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

By email < co_rewrite@fstb.gov.hk > and by post

11 August 2010

Our Ref.: C/RIFEC, M72029

Companies Bill Team
Financial Services and the Treasury Bureau
15th Floor, Queensway Government Offices
66 Queensway
Hong Kong

Dear Sirs,

Re: Consultation Paper on Draft Companies Bill
Second Phase Consultation

Please find attached the comments of the Hong Kong Institute of Certified Public Accountants on the above-referenced consultation paper.

If you have any questions on our submission or wish to discuss it further, please contact Mary Lam, Assistant Director, Specialist Practices of the Institute by telephone on 2287 7086.

Yours faithfully,

Mary Lam
for Peter Tisman, Director, Specialist Practices

PMT/ML/ay
Encl.

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Reply Form for the Draft Companies Bill – Second Phase Consultation

1. The purpose of this reply form is to facilitate providing views and comments on the Consultation Paper entitled Draft Companies Bill – Second Phase Consultation ("Consultation Paper") published by the Financial Services and the Treasury Bureau ("FSTB") on 7 May 2010.

2. The Consultation Paper can be downloaded from the FSTB's website at http://www.fstb.gov.hk/fsb.

3. If you have any views or comments on the Consultation Paper, you are welcome to complete this reply form and return it to us on or before **6 August 2010** by one of the following means:

By mail or hand delivery to:	Companies Bill Team Financial Services and the Treasury Bureau 15/F, Queensway Government Offices 66 Queensway Hong Kong Re: **Consultation Paper on Draft Companies Bill – Second Phase Consultation**
By fax to:	(852) 2869 4195
By e-mail to:	co_rewrite@fstb.gov.hk

4. Any questions about this reply form may be addressed to Miss Sandy CHAN, Executive Assistant (Companies Bill Team), who can be reached at (852) 2867 5844 (phone), (852) 2869 4195 (fax) or co_rewrite@fstb.gov.hk (email).

5. Submissions will be received on the basis that we may freely reproduce and publish them, in whole or in part, in any form, and use, adapt or develop any proposal put forward without seeking permission or providing acknowledgment of the party making the proposal.

6. Please note that names of respondents, their affiliation(s) and comments may be posted on the FSTB's website or referred to in other documents we publish. If you do not wish your name and/or affiliation to be disclosed, please state so when making your submission. Any personal data submitted will only be used for purposes which are directly related to consultation purposes under this consultation paper. Such data may be transferred to other Government departments/agencies for the same purposes. For access to or correction of personal data contained in your submission, please contact Miss Sandy CHAN, Executive Assistant (Companies Bill Team), who can be reached at (852) 2867 5844 (phone), (852) 2869 4195 (fax), or co_rewrite@fstb.gov.hk (email).

PART A: GENERAL INFORMATION OF THE RESPONDENT

Name/Name of Organisation	: Hong Kong Institute of Certified Public Accountants
If organisation, name and title of Contact Person	: Peter Tisman, Director, Specialist Practices
	(Please fill in if the respondent is a company or organization)
Phone Number	: (852) 2287 7084
E-mail Address	: peter@hkicpa.org.hk

If you do not wish to disclose your affiliation or name to the public, please check the box here:

☐ Our organisation does not wish to disclose our name.

☐ I do not wish to disclose my name.

PART B: DETAILED QUESTIONS FOR RESPONSE

You may provide your views or comments on all or any of the questions. If the provided space is insufficient, please attach additional pages.

Question 1

(a) Do you agree that the restrictions on financial assistance should be abolished for private companies?

We have some reservations about completely abolishing the restrictions on financial assistance for private companies at this time, rather than taking the route currently proposed in the draft Companies Bill ("CB") and adopting the model in the New Zealand Companies Act. Paragraph 2.13 of the Consultation Paper on Draft Companies Bill Second Phase Consultation ("the Paper") suggests that the risks posed by unwise or unscrupulous financial assistance may be sufficiently covered by more targeted legal provisions, such as those relating to directors' fiduciary duties and duty of care, the requirements for the exercise of directors' powers for proper purposes and minority shareholder remedies. Footnote 22 suggests that this view is shared by the UK Company Law Review Steering Group, and we note that the UK has abolished the restrictions on financial assistance for private companies. However, the strengthening of such more targeted provisions, referred to in paragraph 2.14, are legislative proposals contained in the CB, which have not been passed. Furthermore, while we would agree that a duty of directors to prevent insolvent trading would "create a substantial disincentive for directors to sanction financial assistance which reduces the company's assets in a way that endangers creditors", as stated in paragraph 2.14, insolvent trading provisions are also only at the proposal stage, even though, as also stated, the government intends to bring them forward as part of the legislative proposals relating to corporate rescue. The fate of the foregoing proposals, therefore, is uncertain, particularly the proposals on insolvent trading, so in our view, it would be premature to abolish restrictions on the giving of financial assistance for private companies on the assumption that these proposals will be enacted. In this regard we note that the UK already has insolvent trading provisions in the statute books.

