Investigation Report

(Case: I01-07)

[Auditor]

Re: audit of [Listed Entity]

Consolidated financial statements

for the year ended [financial year-end date]

Audit Investigation Board

26 November 2008

This report has been adopted by the Financial Reporting Council on 4 December 2008 in accordance with section 35(3) of the Financial Reporting Council Ordinance (Cap. 588).

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The enclosures are not published because they may contain non-public third party information.

Notes concerning this report

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

Any references in this report to breaches of any law, regulation, standards of accounting, auditing and assurance, practice or principle, or GEM Listing Rule should be understood in the context of that Ordinance only and pursuant to which this report was prepared.

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

Abbreviations

AIB	Audit Investigation Board
Asset Acquisition Agreement	Agreement between [Subsidiary] and [Non-controlling Shareholder] dated [a date] for the acquisition of [a type of assets]
Audit Working Papers	Working papers in relation to the audit of the Relevant Financial Statements
[Non-controlling Shareholder]	[Non-controlling shareholder of Subsidiary]
Comment Letter	Comment Letter from [Auditor] dated 14 November 2008
Council	Members of the Financial Reporting Council in meeting
[Subsidiary]	[Non-wholly owned subsidiary of Listed Entity]
[Listed Entity]	[Listed entity]
Dispute	Dispute between [Listed Entity] and [Non-controlling Shareholder] over [Subsidiary]
FRC	Financial Reporting Council
FRC Ordinance	Financial Reporting Council Ordinance
HKAS	Hong Kong Accounting Standards
HKFRS	Hong Kong Financial Reporting Standards
HKSA	Hong Kong Standards on Auditing
[Auditor]	[Auditor]
[Engagement Director]	[Engagement Director], the engagement director of the audit of the Relevant Financial Statements
[Engagement Manager]	[Engagement Manager], the engagement manager of the audit of Relevant Financial Statements
PPE	Property, plant and equipment
Relevant Financial Statements	Consolidated financial statements of [Listed Entity] for the year ended [financial year-end date]

SAS	Statement of Auditing Standards
Secretariat	Secretariat of the FRC
The Group	Listed Entity and its subsidiaries

Executive Summary

Introduction

This report contains the findings of the investigation conducted by the AIB pursuant to section 23(1)(b) of the FRC Ordinance in respect of the audit of the Relevant Financial Statements by [Auditor]. The investigation focused on the audit of [Listed Entity]'s interest in [Subsidiary] for inclusion in the Relevant Financial Statements as a subsidiary.

Background

[Background information omitted]

[Background information omitted]

The FRC received a complaint on 26 September 2007.

The allegations of the complaint related to the audit of [Subsidiary] included as a subsidiary in the consolidated financial statements of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date].

[Auditor] was the auditor of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date]. The auditor's report for the two years contained no modification.

The Secretariat obtained information from [Auditor] and further information from the complainant. In the light of the information available, the Council decided not to pursue the allegations in the complaint in relation to the audit of the consolidated financial statements of [Listed Entity] for [preceding financial year-end date].

Initiation of investigation

Having taken into consideration all the information laid before it, the Council, on 31 October 2007, decided to initiate an investigation and directed the AIB in accordance with section 23(1)(b) of the FRC Ordinance to investigate the possible auditing irregularity and the question whether or not there is such an irregularity in relation to the audit of the Relevant Financial Statements.

The Relevant Financial Statements showed a consolidated profit of [currency and amount] and consolidated net assets of [currency and amount]. The Relevant Financial Statements were said to be prepared in accordance with HKFRS.

A loss of [currency and amount] and net assets of [currency and amount] of [Subsidiary] were included in the Relevant Financial Statements.

Scope of investigation

The investigation was to collect information and evidence relating to the question whether or not there is an auditing irregularity in relation to the audit of the Relevant Financial Statements in respect of the following areas:-

a. the dispute between [Listed Entity] and [Non-controlling Shareholder];

b. bank balances and [a type of assets] owned by [Subsidiary]; and

c. the amount due from [Non-controlling Shareholder] to ([Subsidiary]).

[Explanation of the relationship between a type of assets and the PPE omitted]

Relevant auditing and assurance standards

The auditing and assurance standards applicable at the time of the audit of the Relevant Financial Statements and which are relevant to the findings on the question whether or not there is an auditing irregularity in this report are set out below:-

HKSA 200 (Revised)	*Objectives and General Principles Governing an Audit of Financial Statements*
HKSA 500	*Audit Evidence*
SAS 230	*Documentation*

Views of the AIB

It appears to the AIB there is evidence to suggest that the audit of the Relevant Financial Statements in respect of the audit of the amount due from [Non-controlling Shareholder] and the valuation of the PPE of [Subsidiary], and, the documentation in the Audit Working Papers, did not fully comply with the relevant auditing and assurance standards.

Amount due from [Non-controlling Shareholder]

[Auditor] identified the recoverability of the amount due from [Non-controlling Shareholder] as a major issue. [Auditor] did not seek written confirmation of this amount since the management of [Listed Entity] requested it not to do so and the management of [Non-controlling Shareholder] verbally informed [Auditor] that it would not confirm the balance in view of the Dispute. [Auditor] performed some additional audit procedures, e.g. checking opening balance and review movement of the account. The AIB considers that these additional audit procedures did not contribute any independent evidence on the recoverability of the amount. [Auditor] also explained that it was told by the management of [Listed Entity] that the amount would be settled by future transfer of assets. However, no independent evidence was obtained to substantiate that. [Auditor] relied on management representation to conclude that there was no recoverability issue. It appears to the AIB there is evidence to suggest that sufficient independent audit evidence had not been obtained on the recoverability of the amount due from [Non-controlling Shareholder] as required by paragraph 2 of HKSA 500 *Audit Evidence*.

PPE of [Subsidiary] – valuation

Although there were significant additions of [a type of assets] by the end of [the preceding financial year], revenue and gross profit fell significantly in [the current financial year] and [Subsidiary] was in loss in that year. [Auditor] explained that the loss was caused by a significant increase in administrative and selling expenses. The AIB did not concur to this view because the increase in administrative and selling expenses in [the current financial year] was less than the loss for the year. The AIB considers there were impairment indications in relation to the PPE of [Subsidiary]. No evaluation of impairment was performed. There was no evidence in the Audit Working Papers that [Auditor] had asked for budgeted cash flows of the assets. It appears to the AIB there is evidence to suggest that [Auditor] did not exercise sufficient professional skepticism according to paragraph 15 of HKSA 200 (Revised) *Objectives and General Principles Governing an Audit of Financial Statements* in the audit of the PPE of [Subsidiary].

Documentation

Certain audit procedures performed and the reasoning on certain audit matters, which, the AIB considers, were important in providing evidence to support the audit opinion, were not documented in the Audit Working Papers. It appears to the AIB there is evidence to suggest that the documentation in the Audit Working Papers, with respect to the audit of the Dispute, the amount due from [Non-controlling Shareholder] and the PPE of [Subsidiary], was insufficient according to the requirement in paragraph 2 of SAS 230 *Documentation*.

The AIB also looked into the following areas of the audit of [Subsidiary].

Dispute

The management of [Listed Entity] informed [Auditor] that the Dispute related to the operation of [Subsidiary] and might lead to its liquidation. The discussion about the plan to dissolve [Subsidiary] was in progress at the time of the issue of the Relevant Financial Statements. [Auditor] had direct communication with the counterparty of the Dispute and did not notice any inconsistency. [Auditor] performed additional audit procedures and satisfied that there were no litigations and claims. [Auditor] concluded that the Dispute would not affect the Relevant Financial Statements. It appears to the AIB that it was not unreasonable for [Auditor] to arrive at such a conclusion at the time.

The AIB considers the statement made by a director of [Listed Entity] in his representation to [Auditor] relating to the liquidation of [Subsidiary] did not fully reflect the true position.

PPE of [Subsidiary] – existence

[Auditor] verified the existence of the PPE of the Group by physical examination. Specific items were selected and rotational basis of samples selection were used for physical examination. The AIB considers that it was reasonable for [Auditor] not to select the PPE of [Subsidiary] for physical examination.

Completeness of disclosures with respect to any restriction on the bank accounts and other assets of [Subsidiary]

It appears to the AIB that [Auditor] had obtained sufficient audit evidence in respect of the completeness of disclosures with respect to any restriction on the bank accounts and other assets of [Subsidiary]. Neither the bank nor the management of [Listed Entity] informed [Auditor] of the restriction on the bank accounts. In the absence of information, the AIB considers there was no reason for [Auditor] to suspect that there was any restriction on the bank accounts and other assets of [Subsidiary].

Comments on investigation report from [Auditor]

The first draft of the investigation report was sent to [Auditor] for comments on 5 May 2008. After taking into account, among other things, the comments of [Auditor], the AIB revised the investigation report. The second draft of the report was sent to [Auditor], [Engagement Director], [a director who performed quality review of the engagement] and [Engagement Manager] for comments on 24 October 2008. On 14 November 2008, [Auditor] provided its comments and [Engagement Director], [the director who performed quality review of the engagement] and [Engagement Manager] also wrote to confirm that they agreed with the comments of [Auditor]. [Auditor] strongly disagreed with the views of the AIB. [Auditor] believed that it fully complied with the relevant auditing and assurance standards in relation to the audit of the Relevant Financial Statements. The letters are attached as Annex 5L, Annex 5M, Annex 5N and Annex 5O to this investigation report.

The AIB considered the comments from [Auditor] on the second draft of the report and the views of the AIB stayed the same.

Comments on investigation report from [Listed Entity]

[Listed Entity] did not provide any comment in relation to the management representation regarding the liquidation of [Subsidiary].

Section 1 Introduction

1.1 General

1.1.1 This report contains the findings of the investigation conducted by the AIB pursuant to section 23(1)(b) of the FRC Ordinance in relation to the audit of the Relevant Financial Statements by [Auditor].

1.1.2 The FRC received a complaint on 26 September 2007 in relation to [Auditor].

1.1.3 The allegations of the complaint related to the audit of [Subsidiary] included as a subsidiary in the consolidated financial statements of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date].

