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

24 May 2012

By email < bc_03_10@legco.gov.hk > **and by post**

Our Ref.: C/CB, M83394

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

Thank you for giving us the opportunity to present the Institute's views on clause 399 of the Companies Bill, which introduces a criminal offence in relation to omissions from auditors' reports.

As we explained at the meeting of the Bills Committee on 16 May the accounting profession is very concerned about this provision, which introduces a criminal offence in respect of conduct which may not involve any element of dishonesty, fraud or intent to make personal gain.

At the Bills Committee meeting, we were asked to provide some additional information and also to suggest alternative wording for the offence that might make it less objectionable from the profession's point of view. This is the purpose of the current submission.

Summary

Among the key points made in this submission are:

- As drafted, clause 399 does not require an auditor to have acted in any way dishonestly for criminal proceedings to be initiated against him. In our view, dishonest conduct should be a bare minimum requirement for imposing a criminal sanction under this clause.

- A criminal record for an offence relating to his work could spell the end of an auditor's career, even though the sanction does not include imprisonment.

- There is uncertainty over which individuals may be held liable under clause 399.

- The provision in the Companies Act 2006 in the United Kingdom, on which clause 399 is modelled, was introduced only as a balance in the context of other legislative changes which, in principle, allow auditors to limit their civil liabilities.

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Subsequent guidance issued to prosecutors in the UK suggests that the scope of offence may be too broad.

- We are not aware of equivalent provisions imposing criminal sanctions on auditors in other jurisdictions.

- Auditors in Hong Kong already face unlimited, potentially huge, civil liabilities in relation to their errors, which could bankrupt them. As in UK, if criminal sanctions are to be considered in Hong Kong, the question of auditors' liabilities as a whole should be reviewed.

Accountability of auditors for errors

It was suggested by some delegates and members attending the Bills Committee meeting that, if an auditor omits relevant statements from his report, i.e., that the financial statements are not in agreement with the accounting records in any material respect or that the auditor has failed to obtain all the information or explanations that, to the best of his knowledge and belief, are necessary and material for the purpose of the audit, he should have to take responsibility for this.

In our view, such statements do not acknowledge the fact that auditors who make an "honest" mistake are already accountable and face unlimited civil liabilities, which are potentially huge and could destroy their careers. This, after all, is the reason why the profession in Hong Kong has already rung alarm bells and sought changes to the liability regime, and why governments, in a growing number of jurisdictions around the world, have already introduced changes in the law to set some form of quantifiable and justifiable cap on auditors' liability.

Hong Kong has lagged behind many other jurisdictions in addressing the auditors' liability issue, with the risk of major firms going under and the uncertainty that this poses to the capital market. This is an issue that needs to be addressed sooner rather than later; instead, however, the Companies Bill will impose more draconian penalties in the form of criminal liabilities on the profession.

Objection to clause 399

The Institute's position remains that we do not see the need for clause 399.

We are not aware of a problem that demands to be addressed of auditors abusing or conspiring to defraud shareholders and we do not see the need to introduce a new criminal sanction as a deterrent, which would suggest that there is such a problem.

Moreover, for conduct not involving any dishonesty, we believe that, criminal sanctions are not the appropriate remedy.

Indeed, a number of legislators also spoke against the imposition of criminal sanctions against professional negligence (albeit a more severe form of such, namely, recklessness) without dishonest intent.

At the Bills Committee meeting, the Hon. Ronny Tong made the valid point that, currently, under the Bill, there is no need to establish that an auditor acted in any way dishonestly in order to institute criminal proceedings against him. He may have acted only slightly more than carelessly. This point was echoed by the Hon. Miriam Lau, and other legislative councillors also understood the concern.

Given the subjective nature of what is regarded as material[1], it is even debatable whether, under clause 399 as drafted, an auditor needs to have done anything incorrect at all in his own eyes.

A charge of acting "recklessly" can also be laid by establishing that an auditor "ought to have known (理應知道)" about an omission rather than that he had actual knowledge.

