SCAA Seminar
S.408 CO Offences Relating to Contents of Auditor’s Report

Mr. Ludwig Ng
ONC Lawyers
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Agenda

• S.407 and s.408 CO

• Interpretation of “knowingly” and “recklessly”

• Persons liable

• Penalty

• Scope of potential liability for auditors

• The likely application of s.408 by the court

• Relations with negligence claims and disciplinary offences

• Relations with s.21 Theft Ordinance – False statements by officers of corporate
S.407 CO Auditor’s opinion on other matters

• Auditors must include the following opinion in an auditor’s report (if applicable):

  • Adequate accounting records have not been kept by the company (s.407(2)(a));

  • The financial statements are not in agreement with the accounting records in any material respect (s.407(2)(b));

  • The fact that 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 have not been obtained (s.407(3)).
S.408 CO Offences relating to the contents of auditor’s report

(1) Every person specified in subsection (2) commits an offence if the person *knowingly or recklessly* causes a statement required to be contained in an auditor’s report under section 407(2)(b) or (3) to be omitted from the report.
Interpretation of “knowingly” and “recklessly”

“Knowingly”

Administration’s Response to Recent Submissions 15 June 2012

• Subjective test

• Actual knowledge required – proof of knowledge on the part of the offender of all material circumstances of the offence i.e. the person knew and caused the statement required to be included in the report to be omitted

• No imputed knowledge – NOT the legislative intent to impute knowledge on the basis that because of the professional qualification the person ought to have known
Interpretation of “knowingly” and “recklessly”

“Recklessly”

Administration’s Response to Recent Submissions 15 June 2012

• High threshold for conviction

• Mere negligence would not constitute recklessness

• Proof that the individual concerned was aware that an action or failure to act carried risks, that he personally knew that the risks were not reasonable ones to make, and that despite knowing that, he went ahead
Interpretation of “knowingly” and “recklessly”

“Recklessly”

Administration’s Response to Recent Submissions 15 June 2012

- **Subjective test** for recklessness – *Sin Kam Wah v HKSAR* [2005] HKEC 792

“it has to be shown that the defendant’s state of mind was culpable in that he acted recklessly in respect of a circumstance 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.”
Interpretation of “knowingly” and “recklessly”

- The Sin Kam Wah case overruled an earlier case which set a lower threshold for Recklessness:

- *R v. Chau Ming Cheong* [1983] HKC 68

- “Recklessness on the part of the doer of an act presupposes that there is something in the circumstances that would have drawn the attention of an ordinary prudent individual to the possibility that his act was capable of causing the kind of serious harmful consequences that the section that created the offence was intended to prevent and that the risk of those harmful consequences occurring was not so slight that an ordinary prudent individual would feel justified in treating them as negligible. It is only when this is so that the doer of the act is acting ‘recklessly’ if, before doing the act, he either fails to give any thought to the possibility of there being such risk or, having recognized that there was such a risk, he nevertheless goes on to do it.”
Interpretation of “knowingly” and “recklessly”

“Recklessly”

- Many offences in HK can be committed by “Recklessness”

- Rape (s.118 (3), Crimes Ordinance) (ref CACC 208/2006)
  (3) A man commits rape if-
  (a) he has unlawful sexual intercourse with a woman who at the time of the intercourse does not consent to it; and
  (b) at that time he knows that she does not consent to the intercourse or he is reckless as to whether she consents to it.

- CACC 208/2006
  Victim was a night club hostess who did not sell sex. D who ignored her acts of protest was guilty as he was at least reckless as to whether she consented.
Interpretation of “knowingly” and “recklessly”

“Recklessly”

- **Arson** (s.60(2)(b) Crimes Ordinance)(ref CACC 325/2011)
  - (2) A person who without lawful excuse destroys or damages any property, whether belonging to himself or another-
  
  ...(b) intending by the destruction or damage to endanger the life of another or being reckless as to whether the life of another would be thereby endangered, shall be guilty of an offence.

- D who was only a driver and lookout man was NOT guilty of recklessness as he did not know the full extent of the criminal enterprise.
Interpretation of “knowingly” and “recklessly”

“Recklessly”

• False information to SFC (s.384(1), Securities and Futures Ordinance) (Ref: FACC 3/2008)
  (1) … a person commits an offence if-
  (a) he, in purported compliance with a requirement to provide information imposed by or under any of the relevant provisions, provides … any information which is false or misleading in a material particular; and
  (b) he knows that, or is reckless as to whether, the information is false or misleading in a material particular.

