

## STATEMENT OF DISCIPLINARY ACTION

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### A. The Disciplinary Action

1. Pursuant to sections 37CA and 37I(1A) of the Accounting and Financial Reporting Council Ordinance (Cap. 588) (**AFRCO**), the Accounting and Financial Reporting Council (**AFRC**) has:
  - 1.1. publicly reprimanded each of Deloitte Touche Tohmatsu (**Deloitte**) and Mak Chi Lung (**Mak**);
  - 1.2. imposed a pecuniary penalty of **HK\$568,000** against Deloitte; and
  - 1.3. imposed a pecuniary penalty of **HK\$336,000** against Mak,(collectively, **Disciplinary Sanctions**).
2. The Disciplinary Sanctions were imposed in relation to the audits of the consolidated financial statements of Sound Global Ltd. (**Company**) (previous stock code: 00967, now delisted) and its subsidiaries (collectively, **Group**) for the years ended 31 December 2012 and 31 December 2013 (**2012 and 2013 Financial Statements** respectively).
3. Deloitte<sup>1</sup> conducted the audits of the 2012 Financial Statements (**2012 Audit**) and the 2013 Financial Statements (**2013 Audit**). Mak<sup>2</sup> was the engagement partner for the 2012 and 2013 Audits. Unless otherwise stated, **Auditor** refers to both Deloitte and Mak.
4. The AFRC found multiple audit deficiencies in the 2012 and 2013 Audits concerning revenue from turnkey services, revenue from sales of equipment under construction contracts and bank balances and trade receivables. As a result, the AFRC found that the Auditor failed or neglected to observe, maintain or otherwise apply the professional standards below in the relevant years of audits:
  - 4.1. in each of the 2012 and 2013 Audits, in relation to revenue from turnkey projects and services:
    - 4.1.1 paragraph 15 of the applicable versions of Hong Kong Standard on Auditing (**HKSA**) 200 (*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*) (**HKSA 200**);

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

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

- 4.1.2 paragraphs 12 and 23 of the applicable versions of HKSA 240 (*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*) (**HKSA 240**);
  - 4.1.3 paragraph 17 of the applicable version of HKSA 330 (*The Auditor's Responses to Assessed Risks*) (**HKSA 330**);
  - 4.1.4 paragraphs 6 and 7 of the applicable versions of HKSA 500 (*Audit Evidence*) (**HKSA 500**);
  - 4.1.5 paragraph 7 of the applicable version of HKSA 530 (*Audit Sampling*) (**HKSA 530**);
  - 4.2. in the 2013 Audit, in relation to external confirmations on bank balances and trade receivables, paragraphs 10, 14 and A11 of the applicable version of HKSA 505 (*External Confirmations*) (**HKSA 505**); and
  - 4.3. in each of the 2012 and 2013 Audits, paragraphs 100.5(c) and 130.1 of the applicable versions of the Code of Ethics for Professional Accountants (**COE**).
5. By failing or neglecting to observe, maintain or otherwise apply the above PAO professional standards<sup>3</sup> in the relevant years of audits, each of Deloitte and Mak committed professional irregularities under section 3B(1)(c) of the AFRCO, and is guilty of CPA misconduct pursuant to section 37AA(1)(a) of the AFRCO and section 71 of the Accounting and Financial Reporting Council (Transitional and Saving Provisions and Consequential Amendments) Regulation (Cap. 588B) (**Transitional Regulation**).

## **B. Summary of Facts**

- 6. The Company was listed on the Main Board of The Stock Exchange of Hong Kong Limited from September 2010 to September 2022.<sup>4</sup> The Group was principally engaged in turnkey water and wastewater treatment.
- 7. Turnkey projects and services business was the core operation of the Group. According to the 2012 and 2013 Financial Statements, revenue from turnkey projects and services amounted to RMB2,446.0 million and RMB2,882.9 million, representing about 92.2% and 91.8% of the total revenue of the Group for the years ended 31 December 2012 and 2013 respectively.
- 8. The Group's turnkey projects and services were divided into two types: (i) engineering, procurement, and construction projects (**EPC projects**), and (ii)

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<sup>3</sup> As defined in section 2 of the AFRCO.

