots of VAT inquiry results, either because no screenshots could be found in the audit working papers, or the screenshots did not match with the documented transaction details of the VAT invoices.

20. Based on the above, the AFRC found that, for each of 2011 Audit, 2012 Audit and 2013 Audit, the Auditor failed to properly design and perform further audit procedures responsive to the assessed risks of material misstatement of revenue in accordance with ISA 330.6 and ISA 500.6.

Tests of Controls

21. At the audit planning stage, the Auditor documented that completeness and cut-off of costs of sales were identified as "significant risks".

22. The Auditor inquired about the Group's internal controls in relation to its revenue cycle. They documented that a goods delivery note would be signed by the Group's sales personnel and the customer's representative as evidence for completion of the goods despatch.

23. When testing the operating effectiveness of the internal control, the Auditor failed to:

    23.1. check whether the goods delivery notes had been signed by the Group's sales personnel;

    23.2. inspect proof of the customer's acknowledgement of receipt of the goods, which was an important external evidence for goods delivery; and

    23.3. seek explanations from the management or perform additional audit procedures to address the discrepancies between the amounts of sales as recorded in the sales invoices and the journal vouchers respectively.

24. Further, there was a lack of internal control over the completeness of sales, as the Group did not have any control over (i) the use of the goods delivery notes in sequential order and (ii) the marking of the actual date of goods delivery or receipt on the goods delivery notes. The Auditor failed to identify that there was a lack of sufficient internal controls in these areas. No assessment was performed to evaluate whether such insufficient internal control would give rise to additional risks of material misstatements in relation to revenue recognition.

25. Based on the above, the AFRC found that, for each of 2011 Audit, 2012 Audit and 2013 Audit, the Auditor failed to:

    25.1. properly evaluate the design and implementation of the internal controls in accordance with ISA 315.13; and

    25.2. perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of the relevant controls in accordance with ISA 330.8.

Sales Transaction Test

26. The Auditor selected samples of the goods delivery notes and matched them with the corresponding sales vouchers for ascertaining the completeness of sales and testing the understatement of sales. They concluded that no material error was noted. Based on the Auditor's documentation of their understanding of the revenue cycle, the Group issued a goods delivery note on the same day when the customer's representative collected the goods.

27. However, it was found that:

    27.1. the goods delivery notes were not issued in sequential order. The Auditor did not obtain audit evidence to ascertain that the samples were selected from a complete population. Hence, the test was unable to address the risk of understatement of sales; and

    27.2. for most of the selected samples in each of the three financial years, revenue from the sales of goods was recognised in advance of the delivery of goods. This was inconsistent with the Group's accounting policy for revenue recognition which stated that revenue would be recognised when the goods were delivered and titles were passed. The Auditor did not identify the inconsistency, nor did they inquire with the Group about the reason for such deviation from the accounting policy.

28. Based on the above, the AFRC found that, for each of 2011 Audit, 2012 Audit and 2013 Audit, the Auditor failed to:

28.1. obtain audit evidence to ascertain the completeness of the population from which items were selected for testing in accordance with ISA 500.9; and

28.2. properly evaluate whether the Group had appropriately applied the revenue recognition policy in accordance with ISA 500.6.

<u>Red Flags in relation to the Sales of Two Major Customers</u>

29. In respect of two major customers of specialty fluorochemicals products, the Auditor identified that there were significant discrepancies between (i) the reported size of sales and inventories in their financial records obtained from the departments for industry and commerce and (ii) their purchases from the Group. Therefore, the Auditor selected 40% and 50% of the sales transactions of these two customers respectively to perform additional audit procedures.

30. In performing the sales transaction test, the Auditor inspected the sales vouchers, invoices, goods delivery notes, and bank-in slips or bank statements for sale receipts. In respect of the goods delivery notes, the Auditor ascertained if there was any signature of the Group's sales personnel, but not the customer's representatives.

31. However, such additional audit procedures could not provide evidence as to whether the goods were delivered to and accepted by these customers. The Auditor should have critically evaluated the evidence obtained and performed further audit procedures in response to the red flags identified in relation to the sales to these customers.

