

Bills Committee on Companies Bill

Clause 399 – Offences relating to Contents of Auditor’s Report

Administration’s Response to Recent Submissions

Purpose

This paper sets out the Administration’s response to the major concerns raised in recent submissions received by the Bills Committee on clause 399 of the Companies Bill regarding the contents of auditor’s report. The text of clauses 398 and 399, as well as the proposed Committee Stage Amendment (CSA) agreed by the Bills Committee, are at **Annex**.

Administration’s Response

Policy Objective of Clause 399

2. Users of a company’s financial statements rely heavily and place a lot of trust on the work and report of the independent, professional auditors. Where there are irregularities in the company’s financial statements, the auditors are expected to flag these up in the auditor’s report and bring them to the attention of the users. Section 141 of the current Companies Ordinance therefore requires, inter alia, that –

- (a) if the financial statements are not in agreement with the accounting records, the auditors shall state that fact in the auditors’ report;
- (b) if the auditors fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit, they shall state that fact in their report.

Clause 398 of the Companies Bill in effect reproduces the above existing requirements, with the addition of the materiality test as suggested by some

respondents in the course of consultation.

3. However, under the Companies Ordinance, there is no sanction for the breach of the two statutory requirements. This is undesirable from the enforcement perspective. Having regard to the introduction of new offences relating to such omissions in the United Kingdom (“UK”) Companies Act 2006, we propose adding a new clause 399 which imposes a maximum fine of \$150,000 for knowingly or recklessly causing the statements to be omitted.

4. The proposed clause 399 is an important step to enhance the reliability and integrity of financial statements and to further improve the regulatory regime for auditors. The two statements concerned – that the auditor cannot obtain adequate information or explanation and that the financial statements are not in agreement with the accounting records – are very important pointers to assist the users of a company’s financial statements to take an informed view about the financial statements.

5. To facilitate auditors’ work and compliance with the statutory requirements, we also propose measures in the Bill to enhance auditors’ right to information by providing for a wider range of people to provide auditors with the necessary information or explanation. Breaches in relation to the provision of information to auditors will attract fine and imprisonment.

Consultations and Deliberations at Bills Committee

6. Clause 399 has been the subject of extensive public consultations back in 2010 and thorough discussions at the Bills Committee. The current position represents the consolidated outcome of consultations and deliberations over a two-year timeframe.

7. The above legislative proposal, with the proposed wording of the draft clauses, were highlighted among other issues in the second phase public consultation on the draft Companies Bill launched in May 2010¹. Ten respondents commented on the proposal. Six respondents (including

¹ Paragraphs 51 to 53 of the Consultation Paper on the draft Companies Bill Second Phase Consultation, May 2010 which is available on the FSTB’s website <http://www.fstb.gov.hk/fsb> and the Companies Registry’s website <http://www.cr.gov.hk>

three audit firms) indicated support or no-objection to the introduction of criminal offences. Two audit firms who responded further recommended qualifying the offences to “omissions in a material respect”. (As explained in paragraph 2 above, this recommendation has been adopted in the Bill.) Four respondents objected to the proposal. Among these the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Society of Chinese Accountants and Auditors questioned the necessity of criminal sanctions on the grounds that there is already a disciplinary mechanism under the Professional Accountants Ordinance (Cap. 50). HKICPA also expressed concerns about the implementation aspects of the proposal.

8. The major views received have been summarised and responded to in the consultation conclusions published in October 2010. The respondents’ submissions and the consultation conclusions can be found at the link: www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/consult-conclusion.htm.

9. As far as deliberations at the Bills Committee are concerned, the Administration explained in detail the policy and legal considerations regarding clause 399 and responded to public views in three Bills Committee papers (LC Paper No. CB(1)339/11-12(01), CB(1)1184/11-12(01) and CB(1)1979/11-12(02)). The issue was fully discussed, alongside HKICPA’s submissions of 28 June and 21 December 2011, in the course of scrutinising the relevant part of the Companies Bill. On 16 May 2012, deputations (including the HKICPA) were invited to express their views specifically on clause 399.

