

Proceedings No. D-10-0497F

IN THE MATTER OF
complaints made under section 34(1A) of the
Professional Accountants Ordinance (Cap. 50)

BETWEEN

Registrar of the Hong Kong Institute of
Certified Public Accountants

COMPLAINANT

AND

Mr. Ho Chun Shing
CCIF CPA Limited

1st RESPONDENT
2nd RESPONDENT

Members: Mr. SHUM Sze Man Erik Ignatius (Chairman)
Mr. WONG Chun Bong, Alex
Ms. WONG Sau Pik, Judy
Mr. TSE Wai Chuen, Tony

REASONS FOR SANCTION AND COSTS

Date of Hearing: 25 July 2013

Dates of Written Submissions: 20 May 2013 (Complainant's) and
20 May 2013 and 24 July 2013 (Respondents')

Date of Reasons for Sanction and Costs: 29 August 2013

Introduction

1. These proceedings relate to two complaints (collectively known as “**the Complaints**”) made by the Registrar of the Hong Kong Institute of Certified Public Accountants (“**the HKICPA**”) as the Complainant against Mr. Ho Chun Shing, (“**the 1st Respondent**”) a certified public accountant (Membership No.: A17367) and CCIF CPA Limited (“**the 2nd Respondent**”), a corporate practice (Corporate Practice No.: M041) registered with the HKICPA (collectively known as the “Respondents”) to whom Section 34(1)(a)(vi) of the Professional Accountants Ordinance (Cap. 50) (“**the PAO**”) applies.
2. On 22 March 2013, the Committee handed down its Reasons for Decision and directed the Parties to file and serve written submissions on the sanctions to be imposed in relation to the First Complaint in Audit Area 1 (Description of factors contributing to goodwill) and the First Complaint and Audit Area 2 (Non-recognition of deferred tax liabilities) and on costs.
3. On 20 May 2013, the Parties filed their respective submissions on sanctions and costs and made an application for an oral hearing. The application was granted and the Parties appeared before the Committee to make oral submissions at a hearing on 25 July 2013.
4. At the conclusion of the Oral Hearing on Sanctions and Costs (“**the Hearing**”), the Committee ordered that:-
 - (1) Both Respondents be reprimanded under section 35(1)(b) of the PAO;
 - (2) The Respondents each pay a penalty of **HK\$60,000.00** under Section 35(1)(c) of the PAO; and
 - (3) The Respondents do jointly and severally pay the costs and expenses of and incidental to the proceedings of the Institute in the sum of **HK\$1,030,000.00** under Section 35(1)(iii) of the PAO.

5. The Committee reserved the reasons for its Decision on Sanctions and Costs to be handed down in due course. The Committee now hands down its reasons.

The Proceedings and Decision

6. The Complaints against the 1st and 2nd Respondents concerned three audit areas (the “**3 Audit Areas**”) in the Respondents’ Audit of the Relevant Financial Statements, see §29 of the Decision:-
 - (1) Non-disclosure of a description of the factors that contributed to costs that resulted in the recognition of goodwill contrary to Hong Kong Financial Reporting Standard 2—“Business Combinations” (“**HKFRS 3**”) (“**Audit Area 1—Description of factors contributing to goodwill**”);
 - (2) Non-recognition of deferred tax liabilities (“**DTL**”) arising from fair value adjustments on intangible assets resulting from the acquisition of the subsidiaries contrary to Hong Kong Accounting Standard 12— (“**HKAS 12**”) (“**Audit Area 2—Non-recognition of deferred tax liabilities**”); and
 - (3) Overstatement of impairment loss on goodwill contrary to Hong Kong Accounting Standard 36—“Impairment of Assets” (“**HKAS 36**”) (“**Audit Area 3—Goodwill impairment loss**”).
7. At the end of a hearing on liability, the Committee found that the Respondents had not fully complied with different aspects of their auditing work. The findings of the Committee are that in two specific areas the Respondents’ work in relation the Audit was deficient.
8. It is not disputed that the Respondents fought the case on all fronts and pleaded not guilty to each Complaint, a course which they are entitled to take.
9. A summary of the Committee’s findings can be found at §386 of the Decision:-

- (1) In relation to Audit Area 1, the First Complaint was proved (to a limited extent, see below) and the Second Complaint, being alternative, was dismissed (§§261-262, 386(1));
 - (2) In relation to Audit Area 2, the First Complaint was proved and the Second Complaint, being alternative, was dismissed (§§322-323, 386(2); and
 - (3) In relation to Audit Area 3, the First and Second Complaints were not proved and were dismissed. (§§383, 386(3))
10. At the hearing, neither the Complainant nor the Respondents gave oral testimony on facts but only adduce oral testimony of their respective expert witnesses. The Complainant engaged Mr. Roderick Sutton (“**Mr. Sutton**”) as its expert witness whose written opinions were given in his expert report dated 12 October 2012 (**the “Sutton Report”**). The Respondents’ expert witness was Mr. Peter Wan (“**Mr. Wan**”) whose written opinions were embodied in four reports, respectively dated 8 December 2010, 4 January 2011, 5 July 2012, and 8 November 2012. As could be seen from the Committee’s Decision the expert evidence played a significant role in the Proceedings. (§§12, 81 of the Decision)
11. It is pertinent to note that both parties accept that this case does not involve allegations of dishonest, dishonorable or immoral conduct on the part of the Respondents. No allegations of fraud were involved. The Complaints relate to breaches of accounting/auditing standards and Code of Ethics that do not amount to serious breaches and were nothing even close to any criminal or dishonest wrongdoing. (§74 of the Decision) Whilst this is irrelevant to the determination of liability, it is a relevant factor which the Committee takes into account in its Decision on Sanctions and Costs.

Summary of the Complainant's Submissions

Sanctions

12. At the Hearing, Mr. Choy, Counsel for the Complainant, made submissions on sanctions as summarized as follows:-

- (1) It would be inappropriate in the circumstances of the case, to consider making any order removing the Respondents from the Register (section 35(1)(a) of the PAO) or any order in relation to the revocation of their practising certificates (section 35(1)(da) & section 35(1)(db) PAO), when the case does not concern dishonest and dishonorable conduct;
- (2) The 1st and 2nd Respondents be reprimanded (section 35(1)(b) PAO) as *“There is a clear need for the Institute to issue a reprimand against both Respondents, so as to convey to all its members its disapproval of the Respondents’ failures to fully comply with the necessary professional standards. It is also important to remind the Respondents that, as professional accountants, they are strictly required to abide by the accounting standards promulgated by the Institute.”* (§6 of the Complainant’s Submissions on Sanctions and Costs dated 20 May 2013 (**“the Complainant’s Submissions”**)); and
- (3) The 1st and 2nd Respondents be ordered to pay an appropriate penalty to the Institute as *“the breaches committed are in relation to their discharge of their professional duties in relation to work for which they received compensation”* (section 35(1)(c) PAO)

13. Mr. Choy submitted that the Committee should consider the following factors in deciding what appropriate sanctions to impose:-

- a. Mr. Ho has a clear disciplinary record;
- b. In February 2010, the 2nd Respondent was found to have committed a disciplinary offence in relation to its audit of a listed company and the calculation of revaluation surplus;

- c. In the present case, the Respondents were found to have committed breaches in two separate and distinct audit areas;
- d. The subject audit concerns a publicly listed company. Therefore, the Respondents' failures would have ramifications on the overall integrity of the capital markets system and the public's confidence in the oversight role that the auditors are paid to perform;
- e. Audit Area 1 concerns an area which the auditors themselves had identified as entailing high audit risks, and yet the Respondents still carried out their work with insufficient attention to the requirements of the relevant professional standards;
- f. The amount of the deferred tax liabilities which were not recognized is 90-100% over the audit materiality set by the Respondents;
- g. The charges concerned a financial audit of a listed company, and thus it is appropriate to assess on a very well-remunerated piece of work. The 2nd Respondent would have charged a substantial fee (the work was budgeted for HK\$990,000—*vide* Hearing Bundle D1/200) in relation to the subject audit; and
- h. The Complaints with regard to Audit Areas 1 & 2 were found proven against the Respondents after a very full hearing.

(§8 of the Complainant's Submissions)

Costs

- 14. The Complainant seeks an order of costs under sections 35(1)(iii) and 35(1)(d)(ii) of the PAO to cover the costs and expenses borne by the Institute for the proceedings, the costs of the Committee and the costs of the Financial Reporting Council ("**The FRC**"). A Schedule of Costs has been attached to the Complainant's written submissions filed on 20 May 2013.
- 15. Mr. Choy referred the Committee to the case of Baxendale-Walker v Law Society [2007] EWCA Civ 233, where the Divisional Court dismissed a solicitor's appeal on

costs in a disciplinary action where the first of two of the Law Society's allegations against the solicitor was not proved and the second was admitted by the solicitor, hence the Tribunal found that complaint to be proven. The Law Society cross-appealed against the order for costs. The Divisional Court dismissed the solicitor's appeal but allowed the Law Society's cross-appeal and ordered the solicitor to pay 60% of the Law Society's costs, holding that the principles relating to costs in proceedings brought in the public interest in exercise of regulatory functions differed from those which applied to ordinary civil litigation. Mr. Choy referred the Committee to §34 of the Judgment:-

“Our analysis must begin with the Solicitors Disciplinary Tribunal itself. The statutory tribunal is entrusted with wide and important disciplinary responsibilities for the profession, and when deciding any application or complaint made to it, section 47(2) of the Solicitors Act 1974 undoubtedly vests it with a very wide costs discretion. An order that the Law Society itself should pay the costs of another party to disciplinary proceedings is neither prohibited nor expressly discouraged by section 47(2)(i). That said, however, it is self-evident that when the Law Society is addressing the question whether to investigate possible professional misconduct, or whether there is sufficient evidence to justify a formal complaint to the tribunal, the ambit of its responsibility is far greater than it would be for a litigant deciding whether to bring civil proceedings. Disciplinary proceedings supervise the proper discharge by solicitors of their professional obligations, and guard the public interest, as the judgment in Bolton's case [1994] 1 WLR 512 makes clear, by ensuring that high professional standards are maintained, and, when necessary, vindicated. Although, as Mr Stewart maintained, it is true that the Law Society is not obliged to bring disciplinary proceedings, if it is to perform these functions and safeguard standards, the tribunal is dependent on the Law Society to bring properly justified complaints of professional misconduct to its attention. Accordingly, the Law Society has an independent obligation of its own to ensure that the tribunal is enabled to fulfill its statutory responsibilities. The exercise

of this regulatory function places the Law Society in a wholly different position to that of a party to ordinary litigation. The normal approach to costs decisions in such litigation—dealing with it very broadly, that property incurred costs should follow the “event” and be paid by the unsuccessful party—would appear to have no direct application to disciplinary proceedings against a solicitor.”
(p.435D-H; §34)

16. In his oral submissions, Mr. Choy wished to draw an analogy to section 47(2) of the Solicitors Act 1974 which accords the Solicitors Disciplinary Tribunal with a wide discretion. Mr. Choy submits that it is self-evident that when the Law Society is investigating professional misconduct, the ambit is far greater than that in ordinary civil litigation. There is a public interest in ensuring that high professional standards are maintained and the tribunal is dependent on the Law Society, and by way analogy the Complainant, to bring complaints in exercise of its regulatory function. Thus, Mr. Choy submits that the usual “costs to follow the event” principle should not apply in the Committee’s approach to costs and despite the fact that both Complaints in Audit Area 3 were found not proven by the Committee, the Complainant should be awarded its costs in full.

17. Mr. Choy submitted that the Respondents should be ordered to pay the full sum in their Schedule of Costs for the following reasons:-
 - (1) The Complainant was substantially successful in the main issues of the matter and the main Complaint against the Respondents (the 1st Complaint) had been proven with respect to two out of three Audit Areas;
 - (2) As to the alternative Complaint (the 2nd Complaint) with respect to Audit Area 3, whilst the Committee found against the Complainant, the Committee did not endorse many of the assertions and arguments made by the Respondents or their experts;

- (3) Instead, the Committee came to the view that the Complainant had failed to discharge its burden of proof that HK\$20.8 million of potential misstatement in Goodwill Impairment was sufficiently significant to trigger off a need for documentation of work done in this area as audit evidence;
- (4) That the Respondents' case was that they saw a need for documentation for work done in this area as audit evidence, but regarded themselves as having adequately documented the audit evidence, and took the view that it was unnecessary to document their purported conversations with Vigers;
- (5) It is thus proper for the Complainant to have pursued this Audit Area, so as to demonstrate that the extant audit documentation kept by the Respondents would not have qualified as adequate audit evidence;
- (6) In defending their cases in all Audit Areas, the Respondents had chosen to contend on certain central issues (for example that the factors contributing to goodwill were not disclosed and that the calculation of DTL was erroneous), even though their own expert had made significant concessions in his previous opinions;
- (7) The Respondents engaged both an expert accountant and an English Queen's Counsel to assist in their preparation of the matter, necessitating the Complainant to prepare its case with the assistance of its own expert;
- (8) The Respondents were represented by two counsel at the proceedings; and
- (9) The Respondents refused to consider the possibility of a section 35B PAO Consent Order.
- (10) Disciplinary proceedings such as the present one are brought by the relevant regulatory bodies to protect the public interest and constitute an exercise of their duties as regulatory bodies. This has been considered in detail in §§15-16 above; and

- (11) Thus far, these proceedings have been funded by the members of the Institute, it would be unfair to these members to have to bear such expenses even after the Committee has concluded that the Respondents did breach the relevant professional standards.

(§10 of the Complainant's Submissions)

Summary of the Respondents' Submissions

18. The submissions by Mr. Pao, counsel for the Respondent, can be summarized as follows.

Sanctions

19. At §§1-8 of the Respondents' 2nd Written Submissions on Sanctions and Costs dated 24 July 2013 ("**the Respondents' 2nd Written Submissions**"), Mr. Pao submitted that the appropriate sanction is a moderate penalty under section 35(1)(c) of the PAO which fully reflects the mitigating factors. The Respondents invited the Committee not to make a reprimand in view of the consequent reputational detriment. (§9)
20. In the Respondents' 2nd Written Submissions, the Respondents invited the Committee to take into account the following nature of the complaints found proven:-
- (1) No allegation or finding of any fraud, dishonesty, illegal or immoral conduct by the Respondents. (§7(1)(a))
 - (2) No allegation or finding of any financial loss or tangible prejudice suffered by any person consequent on the Complaints which were found proven. (§7(1)(a))
 - (3) The complaints proven were limited to two discrete items in the financial statements of a single company (albeit a public one) for a single year, and there is no allegation or suggestion that similar contraventions were made by the Respondents on a wider scale. (§7(1)(b))

- (4) There was no knowing or deliberate violation of the Rules—*“the complaints proven involved technical aspects of non-compliance with applicable auditing standards and there is no allegation or finding of any knowing contravention of these standards by the Respondents who, at the highest, were bona fide and honestly inadvertent.”* (§7(1)(c))
 - (5) The conduct of the Respondents, though found to have been in breach of the applicable auditing standards, nevertheless involved matters which required professional judgment and was, to a large extent, supported by the opinion of a duly qualified expert in the field. (§7(1)(d))

21. As to the Respondents themselves, Mr. Pao submitted that:-
 - (1) The Respondents have throughout the proceedings treated the Complaints and disciplinary procedure with due respect and degree of seriousness which they warrant, including taking advice from leading counsel in Hong Kong and in London, together with instructing a local expert. (§7(2)(a) of the Respondents’ 2nd Written Submissions)
 - (2) Since the commencement of the Financial Reporting Council complaint in May 2009 which gave rise to the Complaints, the Respondents have been subject to substantial professional pressure and strain by virtue of the prolonged existence of these proceedings. (§7(2)(b))
 - (3) The Respondents had to come to defend their professional reputation and exonerate themselves in respect of Audit Area 3, in respect of which both complaints were dismissed by the Committee. (§7(2)(c))

22. With respect to the specific Audit Areas, Mr. Pao submitted that:-
 - (1) Audit Issue 1- this is the first case which has decided that anticipated profitability must be disclosed as a factor contributing to goodwill and hence the Respondents could not be said to have knowingly ignored established precedent; the practice of other auditors at least shows that

the contrary understanding was not uncommon in the industry.

(§7(3)(a))

- (2) Audit Issue 2- the calculation of DTL was not a straightforward or simple issue; this is evidenced by the fact that even the AIB made an erroneous calculation of the DTL in its investigation report. (§7(3)(b))
- (3) The severity of the contraventions found to have been committed by the Respondents must therefore be judged in view of these factors. (§7(3)(c))

23. At the Hearing, Mr. Pao orally submitted to the Committee, *inter alia*, that:-

- (1) The Respondents have had this case hanging over their heads for four years since the initiation of the Complaints in 2009. For any professional to have to deal with such disciplinary proceedings for such a long period of time is in itself a penalty;
- (2) Although the 1st Complaint in Audit Areas 1 and 2 were found proven by the Committee, the Committee's Decision was not against the Respondents on all issues;
- (3) The breaches of the auditing standards were not the most serious of its kind and were the product of genuine and honest inadvertence of the Respondents; and
- (4) In response to the Complainant's submission that the 2nd Respondent would have charged a "substantial fee"¹ and orally that the Respondents were well-remunerated, Mr. Pao asserts at §8 of the Respondents' 2nd Submissions and orally that this is irrelevant.

Costs

24. In reply to the Complainant's submissions that the normal "costs follow the event" principle inherent in civil litigation should not apply to disciplinary proceedings, Mr. Pao submitted that the Committee should look to the specific guidance at §70 of

¹ Complainants' Submissions at §8(g)

Guidelines 1.101A: Guidelines for the Chairman and the Committee on Administering the Disciplinary Committee Rules, Hong Kong Institute of Certified Public Accountants, March 2007. This will be recited later in the Decision.

25. The Respondents do not take issue with the listed figures in the Complainant's statement of costs, save for the costs of the two Associate Directors, namely Ms. Winnie Leung and Ms. Carla Tu (who also served as the clerk of the Committee).² The sums claimed are HK\$233,100.00 and HK\$43,200.00, respectively, at a rate of HK\$1,200.00.³
26. In relation to the Respondents' objection to the inclusion of the costs of the two Associate Directors, Mr. Pao submitted that:-
- (1) Ms. Leung and Ms. Tu are salaried personnel of the Institute and are not legally qualified. There is no justification or basis for the hourly rate figure of HK\$1200.00 given by the Complainant;
 - (2) Case D09-0423H, 9 February 2012, at §§29-37, establishes that costs of non-legally qualified staff of the Institute cannot be recovered, but that costs of in-house legal counsel (i.e. Mr. Donald Leo) are recoverable. In that case, in the absence of an objection to the claim for costs in respect of the clerk, the Committee also made an award of costs in that regard on the basis that it was similar in nature to a "disbursement" of the Committee;
 - (3) In law, there is a distinction to be drawn between a notional costs order in respect of in-house legal counsel and normal salaried staff. There is no case law or valid basis to suggest that the costs in respect of salaried staff should be recoverable under the indemnity principle. For this reason, the costs of both Associate Directors should not be allowed. In respect of the costs of the Clerk Ms. Tu, contrary to the decision in

² §11 of the Respondents' 2nd Submissions

³ §11 of the Respondents' 2nd Submissions

D09-0423H, her costs should not be allowed because there is no out of pocket expense by the Committee in respect of her services, and is not a true “disbursement”.

(§§11-13 of the Respondents’ 2nd Submissions)

27. Mr. Pao invited the Committee, in the exercise of its discretion to make a costs order under sections 35(1)(iii) and 35(1)(d)(ii) of the PAO, to give proper recognition to the fact that the Respondents were successful on a number of important issues in the case:-

- (1) Both complaints on Audit Area 3, which were separate and distinct charges involving an entirely different subject-matter from Audit Areas 1 and 2, were dismissed in their entirety by the Committee. The Respondents were therefore the successful party in respect of Audit Area 3 and should be entitled to costs against the Complainant, alternatively a suitable apportionment of costs should be made to reflect the failure of the Complainant on Audit Issue 3 (referring to §70(2) of the Guidelines). (§14(1))
- (2) Substantial parts of Sutton’s expert report were ruled to be objectionable and ignored by the Committee in its Decision (§§58-67 of the Decision, with reference to the list of paragraphs objected to reproduced at §58 of the Decision). Mr. Pao submits that the above result has two effects:-
 - (a) An appropriate specific reduction of the sums of Sutton’s fees in the amounts of HK\$500,000.00 and HK\$250,000.00 as claimed in the Schedule to reflect the fact that a large part of his evidence was objectionable and irrelevant; and
 - (b) A suitable overall apportionment of costs to reflect the fact that the Respondents had to expend significant time, costs and resources to unnecessarily deal with these irrelevant matters. (§14(2))

- (3) The Respondents' successful objection, contrary to the position of the Complainant, to the inclusion of §29 of the Complainant's case (see §§40-50 of the Decision). As a result of the unreasonable failure of the Complainant to drop this allegation, the Respondents were compelled to seek advice on the substance of the allegation from their solicitors, counsel and expert witness, and this should be reflected by a further apportionment of costs (§14(3));
- (4) Although the First Complaint in Audit Area 1 was substantiated against the Respondents, the Committee's decision was not against the Respondents on all grounds. The Complainant was unsuccessful in proving that other factors apart from anticipated profitability and fair value of consideration were factors contributing to goodwill in the context of the First Complaint in Audit Area 1.⁴

28. Mr. Pao thus submitted that in view of the findings of the Committee on Audit Areas 1 to 3, as a matter of principle:-

- (1) the Respondents should be responsible for two-thirds of the allowable costs of the Complainant;
- (2) the Complainant should be responsible for one-third of the allowable costs of the Respondents; and
- (3) There should be an appropriate reduction of the share of the Complainant's allowable costs (two-thirds downwards to two-fifths) for which the Respondents are liable to pay to reflect matters in §27 above, particularly, the inclusion of vast amounts of extraneous material by Mr. Sutton.

(§15 of the Respondents' 2nd Submissions)

⁴ §14(4) of the 2nd Respondents' Submissions & §§210, 221 227 of the Decision

The Complainant's reply on the costs order proposed by the Respondents

29. In relation to Part C of the Respondents' 2nd Submissions and its Schedule of Costs, Mr. Choy orally submitted that:-

- (1) The approach to costs as proposed by the Respondents in §15 of its 2nd Submissions is an inappropriate way of dealing with costs. Mr. Choy again relied on the case of *Baxendale*; and
- (2) The amount of HK\$6,200,000.00 in the Respondents' Schedule of Costs from 15 March 2012 to 25 January 2013 is extravagant.

Undisputed issues

30. The following matters are not in dispute:-

- (1) This is not an appropriate case for the Committee to make an order for removal from the Register (section 35(1)(a) PAO) or any order in relation to the revocation of the Respondents' practising certificates. It is conceded by both parties that this is not a case of a nature so serious as to warrant removal or suspension from the Register. (sections 35(1)(da) and 35(1)(db) PAO)⁵;
- (2) The present case concerned no allegation or finding of any dishonesty, dishonourable conduct, fraud, illegal or immoral conduct by the Respondents; and
- (3) There was no allegation or finding of any financial loss or tangible prejudice suffered by any person as a consequence of the Complaints as proved.

The Committee's Decision on Sanctions

31. In exercising its discretion to impose sanctions in this case, the Committee has taken the following matters and factors into account which apply to both the 1st and 2nd Respondents unless otherwise stated:-

- (1) The 1st Respondent's clear disciplinary record;

⁵§4 of the Complainant's Submissions; §5 of the Respondents' 2nd Submissions

- (2) In February 2010, the 2nd Respondent was found to have committed a disciplinary offence in relation to its audit of a listed company and the calculation of revaluation surplus;
- (3) There was no allegation or finding of any fraud, dishonesty, illegal or immoral conduct by the Respondents;
- (4) There was no allegation or finding of any financial loss or tangible prejudice suffered by any person consequent upon the Complaints as proven;
- (5) In the present case, the 1st and 2nd Respondents were found to have committed breaches in two separate and distinct areas;
- (6) The complaints proven were limited to two discrete items in the financial statements of a single company for a single year. There is no allegation or suggestion that similar contraventions were committed by the Respondents on a wider scale;
- (7) The subject audit concerned a publicly listed company. Thus, the Respondents' failures would have ramifications on the overall integrity of the capital markets system and the public's confidence in the oversight role of auditors;
- (8) Audit Area 1 concerned an area which the auditors themselves had identified as entailing high audit risks, and yet the Respondents still carried out their work with insufficient attention to the requirement of the relevant professional standards;
- (9) The Complaint with regard to the two Audit Areas was found proven against the Respondents after a full hearing in which the Respondents contested each complaint despite the fact that the Committee does recognize that the Respondents are fully entitled to contest the Complaint. However, the case is different from those cases where the respondents gain mitigating advantages by admitting to the charges laid;

- (10) The Respondents have throughout the proceedings treated the Complaints and disciplinary procedure with due respect and seriousness, including taking advice from leading counsel in Hong Kong and in London, together with instructing a local expert;
- (11) The Respondents defended their professional reputation and exonerate themselves in respect of Audit Area 3, in respect of which the Committee dismissed both complaints;
- (12) Since the commencement of the FRC complaint in May 2009 which gave rise to the Complaints, the Respondents have to bear not insignificant pressure and strain; and
- (13) As to the specific audit areas, in relation to Audit Issue 1, this was the first case of the kind concerning the anticipated profitability must be disclosed as a factor contributing to goodwill and thus the Respondents could not be said to have knowingly ignored established precedent.