This could impose a considerable burden of uncertainty on auditors and cause them to perform their duties over-cautiously and defensively. The result would be to add to workload of auditors and the pressure they face, which would not be helpful either to their clients or to the market as a whole.

Even though the sanctions in clause 399 do not include imprisonment, for a professional person, a criminal conviction for an offence relating to his work could do irreparable harm to his reputation and could spell the end of his career.

We are also concerned about the uncertainty surrounding who, precisely, may be held liable under this clause, which was another issue highlighted by legislative councillors at the Bills Committee meeting.

For the reasons explained above, we would respectfully request the Bills Committee to consider removing this clause from the bill.

Alternative wording if clause 399 is retained

If, nevertheless, the Bills Committee does not wish to see clause 399 removed altogether, then, at the very least, we would urge revisions to the wording to restrict the scope of the offence.

We would suggest that if clause 399 is to be retained, the wording of subclause (1) --- be amended as proposed in Appendix 1, so that only when an auditor has acted dishonestly or with intent to defraud, should he become liable for prosecution.

As regards the persons who may be held liable for prosecution, as indicated above, there is uncertainty over which individuals could be caught by the offence. Clause 399(2)(a) refers to "every employee and agent of the auditor who is eligible for appointment as auditor of the company". It is unclear how the phrase "eligible for appointment as auditor of the company" is to be interpreted.

Although we have had further exchanges with the Administration regarding changes to the wording of this part of the clause, doubts still remain. However, if our proposed amendments to the wording of the scope of the offence are accepted, our concerns

[1] As an example, in the context of the Securities and Futures (Amendment) Ordinance 2012, the SFC's draft guidance on disclosure of inside information contains an appendix of over four pages to illustrate how "materiality" has been interpreted in insider dealing cases.

may be mitigated, to some extent, given that only persons involved in the audit and who have been shown to have acted dishonestly or with intent to defraud will be caught.

Request for Bills Committee consideration

In the light of the above, we request that the Bills Committee revisit whether or not clause 399 should be retained and, if so, in what form. In making this assessment, consideration should be given to the context in which the equivalent provision was introduced in the UK, which, as explained at Appendix 2, involved the UK legislature taking an overall view of the question of auditors' liabilities. We would also ask the Bills Committee to consider the practical uncertainties in this clause, particularly in relation to the definition of the persons who may be held liable for prosecution.

If you have any further questions, or require additional clarification, please do not hesitate to contact Peter Tisman, director of specialist practices at the Institute.

Yours sincerely,

Winnie C.W. Cheung
Chief Executive & Registrar

WCC/PMT/ay
Encls.

c.c. Deputy Secretary for Financial and the Treasury (Financial Services), Mr. Darryl Chan

Registrar of Companies, Ms. Ada Chung

Appendix 1

Proposed revised wording of clause 399(1)

399. Offences relating to contents of auditor's report

(1) Every person specified in subsection (2) commits an offence if the person dishonestly or with intent to defraud 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.

Appendix 2

UK Companies Act 2006, section 507

As regards additional information on the Companies Act 2006 in the United Kingdom, on which the clause 399 was said to be based, the relevant section is section 507 (see --- Annex A), in particular subsections (2)(a) and (b). To our knowledge, this is the only major jurisdiction that has provisions of this type on the statute book.

Section 507(1) contains an offence of knowingly or recklessly causing a report "to include any matter that is misleading, false or deceptive in a material particular". While this particular offence is not included in clause 399 of the Companies Bill, a similar and more wide-ranging offence is already provided for in clause 883 of the Companies Bill --- (see Annex B). This difference aside, it is clear that clause 399 is quite closely modelled on section 507 of the Companies Act.

As we have previously mentioned, section 507 was introduced in the UK along with statutory provisions to enable auditors to enter into limitation of liability agreements with the companies they audit. In fact, the liability reform took precedence when the legislation was being drafted and the offences in relation to the content of the auditor's report were included only at a later stage to provide balance and ensure that, overall, there was no perception of diminution of protection to the public. The provisions on limitation of liability agreement are in sections 534-538A of the Companies Act --- (Annex C). These are provided for background reference only, as the Institute has put forward to the Administration its own proposal on liability reform, which advocates a different mechanism to the UK approach and we would not want to cause any confusion in that regard. We simply wish to emphasise that the offences under section 507 of the Companies Act were not introduced in isolation, but as an additional safeguard in the light of other changes, which in principle allowed auditors to agree limits to their civil liability.