32. Based on the above, the AFRC found that, for each of 2011 Audit, 2012 Audit and 2013 Audit, the Auditor failed to obtain sufficient appropriate audit evidence in accordance with ISA 330.6 and ISA 500.6 to respond to the red flags identified in relation to the sales to the two major customers.

<u>Purchase Transaction Test</u>

33. In performing the purchase transaction test, the Auditor selected samples of purchase transactions for each of the three financial years, and inspected the corresponding purchase vouchers, purchase invoices and goods receipt notes. The Auditor concluded that no material error was noted.

34. However, it was found that certain purchase transactions were not recorded at the time when the goods were received. The purchase voucher dates in a number of samples were later than the dates of their corresponding goods receipt notes. In two instances, the purchase transactions were only recorded around one month and two months after the receipt of goods. No follow-up audit procedure was performed.

35. Based on the above, the AFRC found that, for each of 2011 Audit, 2012 Audit and 2013 Audit, the Auditor failed to exercise professional skepticism in

accordance with ISA 200.15 and ISA 240.12 to identify additional risk factors and obtain explanation from the management, in relation to the inconsistent timing of recording the purchase transactions.

Sales Cut-off Test

36. The Auditor conducted the sales cut-off test to ensure that the transactions were recorded in the correct accounting period, and concluded that no material error was noted:

    36.1. for overstatement testing, the Auditor selected samples of sales vouchers with material amounts, and matched the recorded sales with the sales invoices and goods delivery notes; and

    36.2. for understatement testing, the Auditor selected samples of the goods delivery notes, and matched them with the corresponding sales vouchers and sales invoices.

37. However, it was found that:

    37.1. the goods delivery notes were not issued in sequential order. The Auditor did not obtain audit evidence to ascertain that the samples were selected from a complete population. Hence, the test was unable to address the risk of understatement of sales;

    37.2. for most of the selected samples in each of the three financial years, revenue from the sales of goods was recognised in advance of the delivery of goods. This was inconsistent with the Group's accounting policy for revenue recognition which stated that revenue would be recognised when the goods were delivered and titles were passed. The Auditor did not identify the inconsistency, nor did they inquire with the Group about the reason for such deviation from the accounting policy; and

    37.3. the Auditor checked that the selected samples of goods delivery notes for 2011 Audit were signed, but did not perform this test for the selected samples for 2012 Audit and 2013 Audit.

38. Based on the above, the AFRC found that the Auditor failed to:

    38.1. obtain audit evidence to ascertain the completeness of the population from which items were selected for testing in accordance with ISA 500.9 for each of 2011 Audit, 2012 Audit and 2013 Audit;

    38.2. properly evaluate whether the Group had appropriately applied the revenue recognition policy in accordance with ISA 500.6 for each of 2011 Audit, 2012 Audit and 2013 Audit; and

38.3. ascertain if the customers acknowledged receipt of the goods as evidence of the delivery in accordance with ISA 330.6 and ISA 500.6 for each of 2012 Audit and 2013 Audit.

External Confirmations

39. In respect of the sales for lubricant additives and specialty fluorochemicals, the Auditor requested confirmations from (i) 13 customers for 2011 Audit and 2012 Audit, and (ii) 21 customers for 2013 Audit.

40. It was stated in the audit plan that there was significant risk in relation to occurrence of revenue from the sales of specialty fluorochemicals, and the Auditor would confirm the major terms of the agreements in the external confirmations in respect of two major customers.

41. Whilst the confirmation requests to these customers for 2013 Audit covered the major terms of the agreements, the confirmation requests for 2011 Audit and 2012 Audit did not cover this information. Such audit evidence was important for evaluating whether the corresponding sales were consignment, and whether the significant risks and rewards of the ownership of goods were transferred upon sales to these customers such that the sales could be recognised.

42. Based on the above, the AFRC found that the Auditor failed to perform audit procedures responsive to the assessed risks of material misstatement on revenue in accordance with their audit plan and ISA 330.6 and ISA 500.6 for each of 2011 Audit and 2012 Audit.