32. The Committee considers that the following considerations as raised by the parties were irrelevant and thus did not take the following into account in coming to its decision on Sanctions:-

- (1) The Respondents were paid and well-remunerated.⁶ This is clearly irrelevant. As professionals, one is required to act and provide services of a competent standard irrespective of the remuneration, if any. To introduce varying degrees of expectation of competency proportionate to the amount of remuneration would be undesirable and unworkable. Thus, the Committee has disregarded the point that the Respondents were “well-remunerated” or that they would have been paid “a substantial sum” for their work undertaken; and
- (2) In relation to Audit Issue 2, the calculation of DTL was not a straightforward or simple issue as evidenced by the fact that even the AIB made an erroneous calculation to the DTL in its investigation

⁶ §26(4) above referring to Complainants’ Submissions at §8(g)

report.⁷ Accountants are engaged to perform to the requisite level of competency, which includes being meticulous and forming correct calculations based on what is provided to them.

33. Having taken all the above relevant considerations into account, the Committee considers that since the matter involved a public company listed on the Stock Exchange of Hong Kong Limited (as opposed to a private company), although it has not been proved that any third party had suffered damage or loss as a result of the non-compliance by the Respondents, the Committee is of the view that the following Sanctions are appropriate (reasons below):-
- (1) The Respondents be reprimanded under section 35(1)(b) of the PAO;
and
 - (2) The 1st and 2nd Respondents each pay a penalty of HK\$60,000.00 under Section 35(1)(c) of the PAO.

Costs

34. Section 35 of the PAO empowers the Committee to make orders as to costs:-
*“...the Disciplinary Committee may in any case-...
(iii) make such order as the Disciplinary Committee thinks fit with regard to the payment of costs and expenses of and incidental to the proceedings, whether of the Institute (including the costs and expenses of the Disciplinary Committee) or of any complainant or of the certified public accountant, any costs and expenses or penalty ordered to be paid may be recovered as a civil debt.”* (§68 of the Guidelines)
35. In exercising its discretion to award costs and determine the extent to which costs should be recoverable, the Committee bears in mind the relevant principles as enunciated in §70 of the Guidelines:-

⁷ §25(2) above referring to §7(3)(b) of the Respondents' 2nd Submissions

- “(1) *Save where there is good reason to do so otherwise, the Committee should award costs to the successful party in the proceedings;*
- (2) *Where a number of charges have been brought and some have been successfully defended, it should ordinarily be appropriate to reduce the costs awarded in such proportion as to reflect the outcome of the proceedings; and*
- (3) *The starting point in any award of costs should be the **actual costs** (i.e. indemnity costs) incurred by the successful party, subject to the Committee being satisfied that the actual costs were reasonably and necessarily incurred. The Committee may reduce the amount awarded to the extent it considers costs to have been incurred unnecessarily or extravagantly. In deciding what deduction is reasonable, the Committee may consider being guided by the practices of the courts in civil proceedings (which are complex). These are summarized in Annex 5.”*

The Expert Evidence of Mr. Sutton

36. The Committee makes the following observations on the expert evidence of Mr. Sutton, insofar as relevant to the issue of costs:-

- (1) Mr. Sutton gave evidence on extraneous matters which took up the Committee’s and Parties’ time and costs. (§12 of the Decision) Mr. Sutton also filed a Supplemental Expert Schedule of Mr. Rod Sutton—Matters not discussed. (§13) In light of the Committee’s Decision on the preliminary issue of paragraph 29 (§§40-50 of the Decision), the Committee ruled that certain parts of the Sutton Report should be disregarded (§§50, 59 of the Decision); and
- (2) On the first day of the hearing, Mr. Lam SC on behalf of the Respondents handed up to the Committee a one-page “Respondents’ Summary of the Principal Objectionable Paragraphs in Mr. Sutton’s Report which Raise New Issues”, which listed out the objectionable

paragraphs of the Sutton Report grouped under 5 categories. The Respondents invited the Committee to ignore and reject on the same basis as the objection to paragraph 29 of the Sutton Report above, on the ground that they were new allegations which fell outside of the scope of the Proceedings and were not part and parcel of the Complaints (§58 of the Decision). The Committee ruled in favor of the Respondents on the first category with the same reasons as in its ruling on paragraph 29 (§§40-50 of the Decision). As to the fourth category, Mr. Choy on behalf of the Complainants conceded to the objection. As to the second, third and fifth categories, the Committee ruled in favor of the Respondents that the said paragraphs of the Sutton Report were objectionable and were to be ignored by the Committee (see §§58-67 of the Decision).

37. Thus, the Committee will take into account in its exercise of discretion in awarding costs, the amount of extraneous evidence produced by Mr. Sutton which the Committee took time to consider and hear, and ultimately did not rely on.

The Committee's Order on Costs

38. The Committee is of the view that costs should be awarded to the Complainant taking a global and overall view of the matter, in particular that fact that two of three Audit Areas of the Complaints were proved after trial. The Committee awards the amount claimed in the Complainant's Schedule of Costs (HK\$2,001,584.00) and reduces that amount by 45% in light of the following:-
- (1) In relation to Audit Area 3, the First Complaint and the Second Complaint were not proved and were dismissed in their entirety. (§§383, 386(3) of the Decision) Thus the Complaints were found proven on two of three Audit Areas (the second complaints in Audit Areas 1 and 2, respectively, being dismissed as alternative complaints);

- (2) In relation to the 1st Complaint of the 1st Audit Area, the extent of the Committee's findings were much narrower than the original extent of the Complaint—the Complainant was unsuccessful in proving that other factors apart from anticipated profitability and fair value of consideration were factors contributing to goodwill⁸;
- (3) The Committee's decision on the preliminary issue of paragraph 29 in favor of the Respondents, wherein it ruled that certain parts of the Sutton Report should be disregarded (§§40-50 of the Decision) (§§50, 59 of the Decision);
- (4) The Committee's finding that it had found quite a bit of Mr. Sutton's evidence to be extraneous and irrelevant; and
- (5) a discount for notional costs incurred by the Complainants in the Proceedings in relation to Ms. Leung and Ms. Tu.

39. In relation to the notional costs incurred by the Institute for Ms. Leung and Ms. Tu, the Committee has decided to apply a 50% deduction to their costs, hence the following:-

- (1) Item B1- deduct HK\$116,550.00; and
- (2) Item C- deduct HK\$ 21,600.00.

40. The total amount of costs payable by the Respondents, jointly and severally, to the Complainant is calculated as follows:-

$$\begin{array}{r}
 \$2,001,584.00 \\
 - \$ 116,550.00 \text{ (Item B1 deduction)} \\
 - \$ 21,600.00 \text{ (Item C deduction)} \\
 \hline
 = 1,863,434.00 \\
 \times 55\% \\
 \hline
 \$1,024,888.70
 \end{array}$$

⁸ §14(4) of the 2nd Respondents' Submissions & §§210, 221 227 of the Decision

41. The Committee rounded the costs down to **HK\$1,000,000.00**.
42. Counsel for the Complainant submitted that for the Hearing for sanction and costs, the costs incurred were HK\$65,000.00. The Committee made a deduction and awarded costs of the oral hearing in the sum of **HK\$30,000.00**.
43. Thus, the total amount of costs payable by the Respondents, jointly and severally, to the Complainant is **HK\$1,030,000.00**.
44. The Committee thanks leading Counsel and Counsel of both parties for the assistance given to the Committee.

Dated the 29th day of August 2013

Mr. Edwin Choy, instructed by Messrs. Robertsons, solicitors for the Complainant.

Mr. Jin Pao, instructed by Messrs. Hogan Lovells, solicitors for the Respondents.

IN THE MATTER OF complaints
made under section 34(1A) of the
Professional Accountants Ordinance
(Cap. 50)

BETWEEN

Registrar of the Hong Kong Institute of
Certified Public Accountants

COMPLAINANT

AND

Mr. Ho Chun Shing; and

1st RESPONDENT

CCIF CPA Limited

2nd RESPONDENT

Members: Mr. SHUM Sze Man Erik Ignatius (Chairman)
Mr. WONG Chun Bong, Alex
Ms. WONG Sau Pik, Judy
Mr. TSE Wai Chuen, Tony
Ms. LEE Wai Yan, Susanna (absent and excused)

Dates of Hearing: 3rd, 4th and 10th December 2012

Dates of Written Final Submissions: 31st December 2012 (Complainant's) and
7th January 2013 (Respondents')

Date of Reasons for Decision: 22nd March 2013

REASONS FOR DECISION

THE PROCEEDINGS

1. These proceedings relate to two complaints (collectively known as the "Complaints") made by the Registrar (the "Registrar") of the Hong Kong

Institute of Certified Public Accountants (the “HKICPA”) as Complainant against Mr. Ho Chun Shing (“Mr. Ho”), a certified public accountant (Membership No.: A17367), and CCIF CPA Limited (“CCIF”), a corporate practice (Corporate Practice No.: M041) registered with the HKICPA (collectively known as the “Respondents”) to whom Section 34(1)(a)(vi) of the Professional Accountants Ordinance (Cap. 50) (the “PAO”) applies.

Procedural History

2. The history whereby the Complaints against the Respondents were referred to the Disciplinary Committee of the HKICPA (the “Committee”) is set out below.
3. On 25th May 2009 the Financial Reporting Council (the “FRC”) received a complaint in relation to an audit (the “Audit”) performed by the Respondents on the financial statements of MelcoLot Limited (“MelcoLot”) (formerly known as Wafer Systems Limited and Melco LottVentures Limited) for the financial year (the “FY”) of 2007 (the “Relevant Financial Statements”), and directed the Audit Investigation Board (the “AIB”) to conduct an investigation into the matter.
4. The AIB recorded their findings of the investigation in a report dated 2nd August 2010 (the “AIB Report”) which was presented to the FRC.
5. The FRC adopted the AIB Report on 5th August 2010 and referred the matter by a letter dated 16th August 2012 to the then Chief Executive and Registrar of the HKICPA under section 9(f) of the FRC Ordinance (Cap. 588) for the HKICPA to determine what appropriate actions should be taken.
6. By a letter dated 13th May 2011 (the “Complaint Letter”), the Registrar submitted the facts and the Complaints against the Respondents to the Council of the HKICPA (the “Council”) pursuant to Section 34(1A) of the Professional Accountants Ordinance (“PAO”).

7. In September 2011, the Council exercised its discretion under section 34(1A) of PAO to “refer the complaint to the Disciplinary Panels”. The Respondents were notified accordingly by a letter dated 6th September 2011.
8. Consequently, the Committee was duly constituted under section 33(3)(a) of the PAO to deal with the Complaints and commenced the present disciplinary proceedings (the “Proceedings”) against the Respondents with the substantive disciplinary hearing (the “Hearing”) being held on 3rd, 4th and 10th December 2012.
9. Both parties are legally represented throughout the Proceedings. The Complainant was represented by counsel Mr. Edwin Choy (“Mr. Choy”), and the Respondents were represented by counsel Mr. Godfrey Lam, Senior Counsel (“Mr. Lam SC”) leading Mr. Jin Pao.
10. The Complainant’s and the Respondents’ respective cases are set out in the following documents submitted by the parties to the Committee:
 - (1) The “Complainant’s Case” dated 22nd March 2012;
 - (2) The “First and Second Respondents’ Case” dated 3rd July 2012; and
 - (3) The “Complainant’s Reply” dated 31st July 2012.
11. The Complainant and the Respondents filed their respective “checklists” in the prescribed form in compliance with rule 24 of the Disciplinary Committee Proceeding Rules (the “DCPR”) on 5th September 2012 and 10th September 2012 respectively.
12. Neither the Complainant nor the Respondents gave oral testimony through witnesses. Both parties have engaged their own expert witnesses to give expert evidence on the technical aspects arising out of the agreed documentary evidence. The Complainant engaged Mr. Roderick Sutton (“Mr. Sutton”) as its expert witness whose written opinions were given in his expert report dated 12th October 2012 (the “Sutton Report”). The Respondents’ expert witness is Mr. Peter Wan (“Mr. Wan”) whose written opinions are embodied in his four reports, respectively dated 8th December 2010, 4th January 2011, 5th July 2012,

and 8th November 2012 (collectively known as the “Wan Opinions”). The said experts are the only witnesses who gave oral testimonies and were cross-examined at the Hearing.

13. Pursuant to the directions of the Committee made on 20th September 2012, namely, “parties are to file an agreed list of issues/differences between their experts 7 days before the hearing”, the two expert witnesses held a discussion on 20th November 2012 based upon which two tables (“Joint Expert Schedule of Mr. Rod Sutton and Mr. Peter K.T. Wan” and “Supplemental Expert Schedule of Mr. Rod Sutton – Matters not discussed”) setting out what were discussed and what were not discussed at the discussion were prepared and filed on 28th November 2012.
14. At the conclusion of the Hearing, the Committee directed the time-table for the filing of written final submissions and reserved its decision to be handed down in due course. The Committee now hands down the Reasons for Decision (the “Decision”).

The Complaints

15. The particulars of the Complaints, comprising of the First Complaint and the Second Complaint, as stated in the Complaint’s Letter are:

“First Complaint:

CCIF & Mr. Ho breached section 34(1)(a)(vi) of the PAO in that they had failed or neglected to observe, maintain or otherwise apply a professional standard namely paragraph 100.4(c) “Fundamental Principles” of the Code of Ethics for Professional Accountants (“CoE”) as elaborated in section 130 of the COE in respect of their audit of the Financial Statements of MelcoLot.

Second Complaint (alternative to the First Complaint):

Section 34(1)(a)(vi) of the PAO applies to each of CCIF & Mr. Ho in that they had failed or neglected to observe, maintain or otherwise apply a professional

standard, namely Hong Kong Standard on Auditing 230 “Documentation” (“HKAS 230”) as a result of their failure to document matters which were important to the audit of the Financial Statements of MelcoLot.”

16. Both the First Complaint and the Second Complaint were made in respect of each of three different audit areas in the Respondents’ Audit of the Relevant Financial Statements which will be set out in paragraph 29 below. In the whole course of the proceedings no issue arose as to the distinction of the responsibility and liability of the 1st and 2nd Respondent for the relevant auditing work in question. It follows that on each Complaint the liability of the 1st and 2nd respondent will stand and fall together.

Factual background of the Complaints

17. The key factual background of the Complaints which is undisputed is summarized in the following paragraphs.
18. MelcoLot is a limited company incorporated in the Cayman Islands. It first became listed on the Growth Enterprise Market (the “GEM”) in Hong Kong on 17th May 2002. Prior to October 2007, MelcoLot was principally engaged in the provision of network infrastructure solutions to its customers.
19. For the FY 2006, MelcoLot had turnover of HK\$ 326 million, generating net earnings of HK\$ 5 million. At the end of the FY 2006, it had total assets of HK\$ 191 million and net assets of HK\$ 65.2 million.
20. By mid FY 2007, MelcoLot had about 290 million shares in issue and approximately 24 million share options outstanding.
21. CCIF audited MelcoLot’s financial statements for both FY 2006 and FY 2007. CCIF resigned as MelcoLot’s auditors with effect from 26th November 2008 and were subsequently replaced by Deloitte Touche Tohmatsu (“Deloitte”).
22. On 18th October 2007, MelcoLot announced that it was to acquire PAL Holdco and 60% of Oasis Rich for a total consideration of 72 million newly

issued shares (the “Consideration Shares”) of MelcoLot and convertible bonds (the “CBs”) in the principal amount of almost HK\$607 million (the “Acquisition”). The aggregate monetary value of the Consideration Shares and the CBs totalled HK\$ 668 million as at the date of the Announcement.

23. PAL Holdco is a BVI incorporated holding company which had an 80% interest in PAL Development Limited (“PAL”). PAL was described to be a holding company for a group of companies whose activities were focused on lottery business in the Pan-Asia region. Most of its subsidiaries were PRC registered companies.
24. Oasis Rich (“Oasis”) is an investment holding company incorporated in Mauritius and it was described to hold the entire share capital of WS Technology, a wholly owned foreign enterprise established in Shanghai. WS Technology was principally engaged in the manufacturing of lottery terminals for China’s sports lottery and China’s welfare lottery.
25. The Acquisition was completed on 13th December 2007.
26. As the Acquisition was seen as positive news, during the intervening period between the date of the announcement on 18th October 2007 and the completion date on 13th December 2007, the share price of MelcoLot appreciated significantly. As a consequence, the combined fair value of the Consideration Shares and the CBs as at 13th December 2007 was HK\$ 1.163 billion, which was HK\$ 495 million higher than the value of HK\$ 668 million referred to in paragraph 22 above.
27. During the first quarter of 2008, CCIF conducted the Audit on the Relevant Financial Statements. Mr. Ho was the Lead and Engagement Director of CCIF with respect to this Audit and had signed off the relevant audit report (the “Audit Report”) with an unqualified opinion on 26th March 2008.
28. As MelcoLot was listed in the GEM, it was required to comply with the Listing Rules, and as such, the Relevant Financial Statements were prepared in

accordance with all applicable Hong Kong Financial Reporting Standards (“HKFRS”) and Hong Kong Accounting Standards (“HKAS”). CCIF’s Audit of the Relevant Financial Statements was conducted in accordance with the Hong Kong Standards on Auditing (“HKSA”) issued by the Institute.

29. As stated in paragraph 16 above, the Complaints against the Respondents concern three audit areas (the “3 Audit Areas”) in the Respondents’ Audit of the Relevant Financial Statements which are stated as follows:
- (1) Non-disclosure of a description of the factors that contributed to a cost that resulted in the recognition of goodwill contrary to Hong Kong Financial Reporting Standard 3 – “Business Combinations” (“HKFRS 3”) (“Audit Area 1 – Description of factors contributing to goodwill”);
 - (2) Non-recognition of deferred tax liabilities (“DTL”) arising from fair value adjustments on intangible assets resulting from the acquisition of subsidiaries contrary to Hong Kong Accounting Standard 12 – “Income Taxes” (“HKAS 12”) (“Audit Area 2 – Non-recognition of deferred tax liabilities”); and
 - (3) Overstatement of impairment loss on goodwill contrary to Hong Kong Accounting Standard 36 – “Impairment of Assets” (“HKAS 36”) (“Audit Area 3 – Goodwill impairment loss”).
30. These 3 Audit Areas all relate to the accounting treatments and disclosures in connection with the Acquisition governed by the respective HKAS and HKFRS (collectively known as the “Relevant Standards”).
31. The Acquisition was a significant transaction as it had resulted in a substantial amount of goodwill (HK\$ 901 million) being recognized in the Relevant Financial Statements and the MelcoLot group’s entry into the business of lottery management service in the PRC. After the Acquisition, the net asset of the Group was HK\$ 621 million as compared to HK\$ 65 million prior to the Acquisition.

ANCILLARY ISSUES

32. Before the Committee addresses the substantive issues of the Complaints, the following ancillary issues that arose are first examined.

Absence of a Committee member

33. On the day when the Hearing was convened on 3rd December 2012, it was brought to the attention of the Committee that Ms. Lee Wai Yan, Susanna (“Ms. Lee”), who was appointed by the Committee Convenor from Disciplinary Panel A of the disciplinary panels as a member of the Committee for the Proceedings pursuant to section 33(3)(a) of the PAO, was unable to attend the Hearing for medical reasons.
34. According to section 33(3)(b) of the PAO, a disciplinary committee shall consist of 5 members, namely, a person from Disciplinary Panel A to be the chairman of the Committee, 2 persons from Disciplinary Panel A, and 2 persons from Disciplinary Panel B. The absence of Ms. Lee will cause the composition of the Committee to change from a total of 5 members to 4 members, with 2 members from each of Disciplinary Panel A and Panel B.
35. Subsection (1) of section 33B of the PAO provides that the quorum for a disciplinary committee shall be 4 subject to subsection (2) of the same section which effectively provides that if one of the members of the Committee is absent, the respondent or his representatives may object to the complaint being dealt with in the absence of such member, and in case an objection is made and is not withdrawn the disciplinary committee concerned shall neither commence to deal nor, where appropriate, further deal with the relevant complaint until either the objection is withdrawn or the member whose absence occasioned the objection is present.
36. Accordingly, the Committee invited the Respondents, who were entitled to object, to state their position. In response, the Respondents through Counsel confirmed that they did not object to the Complaints being dealt with in the absence of Ms. Lee. It is on this basis that the Committee resolved to formally

convene the Hearing in the absence of Ms. Lee and when the number of members was 4.

37. Before proceeding to receive the parties' opening submissions and evidence, the parties and the Committee held discussions on certain procedural/administrative issues regarding to the conduct of the Hearing which are recorded below.

Procedural/Administrative issues

38. Two procedural issues arose prior to the Hearing. The Committee gave directions for the parties to argue on such preliminary issues. Both parties filed written preliminary submissions that were further supplemented by oral submissions by their respective Counsel at the outset of the Hearing:
- (1) the "Complainant's Submission Re Procedural Issues" dated 15th August 2012;
 - (2) the "First and Second Respondents' Reply" dated 22nd August 2012; and
 - (3) the "Note of Preliminary Submissions for the Respondents" dated 29th November 2012.
39. After due consideration of the written and oral submissions made by Counsel, the Committee gave its ruling on the preliminary issue relating to paragraph 29 of the Complainant's Case under "Audit Area 1 – Description of factors contributing to goodwill" ("Paragraph 29") on the first day of the Hearing in favor of the Respondents with reasons to be handed down in due course. They are now set out below.

Preliminary issue - Paragraph 29

40. This first preliminary issue relates to the Respondents' objection to Paragraph 29 which reads:

"29. By the same token, the Financial Statements did not adequately disclose the factors that led to the recognition of the HK\$ 416 million goodwill impairment loss, as required under the relevant standards."

41. Such objection was first raised in paragraph 37 of the First and Second Respondents' when the Respondents objected to the inclusion of the Paragraph 29 in the Complainant's Case on the basis that it is new in the Complainant's Case and it was never raised in earlier stages of the proceedings before FRC, AIB or HKICPA.
42. The Complainant, on the other hand, asserted that it is entitled to raise this allegation since it does not offend any rule or right to be heard that flows from the principles of natural justice. The key arguments advanced in the Complainant's Submission Re Procedural Issues are summarized as follows:
- (1) The Complainant has fulfilled the obligation to set out its case against the Respondents in Paragraph 29 and full notice to the Respondents had been given as to the factual issues/state of affairs plainly relevant to the Complaints which the Committee will be asked to consider and is entitled to take into account when considering the Respondents' conduct as auditors;
 - (2) What was set out in Paragraph 29 is integral part of the First Complaint against the Respondents in Audit Area 1; and
 - (3) The Complainant considers the Respondents' proposition erroneous that this factual issue should not be allowed to be raised now as it had not been specifically raised in the previous correspondences between the parties because:
 - i. No applicable rules require the Complainant to limit its case against the Respondents to matters specifically mentioned in previous correspondences;
 - ii. The Complainant is entitled to put forth relevant matters which is apparent from documentary evidence;
 - iii. The decision by the Complainant to refer the case to the Committee is not in itself an exercise of any disciplinary powers under section 35 of the PAO;
 - iv. The Respondents had full opportunities to deal with contents of Paragraph 29 in the Respondents' Case as well as at the Hearing, thus their rights under natural justice are preserved and safeguarded and no prejudice has been suffered; and

- v. The issue of disclosure of goodwill impairment has been canvassed by the expert the Respondents seek to call.

43. Further, Mr. Choy's following oral submissions supplemented the Complainant's arguments:
 - (1) Impairment loss on goodwill being on the profit and loss statement is the flip side of the recognition of goodwill being on the balance sheet;
 - (2) Strict rules of evidence does not applied in the present Proceedings;
 - (3) After recognizing an impairment loss on goodwill, the value of the goodwill on the balance sheet will also be reduced; and
 - (4) The Complainant's Case was drafted in sufficiently general sense to allow the "new" issue to fall under the original Complaints and should be heard by the Committee.

44. The crux of the Respondents' counter-arguments was that the allegation in Paragraph 29 was "thrown in" at a late stage without any basis or supporting references and was not part of the Complaints referred to the Council for consideration on 13th May 2011; nor was it part of the Complaints referred by the Council to the disciplinary panels. It thus falls outside of the scope of the Proceedings and outside of the jurisdiction of the disciplinary panels and therefore should be ignored by the Committee. The key points of the Respondents' submissions were:
 - (1) What the Complainant asks the Committee to determine in Paragraph 29 is not factual but is a question of opinion;
 - (2) It is disagreed that the pleading in Paragraph 29 is integral to the First Complaint in Audit Area 1. The complaint in Audit Area 1 is that the Respondents failed adequately to disclose factors contributing to the recognition of goodwill as required by paragraphs 66(a) and 67(h) of HKFRS 3 and these paragraphs do not mention disclosure of factors that led to recognition of goodwill impairment loss;
 - (3) Paragraph 29 is an entirely separate complaint to Audit Area 1 based on different professional standards and different sections of the Relevant Financial Statements; and

- (4) The inclusion of Paragraph 29 is an attempt to include additional allegations against the Respondents without going through the formal procedures of referral by the Council and without adequate particularization.
45. The Respondents further elaborated their submissions in their “Note of Preliminary Submissions for the Respondents”. In summary:
- (1) The primary function of the Committee under section 35 of the PAO is to decide whether or not “*a complaint referred to it under section 34*” is proved. Thus it is only specific identified misconduct which can be referred to the Committee under the statutory scheme;
 - (2) The Complainant’s Case is merely a document required under rule 17 of the DCPR to be submitted after the Proceedings had commenced, to the Committee to set out the Complainant’s “*submissions*” on “*material matters*”;
 - (3) It follows that the Committee’s function is limited to the determination of the Complaints referred to it by the Council;
 - (4) it is not a matter of discretion of the Committee, but a matter of jurisdiction. It would be ultra virus for the Committee to deal with a matter which is not a complaint submitted to the Council, and referred by the Council to the disciplinary panels;
 - (5) It would be most unfair to the Respondents for the Committee to deal with a matter that is not part of the Complaint referred to it by the Council;
 - (6) Paragraph 29 is not a complaint submitted to the Council by the Registrar and then referred by the Council to the disciplinary panels; and
 - (7) All that was said in the Complaint Letter in relation to Audit Area 1 concerned disclosure of factors contributing to the cost of goodwill and nothing was said at all concerning the adequacy of disclosure of events and circumstances leading to goodwill impairment loss. They are two wholly separate and distinct matters.
46. After due consideration of the parties’ written and oral submissions, the Committee ruled in favor of the Respondents that Paragraph 29 fell outside the

Complaints referred and hence outside the scope of these Proceedings for the following reasons.

