



13 June 2012

By email and by post

Our Ref.: C/CB, M83760

Hon. Paul Chan Mo-po, MH, JP
Chairman
Bills Committee on Companies Bill
Room 805, Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Paul,

Re. Companies Bill, clause 399 – offences relating to content of auditor's report

Significant concern about general lowering of the bar for criminal prosecution

1. The Hong Kong Institute of CPAs is concerned about the growing trend to introduce criminal offences that do not require any evidence of dishonesty or intent to defraud for proceedings to be initiated. While we agree that investors, shareholders and the community at large can quite rightly expect to be protected from fraudsters and cheats, if the barriers to prosecution are lowered unduly, as is the case with clause 399, to facilitate prosecutions and achieve convictions, the risks to good people in the profession start to outweigh the returns. The consequence is that they will seek other career options and the eventual corollary will be to drive down quality, which is not in the interests of the market or the community in Hong Kong.
2. During our attendance at the meeting of the Bills Committee on 16 May and in our subsequent submission on 24 May, we proposed that, if clause 399 could not be removed altogether, one way of addressing our misgivings would be to change the threshold for prosecution from "knowingly or recklessly" omitting a required statement from the audit report, to making such an omission "dishonestly or with intent to defraud". This would help to alleviate the deep-rooted uncertainty that will result from the present wording.

Objection to late Committee Stage Amendments (CSAs) further widening scope of the offence

3. We are disappointed to learn that it is not currently proposed to make any change to this clause. Worse still, we note that the Administration has put forward CSAs, which, in practice, will further extend the scope of the clause in terms of who may be held liable for the offence.
4. We strongly object to introducing this proposed change in the clause without sufficient time being given for proper deliberation and consultation with those most affected by the implications of the change.



5. The amended wording under the CSAs, copied in the Annex, will make the individual who signs the audit report and those who perform managerial functions in relation to the relevant auditing work, under the immediate authority of the person who signs the report, liable for prosecution.
6. In the limited time we had to respond to the proposed change, we alerted the Administration that these CSAs would catch relatively junior people in the profession, but our concerns appear not to have been reflected in the Administration's subsequent paper explaining the CSAs.
7. It needs to be said that clause 399 applies to Hong Kong companies of all shapes and sizes that, under the Companies Ordinance, are required to be audited, of which there are now approaching one million on the register. It is not unusual for audit staff of two to three years experience, who may not yet be fully qualified accountants, to manage a small audit under the immediate authority of the person who signs the audit report. The CSAs will place such people at the risk of a criminal sanction that will destroy their careers and which could result essentially from a lack of experience, rather than any intent to commit wrongdoing. If we have children, grand children, nieces and nephews who aspire to become a CPA and practise in Hong Kong, would we wish to jeopardize their future in this manner?
8. In view of the above, we strongly oppose to these late CSAs and suggest that the whole scope of this clause needs to be revisited.

Unclear policy intention will result in an unlevel playing field and drive down audit quality

9. We understand that the Securities and Futures Commission ("SFC")'s submission on clause 399, dated 11 May 2012, which proposed extending the scope of persons who may be held liable for the offence, was influential in the formulation of the late CSA that have now been put forward by the Administration.
10. The submission states: *"We understand that the policy intention is for the sanctions to apply not just to the partner but also senior members of the audit engagement but not to junior persons involved in an audit. We support this policy."*
11. However, the question needs to be asked, what is the policy intent? And, as we explained in paragraph 7 above, the line between a senior person and a junior person is drawn fairly arbitrarily by the CSAs.
12. Imposing a criminal liability on those who are on the engagement team in managerial positions will only aggravate the job pressures which they are already experiencing. The problem that this will create is that aspiring young professionals will, more than likely, change their career from public accounting to other finance-related jobs upon attaining their professional qualifications, which often coincides with the time they are ready for promotion to the rank of manager in firms. The retention rate experienced by firms is already the lowest at the level of two to five years experience, which is precisely the managerial level. This will almost certainly be exacerbated by the enactment of clause 399. What policy intention would this serve?