43. Further, a confirmation request sent to another major customer was not returned. Sales made to this customer represented 25% and 23% of the Group's revenue for the years ended 31 December 2011 and 2012 respectively and were considered very material to the Group.

44. The Auditor performed an alternative audit procedure on non-response to the confirmation request by selecting the sales invoices and journal vouchers for inspection. However, these documents were internally generated by the Group, and could not provide evidence of the delivery and the time when the title of the goods was passed to the customers.

45. It was found that the nature and extent of such alternative audit procedures failed to provide the audit evidence required to respond to the significant risks of material misstatement on revenue. The Auditor should have examined the shipping documentation, contacted the recipient of the confirmation request for follow up, or arranged another confirmation request.

46. Based on the above, the AFRC found that, for each of 2011 Audit and 2012 Audit, the Auditor failed to adequately perform alternative audit procedures in accordance with ISA 505.12 to obtain relevant and reliable audit evidence in the case of non-response to the confirmation request.

Evaluation of the Reasonableness of the Selling Price of the Group's Products

47. The Auditor identified that there were significant risks regarding the occurrence of revenue from the sales of specialty fluorochemicals products. It was stated in their audit plan that they would compare the Group's products with relatively substantial sales and high gross profit margin against its competitors.

48. However, the Auditor only included the information of one competitor and one specialty fluorochemicals product in their comparison, notwithstanding the presence of other specialty fluorochemicals products with relatively substantial sales and high gross profit margin.

49. Further, the concentrations of the Group's product and the competing product selected for comparison were different. The Auditor did not obtain any evidence to substantiate their assumption that the price of such specialty fluorochemical product was directly proportional to its concentration. Hence, the competing product selected for comparison might not be comparable to that of the Group.

50. Based on the above, the AFRC found that, for each of 2011 Audit, 2012 Audit and 2013 Audit, the Auditor failed to sufficiently evaluate the reasonableness of the selling price of the specialty fluorochemical products and be responsive to the assessed risks of material misstatement of revenue in accordance with ISA 330.6 and ISA 500.6.

Analytical Procedure for Revenue and Gross Profit Margin

51. In the risk assessment for cost of sales, the Auditor identified that sales remained strong despite the poor economy at the time. Hence, there was a risk that the cost of sales might be understated and the gross profit margin might be overstated.

52. The Auditor was aware that despite the poor economy, a new specialty fluorochemical product was sold at a relatively high price, and the gross profit margins of several new specialty fluorochemical products remained high. However, the Auditor accepted the management's representation without challenging its reasonableness or obtaining sufficient corroborating evidence.

53. Further, inconsistent with the management's response that there was no seasonal trend for sales of the speciality fluorochemical products, sales in fact increased significantly towards the end of 2011 and 2012. The Auditor failed to identify such fluctuations and investigate it through inquiring with the management and obtaining appropriate audit evidence to substantiate the management's response.

54. Based on the above, the AFRC found that, for each of 2011 Audit, 2012 Audit and 2013 Audit, the Auditor failed to exercise professional skepticism to identify fluctuations in sales and obtain sufficient appropriate audit evidence

to address the assessed risks of material misstatement of revenue in accordance with ISA 200.15, ISA 240.12, ISA 330.6 and ISA 500.6.

Overall Breaches

55. Based on the multiple audit deficiencies found in the 2011 Audit, 2012 Audit and 2013 Audit as stated in paragraphs 17 to 54 above, the AFRC found that the Auditor failed to:

    55.1. obtain relevant and reliable evidence sufficient to enable them to prepare the financial information to be included in the Accountant's Report and to form an opinion on that information in accordance with paragraph 28 of AG3.340; and

    55.2. review the appropriateness of all the accounting policies and the consistency of their application in accordance with paragraph 37 of AG3.340.

56. Further, the AFRC found that, in light of the audit deficiencies as stated in paragraphs 17 to 55 above, the Auditor failed to observe, maintain or otherwise apply the fundamental principle of professional competence and due care under paragraphs 100.5(c) and 130.1 of the COE to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services, and to act diligently in accordance with applicable technical and professional standards.