47. It is clear that the cost of goodwill and the impairment loss on goodwill fall into different parts of the Relevant Financial Statements, with the cost of the goodwill in the balance sheet and the impairment loss on goodwill on the profit and loss accounts.
48. What was submitted by the Registrar to the Council was only one side of the coin but the “*flip side*” was not; as the “*flip side*” was not mentioned in the original Complaints set out in the Complaint Letter.
49. The original Complaints crystalized at the moment when it was referred to the Council. The cases of the parties, such as the Complainant’s Case, was filed at a later stage subsequently and did not form part of the original Complaints. As such the Committee has no power to deal with it. It is of no help to refer to the expert reports to support the Complainant’s arguments since the expert reports are in the nature of evidence which could not alter the nature of the case as presented to the Council.
50. It follows from the above ruling that certain parts of the Sutton Report should be disregarded. However, the above will not have any negative effect on the reliability and credibility of the remaining parts of the Sutton report.

Preliminary issue - Paragraph 14

51. The second preliminary issue raised relates to paragraph 14 of the Complainant’s Reply (“Paragraph 14”) which reads:

“14. The Respondents also emphasize the need to maintain the perspective that only certain facts were then known to the Respondents. The Complainant submits that had the Respondents followed the demands of the Code and relevant standards, they would have become starkly aware of the shortcomings identified as the three Audit Areas. It was due to the fact that the Respondents did not observe the standards imposed by the relevant

Accounting/Auditing standards on them that they had failed to realize the facts surrounding the case. It is submitted that had they done what was required of them under the Code of Conduct and the relevant Accounting/Auditing standards, they would have been well aware of all the necessary facts.”

52. Paragraph 14 was made in response to the matter arose in paragraph 24 of the First and Second Respondents’ Case which reads:

“24. In addition, it is crucial that the assessment of the situation by the Disciplinary Committee must only be made with reference to the facts then known, and not with regard to subsequent developments. The citation of subsequent changes in practice as evidence of prior failure or neglect to observe, maintain or otherwise apply a professional standard is inappropriate. Likewise, reliance on subsequent facts or events constitutes judging a professional’s conduct with hindsight, which is unfair and impermissible.”

53. The Complainant’s position is that its said response was a very general and un-particularized line of argument to the effect that insofar as the Respondents wish to claim that their then limited knowledge of the state of affairs of MelcoLot excuse any of the alleged inadequacies of their work as auditors, their knowledge was limited only because they failed to follow the accounting/auditing standards as detailed in the Complainant’s Case and the Complainant has stated what steps should have been taken in the Complainant’s Case and it is not necessary to repeat each and every point in a reply.
54. The Committee notes that the Respondents had made no further written submissions on this objection other than those stated in paragraph 52 above.
55. After listening to Counsel’s positions at the Hearing, the Committee endorsed the consensus reached by the parties to stall this relatively minor difference and leave the matter for the parties to address in their respective closing submissions and the Committee shall then consider them.

56. Nevertheless, it transpired after the conclusion of the Hearing hitherto that this preliminary issue was not pursued nor addressed any further in both parties' closing submissions.
57. On this basis, the Committee considers that it is not necessary to give any specific ruling in respect of this preliminary issue and the Committee will deal with the point only when it arises in the analysis of the substantive issues.

Other objectionable parts of the Sutton Report

58. Further to the above, Mr. Lam SC on behalf of the Respondents handed up to the Committee on the first day of the Hearing a one-page "Respondents' Summary of the Principal Objectionable Paragraphs in the Mr. Sutton's Report which Raise New Issues" which listed out the objectionable paragraphs of the Sutton Report grouped under 5 categories, listed below, which the Respondents invited the Committee to ignore and reject on the same basis as the objection to Paragraph 29 above, on the ground that they are new allegations that fall outside of the scope of the Proceedings and they are not part and parcel of the Complaints:

- (1) Disclosure in respect of Goodwill Impairment Loss – Paragraphs 4.4.1(ii); 4.4.12 – 4.4.19; 4.6.24 – 4.6.35; 4.6.39 – 4.6.42; 4.6.43(ii); 4.7.2; 4.7.11; 4.9.4(ii); 4.9.6; 4.10.6; 4.13.4(iii); 4.15.2(i); 6.4.1 – 6.4.12;
- (2) General Commentary on Audit Working Papers – Paragraphs 3.4; 4.12; 4.13.4(i); 6.10.3(i) – (ii); 6.10.7 – 6.10.13; 6.11.4; 6.12.2;
- (3) Audit Documentation on Audit Issue Two – Paragraphs 5.13.1 – 5.13.15; 5.15.1(v) – (vi), 5.15.2(ii);
- (4) Explanation of Longer Period for Cashflow Forecasts – Paragraphs 4.6.36 – 4.6.41; 4.6.43(iii); 4.7.11; 4.9.4(iii); 4.9.6; 4.15.2(ii); 6.4.12;
- (5) The assertion that a breach of HKSA 230 results in a consequential breach of the Code of Ethics is not contained in the Registrar's letter or Complainant's Case – Paragraphs 4.3.10; 4.14.2; 4.15.5; 5.3.15; 5.15.4; 6.12.3; 6.13.3.

59. The first category raised above refers to the same area that the preliminary objection has been taken on Paragraph 29 as addressed above. Hence, the Committee has already made its ruling against the Complainant for the objection for this category as aforementioned and therefore the Committee ignores and rejects the relevant paragraphs of the Sutton Report under this category.
60. As to the fourth category, Mr. Choy confirmed at the Hearing that it was his instructions to concede to this objection. As such, the Committee had also at the Hearing decided that it will disregard the paragraphs of the Sutton Report under this fourth category.
61. As to the remaining objection in relation to the second, third and fifth categories, it is the Complainant's position at the Hearing that it will insist on relying on the respective paragraphs in the Sutton Report under these three categories to support its case and leave the matter to be dealt with at their written closing submissions to be made after the Hearing.
62. The Respondents in their written closing submissions maintained their positions that the paragraphs identified in these categories "*are objectionable not only because they fall outside the jurisdiction of this Committee, but also because it would be grossly unfair to take them into account against the Respondents*".
63. In particular, it is the Respondents' submission that the allegations made by Mr. Sutton in the second category following a "general review" of audit documentation exceeded the scope of the limited allegations about audit documentation raised in the Complainant's Case at paragraphs 34 and 48.
64. The third category of allegations amounts only to a general opinion on the auditing working papers on Audit Area 2 supplied to Mr. Sutton which does not relate to the alternative case under this audit area at all.

65. The fifth category is the assertions that a breach of HKSA 230 results in a consequential breach of the Code of Ethics, which is again, not a complaint contained in the Complaint Letter or in the Complainant's Case.
66. It is noted that the Complainant had made no submissions in their written closing submissions, contrary to what was said at the Hearing, to respond to the Respondents' assertions in respect of the said second, third and fifth categories of objections.
67. Having considered the matters set out above, the Committee, in the absence of submissions from the Complainant, rules in favor of the Respondents that the said paragraphs of the Sutton Report stated in the second, third and fifth categories are objectionable for the reasons given by the Respondents and are to be ignored by the Committee.

Standard of proof

68. A dispute on the requisite standard of proof arose between the parties though they do not dispute that the initial burden of proof of proving a complaint in disciplinary proceedings before the Committee rests upon the Complainant as confirmed in rule 13 of the DCPR.
69. The Respondents assert that the DCPR do not specify the standard of proof that should be applied and a stricter standard of proof than merely a balance of probabilities should be adopted by the Committee in the Proceedings, with the core allegations of breach being an ethical standard and the reputation of professional men is at stake. The following reasons were relied on:
- (1) Paragraph 17 of the "Guidelines for the Chairman and the Committee on Administering the Disciplinary Committee Proceeding Rules" (the "Guidelines") state that:
- "The Hong Kong Courts have confirmed that the standard of proof applicable in disciplinary proceedings is the civil standard (proof on a balance of probabilities), suitably adjusted so that the degree of proof required is commensurate with the gravity of the charge. In*

circumstances where a serious charge is being brought... the degree of proof required is likely to equate to the criminal standard.”

This is broadly in line with the decision of the Court of Final Appeal in *A Solicitor v. The Law Society of Hong Kong* (2008) 11 HKCFAR 117.

(2) As the Court of Appeal noted in *Dr Wu Hin Ting v Medical Council of Hong Kong* [2004] 2 HKC 367 at p.378, “*in disciplinary proceedings where suspension or being struck off are realistic penalties that can be imposed, a tribunal would not be in error in applying a stricter standard of proof than merely a probabilities since the charges faced are likely to be of a more serious nature.*”

(3) In Reyes J’s judgment in *HKICPA v Disciplinary Committee*, HCAL 135/2005, 11 November 2005 involving allegations of professional negligence on the part of an accountant, the Disciplinary Committee of the HKICPA had said, as quoted from §44, that:

“We make it clear however that we consider that in the present case the Complainant must prove the Complaints on clear and compelling evidence. Although the charges do not involve dishonesty, fraud or criminality, in our view anything short of proof by clear and compelling evidence would not be sufficient to condemn a professional man (or firm) for these charges, and this is particularly so for the charge of negligence.”

Reyes J upheld the Disciplinary Committee’s approach and noted at §47 that “*the reputation of a professional should not be lightly destroyed by a charge of negligence.*”

70. The Complainant, on the other hand, submitted that the standard of proof borne by the Complainant in these proceedings should be the civil standard – proof on a preponderance of probabilities and quoted what Bokhary PJ said in the Court of Final Appeal decision of *Solicitor v Law Society of Hong Kong* [2008] 2 HKLRD 576:

“61. Only two standards of proof are known to our law. One is proof beyond reasonable doubt and the other proof on a preponderance of probability. The strength of the evidence needed to establish such a preponderance depends on the seriousness and therefore inherent improbability of the allegation to be proved.

62. A criminal charge must be proved beyond reasonable doubt. A civil claim, on the other hand, is to be proved on a preponderance of probability.

63. Sometimes an allegation of grave or even criminal conduct is made in a civil case. In such instances, it was common at one time for the courts to speak in terms of a degree of probability proportionate to or commensurate with the seriousness of the allegation...As will appear from the more recent authorities to which I will come in due course, it is misleading to speak of “a degree of probability”...

...

116. In my view, the standard of proof for disciplinary proceedings in Hong Kong is a preponderance of probability under the Re H approach. The more serious the act or omission alleged, the more inherently improbable it is regarded, the more compelling will be the evidence needed to prove it on a preponderance of probability. If that is properly appreciated and applied in a fair-minded manner, it will provide an appropriate approach to proof in disciplinary proceedings. Such an approach will be duly conducive to serving the public interest by maintaining standards within the professions and the services while, at the same time, protecting their members from unjust condemnation.”

71. In addition, the Complainant asserted that the Complaints do not come close to any criminal or dishonest wrongdoing. They are not such serious breaches which would have made their occurrence inherently improbable and thus the Committee should not impose on the Complainant any standard of adducing relatively more compelling evidence against the Respondents.

72. The Committee accepts the parties' common view that the initial burden of proof rests with the Complainant as confirmed in rule 13 in the DCPR.
73. The Committee further agrees that the DCPR do not specify the standard of proof that should be applied. Nevertheless, the Committee agrees with the Complainant's contention and distinguishes the present case from HKICPA v Disciplinary Committee because the allegations in this Proceeding are not that of negligence which the said authority dealt with.
74. More importantly, as rightly observed by the Respondents in its "Note of Preliminary Submissions for the Respondents", the alleged breach is that of an ethical standard. No allegations involving fraud are involved. The Committee agrees with the Complainant's view that the Complaints relate to breaches of accounting/auditing Standards and CoE that are not serious breaches and are nothing even close to any criminal or dishonest wrongdoing.
75. After due consideration of the parties' submissions on this issue, the Committee considers it is sufficient and appropriate for the purpose of its Decision to state that it shall apply in the present Proceedings the civil standard of proof, to be adjusted to commensurate with the gravity of the Complaints in line with what Chief Justice Li said in paragraph 113 of his judgment in Solicitor v The Law Society of Hong Kong that "...the evidence must be sufficiently compelling to overcome the improbability of the serious allegation being true and thus prove it on a preponderance of probability." However, in the present case after reviewing the evidence the Committee reached their conclusions in respect of those Complaints for which the Respondents are found guilty unanimously and without difficulty even applying the higher standard of proof contended by the Respondents. Therefore, it turns out that the argument on the standard of proof is academic and the Committee's decisions do not turn on its decision on standard of proof.

Standard of Care

76. The Respondents advanced a legal argument that the standard of care to be expected of auditors when preparing an auditor's report is the standard of the

ordinary skilled man exercising and professing to have that special skill. There may well be cases where two auditors reach different judgments on the same facts and that of itself does not render one judgment right and the other wrong.

77. The Complainant considered the Respondents' said contention as inapplicable on the main premise that the Complaints arise neither out of the law of torts, nor out of the law of professional negligence; but rather, in the nature of breaches of CoE and the relevant accounting/auditing standards. Therefore, the above contention of the Respondents could not be elevated into a general defence to the Complaints.
78. The Committee agrees with the submission of the Complainant on this subject. The legal issue of standard of care of an auditor does not come into play in the present Proceedings because of the nature of the Complaints. The Committee should decide the Complaints on the basis of whether the Complainant has proved to the Committee's satisfaction that the Respondents had failed to comply with the relevant standards as set out in the Complaints though in the course of making that decision professional judgments of the Respondents may be a relevant factor.

The Expert Evidence

79. The Committee notes that the Respondents did not lodge any formal challenge to Mr. Sutton's credentials and expertise and status to give evidence as an expert in accountancy.
80. Nevertheless, Mr. Lam SC acting for the Respondents posed fairly extensive questions to query the experience of auditing work of Mr. Sutton in his cross-examination at the Hearing and canvassed this proposition at length in his written closing submissions and invited the Committee to place little weight on Mr. Sutton's expert opinions and to reject his opinion where it conflicts with that of Mr. Wan's. The Complainant, on the other hand, did not challenge the expertise of Mr. Wan as an expert witness in the relevant areas.

81. As the expert evidence plays an important part in these Proceedings, the Committee considers it necessary to attend to this issue before addressing the substantive issues.
82. It is noted that Mr. Sutton sets out his qualifications in detail in the Sutton Report and in his curriculum vitae annexed thereto. He had also confirmed his qualifications in his examination-in-chief. Some key highlights of his qualifications and professional memberships, *inter alia*, are:
- (1) Fellow member of the HKICPA, Member of the Institute of Chartered Accountants in Australia, Member of the Insolvency Practitioners' Association of Australia, Registered Trustee in Bankruptcy & Official Liquidator (Australia);
 - (2) Holds a Bachelor of Business degree in Accounting from Ballarat University, Australia;
 - (3) Senior Managing Partner/Chairman, Asia Pacific Region of FTI Consulting (Hong Kong) Limited and is the leader of the firm's forensic accounting service line which provides litigation support and financial investigation service with a demonstrated proficiency in his field;
 - (4) Joined Ferrier Hodgson (Victoria) in 1988 and became a partner of the firm in 1997;
 - (5) Became an Executive Director of Ferrier Hodgson Limited in Hong Kong in early 2002 which has become FTI Consulting (Hong Kong) Limited ("FTI") in 2010;
 - (6) Have extensive experience in forensic accounting and litigation support matters in addition to various engagements as Liquidators, Receiver, Administrator and Financial Advisor to entities with business difficulties in both Australia and Hong Kong;
 - (7) Has over 23 years of experience in business advisory;
 - (8) Has spoken at seminars and conferences throughout the Asian Region and in Australia on fraud and investigations, compliance and regulatory issues and investing in emerging markets; and
 - (9) Have relevant experience in forensic accounting and litigation support in various court cases and with various companies.

83. In the Respondents' written submissions and from the cross-examination of Mr. Sutton the Respondents submitted that Mr. Sutton:
- (1) Has no prior audit experience and have never sign-off on an auditor opinion in Hong Kong, and as such, his views on what an "experienced auditor" might observe or do are suspect and Mr. Sutton would not have had experience of exercising the professional judgment of an auditor in his practice;
 - (2) Often demonstrated a selective, investigative and prosecutorial mentality which is inconsistent with his role as an expert witness;
 - (3) Misunderstood his instructions and role in this case and displayed a lack of due care and competence in ascertaining the proper scope of this report and his role;
 - (4) Demonstrated that he did not have a solid working knowledge of a number of the accounting standards which he relied upon;
 - (5) Was evasive and defensive on a number of questions, and preferred to make submissions, or to avoid answering directly, rather than to deal with the questions the answer to which he perceived to be disadvantageous to the Complainant;
 - (6) Is a forensic accountant by training and experience, with his primary area of practice as liquidator and trustee-in-bankruptcy, and thus his concern is not to consider the financial statements from the view of a reasonable user;
 - (7) Only performed an investigatory function as a liquidator;
 - (8) Focus on things like fraud as an liquidator rather than whether the financial statements were presented in a user friendly manner;
 - (9) Prior experience as an expert witness primarily involved investigations into fund flows and transactions only;
 - (10) Has previous involvement in professional negligence actions against auditors in the role of a liquidator, not as expert; and
 - (11) Admitted to have never given expert evidence on an audit practice before.
84. The Respondents in their written closing submission invited the Committee to pay particular regard to the contrast of Mr. Wan's significant experience as an

auditor in Hong Kong as compared to Mr. Sutton's lack of audit experience when assessing their evidence as to audit practice and professional judgment in applying accounting standards.

85. On the said arguments the Committee made the following observations and comments.
86. Mr. Sutton clarified in cross-examination that his practice, apart from liquidations and bankruptcies, also includes other areas such as investigation ranging from foreign corrupt practices, restatement of accounts, and dealing with corporations in Hong Kong, China and other parts of Asia. He also refers his role at FTI to include calculating various items such as cash-generating units; determining in the context of accountant negligence cases whether there has been compliance with certain accounting standards.
87. He admitted that he had never done an audit or sign-off on the auditor's opinion of listed companies in Hong Kong. Yet, this does not alter the fact that he is a fellow of the HKICPA. He does not accept that the lack of such audit experience means that he never had to exercise the judgment that such auditors have to make or had never engaged in questions of what reasonable users of financial statement would be able to understand. As liquidators of a number of listed companies in Hong Kong, he was involved in investigations into the liquidations of those companies.
88. Mr. Sutton further explained that he had also been involved as liquidators in professional negligence actions against auditors concerning their auditing work. Despite not being involved as an expert in such actions, these actions by their very nature involved alleged non-compliance with relevant professional standards. His role and involvement included thorough reviews of audit working papers, evaluations of audits with applications of auditing and accounting standards, and whether the auditing work was done properly with due care and competence. Through these experiences, he believed that he is able to exercise the professional judgments that were required of auditors. As liquidators, they were the plaintiffs of the action and thus were unable to give

their own expert evidence and that was the only reason why outside experts are engaged. Through the enormous amount of preparation work required in framing the claims in these actions, despite not acting as an expert of the case, he considers himself to be expert on professional standards, of audit working papers and on reporting of financial statements in accordance with auditing and accounting standards. Mr. Sutton has maintained and shown that he is familiar with the Relevant Standards in these Proceedings.

89. When he was challenged by Mr. Lam SC for his selection of “*fair value of net identifiable assets*” as the relevant materiality benchmark for the Complaints under Audit Area 2 being “*unusual*” and faced allegations to have chosen such an unusual base amount intentionally to “*suit his own purpose*” so as to arrive at a conclusion that the percentage change would have exceeded the 5% rule of thumb threshold, he firmly denied the accusation while conceded to the use of an “*unusual*” benchmark. He explained that the acquisitions of the two companies have so fundamentally and dramatically changed the nature of the company’s business that it warranted to adopt a somewhat unusual calculation to cater for these unusual and special circumstances.
90. He also regarded himself to be an expert liquidator. He gave explanations that fraud or auditors’ failure to detect fraud was not the only focus in his experience as a liquidator and he did not look at the financial statements and audit working papers with a view to fraud. His focus was on whether the relevant standards that ought to have been applied.
91. When being challenged that he would not be assessing financial statements with a view to see whether they were user-friendly or readily understandable to reasonable users, he explained that he would be assessing the financial statements in accordance with accounting and auditing standards and whether they are relevant to users as set out in the relevant standards.
92. When Mr. Sutton was cross-examined as to why he gave customer lists as an example of inseparable intangible assets, which the Respondents suggested to be in contrary to HKAS 38 and customer relationships should be separable

intangible assets, he gave an explanation that customer lists could be separable if its carrying value can be justifiable and it is up to the valuer at the time and it depends on the case. Mr. Lam SC, nevertheless, has not referred the Committee nor to Mr. Sutton any authoritative standards to support his submissions that Mr. Sutton's explanation or opinion about the recognition of customer lists as assets were definitively wrong. The Respondents have also quoted other examples to illustrate and support their allegation that Mr. Sutton does not possess a sound working knowledge of applicable accounting standards.

93. After due consideration of the above arguments and evidence, it is the Committee's view that Mr. Sutton is able to provide credible answers and explanations to the challenges posed to him by the Respondents in a competent manner. The Committee is satisfied that Mr. Sutton has sufficient knowledge and expertise, derived from his considerable experience as forensic accountant and liquidator, to give expert opinions on the subject Complaints and draw inferences from observed facts as an expert in these Proceedings.
94. In particular, the Committee does not agree that the example quoted by the Respondents of Mr. Sutton's use of the "*unusual*" benchmark as mentioned above warrants an inference that he presented his evidence in an imbalanced manner and his choice was an attempt to derive a figure which exceeded the 5% threshold for materiality to "*suit his own purpose*", as proposed by the Respondents. The comparison made was in fact only one piece of evidence that Mr. Sutton relied on to support his opinions. The basis of Mr. Lam SC's submissions that Mr. Sutton chose the "*unusual*" benchmark to "*suit his own purpose*", which is a serious allegation against an expert, was not supported by Mr. Wan's expert evidence and not justified and therefore rejected.
95. On the point that the scope of the Sutton Report might have been wider than the Registrar's referral to the Committee and the Complaints, Mr. Sutton gave evidence that he interpreted his instructions to include looking at the inadequacies of the audit work undertaken by the Respondents. The Committee considers that this factor alone should not be interpreted and taken

that far so as to suggest a display of a lack of due care and competence in ascertaining the proper scope of the report and his role as put forward by the Respondent. The understanding could have everything to do with the vagueness of the instruction given to Mr. Sutton. There is simply insufficient basis for the Committee to cast doubt on the reliability or authenticity of the part of his evidence that are within the scope of the Complaints. That attack on Mr. Sutton's evidence on its own will not diminish the weight to be given to his relevant evidence which should be considered on its own right.

96. The Committee has not formed an impression from Mr. Sutton's oral testimony in court that he played the role of a prosecutorial advocate as suggested by the Respondents. He was observed to be very thorough and detailed when answering questions put to him. His demeanour in examinations and the contents of the Sutton Report gave the Committee an impression that he is competent in giving his opinions on the technical aspects arising out of the evidence of this case.
97. The Committee also rejects the Respondents' contention that it should prefer the evidence of Mr. Wan whenever it conflicts with Mr. Sutton's for reasons given above. The experience of an expert witness may well be an important factor. However, experience alone is not decisive. That factor may be outweighed by other factors relating to the strength, reasonable and logic of the witness's evidence. It is not uncommon for one aspect of one side's expert evidence to be preferred while on other aspects the other side expert evidence prevails. It is in each case a matter for the Committee, looking at all relevant factors in relation to one specific area to determine what weight, if any, is to be given to each part of the expert witness's testimony.
98. The Committee adopts the position that it looks to all relevant factors particular to Mr. Sutton's and Mr. Wan's opinions and testimonies, to determine what weight, if any, is to be given to their evidence when it conflicts; and not merely relying on the extensiveness of credentials and experiences in the audit field of the two experts. The main factor is of course

the soundness, supporting reasoning, reasonableness and logic of the conflicted evidence.

99. Having dealt with the ancillary issues as above, the Committee now turns to the substantive issues of the case under the 3 Audit Areas.

RELEVANT STANDARDS

100. For ease of reference, the applicable passages of Relevant Standards, CoE, and the PAO are set out below. The analyses and interpretations, if any, will be made at the appropriate stages in this Decision.

The Complaints

101. Section 34(1)(a)(iv) of the PAO provides:

“(1) A complaint that –

(a) a certified public accountant –

...

(iv) failed or neglected to observe, maintain otherwise apply a professional standard;

...

shall be made to the Registrar who shall submit the complaint to the Council which may, in its discretion but subject to section 32D(7), refer the complaint to the Disciplinary Panels.”

102. The Code of Ethics for Professional Accountants (issued December 2005, effective on 30 June 2006) (the “CoE”) is as follows:

“Section 100.4 “Fundamental Principles” states: A professional accountant is required to comply with the following fundamental principles:

(c) Professional Competence and Due Care

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a

client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

“Professional Services” is defined as “Services requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services.”