1.2 Background information

1.2.1 [Background information omitted]

1.2.2 [Background information omitted]

1.2.3 [Auditor] was the auditor of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date]. [Auditor]'s role was to conduct the audit of the consolidated financial statements of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date] in accordance with HKSA. The auditor's report for the two years contained no modification.

1.2.4 The Relevant Financial Statements showed a consolidated profit of [currency and amount] and consolidated net assets of [currency and amount]. The consolidated financial statements of [Listed Entity] for the year ended [preceding financial year-end date] showed a consolidated profit of [currency and amount] and consolidated net assets of [currency and amount]. The consolidated financial statements of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date] were said to be prepared in accordance with HKFRS.

1.3 The investigation

1.3.1 The Council initiated the investigation on 31 October 2007.

1.3.2 The AIB consists of the following members:-

a. Mr. M.T.Shum, the Chairman;

b. Ms. Clara Yu (resigned on 25 September 2008);

c. Ms. Joyce Woo (appointed on 16 February 2008);

d. Ms. Velma Cheung (appointed on 25 September 2008)and

e. Ms. Anna Lau.

1.3.3 This investigation report of the AIB was adopted by the Council on 4 December 2008.

1.3.4 The first draft of the investigation report was sent to [Auditor] for comments on 5 May 2008. [Auditor] responded on 27 May 2008. After taking into account, among other things, the comments of [Auditor], the AIB revised the investigation report. The second draft of the investigation report was sent to [Auditor], [Engagement Director], [a director who performed quality review of the engagement] and [Engagement Manager] for comments on 24 October 2008. On 14 November 2008, [Auditor] provided its comments and [Engagement Director], [the director who performed quality review of the engagement] and [Engagement Manager] also wrote to confirm that they agreed with the comments of [Auditor]. [Auditor] provided general comments and specific comments to the views of the AIB. The comment letters from [Auditor], [Engagement Director], [the director who performed quality review of the engagement] and [Engagement Manager] are enclosed as Annex 5L, Annex 5M, Annex 5N and Annex 5O respectively. The general comments from [Auditor] are set out in sections A, B and F of the Comment Letter and are dealt with under section 13 of this investigation report.

1.3.5 The specific comments from [Auditor] are set out in sections C, D and E of the Comment Letter and are dealt with under the appropriate sections in this investigation report.

1.3.6 On 21 May 2008, [Listed Entity] provided its comment. The letter is enclosed as Annex 5K.1a/5K.1b. Details of [Listed Entity]'s comment are discussed in the appropriate sections of this report.

Section 2 The complaint

2.1 The complaint (Annex 1A.1a/1A.1b) related to the audit of [Subsidiary] included as a subsidiary in the consolidated financial statements of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date] by [Auditor]. It alleged that:-

a. [a type of assets] held by [Subsidiary] were demolished in [the preceding financial year] and [the current financial year]. However, the corresponding carrying amounts were not written off in the consolidated financial statements of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date]

b. In [the current financial year], the bank balances of [Subsidiary] were frozen and some other assets were placed under court custody. Such restrictions were not disclosed in the Relevant Financial Statements.

c. An amount of [currency and amount] due from [Non-controlling Shareholder] was not recoverable. The amount was not impaired in the consolidated financial statements of [Listed Entity] for the years ended [preceding financial year-end date] and [financial year-end date]

2.2 In order to assess whether or not it should be recommended to the Council to initiate an investigation, the Secretariat sent a letter to [Auditor] (Annex 4A) asking for explanations on the allegations and details of audit procedures performed in relation to [a type of assets] and bank balances of [Subsidiary] and the amount due from [Non-controlling Shareholder]. [Auditor] replied on 22 October 2007 (Annex 4B).

Audit for the year ended [preceding financial year-end date]

2.3 Based on the information provided by [Auditor] and in the absence of any supporting information in respect of the allegations set out in 2.1a and 2.1c for the year ended [preceding financial year-end date], the Council decided not to initiate an investigation in relation to the audit of the consolidated financial statements of [Listed Entity] for the year ended [preceding financial year-end date].

Section 3 Initiation of investigation

3.1 On 31 October 2007, the Council decided to initiate an investigation (reference I01-07) and directed the AIB to investigate the possible auditing irregularity and the question whether or not there is such an irregularity in relation to the audit of the Relevant Financial Statements in respect of the following areas:-

a. the dispute between [Listed Entity] and [Non-controlling Shareholder];

b. bank balances and [a type of assets] owned by [Subsidiary]; and

c. the amount due from [Non-controlling Shareholder] (to [Subsidiary]).

[Explanation of the relationship between a type of asset and the PPE omitted]

3.2 The accounting, auditing and assurance standards applicable at the time of the audit of the Relevant Financial Statements and which are relevant to the findings of the investigation in this report are set out below:-

HKAS 7	*Cash Flow Statements*
HKAS 16	*Property, plant and equipment*
HKAS 36	*Impairment of Assets*
HKSA 200 (Revised)	*Objectives and General Principles Governing an Audit of Financial Statements*
HKSA 500	*Audit Evidence*
HKSA 505	*External Confirmations*
HKSA 530	*Audit Sampling and Other Means of Testing*
SAS 230	*Documentation*

Section 4 Investigation approach

4.1 Requirements issued

4.1.1 For the purpose of the investigation, the AIB issued requirements under sections 25 and 27 of the FRC Ordinance to [Auditor] for the production of the Audit Working Papers and the provision of explanations of the Audit Working Papers.

4.1.2 The AIB obtained the audit files from [Auditor] during November and December 2007 for detailed review. [Auditor] confirmed (Annex 5A) the records and documents produced were the complete set of the Audit Working Papers.

4.1.3 The AIB also required [Listed Entity] and requested [Subsidiary] to provide relevant information, explanations and documents.

4.2 Background information of [Subsidiary]

4.2.1 [Background information omitted]

4.2.2 [Extract of financial information omitted]

4.2.3 [Auditor] considered that [Subsidiary] was a material subsidiary of [Listed entity] at the time of initially planning the engagement (7.1.2.1). There was no mention in the Audit Working Papers of the change in this assessment when evaluating the results of audit procedures. [Subsidiary] was included under the section of major issues of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers (item 4.6).

4.3 Major areas for investigation

4.3.1 In view of the allegations of the complainant and with reference to the scope of the investigation set out in 3.1, the AIB selected the following Audit Working Papers for detailed review:-

a. audit procedures performed to address the risks of material misstatement due to the Dispute including the possibility of the liquidation of [Subsidiary] (section 7);

b. audit procedures performed in relation to the amount due from [Non-controlling Shareholder] (section 8);

c. audit procedures performed in relation to the PPE of [Subsidiary] (sections 9 and 10); and

d. audit procedures performed in relation to the completeness of disclosures with respect to any restriction on the bank accounts and other assets of [Subsidiary] (section 11).

Section 5 Audit approach of [Auditor]

5.1 The Relevant Financial Statements incorporated the financial statements of [Listed Entity] and its subsidiaries. According to Appendix 8 of the "audit planning memorandum" (Annex 3A.1) of the Audit Working Papers, it was said that the audit of the Group would be conducted jointly by [Auditor] and [the affiliated firm of the Auditor]. The audit of [Subsidiary] would be performed by [Auditor] as part of the audit of the Relevant Financial Statements.

5.2 According to sections 5.2 and 7.1 of the "audit planning memorandum" (Annex 3A.1) of the Audit Working Papers, [Auditor] stated that it did not plan to rely on the Group's internal control for the purpose of the audit of the Relevant Financial Statements since it considered it was more efficient to perform substantive procedures. [Auditor] said that it would seek audit evidence from substantive procedures.

5.3 In Appendix 5 of the "audit planning memorandum" (Annex 3A.1) of the Audit Working Papers, it was said that the materiality in relation to the audit of the Relevant Financial Statements would be [currency and amount]. The planning audit materiality was calculated based on 5% of the profit before tax of the Group as per the draft financial statements prepared by the management of [Listed Entity].

Section 6 The audit engagement team

6.1 According to section 9 of the “audit planning memorandum” (Annex 3A.1) of the Audit Working Papers, [Engagement Director] was the audit engagement director and [Engagement Manager] was the audit engagement manager in relation to the audit of the Relevant Financial Statements. There were five other members in the audit team.

6.2 According to the “Final Review Checklist” (Annex 3B.7) of the Audit Working Papers, it was [Auditor]’s internal policy to carry out a second review of the engagement files by a director. The director who carried out the second review of the audit of the Relevant Financial Statements was [name of the director].

Section 7 Dispute over [Subsidiary]

7.1 Findings of facts

7.1.1 Background

7.1.1.1 On [a date subsequent to the financial year-end date and before the issue date of the Relevant Financial Statements], [Listed Entity] agreed to enter into a mediation agreement (Annex 5E.2a/5E.2b) with [Non-controlling Shareholder] and [Subsidiary] to dissolve [Subsidiary]. The management of [Listed Entity] did not inform [Auditor] of this mediation agreement (7.1.4.2c).

7.1.1.2 On [a date in the financial year], [Non-controlling Shareholder] had filed a petition (Annex 5E.1a/5E.1b) to court to dissolve [Subsidiary] because there was a dispute between [Listed Entity] and [Non-controlling Shareholder] over [Subsidiary]. [Auditor] was not aware of that (7.1.3.6).

7.1.2 Information from the review of the Audit Working Papers

7.1.2.1 In the "audit planning memorandum" (Annex 3A.1) of the Audit Working Papers, the Dispute was included under the section of "critical audit areas". An extract of the "audit planning memorandum" is set out below:-

"According to the management accounts of [Subsidiary], for the nine months ended [three months before financial year-end date], the net assets value of [Subsidiary] amounted to [currency and amount] and the Group's attributable share of net assets of [Subsidiary] amounted to [currency and amount] as at [three months before financial year-end date].

According to the Group's consolidated management accounts for the nine months ended [three months before financial year-end date], the Group's net assets value (less minority interest) amounted to [currency and amount] and the Group's net profit for the period amounted to [currency and amount]. Accordingly we expected that the Group's attributable share of net assets value of [Subsidiary] will approximate to 9.7% and 138% of the Group's net assets value and net profit for the year respectively.

