

Bills Committee on Companies Bill

Administration's Response to Deputations' Views on Clause 399

Purpose

This paper sets out the Administration's response to the deputations' views on clause 399 of the Companies Bill ("CB") on offences relating to contents of the auditor's report.

Deputations' views

2. The Bills Committee has invited deputations to give views on clause 399 on offences relating to contents of the auditor's report. We summarise below the views of the deputations expressed through written submissions or presentation at the meeting on 16 May 2012.

3. Six deputations submitted written submissions or attended the meeting. Federation of Hong Kong Industries, the Hong Kong Electronic Industries Association and the Institute of Certified Management Accountants Hong Kong Office support clause 399. Their major argument is that auditors have a pivotal role to play as "gatekeepers" and deliberate omission of important information in an auditor's report amounts to a serious breach of professional duty. Hence, it is justifiable to impose criminal sanctions on such misconduct and the sanction would not be too onerous on auditors. This would also protect the interests of investors, particularly minority shareholders.

4. The Securities and Futures Commission ("SFC") supports the policy intent to introduce criminal sanctions for auditors in CB. They also support the policy intention 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. They however point out that limiting the scope to persons who are eligible for appointment as auditor may not be in line with this policy intention because many senior members of an audit team are not qualified to act as an auditor. They therefore suggest revising the text to

reflect the policy intent.

5. On the other hand, the Hong Kong Institute of Certified Public Accountants (“HKICPA”) objects to clause 399. They express concern about the consequences of clause 399 and the potential implications for criminal liability of its members. HKICPA questions, given that auditors are subject to disciplinary process, whether criminal sanctions are necessary or appropriate for a reckless omission of a required statement from the audit report without proof of any fraudulent intent. It also expresses concerns covering timeframe for prosecution, materiality, professional judgement, persons liable to prosecution and the primary responsibility of investigation. HKICPA notes that similar legislation on criminal sanctions against auditors exists in the United Kingdom (“UK”) Companies Act, from which clause 399 draws reference. However, this provision was brought into the UK Companies Act as part of a package to bring about auditors’ liability reform. HKICPA considers that clause 399 should not be introduced on its own when there is no similar liability relief for auditors.

6. As for the Chamber of Hong Kong Listed Companies (“CHKLC”), their concern is that the clause may create an impression that employees of the company being audited are covered by the clause. They consider it important to spell out clearly that this clause is only applicable to auditors and their employees and agents but not those of the company.

Overseas experience

7. Clause 399 of the CB is based on section 507(2)(a) and (b) of the UK Act 2006. The relevant sections were introduced in the UK due to a number of reasons, including the problems caused by the failures and practices of some audit firms, the collapses of Enron and WorldCom, the problems caused by audits that went wrong and the government’s aim to achieve proper and effective audit. Though the limitation of liability by contract was also the context of the introduction of the new crime, it is noteworthy that the legislature has also been taken into account the high threshold of the offence, that the new offence does not criminalize negligence and the interest of third parties who rely on the company’s account.

Administration's Response

8. We note that most deputations agree that there should be appropriate criminal sanction in relation to the auditor's report, though HKICPA expresses concern on the offence and SFC considers that the wording should be revised to better reflect the intention of not covering junior persons involved in an audit. To address these concerns, we propose to revise clause 399 so that only the person who signs the auditor's report and the persons who perform managerial functions in relation to the audit under the immediate authority of the person who signs the auditor's report will be liable under clause 399. This amendment ensures that only senior members of the audit engagement will be liable and the offence would not be unduly onerous on auditors. The revised wording is at **Annex**.

9. Regarding HKICPA's comment that reckless omission of a required statement from the audit report without proof of any dishonest or fraudulent intent should not be covered by the offence, we would like to point out that only the person who "knowingly or recklessly" causes the required statement to be omitted would be liable. In this regard, mere negligence would not constitute recklessness. To fall within "recklessness", a person should be suspicious of certain matters but deliberately avoids finding out the truth¹. Hence, "knowingly or recklessly" is already a high threshold which, while seeking to enable users of financial statements to be better informed, avoids the provision being too onerous for auditors. Further raising the threshold will seriously compromise the effectiveness of the offence provision.

10. As for CHKLC's concern, we believe our revised wording is clear enough to exclude employees and agents of the company.

11. We have consulted HKICPA on the revised clause. HKICPA

¹ The test for "recklessness" is now accepted as being that set out in *Sin Kam Wah v HKSAR* [2005] HKEC 792, 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."

is concerned that the revised clause 399(1)(a)(ii) may not be clear enough to capture all the senior people involved in a large audit. In this regard, our proposed wording seeks to set out the persons who should be liable without casting the net unduly wide. We consider the proposed wording appropriate.

Financial Services and the Treasury Bureau
Companies Registry
24 May 2012

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.