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

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

9. In preparing the 2012 and 2013 Financial Statements, the Company applied the following accounting treatment in respect of its turnkey projects and services:
  - 9.1. revenue from EPC projects was recognised on the percentage of completion basis when the total construction costs of the facilities under development could be reliably estimated;
  - 9.2. revenue for both the construction and operational phase of BOT projects was estimated when the project's contractual agreements were entered into;
  - 9.3. revenue from construction contracts was recognised using the percentage of completion method when the outcome of the project can be estimated reliably; and
  - 9.4. revenue from sales of equipment under construction contracts was generally recognised upon delivery and acceptance of equipment.
10. The Auditor conducted the 2012 and 2013 Audits in accordance with HKSA's and expressed unmodified audit opinions on each of the 2012 and 2013 Financial Statements.
11. On 24 July 2017, the Company announced that the trading of its shares was suspended as the Securities and Futures Commission (**SFC**) found that the bank balances of five bank accounts of the Group as at 31 December 2012 and 2013 were overstated by RMB2.1 billion and RMB2.7 billion respectively (**Cash Discrepancies**). The Cash Discrepancies raised questions as to whether there are audit deficiencies in relation to the 2012 and 2013 Audits.

### **C. Summary of Findings**

12. The audit work conducted in respect of the following matters in the 2012 and 2013 Financial Statements were the subject of an investigation conducted by the Audit Investigation Board pursuant to section 23(3) of the then Financial Reporting Council Ordinance (Cap. 588):
  - 12.1. revenue from turnkey projects and services;
  - 12.2. bank balances and cash and restricted bank balances; and
  - 12.3. amounts due from customers for contract work and trade receivables.

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

**Audit deficiencies in relation to Revenue from Turnkey Services**

*Audit procedures on the percentage of completion of turnkey projects*

14. The Auditor failed to obtain corroborative evidence to support the upward adjustments made by the management for the percentage of completion in respect of two BOT projects in the 2012 Audit.
15. In the 2012 Audit, the Auditor selected 17 EPC projects and 4 BOT projects that were under construction to evaluate the reasonableness of the percentage of completion calculated by the management with reference to the proportion of contract costs incurred for work performed to date relative to the estimated total contract costs.
16. In respect of two BOT projects, the management made upward adjustments to the percentage of completion for the purpose of determining the revenue to be recognised. According to the certification of construction work performed filed in the audit working papers, the percentage of completion of these two projects was only 74% as at 29 December 2012 and 54% as at 26 November 2012 respectively. However, as at the year-end date (31 December 2012), a higher percentage of completion (98%) was used to recognise the revenue for these two projects, but there was no evidence to support the further construction costs incurred after the dates of the certification of construction work performed.
17. The Auditor did not obtain corroborative evidence, such as the certifications of construction work performed signed by sub-contractors, to support the post-adjustment. The post-adjustment in respect of these two projects had led to the recognition of an additional revenue of RMB66.4 million in the 2012 Financial Statements.
18. In light of the above, the AFRC found that, in respect of the 2012 Audit, the Auditor failed to perform adequate audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence on the adjustment of percentage of completion of these projects, in breach of paragraph 6 of HKSA 500.

*Audit procedures on total estimated contract costs*

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

20. There were, however, two completed projects in each of 2012 and 2013 with actual costs incurred materially exceeding the total estimated contract costs. This raised doubts as to whether the management had duly revised the total estimated contract costs during the progress of the construction, and whether control had been properly implemented.
21. The management's explanation was that the cost overrun was mainly due to changes in design or scope of the construction and an inflated price of raw materials and wages. However, the Auditor failed to obtain sufficient appropriate audit evidence to corroborate the management's explanations for the cost overrun.
22. Based on the above, the AFRC found that, for each of 2012 Audit and 2013 Audit, the Auditor breached paragraph 17 of HKSA 330, by failing to properly understand the matter, evaluate the potential consequence, and determine whether:
  - 22.1. the test of control that had been performed provided an appropriate basis for reliance on the controls;
  - 22.2. additional tests of controls were necessary; and
  - 22.3. the potential risks of misstatement needed to be addressed using substantive procedures.

