



Our ref. C/CB

21 December 2011

Hon Paul Chan
Legislative Councillor (Accountancy) and
Chairman of Bills Committee on Companies Bill
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Paul,

Section 399 of the Companies Bill – Offences relating to contents of auditor's report

The Hong Kong Institute of Certified Public Accountants (Institute) is concerned about the consequences of Clause 399 of the Companies Bill, which is in relation to offences relating to contents of auditor's report, and the potential implications for criminal liability of our members. Under Clause 399 the auditor and every employee and agent of the auditor who is eligible for appointment as auditor of the company commits an offence if they knowingly or recklessly cause a statement required to be contained in an auditor's report under clause 398 (2)(b) or (3) to be omitted from the report.

Clause 398(2)(b) requires that if the auditor is of the opinion that the financial statements are not in agreement with the accounting records in any material respect the auditor must state this in the auditor's report. Clause 398(3) requires that 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.

Under Clause 399(3), a person who commits the abovementioned offence is liable to a fine of \$150,000.

The above clauses were also included in the draft clauses of the second phase consultation of the Companies Bill in May 2010. We understand from a subsequent meeting with the Companies Bill Team that the team is of a view that criminal sanction is necessary to enforce the duty of the auditor to report such circumstances and hence the proposed clause is still retained in the Companies Bill being introduced to the Legislative Council.

The Institute has concerns on the proposed clause in the Companies Bill and would like to reiterate the issues previously raised through our comment letter to the Companies Bill Team dated 11 August 2010 which is extracted as **Annex 1** for your reference. In summary, we question whether criminal sanctions are necessary given the Institute's power to discipline auditors, and express concerns covering time frame for prosecution, materiality, professional judgement, persons liable to prosecution and who has primary responsibility of investigation.



Furthermore, we have identified that similar legislation on criminal sanctions against auditors was included in the UK Companies Act 2006 as part of a "package deal" with the UK Government to bring an amendment to auditors' liability reform into the 2006 Companies Act.

Given that there is no such "package deal" currently being pursued, the Institute recommends that Section 399 is removed from the Companies Bill. It may be appropriate to reconsider the proposed Section 399 at a point when there are fully rounded proposals on auditor liability reform under consideration.

In order to enable a better understanding of the Institute's positions on the subject by the members of the Bills Committee, we would appreciate if a hearing session can be arranged where we can directly communicate with the members of the Bills Committee.

Thank you for your kind attention and assistance. Should you have any enquiry, please do not hesitate to contact me at chris@hkipa.org.hk.

Yours sincerely,

Chris Joy
Executive Director

c.c. Darryl Chan
Deputy Secretary for Financial Services and the Treasury (Financial Services)
Connie Szeto
Clerk to the Bills Committee

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Extract from the HKICPA Submission to the Companies Bill Team dated 11 August 2010

<p>Part 9 Clauses 9.52</p>	<p><u>Offences relating to contents of auditor's report</u></p> <p>Clause 9.52 introduces a new criminal sanction for an auditor that knowingly or recklessly causes certain statements that are required to be contained in an auditor's report to be omitted from the report. The statements referred to are those required under section 9.51(2)(b) or (3), namely:</p> <ul style="list-style-type: none"> • Section 9.51(2)(b) – the financial statement is not in agreement with the accounting records • Section 9.51(3) – if the auditor fails to obtain all the information or explanations that, to the best of his knowledge and belief, are necessary for the purpose of the audit, the auditor must state that fact in the auditor's report <p>In relation to the above, no definition of "financial statement" is in the CB. We assume it includes the balance sheet, income statement, notes to financial statements, etc. In this regard we would suggest that term "financial statements" (plural) be used in the CB when reference is being made to this set of materials.</p> <p><i>Sanctions</i></p> <p>We query whether criminal sanctions are necessary given the Institute's power to discipline auditors. Under the Professional Accountants Ordinance (Cap. 50) ("PAO") any instances of serious non compliance with professional standards, or professional misconduct, committed by an Institute member (such as tampering with the auditor's report) would be subject to a complaint being raised against the auditor.</p>
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The potential sanctions under the PAO are arguably heavier than the proposed financial penalty under section 9.52(3), albeit they are not criminal sanctions. The penalty under the CB is a maximum fine of up to \$150,000. Sanctions under the PAO could include a maximum penalty of \$500,000 and removal from the register of members or removal of a practising certificate (which is required to sign audit reports), either permanently, or for such period as the disciplinary committee thinks fit.

Given that the PAO sanctions are not criminal, the standard of proof required is also based on lower threshold of the balance of probabilities.

Time frame for prosecution

It is unclear whether an offence under clause 9.52 of the CB is a summary or indictable offence. If it is the former, then the prosecution must be completed within six months of the date of offence (i.e., the audit report date). It is quite possible that the criminal investigation of such matters will take more than six months. On the other hand, under the PAO there is no similar statutory limitation period (subject to any challenges for undue delay).

Therefore, it may be more appropriate to pursue the misconduct stated in section 9.52 under the PAO.

Materiality

We note that the issue of materiality is not referred to in clause 9.51 of the CB. Therefore, it appears that an auditor may be required to report even where the difference is small or insignificant. This is inconsistent with the auditing standards on which the auditor bases his opinion in preparing the auditor's report. The kind of statement that an auditor is required to make under clause 9.51 (e.g., whether the financial statements are in agreement with the accounting records and whether the auditor believes he has obtained all necessary information for his audit) would generally depend partly upon questions of materiality. For example, in respect of certain off balance sheet items, such as contingent liabilities, the auditor might consider as non material the fact that certain items are not disclosed in the notes to the financial statements.

Professional judgment

Imposing a criminal sanction on a person for knowingly or recklessly omitting certain statements from the auditor's report may create a problem, where the inclusion or exclusion of those statements depends upon the exercise of professional judgment.

The profession's adoption of a principle-based rather than a rule-based system of standards can give rise to grey areas, which a court may not be the most suitable forum to resolve. A disciplinary framework involving a

mix of experts from the profession, lay and legally trained persons, may be a more appropriate channel to use in the first instance.

In this regard, the Institute might find itself constrained to follow the decision of a criminal court regarding a professional issue, with which the profession does not agree. In the event that the matter is subsequently referred to a disciplinary committee of the Institute, the committee is not required to look at the propriety of a conviction.

Persons liable to prosecution

Section 9.52(2) of the CB states that the persons liable to be caught include:

- If the auditor who prepares the report is an individual, the auditor or any employee or agent of the auditor who is eligible for appointment as auditor of the company
- If the auditor who prepares the auditor's report is a firm, any member, employee or agent of the auditor who is eligible for appointment as auditor of the company

It is not entirely clear from the wording of the CB whether the engagement partner or other persons involved in an audit could be held vicariously liable for knowing or reckless actions by an employee of the firm. In our view this would not be justifiable, unless it can be proved that the engagement partner or other persons in question had themselves acted knowingly or recklessly.

Who has primary responsibility of investigation?

It is not clear under the CB how investigations would be conducted in relation to alleged non-compliance with clauses 9.51 and 9.52 and how the proposed criminal regime would operate, alongside the disciplinary and investigatory framework administered by the Institute, and the investigatory powers of the Financial Reporting Council in relation to audits of listed companies. More explanation regarding the intended interface between these different elements is needed in order to facilitate public understanding.

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