We would suggest, therefore, this issue be revisited after the other changes referred to above have been implemented.

(b) If your answer to (a) is positive, which of the following options concerning regulation of listed and unlisted public companies would you prefer:

(i) existing rules for listed and unlisted public companies in the CO be retained (i.e. listed companies cannot give financial assistance except for certain exceptions as set out in sections 47C and 47D of the CO while unlisted public companies may give financial assistance subject to solvency test and a special resolution of the shareholders (section 47E of the CO));

(ii) the rules for both listed and unlisted public companies to be streamlined using a solvency test as set out in the draft clauses in Division 5 of Part 5; or

(iii) any other option (please elaborate),

having regard to the need to protect small investors of public companies?

N/A

(c) If your answer to (a) is negative (i.e. you believe that private companies should still be subject to certain restrictions on financial assistance), do you have any specific comments on the draft clauses in Division 5 of Part 5? Please elaborate.

We suggest consideration be given to modifying the solvency requirement by including a balance sheet solvency test, covering both current and total assets/liabilities, to provide a more comprehensive and objective approach in the assessment of solvency and better safeguards. Please also see our reply to question 6 regarding comments on draft clauses.

Question 2

Do you agree that there is no need to impose a statutory requirement in the CB for all listed companies incorporated in Hong Kong and unlisted companies incorporated in Hong Kong where members holding not less than 5% of voting rights have so requested to prepare separate directors' remuneration reports?

We agree that there is no need to impose a statutory requirement in the CB for all listed companies incorporated in Hong Kong and unlisted companies incorporated in Hong Kong, where members holding not less than 5% of voting rights have so requested, to prepare separate directors' remuneration reports. As stated in paragraph 3.11 of the Paper, the government should keep under review the need to introduce further statutory disclosure requirements for listed companies in the light of local and international market experience.

We are of the view that any additional requirements on listed companies due to their nature should be set out in the stock exchange listing rules and, if statutory backing is considered necessary, in the Securities and Futures Ordinance, so as to provide a level-playing field for all listed companies irrespective of their place of incorporation.

As regards unlisted companies, we accept that a requirement for directors' remuneration reports could be misused in the case of shareholder disputes. We consider that the disclosures relating to directors' remuneration should be sufficient for unlisted companies, taking into account the proposed additional disclosure requirements, to be set out in regulations made under clause 9.27 of Part 9 of the CB, including the amount of money or benefits received or receivable by directors under long-term incentive schemes and share options, or by third parties in respect of directors' services; and the nature and value of any benefit in kind, or damages or settlement sum for breach of contract, made to directors for loss of office.

Question 3

Do you have any comments on the proposed changes to the provisions concerning the investigation of a company's affairs and enquiry into company's affairs that may be exercised by the FS described in paragraphs 4.6 to 4.13, the Explanatory Notes on Part 19 and Divisions 1 to 3 and 5 in Part 19 of the CB?

Regarding the physical protection of records and documents which the inspector believes may be removed or destroyed, an inspector should be empowered to take action to safeguard such materials, as by the time an application to court has been approved, it may be too late. The fact that a penalty may be imposed by the court after the event may not be sufficient to deter the removal or destruction of records and documents, as the penalty imposed is likely to be much less than the potential consequences following examination of the records and documents.

Question 4

Do you have any comments on the proposed new powers for the Registrar to obtain documents, records and information as described in paragraphs 4.14 to 4.17, the Explanatory Notes on Part 19 and Divisions 1, 4 and 5 in Part 19 of the CB?

In principle, we support the proposed new powers for the Registrar, to facilitate enforcement activity by the Companies Registry in relation to filing and related requirements.

Question 5

(a) Do you think the CB should make it obligatory for a company to give reasons explaining its refusal to register a transfer of shares?

We consider that the CB should make it obligatory for a company to give reasons explaining its refusal to register a transfer of shares so as to give the transferor or transferee the means to challenge the validity of the directors' decision where this is in question.