• D was chairman of listed co. He was found guilty of recklessly providing false information to SFC. He was negotiating sale of a big chunk of shares and authorized a broker to find buyers. The broker completed the sale but did not inform D. When SFC enquired about the sudden surge in trading volume, D instructed the co sec to say it was not aware of any reasons for such increase.
Persons liable

- S.408(2) CO
  The persons are –
  (a) if the auditor who prepares the auditor’s report is a natural person –
    (i) the auditor; and
    (ii) every employee and agent of the auditor who is eligible for appointment as auditor of the company;

  (b) if the auditor who prepares the auditor’s report is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company; or

  (c) if the auditor who prepares the auditor’s report is a body corporate, every officer, member, employee and agent of the auditor who is eligible for appointment as auditor of the company.
Persons liable

Meaning of “eligible for appointment as auditor”

- S.393(1) CO
  “Only a practice unit is eligible for appointment as auditor of a company under this Subdivision.”

- S.392(1) CO
  “Practice unit has the meaning given by s.2(1) of the Professional Accountants Ordinance (Cap. 50)”

- S.2(1) PAO
  “Practice unit” means
  (a) a firm of certified public accountants (practising) practising accountancy pursuant to PAO;
  (b) a certified public accountant (practising) practising accountancy on his own account pursuant to PAO;
  (c) a corporate practice.
Persons liable

Meaning of “eligible for appointment as auditor”

- The Financial Services and Treasury Bureau has noted a possible legislative defect in s.408(2).

- Since only a “practice unit” is eligible for appointment as auditor of a company and a practice unit means a firm of CPAs, a CPA practising on his own account or a corporate practice, s.408 is NOT applicable to partners, employees, officers and members of the auditor!
Penalty

- S.408(3) CO
  A person who commits an offence under subsection (1) is liable to fine of $150,000.
Scope of potential liability for auditors

Would an auditor be criminally liable for acts and/or omissions of their audit team members?

- Criminal liability depends on the auditor’s state of mind

- An auditor may only be criminally liable for omitting a required statement from the audit report where he actually knew or had reason to suspect the existence of the acts and/or omissions of his junior audit team members

- The same reasoning applies to persons “eligible for appointment as auditor”
Scope of potential liability for auditors

Would an auditor be criminally liable for failing to obtain all necessary information and/or audit evidence as a result of, for example, completing the audit under limited resources or time pressure?

- Criminal liability depends on the auditor’s state of mind
- An auditor is unlikely to be criminally liable for failing to include a required statement in the audit report if the auditor was too busy trying to complete the audit on time or “merely overlooked” the need to obtain certain necessary and material; information or evidence
- Likely to be held negligent rather than reckless
Scope of potential liability for auditors

Would an auditor be criminally liable for not carrying out certain audit procedures, at the client's request?

- Criminal liability depends on the actual information or audit evidence which has been missing as a result of the auditor not performing the audit procedure.

- If such information or evidence is necessary and material for the purpose of the audit and the auditor is aware of this, the omission of the required statement from the audit report may attract criminal liability on the ground of recklessness.
Scope of potential liability for auditors

Would an auditor be criminally liable for placing excessive reliance on statements or representations made by a client’s management during the course of audit?

- Criminal liability depends on the auditor’s state of mind
- An auditor is likely to be criminally liable for the omission of a required statement from the audit report if he has reason to suspect that any statements or representations made by the client’s management would be fraudulent, misleading or incomplete, but they nevertheless choose to rely on them without making any queries or conducting any investigations
The likely application of s.408 by the court

- No auditor has ever been prosecuted in the UK under s.507 Companies Act 2006 since its introduction.

- The first hurdle appears to be the likelihood of prosecution under s.408 CO.
The likely application of s.408 by the court

Guidance for Regulatory and Prosecuting Authorities – s.507 Companies Act 2006 Offences in connection with Auditors’ Reports

• Published by the UK Department for Business Innovation & Skills in February 2010

• Evidential stage
  • “prosecutors should give particular consideration to evidence relating to the state of mind of the person concerned”
  • i.e. “knowingly” or “recklessly”
The likely application of s.408 by the court

Guidance for Regulatory and Prosecuting Authorities –
s.507 Companies Act 2006 Offences in connection with Auditors’ Reports

• Public interest stage
  • “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.”
  • “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 the regulators.”

• The UK Guidance prima facie indicates that the scope of the UK provision is regarded as being potentially too wide and prosecution under the UK provision should only be initiated in the most serious cases.
The likely application of s.408 by the court

What about Hong Kong?