As advised by management, it is possible that the financial information of [Subsidiary] is unable to be made available to us for audit purpose because of the potential dispute between the Group, and [Non-controlling Shareholder] and management of [Subsidiary] (collectively referred to as "[Subsidiary] management"). Group management advised us that they may take proactive actions including legal proceedings against [Subsidiary] Management in order to dissolve [Subsidiary] and to repossess the Group's attributable benefits in [Subsidiary]. The Group is in process of evaluating the legal and financial consequences of different alternatives and has not made decision at this stage."

"In view of the above uncertainty, we preliminarily estimated the impact to our audit opinion in the event that we have a limitation of scope in audit of [Subsidiary]. Based on the financial highlights as mentioned above, we preliminarily considered that the financial information of [Subsidiary] is material to the Group's financial statements. In particular, the inability to ascertain the recoverability of [Subsidiary]'s net assets value will materially undermine our ability to obtain sufficient assurance on the results of the Group for the current year. Based on Statement of Auditing Standards 600 "Auditors' reports on financial statements", such limitation of scope would lead to a qualified opinion with (i) except for limitation; or (ii) disclaimer (if surrounding evidence demonstrates that the impact is so material or pervasive to the financial statements that they could, as a whole, be misleading)."

7.1.2.2 The following audit procedures were performed regarding the Dispute:-

a. obtained written representations from the management of [Listed Entity] (7.1.2.3); and

b. made inquiries of the progress of the Dispute for the purpose of identifying post balance sheet event (7.1.2.4).

7.1.2.3 The "management representation letter" (Annex 3B.6a/3B.6b) filed in the Audit Working Papers was prepared in Chinese and signed by a director of [Listed Entity] on behalf of the board on [issue date of the Relevant Financial Statements]. A translation of items 10, 18 and 19 of the management representation letter is reproduced below:-

Item 10 [Listed Entity] and the Group have no plans or intentions that will materially alter the carrying amounts or the classification of the assets.

Item 18 There have been no events that require adjustments or disclosure in the financial statements, or any matter that requires disclosure to the shareholders subsequent to the balance sheet date and up to the date of this letter. We have no plans or intentions that will materially alter the carrying amounts and the classification of the assets and liabilities.

Item 19 We are discussing with [Non-controlling Shareholder] regarding the plan to dissolve [Subsidiary] and distribute the assets of [Subsidiary]. The plan is still in progress as at the date of this letter. No disclosure is required in [the current financial year] financial statements.

According to [Auditor]'s interpretation, the second last sentence means that the discussion instead of the plan to dissolve [Subsidiary] is in progress as at the date of the letter.

7.1.2.4 According to item 4.6 of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers dated [a date subsequent to the financial year-end date and before the issue date of the Relevant Financial Statements], [Auditor] included the potential liquidation of [Subsidiary] under the section of "major issues". In this document, [Auditor] stated:-

"Management of the Group is in discussion with [Non-controlling Shareholder] for the proposed liquidation of [Subsidiary] whilst the plan is still to be finalized with [Non-controlling Shareholder] and other alternatives may be used. As the final decision has not been made by management as of the date, we concur with management that no post balance sheet event is disclosed in this regard."

7.1.3 Information and explanation provided by [Auditor]

7.1.3.1 On 11 December 2007, [Engagement Manager] was requested to clarify whether or not [Auditor] had performed any audit procedures regarding litigations and claims since [Auditor] was advised by the management of [Listed Entity] at the planning stage that "they may take proactive actions including legal proceedings against [Subsidiary] management in order to dissolve [Subsidiary] and to repossess the Group's attributable benefits in [Subsidiary]".

7.1.3.2 In response to the request on 11 December 2007, [Engagement Director], subsequently replied on 28 December 2007 (Annex 5B) explaining the audit work performed. The following summarizes the audit work performed by [Auditor] regarding litigation and claims:-

a. made appropriate inquiries of the management including obtaining representations (7.1.2.1 to 7.1.2.3);
b. reviewed minutes of meetings of those charged with governance including the board of directors and audit committee of [Listed Entity] (Annex 3B.3 and 3B.4);
c. examined legal expense account;
d. reviewed correspondence between the Group and its legal counsel; and
e. sought direct communication with [Non-controlling Shareholder] (7.1.3.3 and 7.1.3.7).

Based on the audit procedures performed, [Auditor] was not aware of any litigation.

7.1.3.3 In the letter to the AIB dated 28 December 2007 (Annex 5B), it was stated that [Auditor] had "considered the reasonableness and consistency of management representations in the light of the evidence obtained through direct communication with management of [Non-controlling Shareholder], the counter party of the Dispute on the progress of resolving the Dispute (we had not noted any inconsistency with the representation obtained from management of the Group)." Details of the verbal communication with [Non-controlling Shareholder] management are also set out in 7.1.3.7.

7.1.3.4 In the reply letter dated 28 December 2007 (Annex 5B), [Engagement Director] stated:-

"3b. Moreover, based on our understanding, the Dispute only related to the direction of operations of [Subsidiary] but not any financial aspects or any fraudulent acts of [Subsidiary], the Company and [Non-controlling Shareholder]. Therefore the risk of possible material misstatements at the financial statement or disclosure assertion levels as a result of the Dispute was considered not significant throughout our course of the audit."

7.1.3.5 On 4 January 2008, the AIB required (Annex 5D) [Auditor] to state whether or not it was aware of the receipt of notice of proceedings in relation to the Dispute by [Listed Entity] during the audit of the Relevant Financial Statements.

7.1.3.6 In response to the requirement dated 4 January 2008, [Engagement Director], replied on 16 January 2008 (Annex 5G), and confirmed that [Auditor] was not aware of the receipt of notice of proceedings by [Listed Entity].

7.1.3.7 On 24 April 2008, [Engagement Director] confirmed in writing (Annex 5J) matters discussed in the meeting with the AIB on 14 March 2008. An extract of the letter is set out below:-

"[A time shortly before the issue date of the Relevant Financial Statements], there was a meeting between Mr. X of [Non-controlling Shareholder], a personnel from the Company and [Engagement Manager] of our firm. The primary purpose of the meeting was to discuss the release of financial information of [Subsidiary] by Mr. X for the purpose of our audit. Based on the recollection of our [Engagement Manager], at no time during the meeting was a disagreement over the amount due from [Non-controlling Shareholder] or a liquidation of [Subsidiary] mentioned by the other two parties present at the meeting."

7.1.4 Information and explanation provided by [Listed Entity]

7.1.4.1 On 15 January 2008, the AIB required (Annex 5F.1a/5F.1b) [Listed Entity] to explain the following matters:-

a. whether or not it had communicated with [Auditor] about the receipt of notice of proceedings in relation to the Dispute, on or before the Relevant Financial Statements were authorized for issue on [the issue date of the Relevant Financial Statements];

b. whether or not it had obtained legal advice in relation to the litigation about the Dispute and if so, whether or not it had provided the relevant correspondence to [Auditor]; and

c. whether or not it had communicated with [Auditor] about the mediation agreement which agreed to liquidate [Subsidiary], on or before the Relevant Financial Statements were authorized for issue on [the issue date of the Relevant Financial Statements].

7.1.4.2 In response to the requirement dated 15 January 2008, a director of [Listed Entity] replied on 28 January 2008 (Annex 5H.1a/5H.1b) and confirmed:-

a. [Listed Entity] had not communicated with [Auditor] about the receipt of notice of proceedings in relation to the Dispute before the Relevant Financial Statements were authorized for issue on [the issue date of the Relevant Financial Statements] because during the initial stage of the Dispute, it considered the dissolution of [Subsidiary] was still under negotiation and the outcome was uncertain. Besides, it had obtained legal advice with regard to the litigation about the Dispute and the lawyer was of the view that the litigation was ungrounded;

b. the communication between [Listed Entity] and the lawyer in connection with the litigation about the Dispute was made verbally and there was no written correspondence provided to [Auditor]; and

c. [Listed Entity] had not informed [Auditor] regarding the mediation agreement because it considered the financial report was basically finalized and the liquidation procedure of [Subsidiary] had not been commenced as at [the issue date of the Relevant Financial Statements].

7.2 Views of the AIB

7.2.1 It appears to the AIB that it was reasonable for [Auditor] to come to the conclusion that the Dispute would not affect the Relevant Financial Statements at the time.

7.2.2 The AIB considers that the management of [Listed Entity] should have informed [Auditor] of the mediation agreement to dissolve [Subsidiary] (7.1.4.2c).

7.3 Comments on investigation report from [Auditor]

7.3.1 [Auditor] did not provide any comment on this section.

7.4 Comments on investigation report from [Listed Entity]

7.4.1 Relevant parts of the draft investigation report were sent to the management of [Listed Entity] for comment on 13 May 2008. A reply (Annex 5K.1a/5K.1b) was received on 21 May 2008. [Listed Entity] did not provide any comment in relation to the management representation regarding the possible liquidation of [Subsidiary].

Section 8 Amount due from [Non-controlling Shareholder]

8.1 Findings of facts

8.1.1 Background

8.1.1.1 According to the Relevant Financial Statements (Annex 2A.1a/2A.1b), the amount due from [Non-controlling Shareholder] was included as part of "the amount due from related companies". The carrying value of the amount due from [Non-controlling Shareholder] as at [financial year-end date] was [currency and amount] while the carrying value of consolidated amount due from related companies was [currency and amount]. The amount due from [Non-controlling Shareholder] accounted for 27.5% of consolidated amount due from related companies. [Auditor] identified the recoverability of the amount due from [Non-controlling Shareholder] as a major issue in its clearance memorandum (8.1.2.10).

8.1.1.2 No impairment of the amount due from [Non-controlling Shareholder] was noted in the Relevant Financial Statements (Annex 2A.1a/2A.1b).

8.1.2 Information from the review of the Audit Working Papers

8.1.2.1 According to the "lead schedule for the amount due from [Non-controlling Shareholder]" (Annex 3C.1) of the Audit Working Papers, the amount due from [Non-controlling Shareholder] mainly represented a prepayment for acquisition of [a type of assets] and the management of [Listed Entity] expected the balance would be settled by the transfer of assets.