*Audit procedures on completed projects*

23. In the 2013 Audit, the Auditor stated in their risk assessment and audit plan that they would obtain the certificates of final completion for completed projects to ensure that revenue and related contract costs were recognised appropriately. However, the Auditor did not obtain the certificate of final completion for seven completed projects in 2013. For example:
  - 23.1. for two contracts, the engagement team only conducted site visits; and
  - 23.2. for three contracts, the engagement team concluded that the total contribution of contracts to the revenue of the Group was below particular thresholds and as such, no further work was required in respect of these contracts.
24. Without the certificates of final completion, the Auditor would not be able to ascertain if the project was fully completed and that all the corresponding contract revenue, contract costs and attributable profit pertaining to the contract were properly recognised.
25. In the circumstances, the AFRC found that, in respect of the 2013 Audit, the Auditor failed to obtain sufficient appropriate audit evidence to corroborate the

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

*Audit procedures on foreseeable loss for uncompleted projects*

26. In the 2012 and 2013 Audits, 12 uncompleted projects (for the 2012 Audit) and ten uncompleted projects (for the 2013 Audit) were behind the contractually agreed timeline. Some projects were delayed for more than one year. The audit procedures performed by the Auditor (i.e. site visits and interviews) only covered seven out of the 12 delayed projects for the 2012 Audit and three out of the ten delayed projects for the 2013 Audit, and the interviews did not address the delay in construction. Most of the site visit memoranda did not contain the reasons for the project delay. The Auditor failed to obtain an understanding of the reasons for the project delays.
27. In the circumstances, the Auditor ought to have evaluated whether the expected loss should be recognised by, for example:
  - 27.1. performing an analysis of the actual construction progress against the contractually agreed timeline to identify major delays or costs overruns which might result in profitable contracts becoming loss-making;
  - 27.2. obtaining an explanation from the management on the reasons for the delays; and
  - 27.3. reviewing the relevant contracts to check if there are any clauses on penalty or liquidated damages and assessing the need to provide for liquidated damages in the financial statements based on the actual construction progress.
28. Based on the above, the AFRC found that, for each of 2012 Audit and 2013 Audit, the Auditor failed to adequately perform audit procedures to evaluate whether expected loss for uncompleted construction contracts should be recognised, in breach of paragraph 6 of HKSA 500.

**Audit deficiencies in relation to Revenue from Sales of Equipment**

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

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

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

*Cut-off test on the revenue from sales of equipment*

31. In the 2012 and 2013 Audits, the Auditor performed cut-off test on the revenue from sales of equipment. It was unusual that more than 54% of sales of equipment (in the 2012 Audit) and more than 39% of sales of equipment (in the 2013 Audit) were recorded on the respective last dates of the reporting periods.
32. In the circumstances, the AFRC found that, for each of 2012 Audit and 2013 Audit, the Auditor failed to exercise professional skepticism to identify the unusual characteristics, which might indicate a risk of material misstatement due to fraud, in breach of paragraph 15 of HKSA 200 and paragraphs 12 and 23 of HKSA 240.

*Audit procedures on percentage of completion*

33. In the 2013 Audit, the Auditor examined the relevant goods delivery notes for the purpose of ascertaining the costs of equipment sold and calculating the percentage of completion. However, the Auditor failed to consider the fact that the goods delivery notes do not contain any breakdown on the individual costs of each equipment sold.
34. In the circumstances, the AFRC found that, for the 2013 Audit, the Auditor failed to consider the relevance and reliability of the goods delivery note as audit evidence for determining the percentage of completion used for measuring the revenue from sales of equipment, in breach of paragraph 7 of HKSA 500.