- The Statement of Prosecution Policy and Practice – Code for Prosecutors is akin to the UK Prosecutorial Code

- A 2-stage test in determining whether to prosecute
  - Sufficiency of evidence
  - Public interest

- A prosecution should not be started unless the prosecutor is satisfied that there is admissible, substantial and reliable evidence that a criminal offence known to the law has been committed by an identifiable person.

- Even if there is evidence that tends to prove the necessary ingredients of an offence, a bare prima facie case is, not enough to warrant a prosecution.
The likely application of s.408 by the court

What about Hong Kong?

• Uncertain whether the Department of Justice would adopt a similar approach in relation to s.408, the UK Guidance seem to offer some useful insight as to the judicial approach to the offence.
Relations with negligence claims and disciplinary offences

Professional negligence claims against auditors

- Duty of auditors – *Re London and General Bank* [1895] 2 Ch 673
  “An auditor is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly shew the true position of the company’s affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company…He must be honest - i.e., he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case.”
Relations with negligence claims and disciplinary offences

_Caparo Industries Plc v Dickman and others_ [1990] 1 All ER 568

Facts:

- The appellants were the auditors of a public company, F plc.

- On 22 May 1984, F plc announced results for the year ended 31 March 1984 showing profits far short of the predicted figure which resulted in a dramatic drop in the quoted share price.

- The accounts were issued to shareholders on 12 June 1984.

- The accounts were inaccurate and misleading in that they overvalued stock and underprovided for after-sales credits, with the result that an apparent pre-tax profit of some £1.433m should in fact have been shown as a loss of over £400,000.
Relations with negligence claims and disciplinary offences

*Caparo Industries Plc v Dickman and others* [1990] 1 All ER 568

Caparo’s basis of claim:

- From 8 June 1984 onwards, the respondents Caparo began to purchase shares of F plc in market. By October 1984, Caparo had acquired all the shares of F plc.

- Caparo alleged that the purchases of shares after 12 June 1984 and the subsequent bid were all made in reliance on the inaccurate and misleading accounts.

- Caparo alleged that had the true facts been known, it would not have made a bid at the price paid or indeed at all.
Relations with negligence claims and disciplinary offences

_Caparo Industries Plc v Dickman and others_ [1990] 1 All ER 568

Issue:

- Whether the auditors owed a duty of care to Caparo
  (a) as potential investors; or
  (b) as shareholders.
Relations with negligence claims and disciplinary offences

*Caparo Industries Plc v Dickman and others* [1990] 1 All ER 568

House of Lords:

- In relation to investors:
  - The auditor of a public company's accounts owed *no duty of care* to a member of the public at large who relied on the accounts to buy shares in the company.
Relations with negligence claims and disciplinary offences

_Caparo Industries Plc v Dickman and others_ [1990] 1 All ER 568

House of Lords:

- Where a statement is put into general circulation and might foreseeably be relied on by strangers for any one of a variety of different purposes which the maker of the statement had no specific reason to anticipate, there was no relationship of proximity between the maker of the statement and any person relying on it.

- UNLESS it was shown that
  1. the maker knew that his statement would be communicated to the person relying on it, either as an individual or as a member of an identifiable class,
  2. specifically in connection with a particular transaction or a transaction of a particular kind and
  3. that that person would be very likely to rely on it for the purpose of deciding whether to enter into that transaction.
Relations with negligence claims and disciplinary offences

*Caparo Industries Plc v Dickman and others* [1990] 1 All ER 568

House of Lords:

- In relation to shareholders:
  - An auditor owed **no duty of care** to an individual shareholder in the company who wished to buy more shares in the company since an individual shareholder was in no better position than a member of the public at large.
Relations with negligence claims and disciplinary offences

*Caparo Industries Plc v Dickman and others* [1990] 1 All ER 568

House of Lords:

- The shareholders of a company have a collective interest in the company’s proper management.

- The auditor owes a duty to prepare accounts to the body of shareholders as a whole. The accounts were prepared and audited to enable the shareholders as a body to exercise informed control of the company and not to enable individual shareholders to buy shares with a view to profit.

- Any loss suffered by the shareholders will be recouped by a claim against the auditors in the name of the company, not by individual shareholders.
Relations with negligence claims and disciplinary offences

_Caparo Industries Plc v Dickman and others_ [1990] 1 All ER 568

House of Lords:

- Even assuming that the relationship between the auditor of a company and individual shareholders is of sufficient proximity to give rise to a duty of care, the scope of that duty cannot possibly extend beyond the protection of any individual shareholder from losses in the value of the shares which he holds.