Section 130 “Professional Competence and Due Care”

130.1 The principle of professional competence and due care imposes the following obligations on professional accountants:

(a) to maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional services, and

(b) To act diligently in accordance with applicable technical and professional standards when providing professional services.

130.4 Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

103. Hong Kong Standard on Auditing 230 - Documentation (issued February 2006) (“HKSA 230”) provides:

“2. The auditor should prepare, on a timely basis, audit documentation that provides:

(a) A sufficient and appropriate record of the basis for the auditor’s report; and

(b) Evidence that the audit was performed in accordance with HKSAAs and applicable legal and regulatory requirements.

9. *The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:*
- (a) The nature, timing, and extent of the audit procedures performed to comply with HKSAs and applicable legal and regulatory requirements;*
 - (b) The results of the audit procedures and the audit evidence obtained; and*
 - (c) Significant matters arising during the audit and the conclusion reached.*
10. *The form, content and extent of audit documentation depend on factors such as.... It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.*
11. *Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached...*

Audit Area 1 – Description of factors contributing to goodwill

104. Paragraphs 66(a) and 67(h) of HKFRS 3 provide as follows:

“66. An acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of business combinations that were effected:

“(a) during the period.”

67. To give effect to the principle in paragraph 66(a), the acquirer shall disclose the following information for each business combination that was effected during the period:

...

(h) a description of the factors that contributed to a cost that results in the recognition of goodwill – a description of each intangible

asset that was not recognized separately from goodwill and an explanation of why the intangible asset's fair value could not be measured – reliably – or a description of the nature of any excess recognized in profit or loss in accordance with paragraph 56.”

105. Paragraph 10 of the HKSA 701 – Modifications to the Independent Auditor's Report (“HKSA 701”) provides:

“10. In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor's report by using an emphasis of matter paragraph, preferably after the paragraph containing the auditors opinion but before the section on any other reporting responsibilities, if any, to report on matters other than those affecting the financial statements. For example, if an amendment to the other information in a document containing audited financial statements is necessary and the entity refuses to make the amendment, the auditor would consider including the auditor's report an emphasis of matter paragraph describing the material inconsistency.

106. Paragraph 11 of the Hong Kong Standard on Auditing 260 – Communication of Audit Matters with Those Charged with Governance (“HKSA 260”) provides:

*“11. The Auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance. Ordinarily such matters include the following:**

- *The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements.*
- *The selection of, or changes in, significant accounting policies and practices that have or could have, a material effect on the entity's financial statements.*

- *The potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements.*
- *Audit adjustments, whether or not recorded by the entity that have or could have, a material effect on the entity's financial statements.*
- *Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.*
- *Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditors report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter.*
- *Expected modifications to the auditor's report*
- *Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management.*
- *Any other matters agreed upon in the terms of the audit agreement.*

**The list of matters below is not intended to be all inclusive. In addition, other HKSAs discuss specific situations where the auditor is required to communicate certain matters with those charged with governance.*

Audit Area 2 – Non-recognition of deferred tax liabilities

107. HKAS 12 guides the calculation, recognition, presentation and disclosure of any deferred tax assets and liabilities. The relevant paragraphs are:

“Business Combinations

19. The cost of a business combination is allocated by recognizing the identifiable assets acquired and liabilities assumed at their fair

value at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to a fair value but the tax base of the asset remains at cost to the previous owner, a taxable difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill (see paragraph 66).

[...]

66. As explained in paragraphs 19 and 26(c), temporary differences may arise in a business combination. In accordance with HKFRS 3 Business Combinations, an entity recognizes any resulting deferred tax assets (to the extent that they meet the recognition criteria in paragraph 24) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and liabilities affect goodwill or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination. However, in accordance with paragraph 15(a), an entity does not recognize deferred tax liabilities arising from the initial recognition of goodwill."

Audit Area 3 – Goodwill impairment loss

108. Paragraphs 75 and 76 of the HKAS 36 – Impairment of Assets ("HKAS 36") provides as follows:

"Recoverable Amount and Carrying Amount of a Cash-generating Unit

[...]

75. The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined."

76. The carrying amount of a cash-generating unit"

- (a) *includes the carrying amount of only these assets that can be attributable directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and*
- (b) *does not include the carrying amount of any recognized liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.*

This is because fair value less costs to sell and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognized (see paragraph 28 and 43)."

109. Paragraphs 9 and 11 of the HKAS 230 have been set out in paragraph 103 above.

THE LEGAL BACKGROUND

Legal background relied on by the Respondents

110. The Committee takes note that the Respondents has in its First and Second Respondents' Case canvassed the legal background of several key areas that they submitted the Committee should take into account when judging whether the Respondents have failed or neglected to apply a professional standard as alleged in the Complaints. Since these legal backgrounds are relevant and relied on by the Respondents in each of the 3 Audit Areas, it is considered an efficacious way to set out here the crux of the parties' stance from their cases. These submissions will be considered at the appropriate places of the decisions herein when they arise.

Role and purposes of an auditor's report

111. The Respondents submitted that the Committee should ask itself what is the role and purpose of an auditors' report and whether the conduct complained of had an impact on such purpose.

112. An auditor is not responsible for preparing or drafting financial statements.
- (1) Under section 141(3) of the Companies Ordinance (Cap 32), the Respondents as auditors were required to prepare an audit report in order to express whether in their opinion a true and fair view was given by MelcoLot of: its balance sheet; profit and loss account; and the group accounts;
 - (2) Under HKSA 700 “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” (“HKSA 700”), the term “give a true and fair view” is equated with “are presented fairly, in all material respects.”
113. According to Jackson & Powell on Professional Liability (6th edition 2007, paragraph 17-009 at pp.1218-1219), the ultimate aim of such an audit report is explained as twofold:
- (1) To protect MelcoLot itself from undetected errors and wrongdoings; and
 - (2) To provide shareholders with reliable information for the purpose of enabling them to scrutinize the conduct of MelcoLot’s affairs and to exercise their collective powers to reward, control or remove directors.
114. Users of the Relevant Financial Statements are assumed to:
- (1) Be sophisticated readers who could reasonably be expected to derive the relevant information from the accounts even if it was not presented in a single paragraph but required the reader to cross-reference between notes in the Financial Statements; and
 - (2) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence (see paragraph 25 of the Conceptual Framework for the Preparation and Presentation of Financial Statements).
115. Thus, an auditor in preparing an auditor’s report is essentially asked to exercise a high degree of professional judgment.

116. The Complainant contends that the factual matrix of the present case does not engage in the exercise of professional judgment. The relevant standards particularized in the Complainant’s Case are simply standards requiring compliance which cannot be interpreted as somehow optional; they are requirements.
117. Insofar as the Committee is satisfied on the required standard of proof that the relevant standards are in fact require the Respondents to adopt courses of actions the Complainant says they should have taken but failed to do so, the Respondents cannot resort to excuse themselves by saying that, in their own professional judgment, such steps need not be taken.

Materiality

118. Materiality is another area that the Respondents invited the Committee to pay regard to. Their key submissions are stated as follows.
119. An auditor may qualify his opinion if for any reason it is not possible for him to give an unqualified opinion that the company’s financial statements “give a true and fair view” of the company’s affairs, or that they “are presented fairly, in all material respects”.
120. Paragraph 11 of HKSA 701 – Modification to the Independent Auditor’s Report (effective for auditor’s reports dated on or after 31 December 2006) (“HKSA 701”) states that qualifications are required when “in the auditor’s judgment, the effect of the matter is or may be material to the financial statements”.
121. HKSA 320 – Audit Materiality (effective for audits of financial statements for periods beginning on or after 15 December 2004) (“HKSA 320”) describes how an auditor should determine whether a factor is material:
- (1) Paragraph 4 confirms that “*the assessment of what is material is a matter of professional judgment*”;

(2) Paragraph 3 notes that “materiality” is defined in the Framework for the Preparation and Presentation of Financial Statements in the following terms:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful”;
and

(3) Paragraph 5 confirms that when preparing for the audit, an auditor will establish *“an acceptable materiality level so as to detect quantitative material misstatements. However, both the amount (quantity) and nature (quality) of misstatements need to be considered”*.

122. It is common practice as provided in several authoritative texts that the quantitative rule of thumb of materiality is that an amount which is 5% (or below) of the base amount (e.g. net profit, total assets, net assets or total liabilities) is immaterial, whereas an amount which is 10% (or above) of the base amount is material. An amount that falls between 5 to 10% of the base amount is subject to professional judgment.
123. The Complainant contends that the Respondents argument seems to be based on the premise that if, at the end of the day, MelcoLot’s Relevant Financial Statements would not have been required to be given a qualified opinion, it would not have mattered whether the Respondents did carry out its work in accordance with the relevant required standards.
124. The Complainant submitted that this is a wholly inconceivable approach towards the regulatory framework operating with respect to the auditing professionals.
125. In gist, the Complainant’s case is, first and foremost, that it is auditors should have applied the relevant standards to ensure that they are in the position to

identify whether the set of financial statement they are auditing has been prepared in compliance with the relevant standards took place. The Complainant is not charging the Respondents for failure to qualify the audit opinion.

Content of the audit documentation

126. Another area raised by the Respondents is in regard to the contents of the audit documentation.
127. Paragraph 2 of HKSA 320 states that the purpose of the audit documentation is to provide “(a) a sufficient and appropriate record of the basis for the auditor’s report; and (b) evidence that the audit was performed in accordance with HKSAs and applicable legal and regulatory requirements.”
128. The Respondents also referred to paragraph 9 and 10 of the HKSA 230 as set out in paragraph 103 above.

THE UNDISPUTED FACTS AND THE PARTIES’ CASES

Audit Area 1 – Description of factors contributing to goodwill

129. The subject matter of the Complaints in Audit Area 1 was the auditing work done by the Respondents for MelcoLot for the FY 2007 in relation to the disclosure of goodwill in the Relevant Financial Statements.

Undisputed facts and circumstances

130. The undisputed facts and circumstances relevant to the Complaints under this audit area are outlined as follows:
- (1) The accounting item “Impairment loss on goodwill” features as the largest figure in the FY 2007 consolidated income statement. The impairment loss amounted to HK\$ 416 million, contributing substantially to the net loss figure of HK\$ 416.4 million;

- (2) The accounting item “Goodwill” also features as the largest figure in the FY 2007 consolidated balance sheet. Goodwill after impairment amounted to HK\$ 485 million, representing some 41% of MelcoLot’s total assets or some 78% of its net assets;
- (3) The users of these financial statements is directed to Note 19, if they would like to understand more about these very significant items appearing on the consolidated income statement and consolidated balance sheet;
- (4) When one turns to Note 19, one would obtain the following information:
- i. A goodwill of HK\$ 901 million was recognized in the FY 2007 Relevant Financial Statements as a result of the Acquisition;
 - ii. An impairment loss on goodwill of HK\$ 416 million was recognized following an impairment review for goodwill was performed with reference to the valuation carried out by Vigers Appraisal & Consulting Limited (“Vigers”);
 - iii. The valuation carried out by Vigers was based on calculations of projected cash flows budgeted by the management of MelcoLot;
 - iv. After taking into account of the impairment loss, the carrying amount of goodwill stood at HK\$ 485 million as at 31 December 2007.
- (5) Notes 34, 35 and 39 to the FY 2007 Financial Statements contain relevant information:
- i. MelcoLot issued CBs with face value of HK\$ 606.8 million on 13 December 2007;
 - ii. On the date of issuance (i.e. completion date of the Acquisition), the fair value of the issued CBs was recognized to have increased by nearly HK\$ 383 million to almost HK\$ 990 million;
 - iii. MelcoLot issued Consideration Shares at issue price of HK\$ 0.85 per share on 13 December 2007;
 - iv. On the date of issuance (i.e. completion date of the Acquisition), the fair value of the issued Consideration Shares was recognized to have increased by HK\$ 112 million to HK\$ 173.5 million;

- v. The fair value of the CBs and the Consideration Shares was determined using the published price available at the date of Acquisition;
- vi. After taking into account the minority interest, the net assets acquired pursuant to the Acquisition amounted to HK\$ 262.3 million;
- vii. The fair value of the Acquisition consideration was HK\$ 1.163 billion; and
- viii. The difference between the fair value of the Acquisition consideration of HK\$ 1.163 billion and the net assets acquired in the amount of HK\$262.3 million was HK\$ 901 million, and this difference was recognized as goodwill.

(6) Paragraphs 66(a) and 67(h) are the key paragraphs in HKFRS 3 that establish disclosure requirements in the acquirer's financial statement;

(7) To comply with paragraphs 66(a) and 67(h) of HKFRS 3, MelcoLot should give a description of the factors that contributed to a cost that results in the recognition of goodwill;

(8) However, the relevant notes (i.e. Notes 19, 34, 35 & 39) do not contain any description of the factors that contributed to the recognition of goodwill. A reasonably diligent user of the financial statements may work out from note 39 the following information:

	\$' million	\$' million
Fair value of net assets of subsidiaries		262
Difference between fair values of net assets acquired and issued price of bonds and shares (\$668 million - \$262 million):	406	
Change in published price of bonds and shares at date of acquisition from their issued price (\$1.163 million - \$668 million):	495	
	—————	

Goodwill:	901
	<hr/>
Total purchase consideration:	1,163

(9) The staff members of CCIF and Mr. Ho as CCIF's Lead and Engagement Director of this audit should be well aware of the provisions under HKFRS 3. They are moreover expected to apply these provisions under HKFRS 3.

131. The salient points of the Complainant's case and the Respondents' case according to their cases are set out as follows.

The Complainant's Case

132. The crux of the Complainant's case is that there was no disclosure of the factors attributable to the recognition of goodwill of HK\$ 901 million in the Relevant Financial Statements in relation to the Acquisition as required under paragraphs 66(a) and 67(h) of HKFRS 3 (extracts as set out in paragraph 104 above) and the Respondents failed to consider to modify the Audit Report pursuant to paragraph 10 of HKSA 701 and failed to discuss the matter with management over this non-disclosure in accordance with paragraph 11 of HKSA 260 (extracts as set out in paragraphs 105 and 106 above). Alternatively, if such steps had been taken, CCIF and Mr. Ho failed to document how these steps were taken to comply with HKSA 230 (extracts as set out in paragraph 103 above).
133. The Complainant submits that the analysis in paragraph 130(8) above does not address what factors did contribute to the recognition of the HK\$ 406 million of goodwill as difference between the fair value of net assets acquired and issued price of CBs and Consideration Shares. Nor does it set out in clear terms that the increase in fair value of the CBs and Consideration Shares of HK\$ 495 million contributed to goodwill arising from the Acquisition. Users of the financial statements should not be expected to assume that such increase was related to the recognition of goodwill.

134. MelcoLot should have considered factors which could have contributed to the recognition of goodwill such as synergies, strategic expansions, access to markets, etc.
135. Accordingly, it is the Complainant's case that the Relevant Financial Statements did not comply with paragraph 67(h) of HKFRS 3 as the factors contributing to HK\$ 901 million of goodwill were not disclosed.
136. The staff members of CCIF and Mr. Ho as CCIF's Lead and Engagement Director of this Audit should be well aware of the provisions under HKFRS 3 and are expected to apply these provisions.
137. They should have therefore considered whether the Audit Report should be modified pursuant to paragraph 10 of HKSA 701 to highlight the fact that disclosures of the Relevant Factors were not adequate resulting in non-compliance with HKFRS 3.
138. Furthermore, CCIF and Mr. Ho should have discussed with MelcoLot's management personnel who were charged with governance of the expected modification of the Audit Report in accordance with paragraph 11 of HKSA 260 in order to resolve the lack of adequate disclosure in the Relevant Financial Statements.
139. As CCIF and Mr. Ho should have concluded that the disclosures were not sufficient to comply with HKFRS 3 (paragraph 66(a) and 67(h)), they failed to properly apply HKFRS 3. Accordingly, they have failed to comply with paragraph 100.4(c) of the Code – Due care and competence, in that they were not diligent nor competent in applying the relevant accounting and auditing standards in the Audit (i.e. the First Complaint).
140. Alternatively, if CCIF and/or Mr. Ho had considered whether the auditors' report should be modified, such consideration should have documented as required under HKSA 230. Similarly, if CCIF had discussed the matter with MelcoLot's management, such discussion should have been documented. As

there is no such documentation evidencing that these had been done, CCIF and Mr. Ho failed to comply with HKSA 230 (i.e. the Second Complaint).

The Respondent's case

141. The Respondents denied the alleged breach under both the First Complaint and the Second Complaint.
142. It is the Respondents' case that an adequate description was provided in the Relevant Financial Statements of the factors that contributed to a cost that resulted in the recognition of goodwill of HK\$ 901 million in compliance with paragraph 67(h) of HKFRS 3 and therefore the Respondents had exercised due care and competence in applying the relevant accounting and auditing standards in preparing the Audit Report. Accordingly, there has been no breach of paragraph 100.4(c) of the CoE, under the First Complaint.
143. Since it was not necessary for the Respondents to modify the Audit Report, it was unnecessary for them to modify the Audit Report in accordance with HKSA 701 and it was therefore unnecessary to discuss with MelcoLot's management such modification in accordance with HKSA 260 and consequently there has therefore been no breach of HKSA 230, under the Second Complaint.
144. The Respondents' contention of adequate disclosure is supported by Mr. Wan's expert opinion that the information outlined in Note 19, 34, 35, 39 would have enabled financial statement users to have an understanding of how the goodwill arose.
145. The Respondents submitted that it is abundantly clear that MelcoLot did consider possible factors such as "*synergies, strategic expansions, access to markets etc.*" which appeared to have been suggested by the Complainants that could have contributed to a cost that resulted in the recognition of goodwill. However, these factors did not have any direct bearing on the consideration paid by MelcoLot in relation to the Acquisition and thus there was no need for a description of the factors to that effect in the Relevant Financial Statements.

146. The Respondents accept that anticipated profitability of PAL and Oasis was a factor contributing to a cost resulting in the recognition of goodwill and this factor was not referred to expressly in the Relevant Financial Statements. It is obvious to all users that where a company acquires a new business or subsidiary, it does so because it expects that the new business to be profitable. Therefore, it is a self-evident and widespread understanding that where the consideration for the acquisition is greater than the net asset value of the acquired business, the excess sum paid can be taken to account for the anticipated profitability. As a result, the Respondents using their professional judgment did not consider it necessary for the Relevant Financial Statements to expressly disclose of this factor of anticipated profitability. The general understanding was corroborated by a circular issued by MelcoLot which was referred to in the Financial Statements (the “Circular”).
147. The Respondents also referred the Complainant to a large number of financial statements of other companies for the FY 2007 where no such description was made and where the financial statements were accepted by the auditors without relevant qualification. These examples serve to show that a responsible or respectable body of opinion would have acted in the same or a similar way as the Respondents at the relevant time.
148. MelcoLot has also explained how the consideration of the goodwill in the Circular to the shareholders regarding the Acquisition, including the factor of anticipated profitability which had affected the Consideration paid.
149. The Respondents were required to make a judgment as to whether the Relevant Financial Statements contain “*a description of the factors that contributed to a cost that results in the recognition of goodwill*” in relation to HKFRS 3 and gave a true and fair view and it is the Respondents’ case that they did.

150. Users would have been able to derive sufficient information from the Relevant Financial Statements in order to evaluate the nature and financial effect of the goodwill arising from the Acquisition.
151. The Respondents should not be criticized for the presentation or drafting of the financial statements for which they are not responsible. The auditor's function is not to re-write the accounts so that they are more user-friendly or presented in a more accessible manner.
152. As to the Second Complaint, in view of the foregoing, it was not necessary for the Respondents to consider whether or not the Audit Report should be modified pursuant to paragraph 10 of HKSA 701 or to discuss with MelcoLot's management such modification pursuant to HKSA 260. Thus, it was also not necessary to document such considerations and discussions. Paragraph 10 of HKSA 230 also confirms that it is "*neither necessary nor practicable to document every matter the auditor considers during the audit.*"

Audit Area 2 – Non-recognition of deferred tax liabilities

153. The subject matter of the Complaints in Audit Area 2 was the auditing work done by the Respondents for MelcoLot for the FY 2007 in relation to the recognition of DTL corresponding to the fair value adjustment of approximately HK\$ 136 million on the intangible assets of PAL and Oasis.
154. The undisputed facts and circumstances relevant to the Complaints in this audit area are outlined as follows:
- (1) In Note 39 of the Relevant Financial Statements (p.105 of FY2007 Annual Report), it is recorded that, as for the newly acquired subsidiary, PAL, an upward fair value adjustment with respect to its intangible assets in the amount of HK\$ 86.251 million was recognized. It is also recorded that an upward fair value adjustment of HK\$49.676 million was recognized for Oasis. Therefore, a total amount of fair value adjustment of HK\$ 135.9 million was recognized for FY 2007;

(2) However, no DTL were recognized on the Relevant Financial Statements. Indeed, the only reference to the treatment of deferred taxation has nothing to do with the deferred taxation arising out of the fair value adjustment recognized and it is contained in Note 38 – Deferred Taxation, which goes as follows:

“At the balance sheet date, the Group has unutilized tax losses of approximately HK\$27,787,000 (2006: HK\$ 9,333,000) available for offset against future profits. No deferred tax asset has been recognized in respect of the unutilized tax losses due to the unpredictability of future profit streams. These tax losses may be carried forward indefinitely.

(3) CCIF was aware of potential deferred taxation issues during its Audit of the Relevant Financial Statements. On a worksheet entitled “Melco LottVentures Limited – Assessment of deferred tax liabilities from acquisition of subsidiaries”, CCIF’s auditing staff considered the need to provide for DTL;

(4) It is recorded that CCIF’s auditing staff discussed with management of MelcoLot, who were of the opinion that no DTL needed to be recognized, *“as it is probable that the accumulated unutilized tax losses should be used to absorb the future cash flow of intangible assets and the subsidiaries with the intangible assets should share the Group’s common expenses”*;

(5) Applying this logic, the auditing staff estimated the amount of DTL in respect of the fair value adjustment of the intangible assets in the following manner:

	HK\$' million	HK\$' million
Carrying amount:		136
Income from adjusted		
Intangible assets:	([XX])	
Future centralized costs to		
be shared:	_____ [XX]	
Sub-total 1:		([XX])
Sub-total 2:		[XX]

Tax loss brought forward:	(<u>XXX</u>)
Sub-total 3:	[<u>XX</u>]
Tax rates:	[<u>XX</u>] <u>%</u>
Deferred tax liabilities:	6

(6) The relevant CCIF auditing staff member therefore assessed the DTL to be HK\$ 6 million. CCIF's director, as a final review should have reviewed the working papers of its auditing staff;

(7) The following paragraphs of HKAS 12 are relevant:

- i. Objective: "It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probably that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognize a deferred tax liability (deferred tax assets), with certain limited exceptions."
- ii. Paragraph 5 Definitions: "Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences."
- iii. Paragraph 5 Definitions: "Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base..."
- iv. Paragraph 5 Definitions: "taxable temporary differences...are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered and settled..."
- v. Paragraph 5 Definitions: "The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes."
- vi. Paragraph 15: "A deferred tax liability shall be recognized for all taxable temporary differences..."

- vii. Paragraph 19: “Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability...”
- viii. Paragraph 47: “Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates...that have been enacted or substantively enacted by the balance sheet date.”
- ix. Paragraph 67: “As a result of a business combination, an acquirer may consider it probable that it will recover its own deferred tax asset that was not recognized before the business combination...In such cases, the acquirer recognizes a deferred tax asset, but does not include it as part of the accounting for business combination, and therefore does not take it into account in determining the goodwill...”
- x. Paragraph 34: “A deferred tax asset shall be recognized for the carry forward of unused tax losses and unused tax credits to the extent that it is probably that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilized.”
- xi. Paragraph 74: “An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:
 - ...
 - (b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
 - (i) the same taxable entity; or
 - (ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realize the assets and settle the liabilities simultaneously, in each future period in which significant amounts of

deferred tax liabilities or assets are expected to be settled or recovered.”

- (8) The staff member of CCIF and Mr. Ho as CCIF’s Lead and Engagement Director of this audit should be well aware of the provisions under HKAS 12 and are expected to apply these provisions under HKAS 12.

155. The salient points of the Complainant’s case and the Respondents’ case are set out as follows.

The Complainant’s case

156. The Complainant submitted that, bearing in mind the provisions of HKAS 12, in its computation of DTL and its Audit of the Relevant Financial Statements, CCIF failed to properly apply HKAS 12 in that:

- (1) The allocation of PAL and Oasis of future centralized costs and common expenses of the Group of a total HK\$[XX] million is erroneous because, in calculating the fair value adjustment of the intangible assets of HK\$136 million, relevant future costs should have already been taken into account;
- (2) Tax loss brought forward of HK\$28 million should not be included in the computation to arrive at the DTL as not the entire HK\$28 million of unutilized tax losses were related to PAL and Oasis;
- (3) The tax rate of [XX]% applied in the computation was incorrect.

According to CCIF’s audit documentation, it was the effective tax rate for the year ended 31 December 2007 taking into account the Hong Kong tax rate of 16.5% and PRC tax rate of 25% as MelcoLot was exposed to both Hong Kong and PRC tax jurisdictions. However, the future income to be generated from the relevant intangible assets will come from [XX] operating units of PAL and Oasis, [XX] of which were PRC companies subject to PRC income tax. As the operations of the acquired subsidiaries are primarily in the PRC, there was no basis that the Hong Kong tax rate of 16.5% should be taken into account. Accordingly, the 25% PRC Enterprise Income Tax adjusted by any approved tax incentives granted to the specific PRC entity should be used.

