STATEMENT OF DISCIPLINARY ACTION

A. The Disciplinary Action

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

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

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

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

   (collectively, **Disciplinary Sanctions**).

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

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

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

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

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

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

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

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

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

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

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

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

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

4.2. in each of 2011 Audit and 2012 Audit:

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

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

B. Summary of Facts

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

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

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

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

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

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

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

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

C. Summary of Findings

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

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

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

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

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

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

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

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

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

Tests of Controls

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

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

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

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

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

    23.3. seek explanations from the management or perform additional audit procedures to address the discrepancies between the amounts of

sales as recorded in the sales invoices and the journal vouchers respectively.

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

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

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

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

Sales Transaction Test

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

27. However, it was found that:

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

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

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

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

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

Red Flags in relation to the Sales of Two Major Customers

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

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

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

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

Purchase Transaction Test

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

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

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

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

Sales Cut-off Test

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

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

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

37. However, it was found that:

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

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

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

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

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

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

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

External Confirmations

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

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

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

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

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

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

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

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

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

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

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

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

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

Analytical Procedure for Revenue and Gross Profit Margin

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

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

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

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

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

Overall Breaches

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

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

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

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

D. Conclusion

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

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

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

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

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

Aggravating circumstances

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

Mitigating circumstances

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

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