Bills Committee members may also wish to note that, in February 2010, the UK Department for Business Innovation & Skills issued guidance for regulatory and --- prosecuting authorities on section 507 (see Annex D, paragraphs 7-9 in particular). This indicates, prima facie, that the scope of the UK legislation is regarded as being potentially too wide. Amongst other things, the guidance advises that prosecutors should always consider other remedies, e.g., professional disciplinary remedies, and that where the evidential test for recklessness "is met by relying on inference only, it is highly unlikely for a prosecution to be appropriate where the public interest may be met by diversion to disciplinary action on the part of regulators".

In effect, therefore, the UK guidance to prosecutors on section 507 of the Companies Act, suggests that it is only in the most egregious cases that prosecution under this section should be initiated. We note that this also appears to accord with the view expressed by the Securities and Futures Commission in relation to clause 399 (see the SFC's submission to the Bill Committee dated 11 May 2012). The problem is that clause 399, as drafted is not restricted to such situations.

Companies Act 2006

2006 CHAPTER 46

PART 16

AUDIT

CHAPTER 3

FUNCTIONS OF AUDITOR

Offences in connection with auditor's report

507 Offences in connection with auditor's report

(1) A person to whom this section applies commits an offence if he knowingly or recklessly causes a report under section 495 (auditor's report on company's annual accounts) to include any matter that is misleading, false or deceptive in a material particular.

(2) A person to whom this section applies commits an offence if he knowingly or recklessly causes such a report to omit a statement required by—

(a) section 498(2)(b) (statement that company's accounts do not agree with accounting records and returns),

(b) section 498(3) (statement that necessary information and explanations not obtained), or

(c) section 498(5) (statement that directors wrongly took advantage of exemption from obligation to prepare group accounts).

(3) This section applies to—

(a) where the auditor is an individual, that individual and any employee or agent of his who is eligible for appointment as auditor of the company;

(b) where the auditor is a firm, any director, member, employee or agent of the firm who is eligible for appointment as auditor of the company.

(4) A person guilty of an offence under this section is liable—

(a) on conviction on indictment, to a fine;

(b) on summary conviction, to a fine not exceeding the statutory maximum.

Annotations:

Modifications etc. (not altering text)

C1 Ss. 507-509 applied (with modifications) (1.10.2008) by The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (S.I. 2008/1911), **reg. 42**

C2 Ss. 484-539 applied (with modifications) (1.10.2009) by The Unregistered Companies Regulations 2009 (S.I. 2009/2436), regs. 3-5, **Sch. 1 para. 11** (with transitional provisions and savings in regs. 7, 9, Sch. 2)

Part 20

Miscellaneous

Division 1

Miscellaneous Offences

883. Offence for false statement

(1) A person commits an offence if, in any return, report, financial statements, certificate or other document, required by or for the purposes of any provision of this Ordinance, the person knowingly or recklessly makes a statement that is misleading, false or deceptive in any material particular.

(2) A person who commits an offence under subsection (1) is liable—

(a) on conviction on indictment to a fine of $300,000 and to imprisonment for 2 years; or

(b) on summary conviction to a fine at level 6 and to imprisonment for 6 months.

(3) This section does not affect the operation of—

(a) Part V of the Crimes Ordinance (Cap. 200); or

(b) section 19, 20 or 21 of the Theft Ordinance (Cap. 210).

884. Offence for improper use of "Limited" or "有限公司" etc.

(1) A person commits an offence if the person—

(a) is not incorporated with limited liability; and

(b) uses, trades or carries on business under a name or title of which—

Companies Act 2006

2006 CHAPTER 46

PART 16

AUDIT

CHAPTER 6

AUDITORS' LIABILITY

Liability limitation agreements

534 Liability limitation agreements

(1) A "liability limitation agreement" is an agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust, occurring in the course of the audit of accounts, of which the auditor may be guilty in relation to the company.