157. It is the Complainant's submission that the Respondents had not properly conducted the assessment of DTL arising out of the fair value adjustment of MelcoLot's newly acquired subsidiaries.
158. Furthermore, it is apparent that a proper assessment was not communicated with the management of MelcoLot and the audit difference was not properly dealt with.
159. CCIF and Mr. Ho should have concluded that their auditing staff member's computation of the DTL did not comply with HKAS 12 and the computation was in fact erroneous. As they failed to recognize such non-compliance and error, they failed to properly apply HKAS 12. Accordingly, they have failed to comply with paragraph 100.4(c) of the Code – Due care and competence, in that they were not diligent nor competent in applying the relevant accounting and auditing standards in the Audit (i.e. the First Complaint).
160. Alternatively, had Mr. Ho relied upon a different set of calculations to those contained in the audit documentation, these should have been documented together with his reasons for departing from the original set of calculations, as required under HKSA 230 (i.e. the Second Complaint).

The Respondents' case

161. The Respondents denied both the First Complaint and the Second Complaint. In gist, it is their primary case that their computation of DTL contained in the Relevant Financial Statement was reasonable and they had complied with HKAS 12 and had exercised the appropriate duty of care and competence required by paragraph 100.4(c) of the CoE. If it is found that the computation of DTL did not comply with HKAS 12, it is submitted that any errors were not material and would have had no material effect on the Financial Statements. The Relevant Financial Statements gave a true and fair view of the affairs of Melcolot. There was no breach of HKSA 230 because the consideration of DTL in the audit documentation was adequate and no alternative set of calculations was relied upon.

162. In respect of the alleged mis-calculation of DTL, the Respondents disagreed with the Complainant's case in the following ways and detailed justifications of the calculations were also given:
- (1) The allocation of PAL and Oasis of future centralized costs and common expenses of the Group of HK\$ [XX] million was appropriate in the circumstances, because such costs were not already accounted for in the fair value adjustment of the intangible assets;
 - (2) It was fair to assume that the fair value adjustment of the intangible assets of HK\$ 136 million included only costs relevant to the assets themselves, rather than the estimate of future centralized costs;
 - (3) In view of newly promulgated PRC tax laws, it was reasonable to include the tax loss of HK\$ 28 million in the computation of DTL albeit that not all of this sum related to PAL and Oasis;
 - (4) It is denied that it was appropriate simply to apply the applicable PRC income tax rate on the upward fair value adjustment recognized in the Relevant Financial Statements for both PAL and Oasis. The tax rate of [XX%] applied by MelcoLot in the computation of DTL was well-justified by an analysis of the intangible assets from which the fair value adjustment was derived.
163. The Respondents had no reason to disagree with the calculations of DTL unless the amount of any discrepancy was material.
164. The Respondents had supplied alternative calculations for DTL in their letters to the AIB (in the amounts of HK\$ 18 million and HK\$ 23 million) and in the Wan Opinions (in the amount of HK\$ 24 million). The Complainant had also put forward a figure of HK\$ 34 million made by the AIB as the appropriate figure for DTL. Adopting Mr. Wan's opinion, the Respondents rejected and denied the Complainant's figure of HK\$ 34 million. It is the Respondents' case that the said alternative calculations demonstrate that a large amount of professional judgment is required of auditors when determining the basis for the calculation of DTL. Even if the Respondents had used one of the

alternative calculations for DTL, the range of figures they could have arrived at were all immaterial.

165. In reference to the Wan Opinions, recognition of DTL of HK\$ 23 million would have caused the loss recorded for FY 2007 in the Relevant Financial Statements to increase by 3.3%, and the total liabilities after recognition of DTL to increase by 4%. It is industry practice to accept that any percentage difference of less than 5% is immaterial.
166. The Wan Opinions also confirmed that whether the DTL were recorded in the Relevant Financial Statements as HK\$ 6 million, HK\$ 18 million or HK\$ 23 million would have no real impact on the users of the Relevant Financial Statements and it is unlikely that the judgment of a reasonable person relying upon the report would have been changed or influenced.
167. It is also Mr. Wan's opinion that the non-recognition of the amount of DTL would not have resulted in a qualified audit opinion being issued.
168. The figure of HK\$ 12 million fixed by the Respondents in their Audit Planning Memorandum and Summary Review Memorandum as the appropriate level of materiality was a relevant auditing tool and not a prescriptive figure which could be applied to determine whether any figure in any given context was material or not. The fact that the misstatement might have exceeded HK\$ 12 million would not be conclusive. It would all depend on the particular surrounding circumstances.
169. Even if the DTL computations in the audit working papers were incorrect and/or based on inappropriate assumptions, it is the Respondents' alternative case that these would not constitute "*material errors*" that would have a material impact on the Relevant Financial Statements. The largest figure for DTL that might reasonable be put forward is in the region of HK\$ 24 million. The Relevant Financial Statements gave a true and fair view of the affairs of MelcoLot.

170. In relation to the Second Complaint, it is the Respondents' case that they did not rely on alternative calculations of DTL in preparing the Audit Report and consequently there was no requirement for them to document such calculations, and thus the Respondents have not breached HKSA 230.
171. The Respondents further submitted that they had adequately documented their consideration of DTL in the audit documentation because the Respondents had recorded in an audit working paper titled "Assessment of deferred tax liabilities from acquisition of subsidiaries" how they concluded the estimated DTL of HK\$6,335,000 to be immaterial and would not have a material effect on the Financial Statements. Consequently, there is audit documentation setting out the Respondents' thinking process and its conclusion in relation to the non-recognition of DTL.

Audit Area 3 – Goodwill impairment loss

172. The subject matter of the Complaints in Audit Area 3 was the auditing work done by the Respondents for MelcoLot for the FY 2007 in relation to the recognition of goodwill impairment loss on the Relevant Financial Statements.
173. The undisputed facts and circumstances relevant to the Complaints in this audit area are outlined as follows:
- (1) In October 2007, when MelcoLot decided to embark on the Acquisition, the consideration consisted of 72 million Consideration Shares and CBs in the principal amount of HK\$ 607 million. The aggregate monetary value of the Consideration Shares and the CBs totalled HK\$ 668 million as at the date of the Announcement;
 - (2) However, by the completion date of the Acquisition (i.e. 13th December 2007), the share price of the MelcoLot appreciated significantly and, as a consequence, the combined fair value of the Consideration Shares and the CBs as at 13th December 2007 was HK\$ 1.163 billion;

- (3) Therefore, as of 13th December 2007, the assets acquired through the Acquisition would have a carrying amount of HK\$ 1.163 billion (the “Carrying Amount”) on the MelcoLot’s books;
- (4) MelcoLot relied on the valuation reports prepared by Vigers (“Vigers Reports”) to carry out its impairment tests;
- (5) In Vigers’ valuation report on PAL Development Limited dated 26th March 2008, the surveyors adopted the “income approach” and used the discounted cash flow (DCF) methodology to assess PAL’s value:

“Under income approach, the operating values of the Subject can be determined by the Discounted Cash Flow (DCF) method. The Free Cash Flows to Firm before tax (FCFF(excluding tax)) has been used to estimate the benefit stream attributable to the Subject. The term “Firm” here refers to the methodology in arriving the cash flow to the Subject only, not the real cash flow to the Company. Our projection only accounts relevant cash flow to the betting hall, POS and mobile betting operations.

The FCFF (excluding tax) is defined as:

FCFF(exclude tax) = Earning before Interest + Depreciation – Capital Expenditures – Working Capital Needs

** Under the requirement of Hong Kong Accounting Standard, the goodwill impairment test shall carry on a pre tax cash flow basis.”*

- (6) As for PAL, Vigers was of the opinion that as of 31st December 2007, the value of PAL could be reasonably stated as RMB [XX] million, which was roughly equivalent to HK\$ [XX] million (at an exchange rate of RMB 1 = HK\$ 1.07). As MelcoLot in effect held 80% share in PAL, this would have translated to a fair value of HK\$ [XX] million attributable to MelcoLot;

- (7) Vigers also performed a valuation on Wu Sheung Co Limited (“Wu Sheng”), the only operating subsidiary of Oasis, by using the same methodology. Vigers concluded that Wu Sheung’s fair value to be RMB [XX] million, which was roughly equivalent to HK\$ [XX] million. As MelcoLot in effect held 60% share in Oasis, this would have translated to a fair value of HK\$ [XX] million attributable to MelcoLot;
- (8) The combined fair values of PAL and Oasis attributable to MelcoLot therefore amounted to HK\$ [XX] million (the “Recoverable Amount”);
- (9) It is noted that MelcoLot recognized a goodwill impairment loss of HK\$ 416 million. This amount is approximately equivalent to the difference between the total consideration for the Acquisition (HK\$ 1.163 billion) and the Recoverable Amount as assessed by Vigers (HK\$ [XX] million);
- (10) Note 39 to the FY 2007 Financial Statements revealed that the Carrying Amount included monetary assets and monetary liabilities of PAL and Oasis, the net amount of which attributable to the Group was HK\$ 20.8 million monetary assets after minority interest;
- (11) Paragraph 75 and 76 of HKAS36 – Impairment of Assets are relevant accounting standards in relation to this issue on impairment loss on goodwill;
- (12) If Vigers did in fact exclude the HK\$ 20.8 million monetary assets from its valuation of the Recoverable Amount, the impairment of goodwill would have been overstated by HK\$ 20.8 million;
- (13) In the Materiality Summary prepared as part of the Respondents’ audit working papers, audit materiality was set at HK\$ 12 million.
174. The salient points of the Complainant’s case and the Respondents’ case are set out as follows.

The Complainant's case

175. It is the Complainant's case that Vigers did not state whether it had included the monetary assets and liabilities in its valuation.
176. Therefore, the potential for the impairment of goodwill to have been overstated by HK\$20.8 would have been a significant matter requiring the attention by CCIF and Mr. Ho. Given the fact that the valuation reports by Vigers were unclear as to whether they had or had not included the monetary assets in its valuation, CCIF and Mr. Ho should have (a) made inquiries of Vigers to clarify the matters; and (b) documented that such inquiries had been made and the responses from Vigers.
177. No documentation in the working papers was noted that CCIF had:
- (1) Considered monetary assets and liabilities were included in the Recoverable Amount in order to comply with paragraphs 75 and 76 of HKAS 36; and
 - (2) Consulted with Vigers about the treatment of monetary assets and liabilities in its valuation calculation (in particular with regard to the terminal value of the cash flow projection).
178. Furthermore, no written supporting documents were provided by CCIF that it had consulted Vigers about inclusion of monetary assets and liabilities in its valuation calculation.
179. It is in these circumstances that it is submitted that there is insufficient audit documentation to show that CCIF had:
- (1) applied paragraphs 75 and 76 of HKAS 36; and
 - (2) obtained the relevant audit evidence in this regard.
180. As impairment loss of goodwill of HK\$416 million confirmed by CCIF and a possible misstatement of HK\$ 20.8 million of such (at least above the planning materiality of HK\$ 12 million adopted by CCIF in the audit) are considered significant matters that a reasonable auditor would have considered

and documented the relevant audit procedures results and audit evidence obtained in accordance with paragraph 9 of HKSA230. It is accordingly submitted that CCIF and Mr. Ho (in his capacity as lead director) failed to comply with paragraph 100.4(c) of the Code – Due care and competence (i.e. the First Complaint) or paragraph 2 of HKSA230 (i.e. the Second Complaint).

The Respondents' case

181. The Respondents denied both the First Complaint and the Second Complaint.

182. In relation to the Vigers' valuation, the Respondents asserted that it is sufficiently clear from the Vigers Reports whether or not working capital needs or outflow were included in estimating the future cash flow in the valuations, and therefore whether monetary assets and liabilities should be included as the cash generating units of PAL and Oasis. If working capital outflow was not included in the valuations, monetary assets and liabilities should be included as part of the cash generating units and vice versa. In short, the Vigers Reports were clear that they included the relevant monetary assets and liabilities.

183. The Respondents deny that the impairment of goodwill has been overstated by HK\$ 20.8 million in the Relevant Financial Statements. If it is not accepted that the Vigers Reports were clear that they included the relevant monetary assets and liabilities and there was such an overstatement, the figure HK\$ 20.8 million is not material for the purposes of the Financial Statements and the alleged overstatement would not have affected the true and fair view that the Relevant Financial Statements gave of MelcoLot's financial affairs.

184. In view of the above, it was not necessary for the Respondents to note in their working papers that they had considered whether the Vigers Reports included monetary assets and liabilities, and/or that they had consulted with Vigers. Any consultation with Vigers was done by the Respondents in the abundance of caution and there was no need to record it in detail in their working papers.

185. As to the Second Complaint, the Respondents prepared an audit working paper describing how they arrived at the conclusion that impairment loss on goodwill of HK\$ 416 million should be recognized. It is clear from that working paper that the Respondents had no doubt that the PAL report had included the relevant monetary assets in the valuation to generate the future cash flow of PAL.
186. The Respondents also asserted that the Vigers Reports included in the Respondents' working papers together with the Respondents' Audit Programme constituted adequate audit documentation in relation to the issue and it was not necessary to document in detail the Respondents' various conversations with Vigers.
187. In the abundance of caution, the Respondents consulted Vigers during the audit process. Vigers were involved in meetings, telephone calls and email exchanges with MelcoLot and the Respondents regarding the calculation of goodwill impairment loss. At no stage did Vigers object to the inclusion of monetary assets and liabilities in the carrying amount used in the goodwill impairment loss calculations. Consequently, there was no reason for the Respondents to doubt that monetary assets and liabilities should be included.
188. It is rarely the case that an auditor will record in the audit documentation detail on everything he has reviewed, discussed and concluded. What should be included is a matter of judgment that the auditor has to exercise based on his assessment of the audit he undertakes. Paragraph 10 of HKSA 230 states that *"It is...neither necessary nor practicable to document every matter the auditors considers during the audit."*
189. The Respondents did not consider it necessary to record in detail their thought process and communications with Vigers on this issue because:
- (1) the sum of monetary assets and liabilities was insignificant in comparison to the total amount of goodwill impairment loss and consideration;

- (2) the PAL Report was adequately clear on its face that these assets and liabilities were included in the valuation to generate the future cashflow of PAL;
- (3) the cashflow in the valuations was so self-explanatory that it was included by the Respondents' in the normal course as part of their audit working papers;
- (4) MelcoLot was involved in the valuation process with Vigers and decided it was appropriate to include monetary assets and liabilities in their calculations of goodwill impairment loss; and
- (5) Vigers did not raise any concerns regarding the goodwill impairment loss calculations and the inclusion of monetary assets and liabilities, although they were kept informed of the same.

190. There is no indication in the course of the audit to alert the Respondents that there could be controversy in relation to this area, it was not identified as a significant matter requiring further documentation or discussion with MelcoLot's management.

191. In view of the above, the Respondents considered that they have adequately complied with HKAS 36 when considering the Vigers Reports and documented this appropriately, and denied that they have failed to comply with HKSA 230 under/or paragraph 100.4 of the CoE.

REASONS AND ANALYSIS

Audit Area 1 – Non-disclosure of factors contributing to goodwill

192. The undisputed facts and the respective parties' cases are set out in paragraphs 129 to 152 above.

The First Complaint

193. The allegations under this complaint concern the non-disclosure of factors that contributed to the cost that resulted in the recognition of goodwill of the Acquisition in the Relevant Financial Statements in the amount of HK\$ 901 million according to HKFRS 3.

194. It is undisputed that there was no disclosure of the factors attributable to the recognition of goodwill in the Relevant Financial Statements according to the “Joint Expert Schedule of Mr. Rod Sutton and Mr. Peter K.T. Wan” as pointed out by the Complainant. The Respondents also submitted in its closing submissions that the subject issue is limited wholly to an allegation that the Relevant Financial Statements did not contain an explicit statement that the goodwill was attributable to an increase in the fair value of the consideration and the anticipated profitability of the business acquired. Mr. Wan confirmed both in his expert opinions and oral evidence that a direct and clear statement of anticipated profitability of the acquired entities is missing. It is also his oral evidence that it would be difficult for the Respondents to have missed that the note 19 of the Relevant Financial Statement contains no description of the factors contributing to goodwill.

195. The Committee identified three crucial issues relevant to its determination of the subject complaint:

Issue A: What were the relevant factors undisclosed?

Issue B: Should a failure to observe, maintain or otherwise apply HKFRS 3 be judged by having regard to legal background/principles including the role and purposes of an auditor’s report, materiality/professional judgment?

Issue C: Does the omission of disclosure of the relevant factors (if any) under Issue A constitute a breach of HKFRS 3?

Issue A: What were the relevant factors undisclosed?

196. The Committee agrees with the Respondents that the starting point should be the identification of what the undisclosed factors *were* in the present case because it is apparent from the parties’ cases that this is an issue hotly in dispute and the subject complaint can be proved against the Respondents if the Complainant is able to establish that there is a breach in relation to one or

more of these factors. The identification of the actual factors undisclosed will also be of significance in the assessment of the Respondents' alleged non-compliance with HKFRS 3 for each of these factors; as to what precisely the Complainant alleges ought to have been included in the Relevant Financial Statements by way of disclosure under HKFRS 3; and what is the quality and materiality of the alleged omissions.

197. To start with, the Committee considers the Complainant's case on the composition of the goodwill of HK\$ 901 million. As set out in the undisputed analysis in the Complainant's Case in paragraph 130(8) above, the Complainant deduced the said composition by breaking down the HK\$ 901 million goodwill into two components: one being HK\$ 406 million representing the difference between the fair value of net assets acquired and issued price of CBs and Consideration Shares, and the other being HK\$ 495 million representing the change in published price of the CBs and Consideration Shares at the date of acquisition from their issued price (the "increase in fair value of the consideration").
198. It is understood from the Respondents' case that they do not dispute that the said increase in fair value of the consideration of \$ 495 million is a factor contributing to the \$ 901 million of goodwill recognized.
199. The Committee considers it abundantly clear from a purely mathematical calculation that there must exist other factor or factors (amounting to HK\$ 406 million being the difference between the fair value of net assets acquired and issued price of CBs and Consideration Shares), the nature of which are to be addressed, which have contributed to the goodwill of \$ 901 million other than the unexpected increase in fair value of the consideration of \$ 495 million.
200. Turning now to what the factor was or factors were contributing to the HK\$ 406 million component, it is apparent from the parties and their respective experts' views that they are in agreement that anticipated profitability of the business acquired is one such factor.

201. Other than the said two factors agreed by the parties so far (i.e. increase in fair value of the consideration and anticipated profitability), the Complainant asserts in its Complainant's Case that there could well have been other potential factors quoting examples like synergies, strategic expansions, access to/entry into new markets, etc. (the "other potential factors"). This point the Respondents disputed relying on Mr. Wan's evidence that he could only identify two factors contributing to the increase in goodwill that could be relevant, i.e. the increase in fair value of the consideration and anticipated profitability. He opined that the said other potential factors were not factors contributing to goodwill in connection with the Acquisition in question.
202. In their closing submissions, the Respondents criticized the way the Complainant's case on this point was put forward, namely, the Complainant has not alleged either in the Complaint Letter or in its case that there were other factors which contributed to the cost resulting in the recognition of goodwill. Mr. Wan's opinion supported this view that it was not clear from paragraph 27 of the Complainant's Case (which is identical to paragraph 134 above) whether the Complainant stated that these other potential factors were actually factors that had contributed to the recognition of goodwill.
203. Upon review of the materials referred to, the Committee considers that the way the Complainant has "pleaded" this particular allegation is not entirely clear and satisfactory from a plain reading of the said paragraph 27 of the Complainant's Case from the wordings "...*should have considered factors which could have contributed to...*" used. Nevertheless, the Complainant did clarify its case in its written closing submissions. Despite the above, the Committee considers that the Complainant's assertion on the existence of these other potential factors should not be ignored because the Complainant did make its position clear in its closing submissions and the Respondents had considered and addressed fully this allegation in their evidence and submissions and thus no prejudice whatsoever has been occasioned to the Respondents.

204. The Committee notes that both parties have referred to the Circular in their arguments for or against the existence of these other potential factors.
205. To support its assertion of the existence of the other potential factors, the Complainant submits that the following statement in the “Consideration and Payment Terms” section in the Circular with the operative word “and” together with the contents under the section headed “Reasons for and benefits of the Acquisition” clearly show that the directors of the MelcoLot took into consideration potential synergies and the advantages of entering a new market as reasons justifying the acquisition and therefore part of the reasons justifying the Directors’ belief that the consideration paid was fair and reasonable was attributed to potential synergies and the advantages of entering a new market, i.e. the other potential factors:

*“The consideration was determined with reference to (i) the industrial prospects of lottery business in the PRC; (ii) market comparables of price earnings ratios and price to book ratios of companies engaging in the similar line of business as the PAL group and WS Technology. The observed multiples are based on the prevailing market price of the comparable companies and the audited results of these comparable companies for the most recent accounting period and period end; and (iii) the Guaranteed Profit. Taking into account the matters above and the reasons **and** benefits as stated in the paragraph below headed “Reasons for and benefits of the Acquisition”, the Directors...consider the Consideration to be fair and reasonable and in the interests of the Company and the Shareholders as a whole.” [emphasis added]*

“Reasons for the Benefits for the Acquisition

The Board considers that the Acquisition is in the interests of the Company and the Shareholders for the following reasons:

a. the Acquisition builds up the Company’s portfolio of lottery-related technologies...;

b. ...allows the Company to leverage on extensive range of technologies and joint experience of PAL and WS Technology which

placed the Company in a good position to jumpstart the plans for its entry into the Asian lottery markets, particularly in the PRC;

c. ...facilitates the close collaboration between the Company, Melco, LottVision and Firich, which allow the Company to leverage on their distinctive leadership and proven experience in gaming-related business in the Asian region; and

d. ...is in line with the Company's growth strategy of acquiring strategic stakes in potential growth business, with a view to enhancing long-term value for the Shareholders."

206. Nevertheless, the Complainant has not referred to Mr. Sutton's expert evidence to support its submissions. The Committee notes the Sutton Report did not cover this point specifically in much depth. When it was put to Mr. Sutton in his cross-examination by Mr. Lam SC that synergies, etc. were not factors that contributed to goodwill and had they been, disclosures would have been made in line with the 2008 financial statements, Mr. Sutton's reply was that this became a "guessing game" and had the factors been disclosed, there would not have been a need to guess what the factors were. As suggested by the Respondents, he was unable to point to any evidence that would suggest that such other potential factors existed in this case.
207. On the other hand, Mr. Wan's expert opinion, referring to the same Circular, is that he reasonably concluded from the contents of the Circular that the Respondents did pay consideration to these other potential factors in the process of the Acquisition as "possible benefits arising from the acquisition". However, there was no quantitative description of these benefits to the Company and no appropriate additional disclosures made to reflect MelcoLot had made reference to additional factors when determining consideration nor was there further explanation on what proportion of the consideration was attributable to those factors. Therefore, it must have been MelcoLot's conclusion that these other possible factors had no direct bearing on the consideration which MelcoLot agreed to pay for the Acquisition and thus were not factors which had contributed to the goodwill.

208. The Respondents also further relied on the contents in Note 34(b) of the 2008 audited financial statements in which only the two undisputed factors were mentioned but other potential factors were not and its contrast with Note 34(a) in relation to a different acquisition which specified synergies to be a factor to draw an implication that no other factors other than the two said factors were regarded by MelcoLot and its new auditors (Deloitte) to be factors contributing to goodwill for the Acquisition because otherwise the 2008 audited financial statements would have been misleading. Mr. Wan agreed that this reason adds weight to the Respondents' view.
209. The Complainant argued that the Circular is not part of MelcoLot's Relevant Financial Statements and the contents of the Circular were never adopted in the Relevant Financial Statements. In spite of this, the Respondents submitted that it is permissible on a totality of relevant evidence basis to have regard to the 2008 audited financial statements for the purpose of proving what in fact were the actual factors even though the 2008 audited financial statements would not have been made available to the Respondents at the time of the Audit. On this point, the Committee gives little weight to the Respondents' reliance on the 2008 audited financial statements because even Mr. Wan conceded in his opinion that he is "*not proposing that the 2008 Accounts should be used as the basis for consideration of the audit issues in question.*" In this regard, the Committee agrees with the Complainant's submission that Mr. Wan's assertion that there could only be two possible factors contributing to the goodwill is not borne out clearly by the documentary evidence upon which he seemed to have placed much reliance.
210. Having duly considered the above evidence and the burden of proof being on the Complainant, the Committee is not satisfied that the Complainant has adduced sufficient evidence to establish its case in relation to the existence of the other potential factors contributing to goodwill.
211. For the above reasons, the Committee finds that there were only two relevant factors undisclosed and they were the increase in fair value of consideration and the anticipated profitability.

Issue B: Should a failure to observe, maintain or otherwise apply HKFRS 3 be judged by having regard to legal background/principles including the role and purpose of an auditor's report, materiality/professional judgment?

212. The Committee considers that this legal interpretation issue is essential to the determination of the compliance issue because the Respondents invited the Committee to pay regard to the said legal background/principles when judging the Respondents' compliance with HKFRS 3. Whether the Respondents are entitled to rely on these principles is dependent on the proper interpretation of paragraph 67(h) of HKFRS 3 having regard to its context and true purpose. The Committee takes the view that the expert evidence would not assist to any significant extent since this issue is by nature a legal issue.
213. Upon a careful reading of the wording of the paragraph 67(h) of HKFRS 3, the Committee notes an absence of any reference to any of the said principles or words to that effect. What was required to be disclosed is plainly "*a description of the factors that contributed to a cost that results in the recognition of goodwill*". In simple terms, the Committee considers that said standard requires an explanation why an acquirer was willing to pay more than the aggregate value of the net assets of the acquiree. It is trite law that words used in a statute, document or standard should be given their natural and ordinary meaning unless the context otherwise requires. The question is therefore whether the context does require implying those principles advocated by the Respondents.
214. The Committee considers that it will be absurd to disregard those principles of materiality and professional judgment in considering the disclosure requirement under paragraph 67(h) of HKFRS 3 since the consequence will be that every single factor, no matter how trivial, regardless of materiality, will have to be disclosed in the auditing work. This is simply not realistic and practical. The Committee therefore does not believe that is what paragraph 67(h) of HKFRS 3 is intended.