13. We submit that the policy intention behind this provision in the Companies Bill is unclear. Clause 399 will not be an effective deterrent against the most unscrupulous offenders, but it will become a hindrance to the healthy development of the auditing profession.
14. Furthermore, not only are the objectives of the provision unclear, the effect of clause 399 will be to create a very unlevel playing field for auditors of Hong Kong companies compared with auditors of non-Hong Kong companies. Why do we say this?
15. It is common knowledge that the SFC's area of responsibility is the listed company sector in Hong Kong, in which investor protection is a very important consideration.
16. It is important to note, however, that clause 399 will not apply to the non-Hong Kong companies (i.e., those incorporated in Mainland China, British Virgin Islands, Cayman Islands, etc.) which represent 75% of the market capitalisation of the Hong Kong stock exchange, according to the SFC's recently-issued *Consultation paper on the regulation of sponsors*.
17. In addition, it should be noted that, increasingly, in the future, non-Hong Kong companies may be audited by non-Hong Kong auditors, who will be even further beyond the reach of the Hong Kong statute.
18. Quite apart from the inequity of this, we understand that the objectives of the Companies Ordinance Rewrite include bringing the Hong Kong company law into line with international norms and at the same time allowing Hong Kong to be competitive with other jurisdictions. However, we are concerned that, instead of facilitating the conduct of business and encouraging the setting up and operation of companies in Hong Kong, the effect of clause 399 could well be to drive more business offshore.

"Knowingly or recklessly" creates uncertainty for the auditors, with serious adverse consequences for Hong Kong's competitiveness

19. The concepts of "knowingly" or "recklessly" are not succinct enough to provide a clear guidance to the audit profession in a context where professional judgement is inextricably interlinked.
20. Questions have been raised, and they have not been adequately answered, as to whether the test of knowing could be easily satisfied by imputed knowledge through the drawing of inference (a process performed by courts every day in most criminal cases) based on what the court believes a professional with a certain experience and training ought to have known. If this could be the case, we must express serious concern about the potential effect of criminalisation of actions involving professional judgment, and the chilling effect and the adverse consequences that this will have on the healthy development of the profession.



21. Furthermore, what standard will be applied in the test of "recklessness" in the case of a professionally trained auditor? Do we have a variable test to adjust for the difference in age and experience of a defendant? The case law on recklessness clearly shows that its meaning varies and depends on the context, and the evidence supporting it may be quite subjective where someone's professional judgment is being criticized with the benefit of hindsight.
22. It is almost a cliché to say that an auditor is a "watchdog and not a bloodhound". He cannot investigate everything but should display a reasonable degree of professional scepticism. This calls for judgment. Inevitably mistakes will sometimes be made and sometimes the auditor will be the victim of deliberate deception.
23. In cases of high-profile corporate failures, there will inevitably be pressure on prosecutors to find culpability. It is far from being improbable, therefore, that an auditor's professional judgment not to include a particular statement in an audit report, especially where the documentation shows that the auditor himself might have considered the decision to be less than clear-cut, will be challenged as being reckless, with the benefit of hindsight.
24. One of the statements required to be included in an auditor's report, where it applies, is a statement to the effect that the auditor has failed to obtain all the information and explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit. This is an area that calls for a significant degree of professional judgment. An auditor can look only at a sample of transactions and verify the existence and value of some assets only. Management representations, therefore, form an important part of an audit. If this information subsequently turns out to be inaccurate and, as a result, the share price of the company falls substantially, the auditor will immediately be at risk and on the defensive.
25. In sum, we have a very basic concern about the test of "knowingly or recklessly" omitting a required statement from the audit report, because there is no need to show that an auditor has acted in any way dishonestly, fraudulently, or for personal gain, for criminal proceedings to be instituted against him. While it is understandable that the public would support the imposition of criminal sanctions against persons who conspire to deceive or defraud, the net is cast much wider than this under clause 399. While removing the highly subjective threshold of "recklessness" would be a step in the right direction, it would still not offer a complete solution.
26. We should emphasise that we are not trying to protect professionals who behave dishonestly or seek to deceive or defraud shareholders, or other stakeholders.