8.1.2.2 In the "lead schedule for the amount due from [Non-controlling Shareholder]" (Annex 3C.1) and Appendix III of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers, [Auditor] explained the background of the amount due from [Non-controlling Shareholder] which is set out below:-

"In June [the year before the preceding year], [Subsidiary] (the "Company") entered into a master sales and purchases agreement with [Non-controlling Shareholder] to purchase [a type of assets] of [quantity] from [Non-Controlling Shareholder] in the consideration of approximately [currency and amount] and the finalized consideration is to be determined by the professional valuation reports on the [a type of assets]. Movement of amount with [Non-Controlling Shareholder] is as follows:

[Movement of the balance omitted]

According to management and the above master sale and purchase agreement, the above advance amount has been made to [Non-Controlling Shareholder] mainly for the proposed purchase of [a type of assets] owned by [Non-Controlling Shareholder]. According to management, they are negotiating with [Non-Controlling Shareholder] for identifying the target [a type of assets] and plan to effect the purchase with settlement through this current account of [currency and amount] in [the following financial year]."

8.1.2.3 [A quote of the announcement of Listed Entity omitted]

8.1.2.4 In the "lead schedule for the amount due from [Non-controlling Shareholder]" (Annex 3C.1) and Appendix III of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers, [Auditor] stated that it was told by the management of [Listed Entity] that "At this stage, ([Listed Entity]) management is in progress of discussing with [Non-Controlling Shareholder] for proposed liquidation of the Company ([Subsidiary]) and not yet finalized @date of audit and thus [Listed Entity] management represented to us that [Non-Controlling Shareholder] refuses to confirm the balances at this stage for avoiding any risk from the prospective (perspective) of [Non-controlling Shareholder]." As a result, no request for confirmation was sent to [Non-controlling Shareholder]. In relation to the "recoverability and valuation of the current account", [Auditor] performed the following audit procedures:-

a. checked the opening balance of [currency and amount] to a statement of account (Annex 3C.2a/3C.2b) containing the stamp of [Non-controlling Shareholder]; and

b. reviewed the movement in the ledger of the amount due from [Non-controlling Shareholder] of [currency and amount] during the year with reference to the supporting documents.

[Auditor] did not notice any exception based on the audit procedures performed and concluded that "The valuation of the amount as at [financial year-end date] is ascertained".

8.1.2.5 In addition to the above, [Auditor]:-

a. obtained representations from the management of [Listed Entity] (8.1.2.6); and

b. evaluated the assessment of the management of [Listed Entity] relating to the recoverability of the amount due from [Non-controlling Shareholder] (8.1.2.7 and 8.1.2.8).

8.1.2.6 The "management representation letter" (Annex 3B.6a/3B.6b) filed in the Audit Working Papers was prepared in Chinese and signed by a director of [Listed Entity] on behalf of the board of directors on [the issue date of the Relevant Financial Statements]. A translation of item 8 of the management representation letter is reproduced below:-

"The amount due from [Non-controlling Shareholder] of [currency and amount] is fully recoverable."

8.1.2.7 In the "lead schedule for the amount due from [Non-controlling Shareholder]" (Annex 3C.1) and Appendix III of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers, [Auditor] documented the assessment of the management of [Listed Entity] relating to the recoverability of the amount due from [Non-controlling Shareholder] as follows:-

a. "Given a latest transfer of [a type of assets] in [the last month of the preceding financial year] which are properly made in accordance with the terms of the above agreement (master sale and purchase agreement) and client's strategy in developing its [a city] market, management ([Listed Entity]) consider that the recoverability of the amount through transfer of asset is probable and it should not be adversely affected by [Listed Entity]'s discussion of liquidation with [Non-controlling Shareholder]."

b. "Moreover, management considered that they can effectively get possession of [Non-controlling Shareholder]'s share of net assets in [Subsidiary] in case of non-repayment of the above balance." "Accordingly, [Listed Entity] management considered that they can effectively freeze [Non-controlling Shareholder]'s interest in the Company ([Subsidiary]) to recover the above balance in event of any default of [Non-controlling Shareholder]."

8.1.2.8 In the "lead schedule for the amount due from [Non-controlling Shareholder]" (Annex 3C.1) and Appendix III of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers, [Auditor] indicated that it agreed with the management of [Listed Entity] that there was no recoverability issue in relation to the amount due from [Non-controlling Shareholder]. In evaluating the assessment of the management of [Listed Entity] set out in 8.1.2.7, it was stated that "we have checked the articles of association of the Company ([Subsidiary]), any transfer of [Non-controlling Shareholder]'s interest in the Company ([Subsidiary]) should only be made with the consent from [Listed Entity]. As at [financial year-end date], net assets of the Company ([Subsidiary]) amounted to [currency and amount] and [Non-controlling Shareholder]'s share amounted to [currency and amount] which exceeds the amount due from [Non-controlling Shareholder]." "………..we have reviewed article of association filed at F403 and audited the [current financial year] financial statements of the Company ([Subsidiary]) without exception noted. Accordingly, we concurred with management that no recoverability problem is noted at this stage and no provision is suggested and valuation of the amount is considered reasonably stated as at [financial year-end date]".

8.1.2.9 According to clause 11 of [Subsidiary]'s Articles of Association (Annex 3C.3a/3C.3b) filed in the Audit Working Papers, any transfer of interest in [Subsidiary] shall be approved if it is agreed by shareholders with more than 50 per cent of the registered capital. Since [Listed Entity] owned [percentage] of the registered capital of [Subsidiary], a transfer of [Non-controlling Shareholder]'s interest in [Subsidiary] would require the consent of [Listed Entity] according to the Articles of Association.

8.1.2.10 According to item 4.1 of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers, [Auditor] concluded that there was no recoverability issue of the amount due from [Non-controlling Shareholder] under the section of "major issues".

8.1.3 Information and explanation provided by [Auditor]

8.1.3.1 On 11 December 2007, [Engagement Manager] was requested to clarify whether or not [Auditor] had considered there were valid grounds for [Listed Entity] management's request not to seek confirmation from [Non-controlling Shareholder] as required by HKSA 505 *External Confirmations*.

8.1.3.2 In response to the request of 11 December 2007, [Engagement Director], replied on 28 December 2007 (Annex 5B). An extract of the reply is set out below:-

"Management of the Company requested us not to send confirmation to [Non-controlling Shareholder] for the amount due from it as at [financial year-end date], because (i) [Non-controlling Shareholder] would not be willing to respond to any kind of confirmation in respect of the operations or financial position of [Subsidiary] whilst the Dispute is ongoing; and (ii) such confirmation may intensify the Dispute unnecessarily and it is the Company's intention to resolve the Dispute peacefully.

During the field audit of [Subsidiary], management of [Non-controlling Shareholder] verbally told us that [Non-controlling Shareholder] would not respond to a request for confirmation of balances, in view of the Dispute. The representations from the Company and [Non-controlling Shareholder] were consistent in this regard. We were of the view that the Dispute was genuinely on the direction of operations of [Subsidiary]. There was no indication of any fraud or financial irregularity. We consider there are valid grounds for not sending a confirmation in these circumstances as permitted under HKSA 505 "External Confirmations"."

8.1.3.3 On 1 April 2008, [Engagement Director] wrote to the AIB (Annex 5I) to supplement the explanations in connection with the valuation of the amount due from [Non-controlling Shareholder]:-

"Pursuant to an asset acquisition agreement dated [a date], [Subsidiary] agreed to acquire [a type of assets] of [quantity] located in [a city] from [Non-controlling Shareholder] at a consideration of [currency and amount] (the "Framework Agreement"). Pursuant to a supplementary asset acquisition agreement dated [a date] (the Asset Acquisition Agreement), [Subsidiary] agreed to acquire [a type of assets] of approximately [quantity (which was less than the quantity in the original agreement)] located in [a city] from [Non-controlling Shareholder] at approximately [currency and amount] because of the delay in the construction of [a type of assets] that were originally stipulated in the Framework Agreement (the "Supplementary Agreement"). According to both the Framework Agreement and the Supplementary Agreement (the Asset Acquisition Agreement), the acquisitions of [a type of assets] from [Non-controlling Shareholder] were agreed to be completed by [one year before preceding financial year-end date] but the completion date could be extended. The agreed extension of the completion date of the acquisitions was supported by the following events which took place after the original completion date of [one year before preceding financial year-end date]:

(a) Cash payments (including the acquisition consideration of [currency and amount]) were made by [Subsidiary] to [Non-controlling Shareholder] during the [two preceding financial years]; and

(b) [a type of assets] of [currency and amount] were successfully acquired by [Subsidiary] from [Non-controlling Shareholder] in [the last month of the preceding financial year].

With regard to the residual Prepayment as at [preceding financial year-end date] and [financial year-end date], management of the Company considered that, on the basis that the original completion date of the Supplementary Agreement (the Asset Acquisition Agreement) and the Framework Agreement had been extended beyond [one year before preceding financial year-end date], the balance would continue to be used for the purpose of acquiring more [a type of assets] from [Non-controlling Shareholder] without any need for impairment. The purpose of the Prepayment held by [Non-controlling Shareholder] together with its carrying amount were disclosed accordingly in note [a number] to the Group's consolidated financial statements for the years ended [preceding financial year-end date] and [financial year-end date].

During the course of our audit, we did not come across any evidence that contradicts the above management representation."

8.1.3.4 On 24 April 2008, [Engagement Director] confirmed in writing (Annex 5J) matters discussed in the meeting with the AIB on 14 March 2008. An extract of the letter is set out below:-

"[A time shortly before the issue date of the Relevant Financial Statements], there was a meeting between Mr. X of [Non-controlling Shareholder], a personnel from the Company and [Engagement Manager] of our firm. The primary purpose of the meeting was to discuss the release of financial information of [Subsidiary] by Mr. X for the purpose of our audit. Based on the recollection of [Engagement Manager], at no time during the meeting was a disagreement over the amount due from [Non-controlling Shareholder] or a liquidation of [Subsidiary] mentioned by the other two parties present at the meeting."

8.2 Views of the AIB

8.2.1 [Subsidiary] paid [currency and amount] to [Non-controlling Shareholder] as prepayment for the purchase of [a type of assets] in [the two preceding financial years]. Both parties subsequently agreed to reduce the purchase of assets to [currency and amount]. The [a type of assets] were transferred in [the preceding financial year]. There was a balance of [currency and amount] outstanding. Together with an amount of [currency and amount], being lease payments agreed to be borne by [Non-controlling Shareholder], the total amount due from [Non-controlling Shareholder] was [currency and amount] (8.1.2.2 and 8.1.2.3). The supplementary provisions of the Asset Acquisition Agreement (Annex 3D.4a/3D.4b) stipulated for the reduction of the amount of assets acquired but were silent on how the remaining balance of the prepayment would be settled.