215. For these reasons, the Committee concludes that compliance with the said paragraph 67(h) should be judged by having regard to the legal backgrounds/principles suggested by the Respondents.

Issue C: Did the omission of disclosure of the relevant factors (if any) under Issue A constitute a breach of HKFRS 3?

216. The core areas of disagreement are the substance of the omitted disclosure of the two relevant factors and whether the Respondents' defences for non-disclosure are valid.

217. An assessment of the expert evidence is crucial for a determination of the said issues. It is obvious that the expert evidence is in direct contradiction. It is Mr. Sutton's conclusion that the Respondents had failed to apply HKFRS 3 and that would amount to a breach of CoE. On the other hand, Mr. Wan do not consider "*there is a non-compliance, in substance, with the spirit of the disclosure requirement under HKFRS 3*".

218. The disclosure of the two relevant factors will be addressed hereinbelow in turn.

219. The Complainant submitted in its closing submissions that the disclosure of the factor of increase in fair value of the consideration has not been made clear in the notes to the Relevant Financial Statements and it would have required cumbersome "detective work" of cross-referencing different notes on the part of the user of the Relevant Financial Statements in understanding this said factors leading to the substantial rise in goodwill. The notes are structured in such a manner that a reader is put through an exercise of solving a jigsaw puzzle before realizing that the rise in share price did have something to do with the increase in goodwill. Further, the purpose underlying the disclosure requirement mandated by HKFRS 3 cannot be achieved by making disclosure through embedded references and reasonable users of financial statements should not be presumed to be professionally trained accountants; they do not have to equip themselves with the skills of unfolding hidden or semi-hidden

hints embedded in different notes to the financial statements. These are in line with the overall conclusion of Mr. Sutton after his review of the relevant notes of the Relevant Financial Statements that “*no explanation was included in the Relevant Financial Statements to enable the users to understand why MelcotLot had apparently paid HK\$ 901 million over the stated current market value for the assets that it had purchased only 18 days prior to year-end*”. Mr. Sutton also opined that although the numerical change in fair value of the consideration (in the amount of HK\$ 495 million) was disclosed in the Relevant Financial Statements, it was not explained that this was brought about by the difference between the prices of HK\$ 0.85 and HK\$ 2.41 per share and without an explicit disclosure, he queried how users were expected to understand the causation behind the adjustment. He is of the view that most users would not naturally have associated this material shift in the fair value of the consideration as being the primary, consequential, reason for the generation of goodwill.

220. The Respondents’ defence is that the existing disclosure was sufficient and the substance of the complaint of non-disclosure of this factor is about presentation only. The information about this factor is apparent and readily ascertainable by a reasonable user of the financial statements from the reading of several relevant notes as well as the Relevant Financial Statements as a whole together with reasonable diligence and it would indeed be an “inescapable” conclusion. This argument is supported by Mr. Wan who opined that it can be established from the disclosures made in relation to the Acquisition in the Relevant Financial Statements that a substantial portion of the goodwill is attributable to the increase of the fair value of the consideration.
221. Further, the Respondents submitted that HKFRS 3 does not dictate how the factors are to be shown. It is also not the role of an auditor to “beautify” or “re-write” the Relevant Financial Statements. Mr. Wan opined that the presentation of information in financial statements is the responsibility of the directors and management but not the auditors.

222. In order to form its view on the sufficiency of the existing disclosure presentation, the Committee looks closely at the Respondents' demonstration through its reference to the specific information revealed from the notes in the Relevant Financial Statements as follows:

- (1) "goodwill arising on an acquisition of a business or jointly controlled entity represents the excess of the cost of acquisition over the Group's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of the relevant subsidiary at the date of acquisition" (from Note 3(g));
- (2) The Company acquired PAL and Oasis for a consideration of approximately HK\$ 1.163 billion during FY 2007 (from Notes 19(a), 34, 35 and 39);
- (3) The Company incurred a goodwill of approximately HK\$ 901 million from the acquisition (from Notes 19(a) and 39);
- (4) Goodwill was allocated to the lottery management business (from Note 19(b));
- (5) The NAV on acquisition of PAL and Oasis recognized was approximately HK\$ 262 million (from Note 39);
- (6) The goodwill figure of HK\$ 901 million was calculated by deducting the consideration of HK\$ 1.163 billion from the NAV on acquisition of HK\$ 262 million (from Note 39);
- (7) The total consideration for the acquisition was made up of convertible bonds and issued shares (from Note 39); and
- (8) There was a substantial increase in the fair value of convertible bonds and issued shares in the amount of HK\$ 383 million (for convertible bonds) and HK\$ 112 million (shares) (from Notes 34, 35 and 39).

223. It is observed that the said specific notes referred to by the Respondents, as a matter of fact, should not cause any dispute because they are mostly in line with the information contained in the various notes as mentioned in the undisputed facts set out in paragraph 130 above. In addition, the Committee notes that it is sufficiently clear from point (8) of paragraph 222 above that the total increase in fair value of consideration of both the CBs and Consideration

Shares shall be a summation of the said HK\$ 383 million and HK\$ 112 million which equals to HK\$ 495 million.

224. Mr. Wan's expert opinion stressed that despite the lack of the direct statement showing the factors were due to the anticipated profitability of the acquired business (which shall be addressed later) and an unexpected increase in fair value consideration, the Relevant Financial Statements have already included the fundamental information relating to the Acquisition which would have enabled users of the Relevant Financial Statements, generally expected to possess a reasonable accounting knowledge and ability of interpreting financial statements, to evaluate the nature and financial effect of the business combination and conclude that the combination transaction was a significant one which would have changed substantially the existing model and profit trend of MelcoLot. Mr. Sutton disagreed with this view and stressed that he does not consider that the average user, even one with "*reasonable knowledge of business and economic activities*" would have, as easily, been able to draw the same conclusions.
225. The Respondents referred to paragraph 25 of the "Framework for Preparation and Presentation of Financial Statements" which states that users of financial statement are "*assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence*".
226. The Committee acknowledges that there is an inherent limitation on the difficulty to define "users of financial statements" as highlighted by Mr. Wan when he remarked that there is no definition of an experienced or average user of financial statements in the accounting profession and it is simply "*impracticable*" to draw a line to distinguish who is a user with "*reasonable knowledge and economic activities*".
227. After due consideration of the above submissions and evidence, the Committee prefers Mr. Wan's opinion and is of the view that it is more likely than not that the existing presentation of information in the notes to the

Relevant Financial Statement is sufficiently clear, despite having made across several places in the notes to the Relevant Financial Statements rather than in one place, to enable a reasonable user of financial statements to ascertain the factor of increase in fair value of consideration that amounts to HK\$ 495 million as demonstrated by the Respondents in paragraph 222 above. Specifically, the Committee disagrees with Mr. Sutton's opinion to the effect that the HK\$ 495 million change in fair value, despite being stated, would not allow users to understand that it was a factor that contributed to HK\$ 901 million of goodwill. The Committee is of the view that it is more likely than not that a user can derive from points (6), (7) and (8) in paragraph 222 above that an increase of CBs and Consideration Shares of HK\$ 495 million was a component of the total consideration of HK\$ 1.163 billion. Therefore, since the goodwill of HK\$ 901 million was calculated by deducting HK\$ 1.163 billion from the NAV of HK\$ 262 million, it would have been natural for readers to understand that the increase in fair value of HK\$ 495 million would have been a component of goodwill.

228. Moreover, the Committee accepts the Respondents' contention that HKFRS 3 does not dictate how the factors are to be shown or presented by referring to the wordings of this standard and therefore if the Respondents can prove, which it did, that the existing presentation of information allows users to arrive at the same conclusion as it would otherwise have should there be an explicit and direct statement of the factor, they should not be criticized to have breached HKFRS 3 because the extent of detail such disclosure required is not clearly set out by HKFRS 3.
229. Despite having drawn such a conclusion as stated above, the Committee wishes to comment at this juncture on the point raised by the Respondents about the role of auditors. Even though the Committee does not disagree with the general proposition that preparation of the financial statements are the responsibility of directors and management, it cannot endorse the Respondents and Mr. Wan's view that presentation of information in financial statements is not the responsibility of the auditors. The Committee considers this to be a misconceived argument because if an auditor discovers certain errors or non-

compliance with accounting standards during its Audit of the financial statements, it should be an essential and non-delegable responsibility of the auditor to carry out appropriate audit procedures to address such problem. The proposition of the Respondents that an auditor's function is not to re-write the accounts to a more user-friendly manner cannot stand to be a valid justification of any failure of the non-compliance of the Relevant Standards by the auditor.

230. Having addressed the factor on increase in fair value of consideration as above, the Committee now turns to the disclosure of the other undisputed factor of anticipated profitability.
231. The Committee finds that a fair numerical quantification of this factor, from a pure mathematical point of view, would be the amount of HK\$ 406 million, since it is the only agreed factor that contributed to the goodwill of HK\$ 901 million other than the factor of increase in fair value of consideration of HK\$ 495 million as discussed above. In this case, HK\$ 406 million and HK\$ 495 million would respectively account for approximately 45% and 55% of the total goodwill of HK\$ 901 million. The two proportions can reasonably be said to be fairly comparable.
232. The Respondents has advanced various arguments to defend their case and they will be addressed in turn as follows.
233. The Respondents' general defence on the sufficiency of existing disclosures based on existing information already presented in the Relevant Financial Statements as discussed above applies to this factor of anticipated profitability as well. Mr. Wan's evidence is in support of this proposition in general. It is his view that the information in the various notes to the financial statements he referred to would have enabled users of the Relevant Financial Statements to have an understanding of the nature of the Acquisition, how the Goodwill arose and how the amount of its subsequent impairment was determined. Mr. Sutton gave an opposite view in general.

234. Upon reviewing the notes to the Relevant Financial Statements referred to, the Committee does not find the Respondent's submission nor Mr. Wan's opinion convincing and rejects the Respondent's case that the factor of anticipated profitability can be readily understood by the users from the existing information in the Relevant Financial Statements. Neither the Respondents nor Mr. Wan have pointed the Committee to specific note(s) and/or wordings in the Relevant Financial Statements to substantiate their assertion on the sufficiency of disclosure of this factor from the existing information in the Relevant Financial Statements. The Committee therefore proceeds to consider the other arguments presented by the Respondents.
235. The Respondents advanced an argument that not all published financial statements carrying a goodwill in the balance sheet made disclosure of the factor of anticipated profitability even though the amount of goodwill recognized in the financial statements was of a significant amount and the non-disclosure was accepted by their auditor and therefore the non-disclosure is a common practice in the auditing profession. The Respondents quoted examples of a number of Hong Kong listed companies' financial statements as mentioned in paragraph 147 above. Whilst confirming that no goodwill disclosure was made by these companies, Mr. Sutton, upon review of 5 of these companies' annual reports, stood by his opinion in relation to the Respondents' omission of the disclosure of the factors behind goodwill. He is of the view that none of the reviewed companies is comparable to MelcoLot in terms of the significance or substance of the acquisition in relation to the underlying company and that other's behaviour does not excuse one's own. On the other hand, while endorsing the said proposition by the Respondents in general and suggesting that the Respondents' view that anticipated profitability was generally understood to be a component of goodwill was probably shared by some of its peer accounting firms, Mr. Wan in cross-examination admitted that he had not reviewed the audit work papers and thus was unable to know whether the auditors of those quoted companies actually has documented in the respective work papers the reasons for non-disclosure and/or discussion with management of the companies as to why disclosures were not made as required by HKFRS 3.

236. The Committee finds that the mere fact that these quoted companies made no disclosure on the factors contributing to goodwill in their financial statements and annual reports without qualification to their auditors' report cannot support the Respondents' case. As rightly admitted by both experts, there was no chance to review the audit working papers of these companies. The Committee accepts that it is equally plausible, as suggested by Mr. Choy, that the non-disclosure could be based upon audit evidence and/or discussion with management being documented in the respective companies' audit paper giving proper explanation on the non-disclosure. Even if that was not the case, the Committee considers that these peer accounting firms' potentially wrong or inadequate practice that went undetected could not be rightful justification for the alleged omissions of the Respondents. The Committee simply has no sufficient material before it to judge on the other companies' cases. In fact, the Committee also agrees with Mr. Wan's fair suggestion that it could also be the case that the auditor had come to the conclusion that the impact of the non-disclosure did not adversely affect the true and fair view of the financial statements after forming a professional judgment during the course of assessing the impact of the non-disclosure on the financial statements they reported on.
237. The Committee finds that all the said observations can only at best be possibilities or speculations and are insufficient to support a reasonable conclusion as asserted by the Respondents that there was "*a widely held body of reputable professional opinion that the inclusion of an explicit statement as to anticipated profitability was not necessary*" without further supporting evidence. The Committee considers that the quoted examples of other companies' cases are irrelevant to a determination of the subject complaint as the basis of these listed companies' audit opinions were simply not known. Further, the Committee agrees with Mr. Sutton's view on this issue that the application of standards is not dictated by any alleged market practice and to suggest that it was excusable just because others were doing it is no valid defence even though the practice might be "*significant and widespread*" as suggested by the Respondents. In the Committee's view there must be

objective yardstick to decide if the relevant standards are complied with. In other words, if a lot of auditors commit mistakes it does not mean that their mistakes would become the norm to alleviate them from breach of the relevant standards.

238. Further, the Respondents advanced an argument to justify its omitted disclosure on the factor of anticipated profitability to the effect that there is an understanding that most acquisitions are bought with the expectation of being profitable all the more so where it pays a premium over the net asset value is so self-evident and wide-spread and when this happens, the excess sum paid can be taken to account for the anticipated profitability. The Committee is not persuaded by this argument. It is inconceivable that anticipated profitability can be assumed to be a factor by default in the general sense. It is a matter of common sense that business combinations in the business world today can take place for a variety of reasons. As rightly pointed out by Mr. Sutton, *“there is no requirement for the acquisition to be profitable”* and *“[t]here are many and varied reasons why a company makes an acquisitions including synergies, strategic expansions, access to markets, excess cash, or to obtain assets from a bankruptcy, to mention by a few”*. In any case, such submissions of the Respondents were not even endorsed by Mr. Wan who remarked that *“CCIF’s view that anticipated profitability was generally understood to be a component of goodwill was probably shared by some of its peer accounting firms at a time”* is inconclusive expert evidence to support the Respondents’ argument either. For a similar reason, the Respondents’ argument that there is recognition of goodwill in the Relevant Financial Statements at the year-end after provided for impairment loss would suggest that it is supported by future cash flow and so reflected the anticipated profitability of the cash generating units and therefore management anticipated profitability cannot be a valid argument. Such inference is drawn without any proper evidential basis.
239. Another submissions of the Respondents on the adequacy of existing disclosure relate to users of financial statements. This argument was addressed previously in the discussion of the factor of increase in fair value of consideration as above in paragraphs 224 to 228. The respective expert

opinions also apply to the factor of anticipated profitability which the Committee has taken into consideration here in its assessment of the omission disclosure of the factor of anticipated profitability.

240. Having conceded the lack of a direct and explicit statement on the factor of anticipated profitability, the Respondents' contention is supported by Mr. Wan's view that the omission "*is not a deficiency in terms of disclosure such that the true and fair view of the Relevant Financial Statements would have been adversely affected*". Although the Committee notes that there is no expert evidence from Mr. Sutton that directly addressed the said opinion of Mr. Wan, the Committee is of the view that the subject matter of the breach is not about failure to present a true and fair view of the Relevant Financial Statements, but rather, on a breach of omission of disclosure of factors under HKFRS 3 specifically. Therefore, the Committee takes the view that the Respondents' submission on how the deficiency of disclosure could not have impacted on the true and fair view of the Relevant Financial Statements cannot excuse the Respondents' obligations to comply with HKFRS 3.
241. As to the point raised by the Respondents about the role of auditors, the Committee adopts the same view as stated in paragraph 229 above in relation to the disclosure of factor of anticipated profitability which will not be repeated again.
242. Further, the principles of materiality and professional judgment were also raised as by the Respondents as relevant considerations that should be taken into account when considering the issue of omitted disclosure. Mr. Wan's view is that anticipated profitability need not be disclosed because it was not considered to be a material factor. This is consistent with Mr. Wan's answer in cross-examination that although he agreed that the Relevant Financial Statements was "*not in full compliance*" with HKFRS 3, he referred to HKAS 31 [sic HKAS 1 – "Presentation of Financial Statements" (issued December 2007), paragraph 31] which says that non-disclosure is not an issue if the information is not material:

“31. Applying the concept of materiality means that a specific disclosure requirement in a Standard or an Interpretation need not be satisfied if the information is not material.”

243. On the other hand, Mr. Sutton is of the opinion that all disclosure relating to the Acquisition should have been treated as materially important because the Acquisition was a material transaction and a fundamental change of business model that was highly relevant to the Relevant Financial Statement.
244. Mr. Wan disagreed with Mr. Sutton in that professional judgment need to be exercised when omission in disclosure is identified in assessing the significance of the omission to the true and fair view of the Relevant Financial Statements as a whole. This supported the Respondents assertion that it had formed the view as a matter of professional judgment that further disclosure in the Relevant Financial Statement was not necessary in all the circumstances and there was no issue in terms of compliance with HKFRS 3.
245. In view of the conflicting views of the experts, the Committee considers that it important to form its view on whether the disclosure of anticipated profitability is or is not material based on the parties’ submissions and evidence and whether professional judgment should come into play.
246. First of all, it is important to point out that it appears to be an undisputed view shared by Mr. Wan and Mr. Sutton that goodwill was a significant item and, as such, it was important that users be able to understand how this value arose and it was equally important that the components of that goodwill should be disclosed given the significant amounts involved.
247. The parties are not in dispute of the fact that the Acquisition is a substantial one. Mr. Sutton’s opinion is that the Acquisition was *“a fundamental change in the underlying business model and an expansion into a new industry stream for MelcoLot. The size of the Acquisition had the effect of increasing MelcoLot’s net assets ten-fold, was material by any definition, and had the greatest impact on the Relevant Financial Statement”*.

248. The Committee agrees that the significance and materiality of goodwill and the Acquisition itself in the Relevant Financial Statements can be readily discerned from the figures shown in the undisputed fact as stated in paragraph 130 above.
249. For the reason that the Acquisition is a substantial one, Mr. Sutton opines further that all disclosures relating to it should have been treated as materially important as pointed out previously. It is on this point that Mr. Wan disagreed with Mr. Sutton. Mr. Wan viewed that it does not follow that any and all disclosures relating to the Acquisition must necessarily be regarded as material.
250. On this issue, the Committee accepts the Complainant's argument for the following reasons.
251. Other than the undisputed prominent role goodwill plays in the Relevant Financial Statements, the Committee considers that the numerical value of the factor of anticipated profitability is of substantial value in the amount of approximately HK\$ 406 million which accounted for 45% portion of the value of the goodwill and this HK\$ 406 million is of comparable portion to the factor of increase in fair value of consideration of amount HK\$ 495 million (i.e. 55%) as mentioned in paragraph 231. Given this significance in terms of numerical value and portion, one would logically infer that the disclosure of the factor of anticipated profitability would have been as significant as the disclosure of the factor of increase in fair value of consideration unless there are good reasons to prove otherwise, especially when there are explicit requirements in the accounting standards (i.e. paragraph 66(a) and 67(h) of HKFRS 3) specifically requiring disclosure of these factors. The Committee is of the view that the Respondents have not provided sufficient reasons, other than the exercise of professional judgment, to have caused the Committee to depart from this common sense and logical view.
252. Given the significance of the goodwill and the Acquisition, the Committee also considers that it is logical to expect that the disclosure of factors

explaining the components of these significant amounts will be material to users of the Relevant Financial Statements. As referred to by Mr. Sutton in his expert opinion, paragraph 30 of the Framework for the Preparation and Presentation of Financial Statements states that *“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statement...”*. His view is that there was a material omission of the factor of anticipated profitability that had the potential to impact the decision making process of a user of the Relevant Financial Statements. This supports the Complainant’s submission that any reasonable user of the Relevant Financial Statement would want to know what accounted for this increase of goodwill and the disclosure of factors that contributed to the recognition of goodwill is crucial to enabling users of the Relevant Financial Statements to understand the financial impact of the Acquisition. With the above evidence and submissions, the Committee agrees.

253. The significant influence the disclosure of factors of goodwill will have on the users of the Relevant Financial Statements adds weight to support the Complainant’s argument that the disclosure was material and necessary.
254. For reasons given above, it is the Committee’s conclusion that the disclosure of the factor of anticipated profitability is material and necessary. Having formed this view, the Committee agrees with the Complainant’s view that paragraph 31 of HKAS 1 has no relevance because the factors contributing to goodwill are plainly material.
255. Nevertheless, this is not the end of the matter because the Respondents’ exercise of professional judgment has to be dealt with.
256. In relation to this argument on professional judgment, the Committee accepts the Respondents’ view that an auditor’s professional judgment is relevant since, as rightly pointed out by the Respondents, there is no definition as to what “disclosure” means or as to what constitutes “enough” or “sufficient” disclosure in HKFRS 3 and therefore the decision about “what is enough” is a matter of professional judgment.

257. Nevertheless, the Committee does not find Mr. Sutton’s opinion entirely wrong or contradictory when he said that the requirements to conform with the HKFRS and HKAS is not a choice nor is it optional, nor do they serve as an illustration of best practice and, as such, no professional judgment is necessary because if one is to interpret the assertion to mean that the necessity or obligation of an auditor to conform with these said standards are not optional from a “compliance” point of view. The Committee is of the view that professional judgment comes into play at the execution or application of the standards when the requirements as to compliance are not defined in detail. The Committee agrees with Mr. Sutton’s remarks made in his opinion that “*I acknowledge that the Hong Kong accounting standards...are principle based and so often allow for the exercise of professional judgment in their application*”.
258. Having stated its view on the principle of professional judgment and its preliminary conclusion formed on the materiality of the disclosure of the factor of anticipated profitability, the Committee finds that the Respondents had simply exercised their professional judgment clearly wrongly on unsound basis when it concluded that the disclosure of the factor of anticipated profitability was immaterial and therefore no disclosure was required. The factor should have been disclosed, as required by HKFRS 3, whether in a separate and explicit statement or in other forms. The Committee considers that the professional judgment erroneously made by the Respondents in the Audit cannot constitute a valid defence or justification for non-compliance with HKFRS 3.
259. After due consideration of the above, the Committee concludes that the factor of anticipated profitability was not disclosed in the Relevant Financial Statements as required under HKFRS 3 and the Respondents were thus in breach of the said standard.
260. As for the Complainant’s allegation on the Respondents’ breach of HKSA 701 and HKAS 260, the said breach is not supported by Mr. Sutton’s expert

opinion because Mr. Sutton is not able to definitively ascertain from the documentation provided to him whether the Respondents were not aware of the inadequate disclosure at the time of the Audit or they were aware but did not document their rationale for deciding that no further disclosure was necessary. He was not able to tell what the Respondents would have done, had they been aware of the non-disclosure at the time of the Audit, such as discussions with MelcoLot's management. It is also Mr. Wan's opinion that he does not consider there is a non-compliance with the requirements of HKSA 700 "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements" which gives guidance on how to modify an audit report if the auditor feels that that is necessary. For these reasons, the Committee considers this allegation has not been established against the Respondents.

The Second Complaint

261. Having found that the First Complaint is proved to the extent as stated above against the Respondents, the Committee shall not deal with the Second Complaint being an alternative charge to the First Complaint.

Conclusion on Audit Area 1

262. For reasons given above, the Committee finds that the First Complaint has been proved against the Respondents to the extent as stated above and the Second Complaint is dismissed accordingly.

Audit Area 2 – Non-recognition of deferred tax liabilities

263. The undisputed facts and the respective parties' cases are set out in paragraphs 153 to 171.

The First Complaint

264. There are two important undisputed factual basis of the subject complaint, namely, first of all, the Respondents assessed DTL to be HK\$ 6.3 million (approximately HK\$ 6 million) in their Audit, and secondly, no DTL arising

out of the fair value adjustment was recognized in the Relevant Financial Statements and no related reference was made in the supporting notes.

265. The following issues are considered by the Committee in respect of the subject complaint:

Issue A: Was there a miscalculation of DTL?

Issue B: Should a failure to observe, maintain or otherwise apply HKAS 12 be considered having regard to legal background/principles including the role and purposes of an auditor's report, materiality/professional judgment?

Issue C: Was the correctness of the amount of DTL material?

Issue A: Was there a miscalculation of DTL?

266. To address the First Complaint and the related allegation related to non-compliance of HKAS 12 due to non-recognition of DTL, the Committee considers it necessary to determine the amount of DTL that should have been recognized and decide whether there was a miscalculation of DTL by the Respondents according to HKAS 12. As reflected by the respective parties' expert evidence, the Committee notes that an appropriate calculation of DTL in compliance with HKAS 12 should have resulted in the correct amount for DTL being a sum larger than the said HK\$ 6 million.
267. In this regard, both parties and their respective experts have given detail submissions in their cases and expert evidence in relation to the calculation method of DTL mainly in relation to allocation of centralized costs and common expenses, treatment of tax losses brought forward, and the appropriate tax rates to apply as stated in paragraph 156 and 162 above.
268. However, notwithstanding the said disputes, both parties have supplied alternative figures/calculations for DTL at various stages of the Proceedings as referred to in paragraph 164.