(b) If your answer to (a) is in the affirmative, should the company be required to provide reasons with the refusal:

(i) in the manner of the UKCA 2006 (i.e. mandatory whenever there is a refusal); or

(ii) upon request, as in the case of transmissions by operation of law under section 69(1A) of the CO?

We would favour option (ii), i.e., require a company to provide reasons with the refusal upon request, as in the case of transmissions by operation of law under section 69(1A) of the CO.

Comment on Draft Clauses

Question 6 Do you have any comments on the draft provisions in the CB Consultation Draft – Parts 1, 3 to 9, 13 and 19 to 20? If so, please elaborate.	
Clause No.	**Comment**
Part 5 Clause 5.3	**Solvency test** We support the adoption of a uniform solvency test for the transactions specified under this part of the CB to provide consistency and clarity. Nevertheless, we should like to reiterate the view that we expressed in response to the 3rd Consultation Paper on the Rewrite of the Companies Ordinance, that the existing solvency requirement in Hong Kong, which is basically a cash flow test, should be modified by including a balance sheet solvency test, covering both current and total assets/liabilities. This would provide a more comprehensive and objective approach to the assessment of solvency and a better safeguard for creditors. In the event of financial difficulties, creditors would look not only to cash flows for repayment but also to the assets on the balance sheet of a company.
Part 8 Clause 8.13(2)	**Replacing the issue of a certificate of due registration with an acknowledgment of receipt** As indicated in the Institute's response to the 2nd Consultation Paper on the Rewrite of the Companies Ordinance, we do not favour making substantial changes to the existing registration process. Currently, the public is provided with additional comfort as to the legal correctness of particulars submitted for registration, as the Registrar of Companies compares the particulars with the instrument of charge and thereafter, issues a certificate of due registration to indicate that he/she is satisfied that the particulars are correct and that all the requirements as to registration have been complied with. The proposed acknowledgment of receipt of the documents submitted for registration, as opposed to a certificate of due registration, is not to be treated as conclusive evidence that the registration requirements have been complied with (paragraph 16 in Part 8 of the Paper). Thus it seems the register will cease to provide conclusive evidence from a legal standpoint that a charge has been properly registered. This represents a significant change of approach in terms of the reliance that may be placed on the register.
Part 8 Clauses 8.4(5), 8.5(6), 8.7(3), 8.8(4) & 8.9(5)	**Shortening the period for registration of charges** As indicated in the Institute's response to the 2nd Consultation Paper on the Rewrite of the Companies Ordinance, we consider that a reasonable time should be allowed to register a charge given that documentation may need to be obtained from overseas. The current five-week period is a

	maximum period and charge holders/companies could be encouraged to register earlier than this. We do not favour prescribing a shorter period than this in the CB.
Part 9 Clauses 9.2 - 9.9	**Relaxing the qualifying criteria for private companies to prepare simplified financial and directors' reports** It is noted that clauses 9.2(1)(a), 9.4(1) and (2) of the CB provide that a private company (except for the companies specifically prohibited under these clauses) will automatically be qualified to prepare simplified financial and directors' reports ("simplified financial reports" in terms of being able to apply the small and medium-sized entity financial reporting standards ("SME-FRS") issued by the Institute in 2005), provided it is a "small private company" that satisfies any two of the following conditions, as specified in clause 9.8(1): • Total annual revenue of not more than HK$50 million • Total assets of not more than HK$50 million • Not more than 50 employees. Clauses 9.2(1)(b) and 9.3(1) provide that private companies that do not meet the conditions specified in clause 9.8(1) (i.e., which do not qualify as a "small company") can still elect for simplified reporting if members holding at least 75% of the voting rights so resolve and no other member objects. In addition, clauses 9.2(3) and 9.6(1) extend simplified reporting to small private groups if the group satisfies any two of the following conditions under clause 9.8(6): • Total annual revenue of not more than HK$50 million net • Total assets of not more than HK$50 million net • Not more than 50 employees. Clauses 9.2(3), 9.3(2) and (3) provide that private groups that do not meet the conditions specified in clause 9.8(6) can still elect for simplified reporting with the approval of members holding at least 75% of the voting rights (with no member objecting) in the holding company or in the non-small private companies. We believe that SME-FRS provides an effective accounting framework for SMEs, which has served Hong Kong well for the past five years and is widely used. Consistent with the principles behind the original development of SME-FRS, we would not object to extending the application of SME-FRS to small private groups, subject to the overall size criteria. However, we are concerned about the proposal to extend the possible use of SME-FRS to private companies/groups of any size, where members holding 75% of the voting rights so resolve and no member objects.

