

31 January 2001

HONG KONG SOCIETY OF ACCOUNTANTS
SUBMISSION
SECURITIES & FUTURES BILL

1. Section 172 – Power to require production of records and documents concerning listed corporations

1.1 The Society has accepted the need for the legislation to give the Securities and Futures Commission (SFC) the power to compel production of records by third parties (including audit working papers) and to require explanations to be provided where necessary.

1.2 A number of concerns have been expressed previously on this matter and some of them have been satisfactorily dealt with by the Administration. Some others will have to be dealt with by the Society by means of guidance to auditors in the form of a Practice Note. Provided that a common understanding between the SFC and the Society as to the operation of the law can be reached, then those concerns should also be allayed.

The use of audit working papers

1.3 Audit working papers are prepared by auditors for the purpose of reporting an opinion to shareholders on whether a company's financial statements show a true and fair view. Auditors do not investigate every facet of a company's affairs, nor do they examine every transaction – instead they perform such work as is necessary to provide a reasonable basis for their opinion. Audit working papers are the property of the auditor and not the company. In some cases when the SFC is investigating a listed company, the audit working papers may be useful. In other cases they may not be useful for the purposes of an investigation.

1.4 In all cases, it is reasonable to expect that the SFC would seek access to audit working papers only after it has commenced an investigation into a listed company and has determined, from inspection of the company's own records, that the audit working papers would be relevant. It is an important principle that the confidentiality and ownership of audit working papers should be respected. It would be inappropriate for audit working papers to be used by the SFC as the starting point of an investigation or as a means of "fishing" for things to investigate further.

1.5 We have been assured by the Administration and the SFC that it is not intended that audit working papers would be used for "fishing expeditions". We are still concerned, however, that section 172(7)(a) of the Bill refers to:

"... audit working papers, relating to the affairs of a corporation to which any direction has been or may be given under subsection (1)(i) or (ii); ...".

The inclusion of the words "or may be" suggests that the SFC could require production of audit working papers without having first given any direction to the corporation which is the subject of investigation. This would appear to run contrary to the assurances which we have been given as the SFC could, unless these words are removed, be able to require production of audit working papers as the first step in an investigation. We believe that this would be inappropriate and that consideration should be given to deleting the words "or may be" from section 172(7)(a).

Immunity issues

1.6 We had previously expressed concern that auditors who are providing audit working papers and explanations to the SFC under the provisions of section 172 should not be exposed to additional liability as a result of rendering such assistance. Given that audit working papers produced under section 172 will be used for a purpose other than that for which they were originally intended, there is a risk that explanations given by auditors to the SFC in relation thereto could, if taken out of context, be subsequently used against the auditor in civil litigation by third parties.

- 1.7 We have been assured that it is unlikely that the SFC would be able to grant third parties access to correspondence or records of discussions with auditors held under section 172. We have also been assured that the general immunity provisions contained in section 368 are adequate to ensure that unintended liabilities would not be incurred by auditors cooperating with the SFC under section 172.

Penalties for non-compliance

- 1.8 We acknowledge that the law needs to provide for penalties for non-compliance with the provisions of section 172. We are still a little concerned, however, that auditors should be subject to criminal sanctions under section 172(13) for failure to produce working papers or give explanations. While we note that there is the “reasonable excuse” proviso in the legislation, it seems that the threat of heavy criminal penalties could nonetheless be used to enforce onerous or perhaps unreasonable requests by the SFC. We should be grateful if consideration could be given as to whether the penalties set out in section 172(13) are appropriate for use against third parties (such as auditors) who are called upon to assist in an investigation.

2. **Section 369 – Immunity in respect of communication with Commission by auditors of listed corporations, etc.**

- 2.1 We have no particular comment on section 369 other than that we should like to reiterate our view that, as auditors are frequently not the first people to detect fraud, the Administration should consider extending this immunity to company secretaries, independent directors, employees, and the like. In the meantime, we shall be drawing up guidance in the form of a Practice Note for auditors on the practical application of this section. We shall need the cooperation of the SFC in finalising the Practice Note.