**Audit deficiencies in relation to Bank Balances and Trade Receivables**

*External confirmations on bank balances*

35. In the 2013 Audit, the Auditor requested banks to confirm the amounts of bank balances held by the Group's subsidiaries. In particular, the Auditor requested the banks to return the confirmations directly to the Auditor. The purpose of the audit procedure was to obtain reliable audit evidence on the existence and accuracy of the bank balances.
36. Notably, four courier slips (attached to returned bank confirmations) bear the addresses of the Group's subsidiaries as the senders' addresses, which indicate that these confirmations were returned from the subsidiaries, rather than from the banks directly. External confirmations that do not come from the originally intended confirming party carry the risks of interception, alteration or fraud as set out in paragraph A11 of HKSA 505.

37. In the circumstances, the Auditor ought to have performed additional procedures, such as directly contacting the recipients of the confirmation requests (i.e. the banks) to resolve those doubts.
38. Based on the above, the AFRC found that, for the 2013 Audit, the Auditor failed to sufficiently identify factors that gave rise to doubts about the reliability of the responses to the confirmation requests and failed to obtain further audit evidence to resolve those doubts, in breach of paragraph 10 of HKSA 505.

*External confirmation on trade receivables*

39. In the 2013 Audit, the Auditor requested customers to confirm the amounts of trade receivables due from them to the Group's subsidiaries. In particular, the Auditor requested the customers to return the confirmations directly. The purpose of the audit procedure was to obtain reliable audit evidence on the existence and accuracy of the trade receivables.
40. Notably, one courier slip (attached to a returned confirmation) bears the address of a subsidiary of the Group as the sender's address, which indicates that the confirmation was returned from the subsidiary, rather than from the customer directly.
41. In the circumstances, the Auditor ought to have performed additional procedures, such as directly contact the recipient of the confirmation request to resolve those doubts.
42. Based on the above, the AFRC found that, for the 2013 Audit, the Auditor failed to sufficiently identify factors that gave rise to doubts about the reliability of the response to the confirmation request and failed to obtain further audit evidence to resolve those doubts, in breach of paragraph 10 of HKSA 505.

*Unconfirmed bank balance of approximately BDT57.2 million*

43. In the 2013 Audit, the Auditor requested a bank to directly confirm various bank balances held by a subsidiary of the Group, including but not limited to a bank balance of approximately BDT57.2 million (approximately RMB4.5 million).
44. The bank balance of BDT57.2 million was not confirmed in the returned bank confirmation. This constituted an exception in the returned external confirmation, which ought to have caused the Auditor to perform follow up procedures, such as contacting the bank to resolve those doubts.
45. Based on the above, the AFRC found that, for the 2013 Audit, the Auditor failed to investigate and perform any follow up procedures on this exception, in breach of paragraph 14 of HKSA 505.

### **COE breaches**

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

### **D. Conclusion**

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

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

- 48.1. the conduct involved multiple audit deficiencies and breaches of the PAO professional standards in the areas of revenue recognition and bank balances that are fundamental to the work of an auditor;
- 48.2. the Auditor knew that the turnkey projects and services business was the core operation of the Group and was significant to the 2012 and 2013 Financial Statements;
- 48.3. the Auditor's misconduct demonstrated a concerning lack of professional skepticism and over-reliance on management representations; and
- 48.4. there was no finding of intentional, dishonest or deliberate misconduct by Deloitte or Mak.

### **Aggravating circumstances**

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

### **Mitigating circumstances**

- 48.6. Mak has a clean disciplinary record with the AFRC and HKICPA; and
- 48.7. the AFRC has taken into account the cooperation provided by the Auditor in this case. Amongst others, the Auditor admitted their misconduct and initiated resolution discussions with the AFRC. The Auditor further accepted the Disciplinary Sanctions against each of

them and entered into an agreement with the AFRC pursuant to section 37I(1A) of the AFRCO before the issuance of a Notice of Proposed Disciplinary Action.