D. Conclusion

57. Having considered all relevant circumstances, the AFRC is of the view that each of Deloitte and Wong is guilty of CPA misconduct.

58. In determining the Disciplinary Sanctions, the AFRC has had regard to its Sanctions Policy for Professional Persons, Guidelines for Exercising the Power to Impose a Pecuniary Penalty for Professional Persons and the Guidance Note on Cooperation with the AFRC, and has taken into account all relevant circumstances, including the following:

    58.1. the conduct involved multiple breaches of auditing standards in the area of revenue recognition that is fundamental to the work of an auditor, and where the Auditor identified there to be "significant risks" and presumed risks of fraud;

    58.2. the engagement concerned the IPO of the Company's shares on the Main Board, where substantial public interest was at stake. The audit deficiencies could increase the risk of undetected material misstatements, which might be prejudicial to the interest of the investing public;

    58.3. there was no finding of intentional, dishonest or deliberate misconduct by Deloitte or Wong;

Aggravating circumstances

58.4. Deloitte has a clean disciplinary record with the AFRC, but has a history of non-compliance with the HKICPA where the HKICPA had previously issued two disapproval letters;

Mitigating circumstances

58.5. Wong has a clean disciplinary record with the AFRC and HKICPA; and

58.6. the AFRC has taken into account the cooperation provided by the regulatees in this case. Amongst others, the regulatees admitted their misconduct and initiated resolution discussions with the AFRC. The regulatees further accepted the Disciplinary Sanctions against each of them and entered into an agreement with the AFRC pursuant to section 37I(1A) of the AFRCO before the issuance of a Notice of Proposed Disciplinary Action.

STATEMENT OF DISCIPLINARY ACTION

A. The Disciplinary Action

1. Pursuant to sections 37CA and 37I(1A) of the Accounting and Financial Reporting Council Ordinance (Cap. 588) (**AFRCO**), the Accounting and Financial Reporting Council (**AFRC**) has:

    1.1. publicly reprimanded each of Deloitte Touche Tohmatsu (**Deloitte**) and Mak Chi Lung (**Mak**);

    1.2. imposed a pecuniary penalty of **HK$568,000** against Deloitte; and

    1.3. imposed a pecuniary penalty of **HK$336,000** against Mak,

    (collectively, **Disciplinary Sanctions**).

2. The Disciplinary Sanctions were imposed in relation to the audits of the consolidated financial statements of Sound Global Ltd. (**Company**) (previous stock code: 00967, now delisted) and its subsidiaries (collectively, **Group**) for the years ended 31 December 2012 and 31 December 2013 (**2012 and 2013 Financial Statements** respectively).

3. Deloitte[1] conducted the audits of the 2012 Financial Statements (**2012 Audit**) and the 2013 Financial Statements (**2013 Audit**). Mak[2] was the engagement partner for the 2012 and 2013 Audits. Unless otherwise stated, **Auditor** refers to both Deloitte and Mak.

4. The AFRC found multiple audit deficiencies in the 2012 and 2013 Audits concerning revenue from turnkey services, revenue from sales of equipment under construction contracts and bank balances and trade receivables. As a result, the AFRC found that the Auditor failed or neglected to observe, maintain or otherwise apply the professional standards below in the relevant years of audits:

    4.1. in each of the 2012 and 2013 Audits, in relation to revenue from turnkey projects and services:

        4.1.1 paragraph 15 of the applicable versions of Hong Kong Standard on Auditing (**HKSA**) 200 (*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*) (**HKSA 200**);

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1 Deloitte is registered as a CPA firm and a public interest entity auditor with the AFRC (registration number 0166).

2 Mak is a member of the HKICPA (number A14541) and currently holds a practising certificate (number P05732). He is currently a registered engagement partner and a registered engagement quality control reviewer of Deloitte.