	We note that, for example, in the UK and other jurisdictions, companies and groups may apply the simplified reporting framework only if they meet size criteria. There is no similar provision for companies and groups that do not meet the size criteria to opt for simplified reporting, subject to shareholder consent. We are aware that there is an argument that, if shareholders are satisfied with the information available to them, and major creditors can ask for more information if they wish to as a condition of extending credit, then why should groups of larger private companies not be able to reduce their costs by taking advantage of a simplified financial reporting framework. The existing SME-FRS was developed essentially for SMEs, which generally have much simpler accounting requirements, as an alternative to the full Hong Kong Financial Reporting Standards ("HKFRS"), primarily based on cost-and-benefit considerations. As such, the SME financial reporting framework, in principle, may not be able to reflect, with the degree of transparency that would be expected, the state of affairs of groups of sizeable companies with more complex accounts. Since 30 April 2010, entities that do not have public accountability have had the option of adopting HKFRS for Private Entities for financial reporting purposes, which are less onerous in terms of disclosure requirements than the full HKFRS. Given the economic impact that larger private companies/groups tend to have on the community, for public interest reasons, we would advise against extending the scope of the SME-FRS in the way proposed in the CB. To further support this view we are analyzing the key differences in accounting requirements between HKFRS for Private Entities and SME-FRS and assessing the potential cost benefit impact of either option. We will be pleased to share our findings in due course. Regionally, a number of jurisdictions are moving towards the adoption of full International Financial Reporting Standards ("IFRS") and IFRS for SMEs, upon which the HKFRSs and HKFRS for Private Entities are based. Therefore, Hong Kong's position as an international financial centre, and a leading light of good corporate governance and transparency within the region, could be disadvantaged if our new company law were to provide for more extensive adoption of SME-FRS by sizeable and economically significant private companies/groups. For the reasons explained above, we would suggest that the government reconsider this particular proposal and limit the expanded scope of SME-FRS to groups meeting the size criteria.
Part 9 Clause 9.25	**Requiring all companies incorporated in Hong Kong presents financial statement with "true and fair view"** Clauses 9.24 to 9.28 require a company and a holding company to prepare financial statements. The financial statements, including those

	prepared for companies falling within the reporting exemption, are required to give a true and fair view and comply with the applicable accounting standards. We do not support the proposal that all companies incorporated in Hong Kong should be required to present their financial statements in accordance with a "true and fair view". Currently, auditors are not permitted to express a "true and fair" opinion on financial statements prepared under SME-FRS, as the SME-FRS is considered to be a compliance framework, as defined in Hong Kong Standard on Auditing (HKSA) 200 (Clarified). For financial statements prepared under SME-FRS, therefore, auditors should express an opinion as to whether the relevant financial statements are prepared, in all material respects, in accordance with the framework. We recommend that the CB adopt wording consistent with the above and which, in effect, requires, in the case of companies adopting SME-FRS, that their financial statements are prepared, in all material respects, in accordance with the applicable financial reporting standards. We are happy to discuss further with the government appropriate wording to be included in the CB
Part 9 Clause 9.25(3)	**<u>Definition of an "associate" of an auditor</u>** Clause 9.25(3) and Part 2 of the Schedule to Part 9 introduces a new requirement to disclose in the financial statement the nature of services and the amount of remuneration received or receivable by an "associate of the auditor", in addition to the auditor. No definition of "associate" is included. As drafted, disclosure seems to be required only in respect of services provided for the company by an auditor and its associates. This raises a number of questions. For example, is the disclosure to be confined to the company itself or does the provision intend to encompass disclosures for its group? Do the services covered include the audit, as well as non-audit services? As the schedule is not clear as to the types of services that should be disclosed, it is likely to lead to disparities in disclosures between different companies. The drafting of the CB could be interpreted to mean that only one figure needs to be disclosed with no analysis between audit and non-audit services, and no sub-division of the latter. If group disclosures are intended to be covered then a definition of a company's associates may also be required. Depending upon how "associate of the auditor" is to be interpreted, this requirement could be less than straightforward and potentially onerous. For example, we note that the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008