(2) Section 532 (general voidness of provisions protecting auditors from liability) does not affect the validity of a liability limitation agreement that—

(a) complies with section 535 (terms of liability limitation agreement) and of any regulations under that section, and

(b) is authorised by the members of the company (see section 536).

(3) Such an agreement—

(a) is effective to the extent provided by section 537, and

(b) is not subject—

(i) in England and Wales or Northern Ireland, to section 2(2) or 3(2)(a) of the Unfair Contract Terms Act 1977 (c. 50);

(ii) in Scotland, to section 16(1)(b) or 17(1)(a) of that Act.

Annotations:

Modifications etc. (not altering text)

C1 Ss. 484-539 applied (with modifications) (1.10.2009) by The Unregistered Companies Regulations 2009 (S.I. 2009/2436), regs. 3-5, **Sch. 1 para. 11** (with transitional provisions and savings in regs. 7, 9, Sch. 2)

535 Terms of liability limitation agreement

(1) A liability limitation agreement—

(a) must not apply in respect of acts or omissions occurring in the course of the audit of accounts for more than one financial year, and

(b) must specify the financial year in relation to which it applies.

(2) The Secretary of State may by regulations—

(a) require liability limitation agreements to contain specified provisions or provisions of a specified description;

(b) prohibit liability limitation agreements from containing specified provisions or provisions of a specified description.

"Specified" here means specified in the regulations.

(3) Without prejudice to the generality of the power conferred by subsection (2), that power may be exercised with a view to preventing adverse effects on competition.

(4) Subject to the preceding provisions of this section, it is immaterial how a liability limitation agreement is framed.

In particular, the limit on the amount of the auditor's liability need not be a sum of money, or a formula, specified in the agreement.

(5) Regulations under this section are subject to negative resolution procedure.

Annotations:

Modifications etc. (not altering text)

C2 Ss. 484-539 applied (with modifications) (1.10.2009) by The Unregistered Companies Regulations 2009 (S.I. 2009/2436), regs. 3-5, **Sch. 1 para. 11** (with transitional provisions and savings in regs. 7, 9, Sch. 2)

Commencement Information

I1 S. 535 wholly in force at 6.4.2008; s. 535 not in force at Royal Assent, see s. 1300; s. 535 in force for specified purposes at 20.1.2007 by S.I. 2006/3428, **art. 3(3)** (subject to art. 5, Sch. 1 and with arts. 6, 8, Sch. 5); s. 535 in force at 6.4.2008 by S.I. 2007/3495, **art. 3(1)(d)** (with arts. 7, 12, Sch. 4 paras. 9-19)

536 Authorisation of agreement by members of the company

(1) A liability limitation agreement is authorised by the members of the company if it has been authorised under this section and that authorisation has not been withdrawn.

(2) A liability limitation agreement between a private company and its auditor may be authorised—

(a) by the company passing a resolution, before it enters into the agreement, waiving the need for approval,

(b) by the company passing a resolution, before it enters into the agreement, approving the agreement's principal terms, or

(c) by the company passing a resolution, after it enters into the agreement, approving the agreement.

(3) A liability limitation agreement between a public company and its auditor may be authorised—

(a) by the company passing a resolution in general meeting, before it enters into the agreement, approving the agreement's principal terms, or

(b) by the company passing a resolution in general meeting, after it enters into the agreement, approving the agreement.

(4) The "principal terms" of an agreement are terms specifying, or relevant to the determination of—

(a) the kind (or kinds) of acts or omissions covered,

(b) the financial year to which the agreement relates, or

(c) the limit to which the auditor's liability is subject.

(5) Authorisation under this section may be withdrawn by the company passing an ordinary resolution to that effect—

(a) at any time before the company enters into the agreement, or

(b) if the company has already entered into the agreement, before the beginning of the financial year to which the agreement relates.