4.1.2 paragraphs 12 and 23 of the applicable versions of HKSA 240 (*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*) (**HKSA 240**);

4.1.3 paragraph 17 of the applicable version of HKSA 330 (*The Auditor's Responses to Assessed Risks*) (**HKSA 330**);

4.1.4 paragraphs 6 and 7 of the applicable versions of HKSA 500 (*Audit Evidence*) (**HKSA 500**);

4.1.5 paragraph 7 of the applicable version of HKSA 530 (*Audit Sampling*) (**HKSA 530**);

4.2. in the 2013 Audit, in relation to external confirmations on bank balances and trade receivables, paragraphs 10, 14 and A11 of the applicable version of HKSA 505 (*External Confirmations*) (**HKSA 505**); and

4.3. in each of the 2012 and 2013 Audits, paragraphs 100.5(c) and 130.1 of the applicable versions of the Code of Ethics for Professional Accountants (**COE**).

5. By failing or neglecting to observe, maintain or otherwise apply the above PAO professional standards[3] in the relevant years of audits, each of Deloitte and Mak committed professional irregularities under section 3B(1)(c) of the AFRCO, and is guilty of CPA misconduct pursuant to section 37AA(1)(a)of the AFRCO and section 71 of the Accounting and Financial Reporting Council (Transitional and Saving Provisions and Consequential Amendments) Regulation (Cap. 588B) (**Transitional Regulation**).

B. Summary of Facts

6. The Company was listed on the Main Board of The Stock Exchange of Hong Kong Limited from September 2010 to September 2022.[4] The Group was principally engaged in turnkey water and wastewater treatment.

7. Turnkey projects and services business was the core operation of the Group. According to the 2012 and 2013 Financial Statements, revenue from turnkey projects and services amounted to RMB2,446.0 million and RMB2,882.9 million, representing about 92.2% and 91.8% of the total revenue of the Group for the years ended 31 December 2012 and 2013 respectively.

8. The Group's turnkey projects and services were divided into two types: (i) engineering, procurement, and construction projects (**EPC projects**), and (ii)

[3] As defined in section 2 of the AFRCO.

[4] The Company was also incorporated in the Republic of Singapore and listed on the Main Board of the Singapore Exchange Securities Trading Limited from October 2006 to January 2014 (previous stock code: E6E, now delisted).

build-operate-transfer projects (**BOT projects**). BOT projects were divided into two phases – the construction phase and the operational phase. In completing these projects, the Group generally entered into contracts with sub-contractors to construct the water and wastewater treatment facilities.

9. In preparing the 2012 and 2013 Financial Statements, the Company applied the following accounting treatment in respect of its turnkey projects and services:

    9.1. revenue from EPC projects was recognised on the percentage of completion basis when the total construction costs of the facilities under development could be reliably estimated;

    9.2. revenue for both the construction and operational phase of BOT projects was estimated when the project's contractual agreements were entered into;

    9.3. revenue from construction contracts was recognised using the percentage of completion method when the outcome of the project can be estimated reliably; and

    9.4. revenue from sales of equipment under construction contracts was generally recognised upon delivery and acceptance of equipment.

10. The Auditor conducted the 2012 and 2013 Audits in accordance with HKSAs and expressed unmodified audit opinions on each of the 2012 and 2013 Financial Statements.

11. On 24 July 2017, the Company announced that the trading of its shares was suspended as the Securities and Futures Commission (**SFC**) found that the bank balances of five bank accounts of the Group as at 31 December 2012 and 2013 were overstated by RMB2.1 billion and RMB2.7 billion respectively (**Cash Discrepancies**). The Cash Discrepancies raised questions as to whether there are audit deficiencies in relation to the 2012 and 2013 Audits.

C. Summary of Findings

12. The audit work conducted in respect of the following matters in the 2012 and 2013 Financial Statements were the subject of an investigation conducted by the Audit Investigation Board pursuant to section 23(3) of the then Financial Reporting Council Ordinance (Cap. 588):

    12.1. revenue from turnkey projects and services;

    12.2. bank balances and cash and restricted bank balances; and

    12.3. amounts due from customers for contract work and trade receivables.