10. On 26 May 2012, the Bills Committee again discussed the views of the deputations – including HKICPA’s further submission of 24 May 2012 (which included a proposal to revise the wording of clause 399) – and the Administration’s response. Members considered that it is of paramount importance to ensure that an effective regulatory regime for auditors, who have a statutory duty to report on the financial statements prepared by companies, is in place in Hong Kong. They generally agree that the imposition of appropriate criminal sanctions on auditors’ deliberate omission of important formation in auditor’s report is appropriate. Some Members pointed out that small investors have high expectation of the

company's auditor in playing an independent gatekeeper's role in respect of the company's financial reporting. Any omission of important financial information would adversely affect investors' interests. These Members agree with the CSA proposed by the Administration (see paragraph 11 below). However, a Member expressed reservation over the high threshold of "knowingly or recklessly" for the offence and opined that the maximum penalty for the offence should be increased to include imprisonment.

Administration's Proposed CSA

11. As can be seen from Annex A, the original wording of clause 399 imposes criminal sanction on a wide range of persons (including the auditor and every employee and agent of the auditor eligible for appointment as auditor), regardless of seniority. The Bills Committee was concerned that this would be too onerous on junior members of an audit team and suggested that the sanction should only be imposed on the signing partner and the manager in charge of the engagement. The proposed CSA reflects this view and sets out that only the person signing the auditor's report and those who perform managerial functions in relation to the audit under the immediate authority of the person signing the auditor's report will be liable. The CSA is intended to carve out a sizeable group of junior auditors and narrow the range of persons held liable. We note HKICPA's concern about the CSA criminalising audit staff not yet fully qualified. This is discussed in paragraph 16 below.

The Criminal Offence

12. Before going into the detailed provision of clause 399, there is a need to differentiate between a criminal prosecution and a civil liability case which, for example, involves professional negligence. In a criminal prosecution, the burden of proof is on the prosecution and it is for the prosecution to prove the case beyond reasonable doubt. By contrast, in civil proceedings, the plaintiff needs only prove his case on the balance of probabilities.

13. Clause 399 does not criminalise negligence. It targets only the person who "knowingly or recklessly" causes the two required

statements to be omitted.

14. HKICPA is concerned about whether the test of “knowingly” could be easily satisfied by imputed knowledge through the drawing of inferences. This would not be the case. Where “knowingly” is included in the definition of an offence, it is clear that the requisite mental state is required for the commission of the offence, and it is necessary for the prosecutor to prove knowledge on the part of the offender of all material circumstances of the offence. The clear view of the court according to the authorities is that that nothing short of actual knowledge will suffice. In order to prosecute under the “knowingly” threshold in clause 399, it will be necessary to prove that the person knew and caused the statement required to be included in the report to be omitted. This knowledge will be ascertained from the evidence, including the evidence given by the auditor as to what he actually knew. This is a subjective test. Knowledge will not be imputed on the basis that because of the professional qualification the person ought to have known. This is not the intention of the provision and it is not how it will be interpreted by the courts.

15. The other concern raised by the HKICPA is about the test of “recklessness”. The threshold for conviction for recklessness is very high. To prove that someone has acted recklessly, it is necessary to show that he was aware that an action or failure to act carried risks, that he personally knew that the risks were not reasonable ones to make, and that despite knowing that, he went ahead.

16. There is established legal authority on this test. The test for “recklessness” according to the principle set out in the case of *Sin Kam Wah v HKSAR* [2005] HKEC 792, is as follows, “*it has to be shown that the defendant’s state of mind was culpable in that he acted recklessly in respect of the circumstances if he was aware of a risk which did or would exist, or in respect of a result if he was aware of a risk that it would occur, and it was, in circumstances known to him, unreasonable to take the risk. Conversely a defendant could not be regarded as culpable so as to be convicted of the offence if, due to his age or personal characteristics he genuinely did not appreciate or foresee the risks involved in his actions.*” A person will not be liable under the revised formulation of the offence

unless he performs managerial functions in relation to the audit under the immediate authority of the person signing the report and knowingly or recklessly causes the required statement to be omitted. The provision would only cover cases where there is evidence of the requisite mental state of “knowingly” or “recklessly” at the time of commission of the offence. In any event, insofar as “recklessness” is concerned, in the case of a young inexperienced auditor, even in cases where he may be required to perform some managerial functions, he could not be regarded as culpable so as to be convicted of the offence if, owing to his age or inexperience, he genuinely did not appreciate or foresee the risks involved in omitting the two required statements.