269. It is Mr. Sutton’s opinion that the amount of DTL that should have been recognized in accordance with HKAS 12 is HK\$ 24 million whilst Mr. Wan accepted the Respondents’ calculation of HK\$ 23 million (as the impact of HK\$ 1 million difference from his own calculation of DTL at HK\$ 24 million was considered insignificant). Mr. Wan also confirmed in cross-examination that he believed his calculations are in accordance with HKAS 12.
270. Based upon the parties experts evidence and as pointed out by the Complainant in their closing submissions, the Committee accepts that the “*deferred tax liabilities of HK\$ 6.3 million (which should have been HK\$ 23/24 million) was a miscalculation*”. The said quote was extracted by the Complainant from the “*Chart Summary of Peter Wan’s Report v RJS’s Report*” prepared by the experts (which is the same document as the “Joint Expert Schedule of Mr. Rod Sutton and Mr. Peter K.T. Wan” mentioned in paragraph 13).
271. However, as rightly pointed out by the Complainant, Mr. Wan took a more “*ambivalent view*” during cross-examination and it was only until then that he said he was unable to say whether the Respondents were correct or incorrect in arriving at the HK\$ 6.3 million as the final figure because he does not have sufficient knowledge about the PRC regulations.
272. Despite giving such oral testimony when he himself calculated DTL to be in the region of HK\$ 24 million, the Committee notes that Mr. Wan did in fact stated clearly in his opinions that he did not accept HK\$ 6 million: “*It would be imprudent for me to accept that the amount of deferred tax liabilities was HK\$6,335,000 as at 31 December 2007 just based on existing information on hand.*”. In the absence of sufficient knowledge of PRC regulations, Mr. Wan did in fact “*conservatively*”, as submitted, calculated the DTL to be of HK\$ 24 million.
273. In view of the above, the Committee considers that there is more than sufficient basis to conclude that the Respondents did in fact miscalculate DTL and the correct amount should be in the range of HK\$ 23/24 million.

274. Therefore, prima facie, the Committee considers that the Respondents have failed to properly apply §19 and 66 of HKAS 12.
275. By reason of the above conclusion and the circumstances, the Committee considers it not necessary to analyze and resolve the parties' dispute on the issue of the calculation method of DTL as mentioned in paragraph 267 above, save for and except to mention the following. The Respondents criticized Mr. Sutton for having referred to the wrong provision in his Sutton Report, namely, s.19 of the Inland Revenue Ordinance (Cap. 112) instead of s.19C which he only confirmed to be the "correct" provision to use instead upon being queried by Mr. Choy in re-examination. The Respondents submitted that Mr. Sutton is in no position to criticize the Respondents as to their calculation of tax losses given his own carelessness. The Committee considers such "*carelessness*" on the part of Mr. Sutton to have quoted an incorrect section number to be a minor mistake with minimal impact on his opinions generally as the error had not affected the substantive mathematical calculations in question and hence does not affect the Committee's judgment on the reliability of Mr. Sutton's expert evidence in general.
276. Relying upon the conclusion that there was a miscalculation of DTL by the Respondents, the Committee rejects the Respondents' primary case that their calculation of DTL was reasonable and that they had complied with HKAS 12. As rightly submitted by the Complainant, the Respondents calculation of HK\$ 6 million represents an understatement of more than 70% of the DTL when it is compared with Mr. Wan's or Mr. Sutton's calculation of HK\$ 23/24 millions. The Committee considers that it is not a "*reasonable*" calculation and the Respondents had failed to comply with HKAS 12 when it conducted audit work with regard to MelcoLot's DTL, subject to the other issues B and C.
277. The Committee now turns to consider the Respondents' alternative defence, the crux of which is that any errors in the calculation of DTL were not material and would have had no material effect on the Relevant Financial Statements.

Issue B: Should a failure to observe, maintain or otherwise apply HKAS 12 be considered having regard to legal background/principles including the role of auditors/purposes of audit reports, materiality and professional judgment?

278. The Committee adopts the same approach and conclusions as it did under Issue B in the Audit Area 1 for this legal interpretation issue. Therefore, it is the Committee's view that whether the Respondents are entitled or allowed, to rely on the said principles to defend their case should, depend on the proper interpretation of the wording of paragraphs 19 and 66 of HKAS 12 (full extracts having been set out in paragraph 107) having regard to its context and purpose.
279. The Committee adopts the reasoning in paragraphs 212 and 213 herein in relation to the said paragraph 19 and 66 of HKAS12.
280. Again, the Committee considers that it will be absurd if one is to construe that the principles of materiality and professional judgment should be disregarded in interpreting paragraphs 19 and 66 of HKAS 12 since the consequence will be that no matter how trivial the deferred tax liability is, strict compliance of the said paragraph is necessary. This is against common sense and practical point of view and the Committee does not consider that is what HKAS 12 intends.
281. For these reasons, the Committee is therefore of the view that compliance of paragraphs 19 and 66 of HKAS12 should be considered having regard to the legal background/principles as put forward by the Respondents.

Issue C: Was the correctness of the amount of DTL material?

282. Having concluded that the Committee should have regard to the principle of materiality when deciding if the Respondents failed to comply with HKAS 12, the Committee now evaluates whether the non-recognition or the correct amount of DTL of HK\$ 23/24 million is material such that the Respondents

should be held to have breached HKAS 12. The expert evidence in this respect is in direct contradiction.

283. The Respondents' argument is that since the amount of DTL in the Relevant Financial Statement is immaterial, there is no breach of HKAS 12. Mr. Wan's view is that *"[b]ased on the conclusion that the effect of the deferred tax liabilities on the Relevant Financial Statement was immaterial, I do not consider there is any case of non-compliance with paragraphs 19 and 66 of HKAS 12."* He also quoted paragraph 31 of HKAS 1 which states that *"Applying the concept of materiality means that a specific disclosure requirement in a Standard or an Interpretation need not be satisfied if the information is not material."*
284. The Complainant's stance is that the miscalculation is patently material: the correct figure of HK\$ 23/24 million is approximately four times the amount the Respondents arrived at (i.e. HK\$ 6 million). Mr. Sutton's view is: *"Regardless of the amount of deferred tax liability, I concur with the AIB's view that the failure to recognize the deferred tax liability constituted non-compliance with HKAS 12- "Income Taxes" in the Relevant Financial Statements"*.
285. As to how an assessment of materiality of the amount should be conducted, it appears to be a common view shared by the parties and their respective experts in this audit area that the size (quantitative factor) and nature (qualitative factor) of omissions or misstatements, or a combination of both, could be the determinative factor of materiality and that omissions and misstatements are material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. It is understood that such views were drawn from various professional standards including paragraph 11 of the HKAS 1, paragraph 2 of the International Standard on Auditing 320 – "Materiality in Planning and Performing Audit", paragraph 8 of HKAS 8 – "Accounting Policies, Changes in Accounting Estimates and Errors" and paragraphs 5 and 8 of HKSA 320 – "Audit Materiality".

286. The Committee therefore adopts this agreed approach required by the professional standards that materiality is ordinarily assessed both quantitatively and qualitatively.
287. Financial effect on the Relevant Financial Statements was raised as a contributing factor. Mr. Wan has tabulated an analysis of the financial effects (in effect, percentage change) on the Relevant Financial Statements if the amount of DTL of HK\$ 23 million was recognized with reference to a number of conventional base amounts including goodwill (before and after impairment), net assets, total assets, total liabilities, DTL, impairment loss on goodwill, and the loss for the year. The result showed that the financial effects were all below the 5% rule of thumb benchmark for tolerance for errors or misstatements in a set of financial statements generally applied in the profession except for the base amount of DTL itself which has a percentage increase from nil to 100%. The Committee agrees with the Respondents that such 100% change is irrelevant because the recognition of any provision or amount not previously recognized would constitute a 100% increase even if the recognized amount is HK\$ 1. The Respondents' view was that the 5% rule of thumb is commonly applied by auditors in assessing the materiality of a particular item. If an item is 5% or below, it is generally regarded as not material. Even if an item exceeds 5%, if it falls below 10%, it may still be regarded as immaterial as a matter of professional judgment according to extracts from textbooks the Respondents referred to.
288. Mr. Wan stated further that had the DTL been HK\$ 23 million, not adjusting it would not have caused a significant distortion in the understanding of the Acquisition, the financial performance and financial position of the Group.
289. Mr. Sutton, on the other hand, also carried out a financial effect assessment with a similar approach on the materiality of the omission of DTL (based on an amount of HK\$ 24 million) with fair value of net identifiable assets acquired both before and after adjusting for minority interests selected as the base amounts. The result showed that the percentage change in the two base

amounts if DTL had been recognized exceeded the five percent rule of thumb benchmark (7.06% and 6.41% respectively). His view is that DTL of HK\$ 24 million was material in terms of both size and nature.

290. Mr. Wan accepted that Mr. Sutton's said assessment is another way to present the impact of the non-recognition, and nevertheless added that, between 5 – 10 % benchmark, the auditor will have to make a judgment call.
291. When Mr. Sutton was cross-examined as to what should and should not be the base amount to be used to assess materiality, it was put to Mr. Sutton by Mr. Lam SC that he chose an unusual base amount to suit his own purpose so as to end up with a percentage change higher than the 5% of the rule of thumb benchmark. Mr. Sutton in his answer firmly disagreed to such proposition, though he conceded that he had used such base amounts in an unusual calculation to cater for these unusual circumstances because the Acquisitions have so fundamentally and dramatically changed the nature of MelcoLot's business.
292. The Committee is of the view that the Respondents' "*natural inference*" drawn in their closing submissions that Mr. Sutton had chosen a base amount that would yield a percentage over 5% to suit his own purposes, which is a very serious allegation, is without basis. The Committee accepts Mr. Sutton's explanation as stated above and he gave his honest opinion in this regard as best as he could. For this reason, the Committee is of the view that it should give no weight to the Respondents' challenge on this point.
293. The Committee also notes the benchmark of "total liabilities of HK\$ 549 million" used by AIB in its assessment of the percentage of DTL of HK\$ 34 million and the DTL of \$ 24 million would be of 4.37% of this benchmark as the Respondents submitted.
294. The Committee acknowledges that there can be a great number of ways to assess the financial effects using the percentage of DTL out of a financial benchmark because that depends on which benchmark or benchmarks are

chosen as the base amount. Nevertheless, it is of the view that the financial effect of HK\$ 24 million and its difference from \$6 million, is clearly of considerable significance, having regard to the absolute figures themselves and their impact of financial effects. From the various ways to assess financial effects, it cannot be said that such difference and the figure of HK\$ 24 million is not material.

295. The principle of professional judgment also arose as a factor to be considered. The Respondents submitted that materiality levels are not figures set in stone and the materiality of individual items will still have to be assessed by the auditor when the occasion arises and he referred to §11 of HKSA 701 which states that:

“an auditor may not be able to express an unqualified opinion when either of the following circumstances exist and, in the auditor’s judgment, the effect of the matter is or may be material to the financial statements:

- (a) There is a limitation on the scope of the auditor’s work; or*
- (b) There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.” (emphasis added)*

296. The Committee considers that the above standard does not have direct relevance to the argument here because the concept of materiality was discussed in the context of auditor’s judgment of materiality when expressing audit opinions. Despite Mr. Wan’s opinion that *“the non-recognition of the amount of deferred tax liabilities would not have resulted in a qualified audit opinion being issued”*, the Committee notes that his said opinion was made subject to his expectation *“to see a proper documentation in CCIF’s audit file of the discussion and the basis of accepting the non-recognition on ground of materiality and that the final overall materiality be re-visited and amended to a more appropriate level”*. Therefore, the Committee considers that his said opinion on the qualification of audit opinion based on a hypothetical event cannot support the Respondents’ *“immaterial”* argument. The Committee agrees with Mr. Sutton’s opinion that he is unable to agree with AIB’s view

that the Respondents should have expressed qualified opinions because the Respondents were simply not aware of the miscalculation they have made.

297. It is noted that another line of reasoning the Respondents relied on to support its pleaded case of the non-recognition of DTL not constituting “*material errors*” is that the HK\$ 23/24 million which should have been recognized would not have exceeded the audit materiality threshold of HK\$ 12 million because had they noted this extent of non-recognition (i.e. HK\$ 23/24 million) before signing-off their audit opinion, they would have re-assessed the materiality threshold they set for the Audit and, having done this, they would have adjusted upwards the materiality level to a new threshold to HK\$ 28 million (being 5% of the total liabilities of the Group of HK\$ 549 million) from the original level set at HK\$ 12 million and the non-recognition of HK\$ 23/24 million would have not been material and would not have resulted in a qualified opinion as it falls below HK\$ 28 million.
298. The Respondents’ assertion that it is normal audit practice that the final overall materiality would need to be re-visited and possibly amended to a more appropriate level if a possible misstatement above initial planning materiality is supported by Mr. Wan’s written opinions when he stated that “*I would not consider it inappropriate for CCIF not to insist making the adjustment for the HK\$ 23 million...I would expect to see...that the final overall materiality be re-visited and amended to a more appropriate level*”. In this respect, Mr. Sutton held a different view in that he opined that it is not reasonable to revise materiality before taking up adjustments because a revision to audit materiality level is ordinarily taken after the audit adjustments. The Respondents commented that Mr. Sutton had no audit experience to support his assertion. Having considered the above evidence, the Committee is of the view that such challenge on the qualification of Mr. Sutton is unsubstantiated and reiterated that it would not base any preference on the evidence of the experts over the other merely because one has more audit experience than the other as addressed previously; the main consideration is the logic and soundness of the expert’s evidence.

299. It is to be noted that the said Respondents' intended revision of the materiality threshold to HK\$ 28 million had they come to the conclusion that the amount of unrecognized DTL was HK\$23 million was an "*instructions*" given to Mr. Wan and the circumstances under which they were given to Mr. Wan was documented in his expert report. The Committee bears in mind that the Respondents have not given any evidence in the Proceedings. In such circumstances, without the benefit of the logic and reason as to the said instructions which formed the basis of Mr. Wan's opinion, there is little merit in Mr. Wan's view.
300. The Committee finds considerable force in the Complainant's outright objection to this line of argument by the Respondents on the basis that it is very difficult, if not impossible, to evaluate the validity of an argument premised on a counterfactual (i.e. the Respondents would not have known the fact that the properly calculated DTL (i.e. \$23/24 million) would have breached the materiality level it had set for the Audit (i.e. \$12 million)) as the premise does not describe an actual state of affairs. In effect, the Respondents is inviting the Committee to make a finding as to what would or might have happened if the premise were true.
301. The Respondents asserted that the "*what would have happened*" would be that the materiality threshold would have been adjusted to HK\$ 28 million. The only evidence that substantiated this assertion came from Mr. Wan in the form of documentation in his expert reports of his receiving of such confirmation from the Respondents. The Committee notes that Mr. Wan also admitted in cross-examination that he cannot speculate whether the final materiality would still be at HK\$ 12 million had the Respondents knew that the correct DTL is HK\$ 24 million and it is something that he cannot confirm. The Committee agrees with the Complainant's submission that it has not heard any direct evidence from the Respondents and the assertion was purely "*instructions*" given to Mr. Wan which have not been subject to any testing in the Proceedings. The Committee is of the view that it should not accept such an assertion as evidence of truth and is entitled to attach such weight to it as the

Committee considers appropriate based on the principle that the strict rule of evidence does not apply to this Proceedings.

302. Further, the Committee considers that neither the Respondents' nor Mr. Wan provided sufficient explanation as to how the Respondents would justify this change in the calculation of the materiality other than the exercise of professional judgment. The Committee agrees with the Complainant that the circumstances under which the Respondents would have exercised their professional judgment and adjust upwards the threshold if they had found out the correct figure for DTL was in excess of \$12 million suggests the proposed exercise of professional judgment being reactive in nature and is improper. The Committee was referred to paragraph A27 of HKSA 200 (Clarified) (Issued June 2009 and Revised July 2010), as set out below, which support the said criticism of the Respondents: professional judgment cannot be used as an excuse to justify any non-compliance with the Accounting Standards.

“A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient is enable an experienced auditor, having no previous connection with an audit, to understand the significant professional judgments made in reaching conclusion on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient audit evidence.”

303. The Committee considers that this line of argument premised on a counterfactual is flawed and therefore should be rejected. The Committee is of the view that the alleged conduct of the Respondents should be assessed on the basis of their actual conduct at the time when the Audit was conducted, but not what their conduct would have been had they realized the error at the time of the Audit.

304. Having considered the arguments and evidence put forward above, the Committee rejects the Respondents' argument that HK\$ 23/24 million is immaterial as it is below HK\$ 28 million.
305. Having rejected the Respondents' case on their revision of materiality to HK\$ 28 million, the fact remained that the materiality threshold of the Audit is HK\$ 12 million and the misstatement of DTL was in the amount of HK\$ 23/24 million.
306. The Complainant's argument, which the Committee accepts, is that the Respondents should have recognized a DTL, being correctly calculated at HK\$ 24 million, because the liability was double the materiality threshold of HK\$12 million.
307. The Committee observes that, from a purely mathematically or quantitative point of view, it is apparent that the amount of HK\$23/24 million of DTL exceeds the audit materiality of HK\$ 12 million set by the Respondents at the time of the Audit, by approximately 90 to 100%.
308. Another point the Respondents made to support its case of immateriality of DTL is that the misstatement have exceeded HK\$ 12 million would not be conclusive because materiality is a relevant auditing tool which Mr. Sutton admitted could be used to determine, e.g. sample size of substantive procedures, and not a prescriptive figure to be applied to determine whether any figure in any given context was material or not, as directly adopted from Moger QC's written opinion. Moreover, Moger QC also highlights in paragraph 46 of his opinion that the materiality summaries working paper of the Respondents have stated that "*The determination of what is material is a matter of professional judgment. The percentage benchmarks set out below are intended to provide guidance in exercising that judgment. They should not be used as a formula to "calculate materiality"*".
309. The Committee bears in mind that Moger QC is a legal practitioner in a foreign jurisdiction and has not given his opinions as an expert in accountancy

in these Proceedings. Nor was he called as an expert witness. Thus, the Committee treats and gives weight to his opinions as they were incorporated into the Respondents' submissions as legal submissions rather than as expert evidence.

310. The Complainant accepts that the setting of materiality level is a matter of professional judgment. However, in this case, it submitted that it is clear professional judgment had been exercised both at the planning stage and again the final reviewing stage. On both occasions, the Respondents' professional judgment did determine that HK\$ 12 million was an appropriate level to be set as the materiality threshold.
311. As to the assessment of materiality from a qualitative perspective, the Respondents suggested that the non-recognition of DTL was immaterial because the non-recognition of DTL would not cause a change in earnings trends, nor cause the business result to turn from a loss into profit, nor increase management's remuneration and is by nature just an estimated liability, not a definite, actual liability, as admitted by Mr. Sutton in cross-examination.
312. Mr. Wan also gave his view that *"not adjusting the Relevant Financial Statements for this amount [HK\$ 23 million] would not have caused a significant distortion in the understanding of the Acquisition, the financial performance and financial position of the Group"*.
313. Mr. Sutton' view of the subject matter from a qualitative perspective is that the Acquisition itself was a material transaction and by its nature involved a fundamental change in the business model and structure of MelcoLot. The Committee makes note that this is a point that appeared to be well accepted by both parties and their experts as previously addressed under Audit Issue 1.
314. As addressed in paragraph 285 above, omissions and misstatements are material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

315. In this regard, Mr. Wan opined in his first report that he cannot see any real impact the recognition or non-recognition of the amount of DTL of HK\$ 23 million in the Relevant Financial Statements would have caused to the users of the Relevant Financial Statements and it is unlikely that the judgment of a reasonable person relying upon the report would have been changed or influenced.
316. Mr. Wan opined further that *“In considering the financial impact of the Acquisition from the Relevant Financial Statements, the major concern of the users of the financial statement would be....If the above information is available in the Relevant Financial Statements, I do not think the economic decision of a reasonable user would have been different with or without the recognition of the deferred tax liabilities”*.
317. Mr. Sutton gave a different view and reasoned that the Acquisition was a fundamental transaction for MelcoLot and MelcoLot’s share of fair value adjustment on the intangible assets after minority interest of HK\$ 98.8 million represented 38% of the fair value of total net identifiable assets acquired. The DTL of HK\$ 24 million, being a direct consequence of the HK\$ 136 million fair value adjustments on intangible assets, should not be isolated from the fair value adjustments and its associated Acquisition. The intangible assets acquired were expected to be used for generating future income for MelcoLot. The increase in fair value of the intangible assets simply implied that the intangible assets would not be expected to generate more future income.
318. The effect of non-recognition of DTL on the true and fair view of the Relevant Financial Statements was also raised by the Respondents as a consideration to be taken into account. The Committee notes that it is Mr. Wan’s opinion that *“...the financial statements which give a true and fair view should not contain material omissions or misstatements”* and *“if the effect of any omission or misstatement that occurs in a financial statement is not material, the financial statements will still give a true and fair view.”*

319. As such, it is the Committee’s understanding that the Respondents’ submission that the Relevant Financial Statements gave “*a true and fair view*” of the affairs of MelcoLot is a valid statement conditional upon the omission or misstatement being not material. It is merely a resultant effect of a non-material misstatement.
320. After due consideration of all the evidence and submissions put forward by the parties and its views formed above on the assessment of materiality from a qualitative and quantitative perspectives, the Committee concludes that DTL of HK\$ 23/24 million, which should have been recognized in the Financial Statement, is material and that the Respondents was acting in breach of HKAS 12.
321. Having found that the Respondents have failed to properly apply HKAS 12, the Committee finds that the First Complaint in Audit Issue 2 is proved against the Respondents.

The Second Complaint

322. Having found that the First Complaint is proved against the Respondents, the Committee shall not deal with the Second Complaint, being an alternative charge to the First Complaint.

Conclusion – Audit Area 2

323. For reasons given above, the Committee finds that the First Complaint has been proved against the Respondents and the Second Complaint should be dismissed accordingly.

Audit Area 3 – Impairment loss on goodwill

324. The undisputed facts and the respective parties’ cases are set out in paragraphs 172 to 191.

The First Complaint

325. The subject complaint centers primarily on the failure of the Respondents to have properly applied paragraphs 75 and 76 of HKAS 36 when auditing the Relevant Financial Statements.
326. The allegation of a breach of paragraphs 75 and 76 of HKAS 36 is to be considered in the context of the Complainant's case that the Carrying Amount and the Recoverable Amount of the Goodwill should be calculated in the same manner, that is, of "like-with-like" values, before they are compared, and upon which an impairment review is to be performed to calculate an impairment loss if the Recoverable Amount is lower than the Carrying Amount. The dispute as to the "like-with-like" values comparison rests upon the question of whether monetary assets and liabilities in the amount of HK\$ 20 million were included in the Recoverable Amount of the Vigers Reports when both parties agreed that monetary assets and liabilities were included in the Carrying Amount.
327. The Committee notes an important evidence of Mr. Sutton's conclusion that he is unable to draw any conclusion on the issue of technical non-compliance with paragraph 75 or 76 of HKAS 36 in the Relevant Financial Statements as the audit working papers do not include sufficient audit evidence on the matter and henceforth, the resultant breach of CoE cannot be concluded in relation to the applicable Accounting Standard HKAS 36.
328. In the premises, the Committee is of the view that on the above ground based on the Complainant's own expert evidence alone, the Committee is not satisfied that the Complainant has discharged its burden of proof to establish the First Complaint. The Committee therefore finds that the First Complaint in this audit area is not proved on evidence and should be dismissed.
329. The Committee now turns to the alternative complaint, the Second Complaint.

The Second Complaint

330. In essence, this subject complaint turns on the question of whether a possible misstatement of HK\$ 20.8 million is a significant matter such that an auditor

should have considered and documented the relevant audit results and audit evidence obtained in accordance with paragraph 9 of HKSA 230.

331. The Committee considers the following issues in its determination of the subject complaint:

Issue A: As a matter of fact was the Respondents' subjective belief all along that the Recoverable Amount did include monetary assets and liabilities?

Issue B: Whether the Respondents' audit documentation in the audit file objectively enabled an experienced auditor, having no previous connection with the Audit, to understand the audit procedures performed and draw the same conclusion as the Respondents' Belief as required under paragraph 9 of HKSA 230?

Issue C: Should a failure to observe, maintain or otherwise apply HKSA 230 be judged by having regard to legal background/principles including the role and purposes of an audit report, materiality and professional judgment?

Issue D: Has the Complainant discharged its burden of proof in light of the Respondents' alternative defence of materiality?

Issue A: As a matter of fact was the Respondents' subjective belief all along that the Recoverable Amount did include monetary assets and liabilities?

332. The Respondents asserted that they had all along considered that the Recoverable Amount did include monetary assets and liabilities (the "Respondents' Belief") and they were also given that understanding by Vigers during the Audit. The Committee understands the Respondents to be referring to their state of mind or subjective belief at the material time as a fact.
333. As mentioned in paragraph 12, neither the Complainant nor the Respondents had given any evidence. As such, the Respondents' Belief has not been verified or supported by any evidence.

334. Nevertheless, the Respondents pointed to the following documents contained in the Hearing bundles to support its above assertion:

- (1) Submission of CCIF to the AIB dated 12th July 2010;
- (2) Submission of CCIF to the HKICPA dated 21st October 2010;
- (3) Submission of CCIF to the AIB dated 3rd May 2011;
- (4) The Respondents' Case dated 3rd July 2012.