	made pursuant to section 494 of the UK Companies Act 2006 ("UKCA") provide for disclosure of such matters in a note to the company's annual accounts. "Associate" of an auditor is defined in great detail in Schedule 1 to the Regulations. It is also complicated, as it not only scopes in many people and entities, it also excludes others. It covers all possibilities of who may be an associate if the auditor is a sole practitioner, a partnership or a company. We understand that the concept of a "distant associate" in the UK regulations has produced difficulties and the larger audit firms in the UK have had to invest in systems to collate and update the information on the relationships in their networks, the companies for which their partners have been appointed as directors, etc., in order to provide clients with the necessary information. We would suggest that a definition of "associate" for the purposes of the Schedule to Part 9 be included in the CB and that this be made as clear and simple as possible.
Part 9 Clause 9.28	**Financial statement to be accompanied by directors' declaration** The Institute has raised with the government the question of what would happen in a situation in which the directors make a declaration that, in their opinion, the financial statements give a true and fair view of the financial position and the financial performance of the company, but the auditor holds a different view. We understand that the government will look again at this issue.
Part 9 Clauses 9.29(1) & 9.31	**Including an analytical and forward-looking business review in the directors' report** Clauses 9.29(1) and 9.31 require companies that do not fall within the reporting exemption to prepare in the directors' report a principle based business review that is more analytical and forward-looking, non-compliance with which will carry criminal sanctions, as specified under clause 9.29(4) to (6). Shareholders and investors will find it useful to have more analytical and substantive, and forward-looking information included in the business review in companies' annual reports. The judges in the Institute's Best Corporate Governance Disclosure Awards have commented on this on a number of occasions in the findings contained in the judges' report. Internationally, there is a growing trend to encourage more meaningful disclosure in narrative reporting. In 2009/10, the International Accounting Standards Board consulted on proposals in relation to the contents of management commentaries and the Institute made a submission in response to this. However, if criminal sanctions are to attach to a requirement to provide certain information in a business review, that requirement must be expressed in terms that make it clear when it has been complied with and when it has not. In addition, achieving compliance should not be unduly

	onerous. There are elements of the provisions in the CB that arguably do not meet this standard. For example, it is not entirely clear what, in clause 9.29(4), would constitute taking "all reasonable steps to secure compliance" with subsections (1) and (2). While we note that, under sub-clause (6), it is a defence for a director to establish that he had reasonable grounds to believe, and did believe, that a competent and reliable person was charged with the duty of ensuring compliance and was in a position to discharge that duty, this could involve a good deal of subjective judgment. Furthermore, as sub-clause (6) merely provides a defence, the burden of proof will be on the director and he will need to establish, not only that he had objectively reasonable grounds to believe that a competent and reliable person was charged with the relevant duty, but also that he did, in fact, believe that to be the case. This is potentially onerous. Turning to the content of the business review itself, under clause 9.31, sub-clause (1)(d) requires that the business review must contain "an indication of the likely future development in the company's business". As drafted, this could be interpreted as requiring the directors to take view on what others might consider to be likely. The intention may be, and it would surely be more reasonable, for directors to give an indication what in their view is the likely future development in the company's business. Sub-clause (2) requires the business review to be "a balanced and comprehensive analysis, consistent with the size and complexity of the company's business" in relation to the development and performance of the company's business and its position at the end of the year. Again, this requirement encompasses a significant degree of subjective judgment, views on which could be debated at length. In the light of the above, we suggest that the following be considered: (i) Retaining the principles in the primary legislation and placing the more detailed content items in a separate document or code, where the detailed wording would be more amenable to revision, and which could be given statutory recognition. (ii) Restricting the criminal sanctions to wilful or reckless conduct. (iii) Removing the second part of what needs to be proved in the defence under sub-clause (6), i.e., so a director would only need to establish that there were reasonable grounds to believe that a competent and reliable person was charged with the duty of ensuring compliance and was in a position to discharge that duty. (iv) It is important that directors should feel comfortable with making forward-looking statements that are meaningful and not just boiler-plate legalese provided by their lawyers to avoid possible law suits by investors when the future does not turn out as the directors had envisaged. In this regard, we suggest that a "safe harbour" clause