27. However, the vast majority of auditors exercise their professional judgment on daily basis in good faith and it is important that they continue to be able to do so without fear or favour. It is unjustified and unreasonable to introduce the threat of a criminal sanction which could cost them both their professional reputation and their livelihood, where companies subsequently fail or incur substantial losses for shareholders. This will influence the way in which auditors carry out their duties. It will, potentially, have a chilling effect on auditors of Hong Kong companies which, as explained above, will put them at competitive disadvantage compared with auditors of non-Hong Kong companies and non-Hong Kong auditors, who will not face the same threats.
28. The uncertainty that clause 399 will inevitably create, as elaborated above, when added to existing risks and potential unlimited liabilities that audit professionals already have to face, will have a negative impact on the ability of firms to recruit and retain the high-calibre staff needed to serve and support the integrity of Hong Kong's capital market.

Drawing reference from other parts of the world

29. We wish to emphasise again that, as far as we know, the only precedent in any major market worldwide of criminal sanctions targeting auditors for potentially honest omissions from the auditor's report, is in the UK law. From our research, the context in which they were introduced in the UK was entirely different and involved looking at auditors' liabilities as a whole, including civil liabilities.
30. Furthermore, as we have explained in our previous submission, the UK Government undertook to issue, and has issued, specific guidelines for prosecutors to clarify that the equivalent offence in UK was not meant to catch honest mistakes and should be used sparingly. In response to this point, the Administration in Hong Kong has indicated that it could not issue any similar guidance in Hong Kong.
31. We think that the existence of the UK guidance to prosecutors is of particular significance in that it was considered necessary to have guidance to prosecutors as to the manner in which the provision should be applied. It is unfair, therefore, for the Administration in Hong Kong to import an equivalent offence into Hong Kong law without also finding a mechanism for achieving the same checks and balances in the relevant legislation here.

Request to defer enactment of clause 399 pending further study

32. We are seriously concerned that there is a severe time constraint for further amendments to be made to this bill or for the much-needed clarifications to be provided in respect of its impact on the profession and achievement of its policy intent (whatever that may be).
33. We also believe it to be both inappropriate and unfair for the late CSAs to have been made to this provision without stakeholders having been given an appropriate amount of time and sufficient opportunity to fully consider and respond to those changes and their full implications.



34. Accordingly, we would urge the Bills Committee to defer enactment of clause 399 until such time as the various issues that we have raised have been properly assessed, and a more comprehensive review of the legislation relating to the criminal and civil liability of auditors has been conducted.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Winnie Cheung', is written over a light blue horizontal line. The signature is fluid and cursive, with a long horizontal stroke extending to the left.

Winnie C.W. Cheung
Chief Executive & Registrar

WCC/PMT/pm

c.c. Ada Chung
Registrar of Companies

Darryl Chan
Deputy Secretary for Financial Services and the Treasury (FS)

Nick Au Yeung
Principal Assistant Secretary for Financial Services and the Treasury (FS)

Connie Szeto
Clerk to the Bills Committee

Revised Clause 399 / 經修訂的第 399 條

399. Offences relating to contents of auditor's report

- (1) If a statement required to be contained in an auditor's report under section 398(2)(b) or (3) is omitted from the report, an offence is committed by each individual who—
 - (a) either—
 - (i) signs the auditor's report in accordance with section 400; or
 - (ii) performs managerial functions in relation to the auditing work in respect of the auditor's report under the immediate authority of the person mentioned in subparagraph (i); and
 - (b) knowingly or recklessly causes the statement to be omitted.
- (2) A person who commits an offence under subsection (1) is liable to a fine of \$150,000.