17. We should further point out that the evidence considered in the case will be that at the date of the offence, and the suggestion that there could be a conviction with evidence based on professional judgment with the benefit of hindsight should not be a concern.

18. Regarding the suggestion that dishonesty should be the minimum requirement for imposing criminal sanction, it should be noted that an offence committed dishonestly is already covered by the existing criminal law relating to fraud and the offence is one which can be subject to imprisonment.

Factors to Consider for Prosecution

19. HKICPA is also concerned about the pressure on prosecutors to find culpability in high-profile corporate failure cases. The Statement of Prosecution Policy and Practice – Code for Prosecutors published by the Department of Justice² sets out clear guidelines for prosecution. According to the Code, when considering the institution of criminal proceedings, the first two questions to be determined are the sufficiency of evidence and public interest. A prosecution should not be started unless the prosecutor is satisfied that there is admissible, substantial and reliable evidence that a criminal offence known to the law has been committed by an identifiable person. The Secretary for Justice does not support the proposition that a bare prima facie case is enough to justify a decision to prosecute. In the clause 399 context, this should be considered in the

² Available at www.doj.gov.hk/eng/public/pubsoppaptoc.htm

context of the high threshold for conviction as explained above.

20. There are also public interest criteria to be considered. For example –

- where an allegation involves several suspects, the prosecutor, in general, should have regard to the need to ensure that proceedings are pursued only against those whose involvement goes to the heart of the issue;
- if the offence was committed as a result of a genuine mistake or misunderstanding, a prosecution may not be required;
- availability of a civil remedy;
- if the offence is of a technical nature only, a prosecution may not be required.

Level Playing Field

21. Our companies law regime mainly governs companies incorporated in Hong Kong. This is in line with the practice in other comparable common law jurisdictions such as the UK, Australia and Singapore where their company laws mainly govern companies incorporated in their respective jurisdictions.

22. One of the key objectives of the Companies Bill is to maintain a high standard of corporate governance in Hong Kong. The proposed clause 399 is an important provision to enhance the reliability of financial statements and to ensure that users of financial statements would be better informed. It is equally applicable to auditors of close to a million live companies, regardless of the size of the audit firms. We firmly believe that a high standard of corporate governance will serve Hong Kong's long-term economic interest well and create a good business environment for the sustained development of the accounting and auditing profession.

Effective Date of the Companies Bill

23. Upon enactment of the Companies Bill, it is our plan to bring it into operation in 2014. In the interim, the Administration would take measures to facilitate compliance with the new legislation by the corporate

community and concerned stakeholders. We would be happy to work with HKICPA to address the audit profession's concerns about compliance.

**Financial Services and the Treasury Bureau
Companies Registry
15 June 2012**

Auditor's Liability – Clauses 398 and 399

398. Auditor's opinion on other matters

- (1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
 - (a) whether adequate accounting records have been kept by the company; and
 - (b) whether the financial statements are in agreement with the accounting records.
- (2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
 - (a) adequate accounting records have not been kept by the company; or
 - (b) the financial statements are not in agreement with the accounting records in any material respect.
- (3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.
- (4) If the financial statements do not comply with section 378(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

399. Offences relating to contents of auditor's report

- ~~(1) Every person specified in subsection (2) commits an offence if the person knowingly or recklessly causes a statement required to be contained in an auditor's report under section 398(2)(b) or (3) to be omitted from the report.~~
- ~~(2) The persons are—
 - ~~(a) if the auditor who prepares the auditor's report is a natural person—
 - ~~(i) the auditor; and~~
 - ~~(ii) every employee and agent of the auditor who is eligible for appointment as auditor of the company;~~~~
 - ~~(b) if the auditor who prepares the auditor's report is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company; or~~
 - ~~(c) if the auditor who prepares the auditor's report is a body corporate, every officer, member, employee and agent of the auditor who is eligible for appointment as auditor of the company.~~~~
- ~~(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.~~~~
- (3) A person who commits an offence under subsection (1) is liable to a fine of \$150,000.