335. The contents of the above documents (1) to (3) revealed that they were correspondences made by the Respondents in the investigative stage prior to 13th May 2011 when the Complaints were formally submitted to the Council in the Complaint Letter and prior to September 2011 when the Council subsequently referred the Complaint to the disciplinary panel.

336. Having considered the contents of documents (1) to (3), the Committee notes the following:

“CCIF had consulted the professional valuers, Vigers in respect of the valuation reports and was advised that the valuation...had considered the cash flows from the CGU of lottery business and all assets and liabilities, including the monetary assets and liabilities in the terminal value in the cash flow...CCIF is of the view that as the recoverable amount includes the monetary assets and liabilities, the amount of such monetary assets and liabilities should also be included in the carrying amount for the impairment assessment.”

“CCIF have also confirmed with the Valuers during the audit that the Valuation Reports included the monetary assets and liabilities in the terminal value in the cash flow...”

“9. Summary of CCIF and Mr. Ho’s position:

9.2 CCIF’s view is that the recoverable amount includes the monetary assets and liabilities...CCIF had consulted the professional valuer, Vigers, in respect of the valuation reports and was advised that the valuation of the

100% equity interest in the PAL and Oasis Group had considered the cash flows from the CGU of lottery business and all assets and liabilities, including the monetary assets and liabilities in the terminal value in the cash flow.”

337. The Respondents’ Case (document (4) in paragraph 334) also stated under the heading of “*Facts and evidence*” that “*It was clear to the Respondents that the valuation in the PAL Report considered and included the monetary assets and liabilities of PAL to generate the future cash flow of PAL*”. Clearly, the said case is not evidence and the Committee will treat it as a submission only.
338. Even though the exact wordings of the Respondents’ Belief might not be found in the contents as extracted above, having considered the above documents which were made shortly after the allegations were related to the Respondents, the Committee considers it should give due weight to the contents of the abovementioned documents.
339. The Respondents further pointed out that the Complainant does not appear to have challenged the Respondents’ Belief as a matter of primary fact and in fact the Complainant has stated in its checklist (as mentioned in paragraph 11 above) that there are no “*material matters of facts in dispute*”. The Committee agrees with this observation.
340. The Committee bears in mind that the strict rule of evidence in these Proceedings does not apply and Committee may receive any material, and attach such weight to that material, as it considers appropriate in accordance with rule 14 of the DCPR.
341. In conclusion, the Committee accepts the Respondents’ submissions and unsworn evidence that the Respondents’ Belief is established as a fact.

Issue B: Whether the Respondents’ audit documentation in the audit file objectively enabled an experienced auditor, having no previous connection with the Audit to understand the audit procedures performed and draw the same conclusion as the Respondents’ Belief as required under paragraph 9 of HKSA 230?

342. Despite the fact that the Respondents had the Respondents' Belief (subjective state of mind) at the material time, it is the Complainant's case that the Vigers Reports were unclear as to whether they had or had not included monetary assets and liabilities in its valuation. The Complainant's assertion is supported by Mr. Sutton's evidence that it is unclear to him whether or not the comparison between Recoverable Amount with Carrying Amount was made on a like-for-like basis from the Vigers Reports which in effect carries the same meaning as whether monetary assets and liabilities were included in the Recoverable Amount. This is in direct contradiction to the Respondents' case based on Mr. Wan's evidence that having examined the audit working papers, he had no doubt that a like-for-like comparison had been undertaken during the audit in relation to the Carrying Amount and Recoverable Amount.

343. The Committee now turns to consider the parties' submissions on this point.

344. The Complainant pointed to Mr. Wan's answer in cross-examination by Mr. Choy as follows to show that his opinion is to the effect that it is not possible to determine from the Vigers Reports whether the monetary assets and liabilities were included in the Recoverable Amount:

"Mr. Choy: You would agree from the primary documents, just looking at those, you cannot determine MAL [monetary assets and liabilities] were included or not.

Mr. Wan: Sure.

Mr. Choy: In fact, in your first opinion, you do not have to go to it, at paragraph 42, 43, you came to the view that AIB's original view that they were excluded, and CCIF's view that MAL was included, both could be correct.

Mr. Wan: Could be correct, cannot confirm."

345. The Committee agrees that the above appears to convey an impression at once that Mr. Wan is of the view that he cannot confirm whether monetary assets and liabilities were included or not and both are possible. Nevertheless, this is

not the end of the analysis because the Committee should consider the expert evidence in its entirety.

346. Firstly, Mr. Sutton opined that the net present value (“NPV”) derived from the Vigers Reports (which the Committee understood to be what the Recoverable Amount is) is the value of the business including the normal level of working capital required by the business to sustain its operations because the DCF shows no cash outflow for an initial injection of working capital.
347. Mr. Sutton also stressed that the monetary assets and liabilities are not necessarily the same as the working capital of its business and there can be situations where the monetary assets and liabilities of a company exceed the working capital needs of the business. He gave some examples in his report where monetary assets would exceed working capital, such as when retained profits were accumulated without paying dividends or where there was a substantial capital injection from shareholders.
348. Mr. Sutton further stated that “[t]he working capital included in the Vigers NPV, therefore, appears to only represent the normal levels of working capital required by the business. If there are any monetary assets and liabilities in the company in excess of these normal working capital needs, their value would not be included in the Vigers DCF calculation. To account for the value of any excess monetary assets and liabilities, one would have to review the monetary assets and liabilities on the balance sheet of the company and consider whether there was any excess of monetary assets and liabilities over normal working capital. Any such excess would then need to be added on to the DCF value calculated in order to arrive at the value of the company that owned both the business and those excess monetary assets and liabilities. Making such an adjustment (if required) would allow the recoverable value calculated to be compared on a consistent basis with a carrying value that included all monetary assets and liabilities...I have seen no evidence that either Vigers (as part of its valuation report) or CCIF and Mr. Ho (as part of their comparison of recoverable value with carrying value), considered this issue.”

349. After considering Mr. Sutton's opinion as stated above, the Committee refers to paragraph 173(5) which contains the formula used under the DCF methodology in the NPV assessment which is reproduced as follows for ease of understanding:

The FCFF (excluding tax) is defined as:

$$\text{FCFF(exclude tax)} = \text{Earning before Interest} + \text{Depreciation} - \text{Capital Expenditures} - \text{Working Capital Needs}$$

350. It is the Committee's understanding that by "no cash outflow" Mr. Sutton was referring to the line for "Less: Working Capital" in the NPV calculation that was left blank.
351. Upon the consideration of the above, the Committee's preliminary observations are as follows.
352. It is fairly clear to the Committee that Mr. Sutton was in effect saying that the Recoverable Amount being inclusive of normal working capital required to sustain its operation cannot be taken to carry the same meaning as that the Recoverable Amount is inclusive of monetary assets and liabilities because working capital and monetary assets and liabilities are not necessarily the same.
353. The Committee accepts that from a plain reading of the words "Less: Working Capital", a reasonable reader is to understand without much difficulty for that to mean that working capital was subtracted or excluded from the calculation, which might or might not carry the same meaning as monetary assets and liabilities was subtracted or excluded from the calculation depending on whether working capital and monetary assets and liabilities are the same thing or of the same amount, without further explanation or evidence.
354. In fact, Mr. Wan explicitly agreed with Mr. Sutton's statement that monetary assets and liabilities are not necessarily the same as the working capital of its business in his Wan Opinions.

355. As rightly pointed out in the Respondents' submissions, Mr. Sutton had admitted on cross-examination, that the examples he quoted to illustrate the situations where the monetary assets and liabilities of a company exceed the working capital needs of the business had no application to the present case. The Committee takes note that since it is accepted that monetary assets and liabilities and working capital are not necessarily the same, the possibility of other situations when monetary assets and liabilities exceed working capital need, other than those Mr. Sutton quoted, can still exist by applying common sense and logic to the argument.
356. The Respondents submitted that Mr. Wan took the view that if the recoverable amount is calculated on cashflow basis, then the Carrying Amount should include monetary assets because they were needed to produce the cashflow. The Committee examines Mr. Wan opinions referred to:

“24. In my opinion, in order to have a consistent basis for comparison purpose when determining the correct amount of impairment loss, the carrying amount of the CGU should not only include the fair value of the directly related cost components (i.e. property, plant and equipment, intangible assets and interests in jointly controlled entities) acquired and the Goodwill but also any additional resources of the entities acquired that will have to be used to bring the CGU to such a state which enables it to generate the future cash flows for the determination of the valuation of the CGU. Only when this approach is taken will the requirement of paragraph 75 and 76...be complied with.

25. The inclusion of HK\$20.8 million monetary assets and liabilities in the carrying amount of the CGU is consistent with the abovementioned approach as it is clear that the amount of HK\$20.8 million will have to be utilized to increase the sales points of PAL in order to be able to generate the cash flow based on which the valuation was determined.”

357. The Committee is of the view that Mr. Wan’s opinion above only supported his view that the monetary assets and liabilities should be included in the Carrying Amount in principle as an approach and therefore the inclusion of HK\$20.8 million is a consistent event. It does not give a view about whether or not monetary assets and liabilities were included in the Recoverable Amount. The Respondents pointed out that Mr. Sutton stated that “*as an approach it is correct*” when he is cross-examined on this point. The Committee considers Mr. Sutton’s answer reasonable and not contradictory to his expert opinion.
358. The Respondents further submitted that it is the evidence of Mr. Wan that monetary assets and liabilities would have been used by the CGU in producing its income stream and he compared the cash deficit for the first year (RMB [XX]m, RMB [XX]+ m after minority interests) with the monetary assets and liabilities (HK\$ 20.8 million) and concluded that these figures were sufficiently close for the purposes of his calculations.
359. The Committee examines Mr. Wan’s evidence as quoted:
- “45. ...I did notice that PAL had to incur capital expenditures for its line of business amounted to RMB [XX] million, RMB [XX] million and RMB [XX] million for 2008, 2009 and 2010 respectively. Part of the capital expenditures could be financed by internal funds generated from the operations, there was still a cash flow deficit of RMB [XX] million for 2008. I do not think it disputable that bridging this cash flow deficit was crucial to enable the company to generate future cash flows based on which the valuation was made.*
- 46. Thus, it would be a reasonable conclusion that the monetary assets and liabilities of PAL of HK\$ [XX] million as at 31 December 2007 would have to be used for this purpose.”*

360. He clarified his position further in his 4th Wan Opinions in support of the Respondents' submission that the cash flow needed is assumed to be generated by the monetary assets:

“84. ...I then look at the cash flow projections based on which the valuation of the CGU was determined. I noticed that there was a cash flow deficit of RMB [XX] million in 2008 to meet the capital expenditure requirement to enable the business to generate the cash flows in the subsequent years based on which the valuation was made. I agreed that the cash flow deficit would not be necessarily be satisfied by utilising the monetary assets and liabilities that existed in the Relevant Financial Statements and the amount of the net assets and liabilities totaling HK\$ 20.8 million might not be the exact amount of the capital expenditure required, but the two amounts are close enough and any difference is unlikely to be material.”

361. Mr. Sutton held a different view to the above conclusion drawn by Mr. Wan. Mr. Sutton's opposing view is that *“whilst initial working capital levels appear to be implicitly included in the valuation calculations, future working capital needs do not appear to have been considered. Further, I commented that working capital and monetary assets and liabilities are not necessarily the equal and the same as each other. With this in mind, I cannot agree with Mr. Wan that the inclusion of capital expenditure is sufficient to conclude that the monetary assets and liabilities have been included, in full, in the valuation report.”*

362. Assessing the above expert evidence, the Committee does not find the Respondents' assertion and Mr. Wan's opinion persuasive and convincing. The Committee is of the view that the inferences drawn as stated in paragraph 358 to 360 above were premised upon assumptions which lack substantiation from corroborating evidence. In order to arrive at the Respondents' conclusion, it has to be assumed that cash flow deficit of RMB [XX] million of PAL in 2008 arose directly and solely from the capital expenditure of RMB [XX] million after internally generated funds *could be* used to finance it. In addition,

it has to be assumed that the monetary assets and liabilities of HK\$ [XX] million of PAL (MelcoLot's share of [XX%] equals to approximately HK\$ 20.8 million) were utilized to satisfy or meet the cash flow deficit, which Mr. Wan has conceded that it might not necessarily be the case. Further, it has to be assumed that the cash flow deficit must be bridged because the company must be able to generate future cash flows. Lastly, the Committee considers the point that the two amounts of HK\$ [XX] million vis-à-vis RMB [XX] million (before minority interest) or HK\$20.8 million vis-à-vis "RMB [XX]+" (after minority interest) are "*close enough and any difference is unlikely to be material*" is not persuasive. The Committee considers there is no basis to back up Mr. Wan's reasoning.

363. Further, the Respondents submitted that it is clear from the Vigers Reports that while it used the income method of valuation, all assets and liabilities of the group should have been taken into account because it is a valuation of "*100% of the equity interest of PAL Development Limited and its subsidiaries*". It is noted that Mr. Wan's expert opinion did not address this point specifically.
364. Mr. Sutton's opinion on this point is that it is unclear to him what is included in the valuation base of "*100% of equity interest*" and he considered it is possible that Vigers may have referred to "*100%*" as it was aware that MelcoLot was purchasing less than 100% of PAL and thus "*100%*" may just be Vigers' wish to illustrate that they had performed their evaluation on the companies as a whole and not pro-rated their valuation to reflect the acquired portion and as there is no CCIF file note or further information on file that discusses this, he is unable to conclude whether the basis for valuation, as stated in the calculation report, support the Respondents' assertion that monetary assets and liabilities were included in the calculation of the Recoverable Amount.
365. In the absence of any expert opinion from Mr. Wan, the Committee agrees that the possible meaning of the wording "*100%*" on the point as suggested by Mr. Sutton cannot be ruled out entirely because of the absence of further

documentation evidence that can conclusively define what “100% of equity interest” means as a basis of valuation.

366. Lastly, the Respondents pointed out that the line for “*Less: Working Capital*” in the calculations was left blank, showing that working capital needs were not deducted from the Recoverable Amount. In turn they suggest that the Recoverable Amount as valued included monetary assets.
367. The Committee is of the view that this argument cannot stand since it is an agreed view of Mr. Wan and Mr. Sutton that working capital is not necessarily the same as monetary assets and liabilities as previously stated.
368. Rather, Mr. Sutton interpreted the said blank working capital line differently. It is his opinion that no such cash flows means that no consideration appears to have been given to the future working capital needs of the business in question which appears contrary to the methodology section of the Vigers reports, which stated that working capital needs will be deducted in the cash flow projections. There is no expert evidence from Mr. Wan that addressed this point on the consideration of future working capital.
369. The Committee also wishes to point out that the Respondents’ pleaded case of adequate documentation also relied on its the Audit Programme in the working paper as an audit documentation that should be read together with the Vigers Reports. The Committee has received no expert evidence from Mr. Wan on this point whereas Mr. Sutton on the other hand has stated in his opinion that “*[t]he valuation reports are the only audit evidence on CCIF’s Audit File to support the impairment calculation and the subsequent goodwill impairment. There was no additional discussion or analysis or commentary by CCIF in the audit working papers that I have reviewed*”. The Committee considers the said opinion reasonable that Mr. Sutton does not consider that the said Audit Programme constitutes audit evidence to support the Respondents’ assertion that monetary assets and liabilities were included in the Recoverable Amount, be it alone or read together with the Vigers Reports because he did not identify it as an audit evidence to support the impairment calculation. In the absence

of evidence from Mr. Wan to contradict this point, the Committee accepts Mr. Sutton's opinion.

370. As an ancillary issue to the above, the Committee notes it is the Respondents' submissions that Mr. Sutton could not properly be regarded as an "*experienced auditor*" within the meaning of paragraph 9 of HKSA 230 given he had never performed an audit before and cannot said to have a reasonable understanding of an audit. The Committee rejects the Respondents' submission for reasons addressed in the section "The Expert Evidence" in paragraphs 79 to 98 above and considers Mr. Sutton as being qualified to be an "*experienced auditor*".
371. For reasons and analysis given above, the Committee prefers the evidence of Mr. Sutton on this subject and accordingly finds that the Respondents' audit documentation in the audit file to support the goodwill impairment calculation, i.e. the Vigers Reports together with the Audit Programme, did not enable an experienced auditor, having no previous connection with the Audit, to understand the audit procedures performed by the Respondents and subsequently reached the same results and conclusions as the Respondents' Belief, as required under paragraph 9 of HKSA 230.
372. Nevertheless, having made such finding under issue B is not the end of the matter for the case because the Respondents has relied on an alternative defence that, if it is not accepted that the Vigers Reports were clear that they included monetary assets and liabilities, the figure HK\$ 20.8 million is not material for the purpose of the Relevant Financial Statements and would not have affected the true and fair view that the Relevant Financial Statement gave of MelcoLot's financial affairs. The amount of HK\$ 20.8 million represents 2.3% of goodwill before impairment, approximately 1.8% of the recoverable amount of MelcoLot's equity interest in PAL and Oasis and just less than 5% of the impairment loss.

Issue C: Should a failure to observe, maintain or otherwise apply HKAS 230 be judged by having regard to legal background/principles including the role and purposes of an audit report, materiality and professional judgment?

373. The Committee adopts the same approach as it did under Issue B in the Audit Area 1 for this legal interpretation issue. Therefore, it is the Committee's view that whether the Respondents are entitled to rely on the said principles to defend their case should depend on the proper interpretation of the wording of paragraph 9 of HKAS 230 (full extracts set out in paragraph 103) giving regard to its context and true purpose.
374. For the same reasons given in respect of the first two audit areas on this point, the Committee is of the view that the Respondents has established their case that compliance should be judged by having regard to the legal background/principles as submitted by the Respondents.

Issue D: Has the Complainant discharged its burden of proof in light of the Respondents' alternative defence of materiality?

375. Premised on the Committee's finding under Issue A to C above, for the Complainant to successfully establish the Second Complaint against the Respondents, the duty is on the Complainant to discharge its burden of proof that the misstatement of HK\$ 20.8 million of such (at least above the planning materiality of HK\$ 12 million) is a significant matter such that a reasonable auditor would have considered and documented the relevant audit procedure results and audit evidence obtained in accordance with paragraph 9 of HKSA 230.
376. In this regard, again assessment of the relevant expert evidence is required.
377. The following contents of the Sutton Report as relevant:

"6.5.2 The Audit Planning Memorandum recorded that goodwill on the acquisition of the subsidiaries was considered to be of "high risk" in CCIF's Audit MelcoLot. This suggests that any subsequent, related goodwill impairment would also have been considered as "high risk" item for CCIF."

“6.5.3 Further, it is reasonable to conclude, that goodwill and its impairment were two of the areas on which CCIF’s Audit Director should have focused on during his review of CCIF’s Audit File and also on the Relevant Financial Statements, before his sign-off of CCIF’s Audit Report on MelcoLot.”

“6.6.2 In the various correspondence, CCIF and Mallesons assert that there was no breach of HKAS 36 – “Impairment of Assets” by reasons that:

...

(v) CCIF stated that even if it were wrong, the HK\$20.8 million, as identified by the AIB, represented five percent of the impairment (and also five percentage of the loss for the year), which falls into the area of ‘auditor’s judgment’ when assessing the need to make an adjustment to the audit report or not. In CCIF’s judgment, they considered this amount was not material enough to require a modification to the Audit Report.

...

6.6.7 Finally in response to point (v) above, I note both the AIB’s and CCIF’s positions, however as it cannot be proved one way or the other with the information at hand, I consider this a moot point.”

“6.11.4 Paragraph 9:

(i) I acknowledge that an Audit File may not generally document every discussion or every decision in respect of the Audit. However, the Audit Planning Memorandum identified goodwill and its impairment as high risk area. I note a general absence of discussion around the issue of goodwill impairment from my review of CCIF’s audit working paper. As discussed in paragraph 4.13.5, I would have expected a higher degree scrutiny of the issue...”

378. In cross-examination, Mr. Lam SC asked Mr. Sutton if he would accept the reasonable basis amount to test the percentage of materiality of the item of HK\$ 20.8 million would be either goodwill of HK\$ 901 million or HK\$ 416 of impairment loss. Mr. Sutton’s answer was that he cannot answer the question since there is no calculation of monetary assets as at 31st December

2007 and in the absence of such information, anything is purely hypothetical and speculative.

379. When being asked if he accepts that the standards provide that it is neither necessary nor practical for an auditor to document every matter that an auditor considered during an audit, Mr. Sutton's reply was to the effect that at times that can be justified but the audit files should stand on its own so that another auditor ought to be able to pick up the file and conduct the review and reached the same conclusion.
380. In response to Mr. Lam SC's suggestion that Mr. Wan's opinions are opinions that professional auditors are entitled to come to based on their professional experience, Mr. Sutton's reply was to the effect that he agreed to what HKAS 200 says about professional judgment, but professional judgment is not to be exercised and used for what is lack of audit documentation and should be used appropriately. He specifically referred to paragraph A27 of HKAS 200 (extracts as set out in paragraph 303 above) to stress his point that professional judgment cannot be used as an excuse to justify any non-compliance with the accounting standards and the example of not having the balance sheet of 31st December 2007 was an example of not being a compliance of auditing standards. He did not think professional judgment can be used as an excuse for that.
381. Mr. Wan's evidence is in direct contradiction to Mr. Sutton's and the gist of his evidence are:
- (1) It is rarely the case that an auditor will record on the audit work papers in details on everything he has reviewed, discussed and concluded. He referred to paragraph 10 of HKSA 230 which states that "*...it is ...neither necessary nor practical to document every matter the auditor considers during the audit*". It is a matter of judgment that the auditor has to exercise based on his assessment of the audit he undertakes;
 - (2) He respects Mr. Ho's judgment since there was no indication in the course of the audit to alert him that there could be controversy in relation to this particular audit conclusion. There was no reason why the audit

engagement team should consider the understanding regarding the inclusion of monetary assets as a significant matter requiring further discussion with the company's management; and

- (3) In response to Mr. Sutton's opinion that a verbal confirmation in respect of the valuation was not adequate given the high risk profile in the APM, his opinion is that this is not necessarily conclusive. He noted that the Respondents had identified goodwill as a high risk item in its APM and its audit focus had been on the correct determination of the goodwill amount and to ensure that it was fairly stated in the Relevant Financial Statements. Impairment testing was carried out and professional valuations were requested to support the determination of the impairment amount, if any, which he said are the appropriate procedures to take. Whether additional procedures were necessary with regard to the question on whether the monetary assets and liabilities were included in the valuation is a matter of professional judgment and the Respondents conclusion was that the verbal confirmation could be relied upon without the need to perform further work.

382. Having considered the respective experts' evidence, the Committee is of the view that there is an obvious lack of sufficient evidence from Mr. Sutton to address Mr. Wan's counter-argument on materiality and professional judgment. In relation to the point about "auditor's judgment" or professional judgment in adjusting the audit opinion, Mr. Sutton's written opinion was that he considered it to be a "*moot point*" and did not express his opinion as noted in paragraph 377 above. It is only at cross-examination that he expressed his views as stated in paragraph 380 above. His opinion on what was lacking in the audit working paper given the high risk profile was "*a general absence of discussion around the issue of goodwill impairment*" and it did not point specifically to what documentation of relevant audit procedures and audit evidence was lacking. As a matter of fact, it is also noted that there is no expert evidence from Mr. Sutton that the Respondents should have made inquiries with Vigers to clarify the matter that the Vigers Reports were unclear as to whether they had or had not included the monetary assets and liabilities in its valuation, as the Complainant had submitted. The Committee also notes

that there is also no expert evidence from Mr. Sutton to explicitly support the assertion that the possible misstatement of HK\$ 20.8 being above the materiality of HK\$ 12 million adopted by the Respondents was considered to be a significant matter.

383. Without sufficient supporting expert evidence, the Committee concludes that the Complainant had failed to discharge its burden of proof in proving to the satisfaction of the Committee that the HK\$ 20.8 of potential misstatement was material as such (at least above the planning materiality of HK\$ 12 million) and to be considered significant matters that a reasonable auditor would have considered and documented the relevant audit procedure results and audit evidence obtained in accordance with paragraph 9 of HKSA 230.
384. For completeness purpose, the Committee wishes to point out that both parties have made extensive submissions and expert evidence over the issue on the whether verbal consultation with Vigers and the documentation of such consultation was necessary. This issue became irrelevant in light of the above conclusion and the Committee does not consider it necessary to address it.

Conclusion – Audit Area 3

385. For reasons given above, the Committee finds that both the First Complaint and the Second Complaints in this audit area are not proved and should be dismissed.

SUMMARY OF THE COMMITTEE’S FINDINGS

386. The Committee finds:
- (1) Audit Area 1 – the First Complaint is proved and the Second Complaint is dismissed;
 - (2) Audit Area 2 – the First Complaint is proved and the Second Complaint is dismissed; and
 - (3) Audit Area 3 – the First Complaint and the Second Complaint are not proved and they are dismissed.

SANCTION AND COSTS

387. As indicated at the end of the Hearing, the Committee hereby directs that the parties do file and serve their written submissions on sanctions to be imposed in relation to the First Complaint in Audit Area 1 and First Complaint in Audit Area 2 and costs within 21 days of delivering of this Decision whereupon the Committee will make a decision of sanctions and costs in writing. There will not be any hearing for the consideration of the sanctions and the costs in the absence of any application by the parties.

Dated the 22nd day of March 2013.

Mr. Edwin Choy, instructed by Messrs. Robertsons, solicitors for the Complainant.
Mr. Godfrey Lam, Senior Counsel and Mr. Jin Pao, instructed by Messrs. Hogan Lovells, solicitors for the Respondents.