



公 司 註 冊 處
COMPANIES REGISTRY

香港金鐘道六十六號
金鐘道政府合署十五樓

QUEENSWAY GOVERNMENT OFFICES
15TH FLOOR, 66 QUEENSWAY
HONG KONG

檔號 REF: CR HQ/1-50/15 Pt. 4

傳真 FAX: (852) 2869 6817

電郵 E-MAIL: crenq@cr.gov.hk

網址 WEBSITE: www.cr.gov.hk

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The New Companies Ordinance (Cap. 622) - Offence Relating to Contents of Auditor's Report

This circular serves to set out the general principles that apply in determining whether an offence relating to the contents of an auditor's report should be prosecuted under section 408 of the new Companies Ordinance (Cap. 622) ("the new CO") or section 16 of the Companies (Revision of Financial Statements and Reports) Regulation (Cap. 622F) ("the Regulation"). The relevant provisions in the new CO and the Regulation will come into operation on 3 March 2014. Members of the accounting profession should also take note of the Guidance on section 408 of the new CO issued by the Hong Kong Institute of Certified Public Accountants.

The Offence

2. Section 407 of the new CO provides that if the auditor is of the opinion that the financial statements of a company are not in agreement with its accounting records in any material respect, or if the auditor has failed to obtain all the information or explanations that are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report ("the specified statements").

3. Section 408 provides that any of the persons specified below commits an offence if the person knowingly or recklessly causes any of the specified statements to be omitted from an auditor's report:

- (a) if the auditor is a natural person, the auditor and every employee and agent of the auditor who is eligible for appointment as auditor of the company;
- (b) if the auditor is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company;

- (c) if the auditor is a body corporate, every officer, member, employee and agent of the auditor who is eligible for appointment as auditor of the company.

Pursuant to section 408(3), a person who commits an offence under the section is liable to a fine not exceeding \$150,000. “Employee” of the auditor refers to someone who is employed by the auditor who prepares the auditor’s report whether the auditor is a natural person, a firm or a body corporate. An employee or agent will be held liable only if he is eligible for appointment as auditor of the company and if he knowingly or recklessly causes any of the specified statements to be omitted.

4. The reference to a person eligible for appointment as auditor of the company in section 408 is not intended to cover any person who might have been eligible had he or she applied for the relevant professional qualifications or certificates.

5. As revised financial statements are required to be audited under the Regulation, section 16 of the Regulation provides for a similar offence and penalty. The general principles set out in this circular apply equally to section 16 of the Regulation.

The Decision to Prosecute

6. The Prosecution Code (“the Code”) published by the Department of Justice (available at www.doj.gov.hk) sets out the relevant guidelines for prosecution. Under the Code, in deciding whether to prosecute, the prosecutor must consider two issues. First, is the evidence sufficient to justify instituting or continuing proceedings? Second, if it is, does the public interest require a prosecution to be pursued?

The Evidential Criteria

7. There must be legally sufficient evidence to support a prosecution; that is, evidence that is admissible and reliable and, together with any reasonable inferences able to be drawn from it, likely to prove the offence. The test is whether the evidence demonstrates a reasonable prospect of conviction. In the context of section 408, to start a prosecution requires, among other things, admissible and reliable evidence on the state of mind of the person concerned. The requisite mental element for commission of an offence is “knowingly” or “recklessly” causing any of the specified statements to be omitted from an auditor’s report. The offence does not criminalize negligence.

8. For the mental element of “knowingly”, the evidential threshold is quite high. A person would be culpable if, at the time of the commission of the offence, he knew and caused the specified statements to be omitted. This knowledge will be inferred from the evidence, including the evidence given by the auditor as to what he actually

knew. Knowledge will not be imputed on the basis of the person's professional qualification.

9. As regards the mental element of “recklessly”, the evidential requirement is also quite high. The test for “recklessness” according to the principle set out in the case of *Sin Kam Wah v HKSAR* [2005] 2 HKLRD 375 at 391 C-E, is that “*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.*” *Sin Kam Wah’s* case was followed in *Tang Yuk Wah v HKSAR CACC 132/2005*, [2005] 4 HKLRD L8 and reinforced in *HKSAR v Siu Tat Yuen* [2007] 4 HKLRD 734.

10. In the context of section 408, a person would be culpable if, at the time of commission of the offence, he was aware that an action or failure to act carried risks that he knew were not reasonable ones to take, and that he went ahead despite knowing that. An inexperienced member of an audit team would not be regarded as culpable if, owing to his / her inexperience, he / she genuinely did not appreciate or foresee the risks involved in omitting any of the specified statements.

11. In considering evidence to support a prosecution, prosecutors will take into account the statutory role of the auditor under the new CO and the applicable procedures and standards. In relation to the audit in question, the following factors will be relevant:

- (a) the way in which the audit was planned and conducted;
- (b) where more than one individual auditor was involved, the structure and management of the audit team; and
- (c) the nature of the company the financial statements of which were being audited, and the way in which the auditor worked with its management and staff.

12. To secure a conviction of the offence all the elements of the offence must be proved beyond reasonable doubt.

The Public Interest Criteria

13. Pursuant to the Code, once the prosecutor is satisfied that the evidence itself can justify proceedings in the sense that there is a reasonable prospect of conviction,

he or she must then consider whether the general public interest requires that the prosecution be conducted.

14. There can be no exhaustive list of the considerations to be addressed when making this assessment, but they include the seriousness of the offence, the level of the suspect's culpability and the attitude, age, nature or physical or psychological condition of the suspect. The prosecutor must consider the justice of the situation and examine all the factors. The factors will vary from case to case, but, in general, the more serious the offence, the more likely it is that the public interest will require a prosecution to proceed.

Enquiries

15. Enquiries concerning this circular should be directed to Mrs Christine Frances Sit, Senior Solicitor (Company Law Reform)¹, at (852) 2867 2640 / crenq@cr.gov.hk.

Ms Ada LL CHUNG
Registrar of Companies

c.c.: CR HQ/ 8-1/6