13. The AFRC found a range of audit deficiencies in the Auditor's work, as summarised below.

<u>Audit deficiencies in relation to Revenue from Turnkey Services</u>

Audit procedures on the percentage of completion of turnkey projects

14. The Auditor failed to obtain corroborative evidence to support the upward adjustments made by the management for the percentage of completion in respect of two BOT projects in the 2012 Audit.

15. In the 2012 Audit, the Auditor selected 17 EPC projects and 4 BOT projects that were under construction to evaluate the reasonableness of the percentage of completion calculated by the management with reference to the proportion of contract costs incurred for work performed to date relative to the estimated total contract costs.

16. In respect of two BOT projects, the management made upward adjustments to the percentage of completion for the purpose of determining the revenue to be recognised. According to the certification of construction work performed filed in the audit working papers, the percentage of completion of these two projects was only 74% as at 29 December 2012 and 54% as at 26 November 2012 respectively. However, as at the year-end date (31 December 2012), a higher percentage of completion (98%) was used to recognise the revenue for these two projects, but there was no evidence to support the further construction costs incurred after the dates of the certification of construction work performed.

17. The Auditor did not obtain corroborative evidence, such as the certifications of construction work performed signed by sub-contractors, to support the post-adjustment. The post-adjustment in respect of these two projects had led to the recognition of an additional revenue of RMB66.4 million in the 2012 Financial Statements.

18. In light of the above, the AFRC found that, in respect of the 2012 Audit, the Auditor failed to perform adequate audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence on the adjustment of percentage of completion of these projects, in breach of paragraph 6 of HKSA 500.

Audit procedures on total estimated contract costs

19. In the 2012 and 2013 Audits, the Auditor selected two samples to evaluate the design and implementation of the relevant internal control activities and tested their operating effectiveness, for the purpose of determining whether to rely on control in auditing the revenue from EPC projects. The relevant control activity relates to the revision of the total estimated contract costs when there was a large variance between the budgeted costs and the actual costs incurred. The Auditor documented that they did not find any exception and planned to rely on the control in auditing the revenue from the EPC projects.

20. There were, however, two completed projects in each of 2012 and 2013 with actual costs incurred materially exceeding the total estimated contract costs. This raised doubts as to whether the management had duly revised the total estimated contract costs during the progress of the construction, and whether control had been properly implemented.

21. The management's explanation was that the cost overrun was mainly due to changes in design or scope of the construction and an inflated price of raw materials and wages. However, the Auditor failed to obtain sufficient appropriate audit evidence to corroborate the management's explanations for the cost overrun.

22. Based on the above, the AFRC found that, for each of 2012 Audit and 2013 Audit, the Auditor breached paragraph 17 of HKSA 330, by failing to properly understand the matter, evaluate the potential consequence, and determine whether:

    22.1. the test of control that had been performed provided an appropriate basis for reliance on the controls;

    22.2. additional tests of controls were necessary; and

    22.3. the potential risks of misstatement needed to be addressed using substantive procedures.

Audit procedures on completed projects

23. In the 2013 Audit, the Auditor stated in their risk assessment and audit plan that they would obtain the certificates of final completion for completed projects to ensure that revenue and related contract costs were recognised appropriately. However, the Auditor did not obtain the certificate of final completion for seven completed projects in 2013. For example:

    23.1. for two contracts, the engagement team only conducted site visits; and

    23.2. for three contracts, the engagement team concluded that the total contribution of contracts to the revenue of the Group was below particular thresholds and as such, no further work was required in respect of these contracts.

24. Without the certificates of final completion, the Auditor would not be able to ascertain if the project was fully completed and that all the corresponding contract revenue, contract costs and attributable profit pertaining to the contract were properly recognised.

25. In the circumstances, the AFRC found that, in respect of the 2013 Audit, the Auditor failed to obtain sufficient appropriate audit evidence to corroborate the

management's representation on the completion status of the projects, in breach of paragraph 6 of HKSA 500.