	be included in the CB, which would provide directors with protection from civil liability for statements or omissions in the directors' report. By way of example, the UKCA contains a "safe harbour" in section 463. This provides that directors are liable solely to the company, and no other person, for a loss suffered by the company if statements are untrue or misleading or there is an omission of anything required to be in the report. The directors are liable if they knew a statement was made in bad faith or recklessly, or an omission was made for deliberate and dishonest concealment of material facts. The protection does not affect any other liability for a civil penalty or criminal offence.
Part 9 Clause 9.53	**New requirements to sign, date and to state the name of the auditor in the auditor's report** In clause 9.53(2), it is stated that an auditor's report must "state the auditor's name" and "bear the date on which it is prepared." We would like to seek clarification on: 1. The auditor's name – whether this is meant to be the name of the individual who signed the auditor's report or the name of the audit firm appointed to be the auditor. As stated in footnote 20a of HKSA 700 (Clarified), in Hong Kong, the auditor's report is normally signed in the name of the firm because the firm as a whole assumes responsibility for the audit. To assist identification, the report will normally state the name of the firm of the auditor and the location of the auditor's office. 2. The date on which it is prepared – whether this is meant to be the date that the auditor's report is physically signed by the auditor. If that is the case, it would be inconsistent with the current practice under HKSA 700. Moreover, it would cause practical difficulties to auditors. The current practice for dating the auditor's report is consistent with the date of approval by the directors. Paragraph 41 of HKSA 700 (Clarified) states that the auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: - all the statements that comprise the financial statements, including the related notes, have been prepared; and - those with the recognised authority have asserted that they have taken responsibility for those financial statements

Part 9 Clauses 9.56, 9.57 & 9.58	**Auditor's rights to information** Paragraph 33 of the Paper states that the auditors' current rights to information set out in CO, sections 133(1) (under which only a Hong Kong subsidiary and its auditor have a duty to give information and explanation) and 141(5) (under which the auditor may request only the officers of the company to provide information) are considered to be too restrictive. A new provision should be drafted along the lines of sections 499 and 500 in the UKCA to allow auditors to require a wider range of persons to provide them with information, explanations or assistance as they think necessary for the performance of their duties as auditors. We are supportive of the principle of enhancing auditors' access and rights to information. The question is whether the proposal as drafted is too open-ended and should be circumscribed to some extent, given the potential impact this proposal could have on businesses. In relation to clause 9.56(5), which provides for the auditor to require a parent company to obtain information, explanation or assistance from the persons specified in clause 9.56(6) of an overseas incorporated subsidiary undertaking, there may be circumstances in which the parent company cannot obtain this due to the application of local laws that do not permit the subsidiary undertaking to provide the required information to companies incorporated elsewhere. Where the overseas subsidiary is listed, for example, selective disclosure of certain information to persons other than directors may be prohibited. Given circumstances such as these, it should be made clear what would constitute taking "all reasonable steps to obtain the information, explanation or assistance without delay", as stipulated on sub-clause (7). Under clause 9.56(2) and (3), we would suggest that the legal requirement to provide an auditor with information, explanation or assistance should not be based upon what "the auditor thinks necessary for the performance of his duties as auditor of the company", but rather on what, objectively, is reasonably necessary for the performance of his duties. We note that wording of sub-clause (5) differs in this respect from sub-clauses (2) and (3) and is closer to the above suggestion. Some of our members in business have expressed concern about giving auditors the right to require information from any employee or ex-employee, regardless of level, and about the proposed criminal offences of failing to provide auditors with information, explanations and assistance. They feel that giving auditors the right to interview employees and ex-employees at any level is unnecessary, and could be disruptive and costly to businesses. They also point out that the proposed new requirement to provide auditors with "assistance" is unexplained, goes beyond the UK law, and is too vague to be made a statutory requirement. Terms such as "assistance", "without delay" and "every responsible person" would have to be more

	clearly defined if they were to form components of a criminal offence, Subjecting any employee or ex-employee to criminal sanctions for failing to provide information, etc. to auditors is potentially unfair and oppressive. It may also make it more difficult for companies to fill in-house finance positions, require them to change recruitment policies and employment contracts, and thereby increase unnecessarily the costs of doing business. The proposed requirement for holding companies to obtain information etc. not just from such subsidiaries, but from individual employees at any level, currently or formerly associated with those subsidiaries, could also be impracticable. Under the circumstances, we would suggest that, in addition to making the other changes referred to above, further consideration be given to this proposal and that, at this stage, auditors' rights to obtain information, etc., be circumscribed and extended to a more specific group of employees or ex-employees of the company, or subsidiary undertaking, such as officers, senior management, and others who hold or are accountable for any of the accounting records of the company.
Part 9 Clauses 9.52	**<u>Offences relating to contents of auditor's report</u>** 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: • 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 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. *Sanctions* 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.

	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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