Paragraph (b) has effect notwithstanding anything in the agreement.

Annotations:

Modifications etc. (not altering text)

C3 Ss. 484-539 applied (with modifications) (1.10.2009) by The Unregistered Companies Regulations 2009 (S.I. 2009/2436), regs. 3-5, **Sch. 1 para. 11** (with transitional provisions and savings in regs. 7, 9, Sch. 2)

537 Effect of liability limitation agreement

(1) A liability limitation agreement is not effective to limit the auditor's liability to less than such amount as is fair and reasonable in all the circumstances of the case having regard (in particular) to—

(a) the auditor's responsibilities under this Part,

(b) the nature and purpose of the auditor's contractual obligations to the company, and

(c) the professional standards expected of him.

(2) A liability limitation agreement that purports to limit the auditor's liability to less than the amount mentioned in subsection (1) shall have effect as if it limited his liability to that amount.

(3) In determining what is fair and reasonable in all the circumstances of the case no account is to be taken of—

(a) matters arising after the loss or damage in question has been incurred, or

(b) matters (whenever arising) affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage.

Annotations:

Modifications etc. (not altering text)

C4 Ss. 484-539 applied (with modifications) (1.10.2009) by The Unregistered Companies Regulations 2009 (S.I. 2009/2436), regs. 3-5, **Sch. 1 para. 11** (with transitional provisions and savings in regs. 7, 9, Sch. 2)

538 Disclosure of agreement by company

(1) A company which has entered into a liability limitation agreement must make such disclosure in connection with the agreement as the Secretary of State may require by regulations.

(2) The regulations may provide, in particular, that any disclosure required by the regulations shall be made—

(a) in a note to the company's annual accounts (in the case of its individual accounts) or in such manner as is specified in the regulations (in the case of group accounts), or

(b) in the directors' report.

(3) Regulations under this section are subject to negative resolution procedure.

Annotations:

Modifications etc. (not altering text)

C5 Ss. 484-539 applied (with modifications) (1.10.2009) by The Unregistered Companies Regulations 2009 (S.I. 2009/2436), regs. 3-5, **Sch. 1 para. 11** (with transitional provisions and savings in regs. 7, 9, Sch. 2)

Commencement Information

I2 S. 538 wholly in force at 6.4.2008; s. 538 not in force at Royal Assent, see s. 1300; s. 538 in force for specified purposes at 20.1.2007 by S.I. 2006/3428, **art. 3(3)** (subject to art. 5, Sch. 1 and with arts. 6, 8, Sch. 5); s. 538 in force at 6.4.2008 by S.I. 2007/3495, **art. 3(1)(d)** (with arts. 7, 12, Sch. 4 paras. 9-19)

[F1 538A Meaning of "corporate governance statement" etc

(1) In this Part "corporate governance statement" means the statement required by rules 7.2.1 to 7.2.11 in the Disclosure Rules and Transparency Rules sourcebook issued by the Financial Services Authority.

(2) Those rules were inserted by Annex C of the Disclosure Rules and Transparency Rules Sourcebook (Corporate Governance Rules) Instrument 2008 made by the Authority on 26th June 2008 (FSA 2008/32).

(3) A "separate" corporate governance statement means one that is not included in the directors' report.]

Annotations:

Amendments (Textual)

F1 S. 538A inserted (27.6.2009) by The Companies Act 2006 (Accounts, Reports and Audit) Regulations 2009 (S.I. 2009/1581), **reg. 8** (with application as stated in reg. 1(3))

Modifications etc. (not altering text)

C6 Ss. 484-539 applied (with modifications) (1.10.2009) by The Unregistered Companies Regulations 2009 (S.I. 2009/2436), regs. 3-5, **Sch. 1 para. 11** (with transitional provisions and savings in regs. 7, 9, Sch. 2)

BIS | Department for Business Innovation & Skills

COMPANIES ACT 2006, SECTION 508

GUIDANCE FOR REGULATORY AND PROSECUTING AUTHORITIES IN ENGLAND, WALES AND NORTHERN IRELAND

OFFENCES IN CONNECTION WITH AUDITORS' REPORTS (SECTION 507)

1. This guidance is issued by the Secretary of State for Business, Innovation and Skills under section 508 of the Companies Act 2006, with the consent of the Attorney General. The purpose of the power in section 508 to issue guidance is to assist regulatory and prosecuting authorities in cases where it appears that an offence under section 507 may have taken place and where the same behaviour could come within the scope of the investigation powers (under paragraph 15 or 24 of Schedule 10 to the Act) of the authorities that supervise or regulate auditors.