Audit procedures on foreseeable loss for uncompleted projects

26. In the 2012 and 2013 Audits, 12 uncompleted projects (for the 2012 Audit) and ten uncompleted projects (for the 2013 Audit) were behind the contractually agreed timeline. Some projects were delayed for more than one year. The audit procedures performed by the Auditor (i.e. site visits and interviews) only covered seven out of the 12 delayed projects for the 2012 Audit and three out of the ten delayed projects for the 2013 Audit, and the interviews did not address the delay in construction. Most of the site visit memoranda did not contain the reasons for the project delay. The Auditor failed to obtain an understanding of the reasons for the project delays.

27. In the circumstances, the Auditor ought to have evaluated whether the expected loss should be recognised by, for example:

    27.1. performing an analysis of the actual construction progress against the contractually agreed timeline to identify major delays or costs overruns which might result in profitable contracts becoming loss-making;

    27.2. obtaining an explanation from the management on the reasons for the delays; and

    27.3. reviewing the relevant contracts to check if there are any clauses on penalty or liquidated damages and assessing the need to provide for liquidated damages in the financial statements based on the actual construction progress.

28. Based on the above, the AFRC found that, for each of 2012 Audit and 2013 Audit, the Auditor failed to adequately perform audit procedures to evaluate whether expected loss for uncompleted construction contracts should be recognised, in breach of paragraph 6 of HKSA 500.

<u>Audit deficiencies in relation to Revenue from Sales of Equipment</u>

Determination of sample size for testing the completeness and occurrence of revenue

29. In the 2012 and 2013 Audits, the Auditor performed vouching test on the revenue from sales of equipment and inspected the goods delivery notes on a sample basis. The purpose of the audit procedure was to ascertain the completeness and occurrence of revenue from sales of equipment. However, the Auditor incorrectly determined the sample size which was based on, among other things, an incorrectly calculated total transaction amount.

30. In the circumstances, the AFRC found that, for each of 2012 and 2013 Audits, the Auditor failed to properly determine the sample size for testing the

completeness and occurrence of revenue from sales of equipment sufficient to reduce sampling risk to an acceptably low level, in breach of paragraph 7 of HKSA 530.

Cut-off test on the revenue from sales of equipment

31. In the 2012 and 2013 Audits, the Auditor performed cut-off test on the revenue from sales of equipment. It was unusual that more than 54% of sales of equipment (in the 2012 Audit) and more than 39% of sales of equipment (in the 2013 Audit) were recorded on the respective last dates of the reporting periods.

32. In the circumstances, the AFRC found that, for each of 2012 Audit and 2013 Audit, the Auditor failed to exercise professional skepticism to identify the unusual characteristics, which might indicate a risk of material misstatement due to fraud, in breach of paragraph 15 of HKSA 200 and paragraphs 12 and 23 of HKSA 240.

Audit procedures on percentage of completion

33. In the 2013 Audit, the Auditor examined the relevant goods delivery notes for the purpose of ascertaining the costs of equipment sold and calculating the percentage of completion. However, the Auditor failed to consider the fact that the goods delivery notes do not contain any breakdown on the individual costs of each equipment sold.

34. In the circumstances, the AFRC found that, for the 2013 Audit, the Auditor failed to consider the relevance and reliability of the goods delivery note as audit evidence for determining the percentage of completion used for measuring the revenue from sales of equipment, in breach of paragraph 7 of HKSA 500.

<u>Audit deficiencies in relation to Bank Balances and Trade Receivables</u>

External confirmations on bank balances

35. In the 2013 Audit, the Auditor requested banks to confirm the amounts of bank balances held by the Group's subsidiaries. In particular, the Auditor requested the banks to return the confirmations directly to the Auditor. The purpose of the audit procedure was to obtain reliable audit evidence on the existence and accuracy of the bank balances.

36. Notably, four courier slips (attached to returned bank confirmations) bear the addresses of the Group's subsidiaries as the senders' addresses, which indicate that these confirmations were returned from the subsidiaries, rather than from the banks directly. External confirmations that do not come from the originally intended confirming party carry the risks of interception, alteration or fraud as set out in paragraph A11 of HKSA 505.