8.2.2 [Auditor] identified the recoverability of the amount due from [Non-controlling Shareholder] as a major issue in its clearance memorandum (8.1.2.10).

a. [Auditor] did not seek written confirmation regarding the amount due from [Non-controlling Shareholder] because (i) the management of [Listed Entity] requested it not to do so, and (ii) the management of [Non-controlling Shareholder] verbally informed [Auditor] that it would not confirm the balance in view of the Dispute (8.1.2.4 and 8.1.3.2). The AIB considers that these should have aroused [Auditor]'s skepticism.

b. [Auditor] performed alternative audit procedures in relation to the amount due from [Non-controlling Shareholder], e.g. checking opening balance and reviewing movement of the account. (8.1.2.4). The AIB considers that these audit procedures did not contribute any independent evidence to substantiate that the amount was recoverable.

8.2.3 The management of [Listed Entity] was of the view that the amount was recoverable because (i) the balance would be settled by future transfer of display assets and (ii) in case of default, [Listed Entity] had the ability to freeze the transfer of shares in [Subsidiary] held by [Non-controlling Shareholder]. Based on the above explanation and the written representation from the director of [Listed Entity], [Auditor] concluded there was no recoverability issue (8.1.2.7, 8.1.2.8 and 8.1.2.10).

8.2.4 It appears to the AIB that the explanation provided by management was unable to support the proposition that there was no recoverability issue in respect of the amount due from [Non-controlling Shareholder].

8.2.5 The agreement of purchase of [a type of assets] from [Non-controlling Shareholder] to [Subsidiary] was completed in [the preceding financial year], leaving a substantial amount outstanding. The management of [Listed Entity] claimed that the amount would be settled by future transfer of assets. No independent audit evidence was obtained by [Auditor] to prove that there was additional agreement or negotiation on further transfer of assets.

8.2.6 [Listed Entity]'s ability to restrict the transfer of [Subsidiary]'s equity was not relevant for assessing the recoverability of the amount due from [Non-controlling Shareholder].

8.2.7 [Auditor] wrote to the AIB that, in a meeting with [Listed Entity] and [the personnel from Non-controlling Shareholder], [Engagement Manager] remembered that there was no mention of any disagreement on the amount due from [Non-controlling Shareholder] (8.1.3.4). The AIB considers that the silence of [Non-controlling Shareholder] personnel should not be taken as evidence to support the valuation of the amount due.

8.2.8 It appears to the AIB there is evidence to suggest that [Auditor] relied overly on the management representation and did not perform procedures to assess the reasonableness of the management representation and did not obtain sufficient evidence regarding the recoverability of the amount due from [Non-controlling Shareholder] in accordance with paragraph 2 of HKSA 500 *Audit Evidence*.

8.2.9 Paragraph 2 of HKSA 500 *Audit Evidence* states that:-

> "2. The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion."

8.3 Comments on investigation report from [Auditor]

8.3.1 In the Comment Letter (Annex 5L), [Auditor] strongly disagreed with the views of the AIB in relation to the amount due from [Non-controlling Shareholder].

8.3.2 [Auditor] explained that it considered materiality at the overall financial statement level. Although it established a preliminary materiality level at the planning stage, it adopted a materiality of 5% of the Group's net assets (i.e. [currency and amount]) when performing the final review of the Relevant Financial Statements. [Auditor] considered the Group's share of the amount due from [Non-controlling Shareholder] (i.e. [currency and amount]) was not material comparing to consolidated net assets.

8.3.3 [Auditor] considered that it appropriately relied on management representation and performed sufficient procedures to assess the reasonableness of its reliance and obtained sufficient appropriate evidence regarding the recoverability of the amount due from [Non-controlling Shareholder].

8.3.4 [Auditor] believed that since [Non-controlling Shareholder] was a related party of [Subsidiary], the management of [Subsidiary] had a better understanding of [Non-controlling Shareholder] and was in a better position to make an informed assessment of the recoverability of the amount due from [Non-controlling Shareholder]. Besides, the acquisition of [a type of assets] by [Subsidiary] was governed by the asset acquisition agreements dated [a date] and [a date] which were legally binding. [Auditor] was of the view that it was not unreasonable for the management of [Subsidiary] to conclude that, because of the two agreements, [Subsidiary] was able to recover the amount due from [Non-controlling Shareholder], by refusing to agree with any transfer of [Non-controlling Shareholder]'s interest in [Subsidiary] and ultimately by taking [Non-controlling Shareholder] to court, if necessary.

8.3.5 [Auditor] considered there was no objective evidence (such as the probability of insolvency or significant financial difficulties of [Non-controlling Shareholder] and significant changes in the technological, market, economic or legal environment that have an adverse effect on [Non-controlling Shareholder]) that the amount due from [Non-controlling Shareholder] was impaired and therefore no recognition of impairment loss was required. Besides, based on the evidence available, there was no objective evidence to suggest that the amount due from [Non-controlling Shareholder] was in dispute.

8.3.6 [Auditor] was of the opinion that [Listed Entity]'s ability to restrict the transfer of [Subsidiary]'s equity was relevant for assessing the recoverability of the amount due from [Non-controlling Shareholder].

8.4 Response of the AIB to [Auditor]'s comments

8.4.1 It was stated in the Audit Working Papers that [Auditor]'s assessment of materiality at the time of initially planning the engagement was [currency and amount] (5.3). There was no mention in the Audit Working Papers of the change in the planning materiality level. According to item 5 "conclusion on materiality" of "clearance memorandum" (Annex 3B.5) of the Audit Working Papers, it was stated that "preliminary materiality for the Group is [currency and amount] based on 5% of the Group's profit before tax as per the draft financial statements prepared by client. No material fluctuation is noted between audited financial statements and management accounts in terms of profit before tax and therefore no adjustment is made to the preliminary materiality as determined in planning stage."

8.4.2 [Auditor] mentioned that it adopted a materiality level of 5% of the net assets of the Group when performing the final review of the Relevant Financial Statements. There was no evidence that such materiality was adopted by [Auditor] when it concluded there was no recoverability issue for the amount due from [Non-controlling Shareholder].

8.4.3 The AIB was not aware of any terms in the Asset Acquisition Agreement which mentioned that in case [Non-controlling Shareholder] did not deliver the [a type of assets] to [Subsidiary], [Subsidiary] could refuse the transfer of [Non-controlling Shareholder]'s [a percentage] interest in itself in order to recover the prepayment. The ability of [Listed Entity] to refuse the transfer of [Non-controlling Shareholder]'s [a percentage] interest in [Subsidiary] was not relevant in assessing the recoverability of the amount due from [Non-controlling Shareholder].

8.4.4 There was a supplementary provision of the Asset Acquisition Agreement dated [a date], in which [Subsidiary] and [Non-controlling Shareholder] agreed to reduce the area of [a type of assets] acquired. In the absence of agreement to the otherwise, it appears to the AIB that a reasonable auditor would take it as that there was no further purchase to be executed and the amount of deposit paid to [Non-controlling Shareholder] should be refunded in due course.

Section 9 PPE of [Subsidiary] - existence

9.1 Findings of facts

9.1.1 Background

9.1.1.1 According to the Relevant Financial Statements (Annex 2A.1a/2A.1b), the carrying value of consolidated PPE was [currency and amount].

9.1.2 Information from the review of the Audit Working Papers

9.1.2.1 According to the "lead schedule for [Subsidiary]'s property, plant and equipment" (Annex 3D.1) of the Audit Working Papers, the carrying value of the PPE of [Subsidiary] as at [financial year-end date] was [amount], comprising [a type of assets], leasehold improvements, motor vehicle and office equipment with a carrying value of [currency and amount], [currency and amount], [currency and amount] and [currency and amount] respectively. [A type of assets] of [Subsidiary] accounted for 9.5% of consolidated PPE and 6.0% of consolidated net assets.

9.1.2.2 According to "productive assets cycle programme" (Annex 3D.5) of the Audit Working Papers, [Auditor] performed physical examinations to verify the existence of the PPE of the Group. It was stated that [Auditor] "randomly selected a sample from the fixed asset register in office and physically checked to its existence, result was satisfactory."

9.1.2.3 Appendix 9 of the "audit planning memorandum" (Annex 3A.1) of the Audit Working Papers was a sampling plan for physical examination of the PPE for [the current financial year] and it also showed the locations of the PPE that had been selected for testing [in the four preceding financial years]. The schedule did not contain information regarding the carrying value of the PPE of each location. There were 17 locations on the schedule. 5 locations would be selected for physical examination in [the current financial year]. It was stated that "we plan (for [the current financial year])/actually went to perform inspection/stocktaking with reference to operation of subsidiaries/branches and frequency of inspection/stocktaking of respective locations on a rolling basis." The location of the PPE of [Subsidiary] was not among those selected for physical examination in [the current financial year]. It was chosen for testing in [the preceding financial year].

9.1.2.4 In response to the AIB's inquiry on 11 December 2007 with regard to [Auditor]'s basis for selecting locations of the PPE for physical examination, [Auditor] produced another version of Appendix 9 of the "audit planning memorandum" (Annex 3A.2). The AIB notes that information relating to the carrying value of the PPE of each location as at [one month before financial year-end date] was in this version of Appendix 9. It was stated that the carrying value of the PPE of [Subsidiary] as at [one month before financial year-end date] was [currency and amount], representing 13.0% of the total carrying value of the PPE of the locations directly audited by [Auditor].

9.1.3 Information and explanation provided by [Auditor]

9.1.3.1 On 11 December 2007, [Engagement Manager] was requested to explain whether or not there was any established basis for selecting locations of the PPE for physical examination by [Auditor].