2. This guidance is intended to assist prosecutors in applying the relevant prosecutorial code and, where appropriate in particular, to make a decision whether prosecution, disciplinary action or other diversion is appropriate.

3. When considering the evidence and the public interest, prosecutors will apply the relevant prosecutorial code ("the Code")[1] issued by the Director of Public Prosecutions, England and Wales, under section 10 of the Prosecution of Offences Act 1985 or by the Director of Public Prosecutions, Northern Ireland under s37 Justice (Northern Ireland) Act 2002. Each prosecutorial code gives guidance on the general principles to be applied when making decisions about prosecution. The prosecutorial codes have two stages. The first is the evidential stage where the evidence is considered. The second stage is the public

[1] http://www.cps.gov.uk/publications/docs/code2004english.pdf,
http://www.ppsni.gov.uk/Site/1/Documents/Publications/Code_for_Prosecutors_Revised_2008.pdf

interest stage, where the prosecutor considers if a prosecution is needed in the public interest.

4. The audit report to which the offence refers is provided as part of a statutory function defined in the Companies Act 2006. The offence reflects the importance of auditors' reports on company accounts. The Act also includes extensive provisions about the regulation and supervision of auditors. Audit is a regulated profession, and every auditor is subject to the disciplines of his or her recognised supervisory body (RSB) and potentially of the Accountancy & Actuarial Discipline Board (AADB) of the Financial Reporting Council (FRC). There is a further background note on the BIS website[2]. The sanctions available to the disciplinary bodies include unlimited fines and withdrawal of audit practice certificates.

The Evidential Stage

5. In considering whether the evidence provided meets the evidential test of the appropriate code for an offence under section 507, prosecutors should give particular consideration to evidence relating to the state of mind of the person concerned. The offence is committed by someone who "knowingly or recklessly causes [an audit report] to include any matter that is misleading, false or deceptive in a material particular" or to omit statements required about certain types of problems with the accounts.

6. In considering evidence in relation to this offence, prosecutors will want to familiarise themselves with the statutory role of the auditor under the Companies Acts and the applicable procedures and standards. In relation to the audit in question, the following factors will be relevant:

    - The way in which the audit was planned and conducted
    - Where more than one individual auditor was involved, the structure and management of the audit team

[2] http://www.berr.gov.uk/files/file54459.pdf

- The nature of the company whose accounts were being audited, and the way in which the auditor worked with its management and staff.

The Public Interest Stage

7. The decision whether to prosecute a case should always take into account the range of remedies that are available to regulators under the professional disciplinary system and consider whether those remedies are sufficient to meet the public interest.

8. Where the evidence of the offence concerns recklessness and the evidential test is met by relying on inference only, it is highly unlikely for a prosecution to be appropriate where the public interest may be met by diversion to disciplinary action on the part of regulators.

9. If there is, or is likely to be available, evidence to meet the evidential test, the following are some of the considerations that may be relevant to the decision on whether it is in the public interest to prosecute:

    - any history of similar conduct and/or regulatory sanctions applied in the past,
    - the pervasiveness of the offending behaviour including the complicity in or approval of the wrongdoing by others
    - the use of the audit report to facilitate any other criminal offences,
    - the effect the misconduct had on any persons who relied on the audit report and the numbers of those persons,
    - any financial loss or harm suffered, or risk thereof, as a result of the audit report,
    - the extent of remedial actions and by whom it has been taken including systems for compliance that have been put in place.