37. In the circumstances, the Auditor ought to have performed additional procedures, such as directly contacting the recipients of the confirmation requests (i.e. the banks) to resolve those doubts.

38. Based on the above, the AFRC found that, for the 2013 Audit, the Auditor failed to sufficiently identify factors that gave rise to doubts about the reliability of the responses to the confirmation requests and failed to obtain further audit evidence to resolve those doubts, in breach of paragraph 10 of HKSA 505.

External confirmation on trade receivables

39. In the 2013 Audit, the Auditor requested customers to confirm the amounts of trade receivables due from them to the Group's subsidiaries. In particular, the Auditor requested the customers to return the confirmations directly. The purpose of the audit procedure was to obtain reliable audit evidence on the existence and accuracy of the trade receivables.

40. Notably, one courier slip (attached to a returned confirmation) bears the address of a subsidiary of the Group as the sender's address, which indicates that the confirmation was returned from the subsidiary, rather than from the customer directly.

41. In the circumstances, the Auditor ought to have performed additional procedures, such as directly contact the recipient of the confirmation request to resolve those doubts.

42. Based on the above, the AFRC found that, for the 2013 Audit, the Auditor failed to sufficiently identify factors that gave rise to doubts about the reliability of the response to the confirmation request and failed to obtain further audit evidence to resolve those doubts, in breach of paragraph 10 of HKSA 505.

Unconfirmed bank balance of approximately BDT57.2 million

43. In the 2013 Audit, the Auditor requested a bank to directly confirm various bank balances held by a subsidiary of the Group, including but not limited to a bank balance of approximately BDT57.2 million (approximately RMB4.5 million).

44. The bank balance of BDT57.2 million was not confirmed in the returned bank confirmation. This constituted an exception in the returned external confirmation, which ought to have caused the Auditor to perform follow up procedures, such as contacting the bank to resolve those doubts.

45. Based on the above, the AFRC found that, for the 2013 Audit, the Auditor failed to investigate and perform any follow up procedures on this exception, in breach of paragraph 14 of HKSA 505.

COE breaches

46. In addition, the AFRC found that, in light of the audit deficiencies as stated in paragraphs 14 to 45 above, Mak failed to observe, maintain or otherwise apply the fundamental principle of professional competence and due care under paragraphs 100.5(c) and 130.1 of the COE to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services, and to act diligently in accordance with applicable technical and professional standards.

D. Conclusion

47. Having considered all relevant circumstances, the AFRC is of the view that each of Deloitte and Mak is guilty of CPA misconduct.

48. In determining the Disciplinary Sanctions, the AFRC has had regard to its Sanctions Policy for Professional Persons, Guidelines for Exercising the Power to Impose a Pecuniary Penalty for Professional Persons and the Guidance Note on Cooperation with the AFRC, and has taken into account all relevant circumstances, including the following:

48.1. the conduct involved multiple audit deficiencies and breaches of the PAO professional standards in the areas of revenue recognition and bank balances that are fundamental to the work of an auditor;

48.2. the Auditor knew that the turnkey projects and services business was the core operation of the Group and was significant to the 2012 and 2013 Financial Statements;

48.3. the Auditor's misconduct demonstrated a concerning lack of professional skepticism and over-reliance on management representations; and

48.4. there was no finding of intentional, dishonest or deliberate misconduct by Deloitte or Mak.

Aggravating circumstances

48.5. Deloitte has a clean disciplinary record with the AFRC, but has a history of non-compliance with the HKICPA where the HKICPA had previously issued two disapproval letters.

Mitigating circumstances

48.6. Mak has a clean disciplinary record with the AFRC and HKICPA; and

48.7. the AFRC has taken into account the cooperation provided by the Auditor in this case. Amongst others, the Auditor admitted their misconduct and initiated resolution discussions with the AFRC. The Auditor further accepted the Disciplinary Sanctions against each of them and entered into an agreement with the AFRC pursuant to section 37I(1A) of the AFRCO before the issuance of a Notice of Proposed Disciplinary Action.