9.1.3.2 In response to the request of 11 December 2007, [Engagement Director], replied on 28 December 2007.

9.1.3.3 In the reply letter dated 28 December 2007 (Annex 5B), [Engagement Director] stated that:-

"In performing our physical inspection of the PPE of the Group, we decided to select specific items from the various sites of the Group based on the following factors:-

a. the nature of major PPE - As the major items of PPE of the Group are [a type of assets] which were erected at different locations, we considered that the newly acquired or built [a type of assets] would be in a better condition of operations in the absence of any blatant indication of impairment. Therefore the year that an item was last physical inspected was one of the selection criteria for performing physical inspection at a particular site of the Group in [the current financial year];

b. the value of PPE by sites; and

c. the risks of material misstatement of PPE of [Subsidiary] relative to the existence assertion as a result of the Dispute is not considered high as the Dispute is only on the direction of operations of [Subsidiary]. The Dispute is not about possible omissions or disappearance of PPE."

9.1.3.4 On 24 April 2008, [Engagement Director] confirmed in writing (Annex 5J) matters discussed in the meeting with the AIB on 14 March 2008. An extract of the letter is set out below:-

"We clarified that, for the purpose of selecting a location for physical inspection of property, plant and equipment, we adopted a rotational basis as modified for a consideration of the materiality of the property, plant and equipment of a location. This has the effect that the locations with higher value of property, plant and equipment will have a higher chance of being selected for physical inspection. This is considered to be an audit sampling method."

9.2 Views of the AIB

9.2.1 [Auditor] verified the existence of the PPE of the Group by physical examination (9.1.2.2).

9.2.2 [Auditor] explained that it selected specific items and samples on rotational basis of the PPE of the Group for physical examination (9.1.3.4). It was noted from the revised version of Appendix 9 of the "audit planning memorandum" (Annex 3A.2) that the items selected made up of 85.5% of the total carrying value of the PPE of the locations directly audited by [Auditor]. The location of the PPE of [Subsidiary] was not selected for physical examination in [the current financial year] (9.1.2.3).

9.2.3 Since there was no information available to [Auditor] that indicated any doubt on the existence of the PPE of [Subsidiary], the AIB considers that it was reasonable for [Auditor] not to select the PPE of [Subsidiary] for physical examination in [the current financial year].

9.3 Comments on investigation report from [Auditor]

9.3.1 [Auditor] did not provide any comment on this section.

Section 10 PPE of [Subsidiary] – valuation

10.1 Findings of facts

10.1.1 Background

10.1.1.1 According to the "lead schedule for [Subsidiary]'s property, plant and equipment" (Annex 3D.1) of the Audit Working Papers, the carrying value of the PPE of [Subsidiary] as at [financial year-end date] was [currency and amount]. The PPE of [Subsidiary] were mainly made up of [a type of assets] and the carrying value of [a type of assets] was [currency and amount]. According to the Relevant Financial Statements (Annex 2A.1a/2A.1b), the carrying value of consolidated PPE was [currency and amount]. [A type of assets] of [Subsidiary] accounted for 9.5% of consolidated PPE and 6.0% of consolidated net assets.

10.1.1.2 No impairment of PPE was noted in the Relevant Financial Statements (Annex 2A.1a/2A.1b).

10.1.2 Information from the review of the Audit Working Papers

10.1.2.1 According to the "lead schedule for [Subsidiary]'s property, plant and equipment" (Annex 3D.1) of the Audit Working Papers, the aggregate amounts of the additions of [a type of assets] were [currency and amount] in [the preceding financial year] and [currency and amount] in [the current financial year]

10.1.2.2 According to the "schedule of depreciation for [Subsidiary]'s [a type of assets]" (Annex 3D.3) of the Audit Working Papers and [various announcements of Listed Entity] (Annex 2C.1a/2C.1b/2B.1a/2B.1b), [a type of assets] were contributed by [Non-controlling Shareholder] on the formation of [Subsidiary] in [the financial year before the preceding financial year] at a cost of [currency and amount] and acquired from [Non-controlling Shareholder] under the Asset Acquisition Agreement in [the preceding financial year] at a cost of [currency and amount]. The values of [a type of assets] contributed/acquired were determined based on valuations.

10.1.2.3 With respect to the valuation of the PPE of [Subsidiary], the following audit procedures were performed:-

a. made inquiries of the management of [Listed Entity] (10.1.2.4);

b. obtained written representations from the management of [Listed Entity] (10.1.2.5);

c. reviewed the reasonableness of depreciation for motor vehicles, leasehold improvements and office equipment held by [Subsidiary] (10.1.2.6); and

d. recalculated depreciation for [a type of assets] held by [Subsidiary] (10.1.2.6).

10.1.2.4 In the "productive assets cycle audit programme" (Annex 3D.5) of the Audit Working Papers, it was said that [Auditor] discussed with the management of [Listed Entity] with respect to the valuation of the PPE and [Auditor] was satisfied that the assets were carried at their current recoverable amounts.

10.1.2.5 The "management representation letter" (Annex 3B.6a/3B.6b) filed in the Audit Working Papers was prepared in Chinese and signed by a director of [Listed Entity] on behalf of the board on [the issue date of the Relevant Financial Statements]. A translation of items 4, 10 and 18 of the management representation letter is reproduced below.

Item 4 With regard to the PPE, we have accounted for the depreciation and the impairment including any provision for idle assets. Depreciation is calculated to write off the cost of items of PPE less their estimated residual value over their estimated useful lives. We have appropriately estimated the useful lives based on the circumstances.

Item 10 [Listed Entity] and the Group have no plans or intentions that will materially alter the carrying amounts or the classification of the assets.

Item 18 There have been no events that require adjustments or disclosure in the financial statements, or any matter that requires disclosure to the shareholders from the balance sheet date to the date of this letter. We have no plans or intentions that will materially alter the carrying amounts and the classification of the assets and liabilities.

10.1.2.6 It was noted in the "lead schedule for [Subsidiary]'s property, plant and equipment" (Annex 3D.1) and "schedule of depreciation for [Subsidiary]'s [a type of assets]" (Annex 3D.3) of the Audit Working Papers that [Auditor] did not identify any material exception based on the audit procedures performed set out in 10.1.2.3(c) and 10.1.2.3(d).

10.1.3 Information and explanation provided by [Auditor]

10.1.3.1 On 11 December 2007, [Engagement Manager] was requested to explain whether or not there was any evaluation of the need for impairment in relation to the PPE of [Subsidiary] by [Auditor].

10.1.3.2 In response to the request of 11 December 2007, [Engagement Director], replied on 28 December 2007. An extract of the reply (Annex 5B) is set out below:-

"The operating loss of [Subsidiary] in [the current financial year] was primarily caused by the significant increase in the administrative expenses and selling expenses incurred mainly for the intended strengthening of the control on the operations of [Subsidiary] by [Non-controlling Shareholder], in view of its dispute with the Company in the operations of [Subsidiary] during [the current financial year].

As [Subsidiary] recorded a gross profit margin, we took the position that there was no impairment indication on the assets of [Subsidiary] as at [financial year-end date].

Notwithstanding that management of the Company was considering all possible means to resolve the Dispute, including ongoing discussion and liquidation of [Subsidiary] as a last resort at the time of our audit, it was considered that such possible outcome of the Dispute would not constitute any impairment on [Subsidiary]. This is because the main business and assets of [Subsidiary] are respectively [a type of business] and [a type of assets] which are divisible between the Company and [Non-controlling Shareholder] in the worst scenario of liquidation of [Subsidiary] without causing significant reduction in the value of the assets. In other words, [a type of] income which is attributable to the individual [a type of business] contracts with customers on identifiable [a type of assets] would not decrease materially even in the event of a liquidation.

We concluded there was no impairment indication on the assets of [Subsidiary] as at [financial year-end date] in accordance with HKAS 36."

10.2 Views of the AIB

10.2.1 The AIB considers that [a type of assets] of [Subsidiary] was material for the purpose of the audit of the Relevant Financial Statements as it represented 9.5% of consolidated PPE and 6.0% of consolidated net assets (10.1.1.1).

10.2.2 According to "[Subsidiary]'s income statements" (Annex 3B.2) of the Audit Working Papers, [Subsidiary] incurred a loss of [currency and amount] in [the current financial year], down from a profit of [currency and amount] in [the preceding financial year]. [Auditor] believed there was no impairment indication of the PPE of [Subsidiary] because the loss of [Subsidiary] resulted from "the significant increase in administrative and selling expenses" and [Subsidiary] still recorded a gross profit (10.1.3.2).

10.2.3 According to "[Subsidiary]'s income statements" (Annex 3B.2) in the Audit Working Papers, administrative, distribution and selling expenses increased by [currency and amount] in [the current financial year] to [currency and amount]. [Auditor] also mentioned in item 4.6 of the "clearance memorandum" (Annex 3B.5) of the Audit Working Papers that "net loss of [currency and amount] ([the preceding financial year]: net profit of [currency and amount]) mainly due to (i) significant increase in staff costs by [currency and amount] to [currency and amount] in [the current financial year] (the preceding financial year: [currency and amount]), and (ii) decrease of gross profit by [currency and amount] mainly due to decrease of sales by [currency and amount]." The AIB considers it was not reasonable to attribute the operating loss solely to an increase in administrative, distribution and selling expenses.

10.2.4 According to "[Subsidiary]'s income statements" (Annex 3B.2) of the Audit Working Papers, revenue dropped by 36.6% to [currency and amount] in [the current financial year] while the gross profit decreased by 83.8% to [currency and amount] in [the current financial year]. The AIB notes that, notwithstanding significant additions of [a type of assets] by the end of [the preceding financial year] (10.1.2.1), there were significant reductions in revenue and gross profit of [Subsidiary] in [the current financial year]. In addition, there was a loss in [the current financial year]. It appears to the AIB that there were impairment indications and [Auditor] should have reviewed the need for impairment of the PPE of [Subsidiary].

10.2.5 Paragraph 14 of HKAS 36 *Impairment of Assets* states that:-

"14. Evidence from internal reporting that indicates that an asset may be impaired includes the existence of:

(d) Operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future."

There was no evidence in the Audit Working Papers that [Auditor] had asked for budgeted cash flows of the assets.

10.2.6 It appears to the AIB that there is evidence suggesting [Auditor] did not exercise sufficient professional skepticism as required by paragraph 15 of HKSA 200 (Revised) *Objectives and General Principles Governing an Audit of Financial Statements* in the audit of the impairment of [a type of assets] of [Subsidiary].

10.2.7 Paragraph 15 of HKSA 200 (Revised) *Objectives and General Principles Governing an Audit of Financial Statements* states that:-

"15. The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated."

10.3 Comments on investigation report from [Auditor]

10.3.1 In the Comment Letter (Annex 5L), [Auditor] strongly disagreed with the views of the AIB in relation to the valuation of the PPE of [Subsidiary]. [Auditor] believed that it exercised sufficient professional skepticism in the audit of [a type of assets] of [Subsidiary], after taking into account their materiality to the Group.

10.3.2 [Auditor] explained that it considered materiality at the overall financial statement level. [Auditor] explained that although it established a preliminary materiality level at the planning stage, it adopted a materiality of 5% of the Group's net assets (i.e. [currency and amount]) when performing the final review of the Relevant Financial Statements. [Auditor] considered the Group's share of [a type of assets] of [Subsidiary] (i.e. [currency and amount]) was not material comparing to consolidated net assets.

10.3.3 [Auditor] considered the reduction in revenue and gross profit of [Subsidiary] did not represent impairment indications because [Subsidiary] was able to maintain a positive gross profit margin.

10.4 Response of the AIB to [Auditor]'s comments

10.4.1 Although [Subsidiary] was able to maintain a positive gross profit margin, it appears to the AIB that the significant reduction in revenue and gross profit of [Subsidiary] represented an impairment indication and [Auditor] should have reviewed the need for impairment of the PPE of [Subsidiary].

10.4.2 In the Audit Working Papers, there was no mention of the issue of impairment to the PPE of [Subsidiary] and [Auditor] did not perform any audit procedure to address the impairment indication such as asking for budgeted cash flows of the assets.

10.4.3 There was no evidence that [Auditor] had taken into consideration the issue of materiality when it came to the conclusion that there was no audit issue on the carrying amount of the PPE of [Subsidiary].

Section 11 Completeness of disclosures with respect to any restriction on the bank accounts and other assets of [Subsidiary]

11.1 Findings of facts

11.1.1 Background

11.1.1.1 According to the "lead schedule for [Subsidiary]'s cash at bank and in hand" (Annex 3E.1) of the Audit Working Papers, the carrying value of the bank balances and cash of [Subsidiary] as at [financial year-end date] was [currency and amount]. According to the Relevant Financial Statements (Annex 2A.1a/2A.1b), the carrying value of consolidated bank balances and cash was [currency and amount].

11.1.1.2 The complainant alleges that the bank accounts and certain assets of [Subsidiary] were frozen by court in [the current financial year] (2.1b). No disclosure was noted in the Relevant Financial Statements (Annex 2A.1a/2A.1b) in relation to restrictions on the bank accounts and other assets of [Subsidiary].

11.1.1.3 [Auditor] was able to check subsequent settlement of unpresented cheques drawn on or before [financial year-end date] (11.1.2.3).

11.1.2 Information from the review of the Audit Working Papers

11.1.2.1 In relation to the completeness of disclosures with respect to any restriction on the bank accounts and other assets of [Subsidiary], the following audit procedures were performed:-

a. sent requests for confirmation for all bank accounts held by [Subsidiary]. [Auditor]'s audit staff sent the requests for confirmation and received the replies in person in the presence of the personnel of [Subsidiary] (11.1.2.2).

b. obtained written representations from the management of [Listed Entity] (11.1.2.2).

11.1.2.2 In the "bank confirmation" (Annex 3E.2a/3E.2b, 3E.3a/3E.3b, 3E.5a/3E.5b and 3E.7a/3E.7b) and "management representation letter" (Annex 3B.6a/3B.6b) filed in the Audit Working Papers, no restrictions on the bank accounts and other assets of [Subsidiary] were mentioned.

11.1.2.3 In the "bank reconciliation statement" (Annex 3E.6a/3E.6b) in relation to one specific bank account filed in the Audit Working Papers, it was stated that [Auditor] inspected bank statements subsequent to the year-end date for settlement of unpresented cheques as at [financial year-end date]. Based on the audit procedures performed, [Auditor] noted that those cheques were subsequently settled.

11.1.3 Information and explanation provided by [Auditor]

11.1.3.1 On 11 December 2007, [Engagement Manager] was requested to confirm whether or not [Auditor] was able to check subsequent settlement of certain unpresented cheques as stated in the "bank reconciliation statement" (Annex 3E.6a/3E.6b) filed in the Audit Working Papers (11.1.2.3).

11.1.3.2 In response to the above request, [Engagement Director], replied subsequently in writing (Annex 5B) on 28 December 2007 and confirmed that [Auditor] did not notice anything which might indicate that that bank account was frozen at the time during the audit of the Relevant Financial Statements.

11.1.4 Information and explanation provided by an officer of [Subsidiary]

11.1.4.1 On 31 December 2007, the Secretariat sent a letter (Annex 5C.1a/5C.1b) to an officer of [Subsidiary] requesting the production of evidence that might indicate the bank accounts and other assets of [Subsidiary] were frozen as at [financial year-end date] including the following documents:-

a. court order to freeze the bank accounts and other assets of [Subsidiary] (11.1.4.3 and 11.1.4.4); and

b. the bank statements of all the bank accounts of [Subsidiary] for [the last month of the current financial year and the first three months of the following financial year] (11.1.4.5).

11.1.4.2 On 14 January 2008, the officer of [Subsidiary] produced copies of the court orders and bank statements. During a meeting with the officer of [Subsidiary] on the same day, he mentioned that only a certain amount of the funds in the bank account of [Subsidiary] was frozen and cash could be withdrawn if the funds in the bank account exceeded the frozen amount.

11.1.4.3 According to the "judgement to freeze [Subsidiary]'s assets" issued by [a court] dated [a date in the financial year] (Annex 5E.3a/5E.3b), the court ordered the sealing up, confiscating and freezing of the assets of [Subsidiary] including [a type of assets] and bank deposits which would be effective for a period of not exceeding 2 years and 6 months respectively. The property preservation ruling was issued pursuant to the application from [Non-controlling Shareholder] on [a date in the financial year] in relation to the dispute between [Listed Entity] and [Non-controlling Shareholder] to dissolve [Subsidiary].

11.1.4.4 In the "judgement to freeze [Subsidiary]'s bank accounts" issued by [a court] dated [a date in the financial year] (Annex 5E.4a/5E.4b), the court ordered the freezing of the bank deposits of [Subsidiary] which would be effective for a period of not exceeding 6 months. The property preservation ruling was issued pursuant to the application from [Listed Entity] on [a date in the financial year] in relation to the dispute between [Listed Entity] and [Non-controlling Shareholder] to dissolve [Subsidiary]. Subsequently on [a date in the financial year] (Annex 5E.5a/5E.5b) and [a date in the financial year]

(Annex 5E.6a/5E.6b), the court reached a judgement to unfreeze a certain portion of the funds in the bank accounts of [Subsidiary].

11.1.4.5 It was noted in the “bank statement” (Annex 5E.7) in relation to one specific bank account that the unpresented cheques as stated in the “bank reconciliation statement” (Annex 3E.6a/3E.6b) filed in the Audit Working Papers were subsequently settled in [the first month of the following financial year]. [Auditor] had performed the audit procedure set out in 11.1.2.3.

11.2 Views of the AIB

11.2.1 [Auditor] requested for bank confirmations and obtained management representations to ascertain the completeness of disclosures of any restriction on the bank accounts and other assets of [Subsidiary] (11.1.2.1). There was no mention of any such restriction in the bank confirmations and the management representation letter received (11.1.2.2).

11.2.2 Since there was no information available to [Auditor] which would suggest any such restriction, it appears to the AIB that it was reasonable for [Auditor] not to perform additional audit work to ascertain the completeness of disclosures of any restriction on the bank accounts and other assets of [Subsidiary].

11.2.3 As only part of the funds of the bank accounts was frozen, [Auditor] was able to check subsequent settlement of unpresented cheques (11.1.4.2, 11.1.4.4, and 11.1.4.5).

11.3 Comments on investigation report from [Auditor]

11.3.1 [Auditor] did not provide any comment on this section.

11.4 Comments on investigation report from [Listed Entity]

11.4.1 Relevant parts of the draft investigation report were sent to the management of [Listed Entity] for comment on 13 May 2008. A reply (Annex 5K.1a/5K.1b) was received on 21 May 2008. [Listed Entity] stated that the Group still had satisfactory title to the bank accounts although a portion of the bank balance of [Subsidiary] was frozen. Therefore, [Listed Entity] disagreed that the representation to [Auditor] in relation to restrictions on the bank accounts of [Subsidiary] was untrue. The AIB considered [Listed Entity] should have disclosed to [Auditor] the fact that part of the bank balance of [Subsidiary] was frozen by the court as it is a required disclosure under HKAS 7 *Cash Flow Statements*.

Section 12 Documentation

12.1 Findings of facts

12.1.1 The AIB obtained the audit files from [Auditor] during November and December 2007 for detailed review. [Auditor] confirmed (Annex 5A) the records and documents produced were the complete set of the Audit Working Papers.

Dispute (section 7)

12.1.2 In the reply letter of 28 December 2007 (Annex 5B), [Engagement Director] mentioned that, among others, [Auditor] had performed the following procedures in respect of the Dispute and concluded that the plan to dissolve [Subsidiary] was not finalized at the issue date of the Relevant Financial Statements:-

a. obtained a management representation (7.1.3.2);

b. reviewed the minutes of meetings of the directors and audit committee of [Listed Entity] (7.1.3.2);

c. examined legal expense account (7.1.3.2);

d. reviewed correspondences between legal counsels and the Group (7.1.3.2); and

e. sought direct communication with the management of [Non-controlling Shareholder], the counterparty of the Dispute on the progress of resolving the Dispute (7.1.3.2).

12.1.3 The AIB is unable to find documentation in the Audit Working Papers in relation to items c, d, and e in 12.1.2 above.

Amount due from [Non-controlling Shareholder] (section 8)

12.1.4 In the reply letter of 28 December 2007 (Annex 5B), [Engagement Director] stated that "during the field audit of [Subsidiary], management of [Non-controlling Shareholder] verbally told us that [Non-controlling Shareholder] would not respond to a request for confirmation of balances, in view of the Dispute" (8.1.3.2). Because of this, [Auditor] did not send a written request for confirmation (8.1.2.4). The AIB is unable to find any documentation of the verbal conversation mentioned above in the Audit Working Papers.

12.1.5 [Engagement Director] subsequently wrote to the AIB that "[a time shortly before the issue date of the Relevant Financial Statements], there was a meeting between Mr. X of [Non-controlling Shareholder], a personnel from the Company and [Engagement Manager] of our firm. The primary purpose of the meeting was to discuss the release of financial information of [Subsidiary] by Mr. X for the purpose of our audit. Based on the recollection of [Engagement Manager], at no time during the meeting was a disagreement over the amount due from [Non-controlling Shareholder] or a liquidation of [Subsidiary] mentioned by the other two parties present at the meeting." (8.1.3.4).

12.1.6 The AIB is unable to find any documentation in the Audit Working Papers which recorded the details of this meeting and its impact on the audit opinion of [Auditor] with respect to the amount due from [Non-controlling Shareholder].

PPE of [Subsidiary] – Existence (section 9)

12.1.7 The AIB is unable to locate the documentation in the planning section of the Audit Working Papers for the following matters:-

a. description of the objective of the test (i.e. assertions being tested);

b. detailed description of the sampling approach such as:-

   i. how the population and sampling unit were defined;

   ii. whether or not the population was stratified i.e. whether or not the locations represented sub-population and samples were examined within the locations selected;

   iii. how the sample size was determined; and

   iv. how the sample was selected.

c. the reason why [Auditor] considered the sampling risk was reduced to an acceptably low level based on the sample size determined.

PPE of [Subsidiary] - valuation (section 10)

12.1.8 In the reply of 28 December 2007 (Annex 5B), [Engagement Director] provided an explanation to support the conclusion that there was no impairment indication on the PPE of [Subsidiary] as at [financial year-end date].

12.1.9 An extract of the reply is set out below:

"The operating loss of [Subsidiary] in [the current financial year] was primarily caused by the significant increase in the administrative expenses and selling expenses incurred mainly for the intended strengthening of the control on the operations of [Subsidiary] by [Non-Controlling Shareholder], in view of its dispute with the Company in the operations of [Subsidiary] during [the current financial year] (the "Dispute").

As [Subsidiary] recorded a gross profit margin, we took the position that there was no impairment indication on the assets of [Subsidiary] as at [financial year-end date].

Notwithstanding that management of the Company was considering all possible means to resolve the Dispute, including ongoing discussion and liquidation of [Subsidiary] as a last resort at the time of our audit, it was considered that such possible outcome of the Dispute would not constitute any impairment on [Subsidiary]. This is because the main business and assets of [Subsidiary] are respectively [a type of business] and [a type of assets] which are divisible between the Company and [Non-controlling Shareholder] in the worst scenario of liquidation of [Subsidiary] without causing significant reduction in the value of the assets. In other words, [a type of] income which is attributable to the individual [a type of business] contracts with customers on identifiable [a type of assets] would not decrease materially even in the event of a liquidation.

We concluded there was no impairment indication on the assets of [Subsidiary] as at [financial year-end date] in accordance with HKAS 36." (10.1.3.2)

12.1.10 The AIB is unable to find the documentation in the Audit Working Papers which recorded the reasons provided by [Auditor] in the reply letter of 28 December 2007 supporting [Auditor]'s conclusion that there was no impairment indication in respect of the PPE of [Subsidiary].

12.2 Views of the AIB

12.2.1 The AIB, on a number of occasions during the course of the investigation, was unable to find documentation in the Audit Working Papers of certain matters which are important in providing evidence to support the clean audit opinion. There are needs for further explanations from [Auditor] to clarify the audit procedures performed and the reasoning for its audit conclusions.

12.2.2 The AIB considers that [Auditor]'s direct communication with the management of [Non-controlling Shareholder] in 12.1.2 above was the only independent evidence that [Auditor] obtained to substantiate the management representation on the Dispute. The AIB believes that it was an important audit evidence for [Auditor] to form an opinion on whether or not the Dispute would affect the Relevant Financial Statements and should have been documented.

12.2.3 In respect of the amount due from [Non-controlling Shareholder], the AIB considers that [Auditor]'s verbal discussion with an officer of [Non-controlling Shareholder] in 12.1.4 above who advised that he would not respond to any confirmation of the balance was an important matter in deciding not to send confirmation and should have been documented.

12.2.4 The AIB considers that the details of the meeting between [Engagement Manager], Mr. X of [Non-controlling Shareholder] and a representative from [Listed Entity] in 12.1.5 above, during which Mr. X did not mention about the disagreement on the amount due from [Non-controlling Shareholder], was taken by [Auditor] as the audit evidence supporting the recoverability of the amount and should have been documented.

12.2.5 In respect of the valuation issue of the PPE of [Subsidiary], [Engagement Director] explained in his reply letter (Annex 5B) that [Auditor] reached the conclusion that there was no impairment indication for a number of reasons despite [Subsidiary] incurred operating losses. The basis of [Auditor]'s conclusion provided in the reply letter was not documented in the Audit Working Papers (12.1.9). The AIB considers that it is necessary for [Auditor] to document the reasoning of its conclusion.

12.2.6 In view of the above, it appears to the AIB that there is evidence suggesting that [Auditor] did not fully comply with paragraph 2 of SAS 230 *Documentation* regarding the documentation in the Audit Working Papers.

12.2.7 Paragraph 2 of SAS 230 *Documentation* states that:-

> "2. Auditors should document matters which are important in providing evidence to support the audit opinion. (SAS 230.1)"

12.2.8 Paragraph 7 of SAS 230 *Documentation* states that:-

> "7. Working papers would include the auditors' reasoning on all significant matters which require the exercise of judgement, together with the auditors' conclusion thereon. In areas involving difficult questions of principle or judgement, working papers would record the relevant facts that were known by the auditors at the time the conclusions were reached".

12.2.9 Although paragraph 7 of SAS 230 *Documentation* was only an interpretation of the requirements of SAS 230 *Documentation*, it indicates that the exercise of judgement on significant matters should be regarded as important audit documentation.

12.3 Comments on investigation report from [Auditor]

12.3.1 In the Comment Letter (Annex 5L), [Auditor] strongly disagreed with the views of the AIB in relation to documentation. [Auditor] believed that the extent of working papers was a matter of professional judgement and it was neither necessary nor practical for it to document every matter it considered after taking into account the materiality.

12.4 Response of the AIB to [Auditor]'s comments

12.4.1 The AIB agrees that it was neither necessary nor practical for the auditor to document every matter in the Audit Working Papers. However, paragraph 2 of SAS 230 *Documentation* required the auditor to document matters which are important in providing evidence to support the audit opinion.

Section 13 General comments from [Auditor]

13.1 General comments from [Auditor]

13.1.1 [Auditor] strongly disagreed with all the views of the AIB in the Executive Summary and in sections 8.2, 10.2 and 12.2 of the investigation report. [Auditor] believed that it fully complied with HKSA in its audit of the Relevant Financial Statements.

13.1.2 [Auditor] expressed concern that the FRC might have acted ultra vires by deciding to initiate an investigation and direct the AIB to investigate the possible auditing irregularity and the question whether or not there is such an irregularity in relation to the audit of the Relevant Financial Statements in response to a complaint received concerning the audit of the financial statements of [Subsidiary] which was not a listed entity.

13.1.3 [Auditor] is of the view that the AIB failed to take the fundamental concepts of "audit materiality" and "true and fair view" into full consideration in arriving at its views in the investigation report.

13.1.4 [Auditor] considered that the investigation report is based on insufficient and inappropriate evidence presented in sections 8.1, 10.1 and 12.1.

13.1.5 [Auditor] requested the Council, in assessing the views of the AIB, to take due consideration of:

a. the sufficiency of professional and industry audit experience of the members of the AIB who have worked on this case;

b. the unreasonableness of the professional judgement exercised by the members of the AIB and whether they have inappropriately relied upon "hindsight" information.

13.1.6 [Auditor] questioned that the important information of the members of the AIB is not available on the website of the FRC and not available in the investigation report.

13.1.7 [Auditor] believes that the views of the AIB are groundless and based on insufficient evidence and the significant resources spent by the FRC and [Auditor] on this case are unwarranted. [Auditor] pointed out that this case involves neither corporate failure nor management fraud of a listed entity and there is no material misstatement.

13.2 Response of the AIB to [Auditor]'s comments

13.2.1 The AIB has sought legal advice on the legality of the investigation and it is confirmed that there is no issue of ultra vires (13.1.2).

13.2.2 The AIB recognizes the importance of the concepts of materiality and true and fair view in auditing. No reasonable auditor would disagree that an auditor is to deliver a reasonable assurance that there is no material misstatement in the financial statements. The purpose of the investigation is to identify, among others, whether or not the auditor has performed the audit in accordance with HKSA for delivering a reasonable assurance (13.1.3).

13.2.3 The AIB's views are based on the information and evidence as set out in the sections "Findings of Facts". These information and evidence primarily come from the Audit Working Papers together with further information supplied by [Auditor]. [Auditor] has been given opportunities to provide further information and evidence for the consideration of the AIB (13.1.4).

13.2.4 The Chairman of the AIB is, by virtual of the FRC Ordinance, the Chief Executive Officer of the FRC. Members of the AIB are appointed by the FRC. The appointment of the Chief Executive Officer of the FRC and members of the AIB are announced through the Gazette. The names of the Chairman and members of the AIB are also available on the website of the FRC. To address the concern of [Auditor], the names of the Chairman and the members of the AIB are stated in the final version of the report (13.1.6).

13.2.5 An auditing irregularity takes place if the audit was not performed in compliance with HKSA irrespective of whether or not there is a corporate failure, management fraud, or a material misstatement in the financial statements (13.1.7).

13.2.6 [Auditor] is entitled to its views on the audit experience and the reasonableness of the professional judgement of the AIB members. The concern of [Auditor] in these respects will be brought to the attention of the Council (13.1.5).

13.3 [Auditor]'s request to be notified of further action

13.3.1 [Auditor] requests to be notified immediately before the Council takes any further action under the FRC Ordinance and to be given an opportunity to seek advice from its lawyers on the best course of action that it may take to protect its interest and right. This request of [Auditor] will be brought to the attention of the Council.