- As a purchaser of additional shares in reliance on the auditor's report, he stands in no different position from any other investing member of the public to whom the auditor owes no duty.
Relations with negligence claims and disciplinary offences

*Moulin Global Eyecare Holdings Limited (in liquidation) & Ors v KPMG (a firm) HCA 118/2007*

- KPMG was the former auditors of the Moulin Group.
- In 1999-2001, KPMG expressed its opinion in the Group’s audit reports that the Group’s account gave a true and fair view of its state of affairs – the Group was solvent and earning profits.
- The Group subsequently went into liquidation.
- The Liquidators of the Group alleged that there were a number of fictitious items in the audited accounts
  - Fictitious sales with the North American debtors
  - Fictitious circular trade finance transactions as purported receipts from the North American debtors
  - Fictitious cash advances to third parties
Relations with negligence claims and disciplinary offences

*Moulin Global Eyecare Holdings Limited (in liquidation) & Ors v KPMG (a firm) HCA 118/2007*

- The Liquidators further alleged that as a result of the misstatements, its audited accounts did not give a true and fair view of its financial affairs in that its revenues and accounts receivables were overstated and its liabilities and expenses were understated.

- The Liquidators brought an action against their former auditors KPMG for losses caused by the alleged negligence of KPMG.
Relations with negligence claims and disciplinary offences

*Moulin Global Eyecare Holdings Limited (in liquidation) & Ors v KPMG (a firm)* HCA 118/2007

- The Liquidators alleged that KPMG was negligent in
  - Failing to obtain adequate or reliable audit evidence in relation to the fictitious transactions;
  - Failing to detect material irregularities in the Group’s accounts in respect of cash overstatements;
  - Failing to detect fraud by the management of the Group.

- The Liquidators argued that had KPMG acted properly, the Group’s account would have disclosed that it had suffered losses and was in fact insolvent, could not have paid dividends which they did, and would not have had to pay the profits tax which they paid, would not be able to obtain further loans and thus would not have incurred interest and bank charges associated with the circular trade finance arrangements.
Relations with negligence claims and disciplinary offences

Disciplinary proceedings against auditors

- Under Professional Accountants Ordinance (Cap.50) (“PAO”), Hong Kong Institute of Certified Public Accountants (“HKICPA”) has powers to discipline auditors for misconducts.

- Upon receipt of a complaint in relation to an accountant, the Council of HKICPA may, in its discretion, refer the complaint to the Disciplinary Committee. (s.34(1) and s.33(3)(a) PAO)
Relations with negligence claims and disciplinary offences

Relevant examples of complaints against auditors (s.34 PAO)

An auditor:

• Has been falsified or caused to be falsified any document (s.34(1)(a)(iii)(A));
• Has been negligent in the conduct of his profession (s.34(1)(a)(iv));
Relations with negligence claims and disciplinary offences

Disciplinary proceedings against auditors

- Under s.35(1) PAO, if the disciplinary committee is satisfied that a complaint is proved, it may, in its discretion, make one or more of the following orders:
  - temporary or permanent removal of name from the register (s.35(1)(a));
  - reprimand (s.35(1)(b));
  - penalty not exceeding $500,000 (s.35(1)(c));
  - payment of costs and expenses of proceedings (s.35(1)(d));
  - cancellation of a practicing certificate (s.35(1)(da));
  - temporary or permanent cancellation of issuing of a practicing certificate (s.35(1)(db)).
Relations with negligence claims and disciplinary offences

*Peter PF Chan v Hong Kong Society of Accountants CACV 469/2000*

- A disciplinary committee of the Hong Kong Society of Accountants found that the appellant, an auditor, had been negligent in the audit of the financial statements of a company.

- The auditor had issued an unqualified opinion that the statements gave a “true and correct view” of the company’s affairs and that they were prepared in accordance with “accounting principles generally accepted in Hong Kong”.
Relations with negligence claims and disciplinary offences

*Peter PF Chan v Hong Kong Society of Accountants CACV 469/2000*

- The disciplinary committee found the auditor negligent, in that:
  - The financial statements were prepared pursuant to s.141D CO. However, since the company had subsidiaries, the statements should have been prepared pursuant to ss.124-6 CO. There was a breach of CO;
  - The financial statement did not comply with Statement of Standard Accounting Practice (“SSAP”) 7 which required holding companies to prepare group accounts; and
  - The financial statements did not comply with para.8 of SSAP 13 as they did not include an appropriate evaluation of an investment property.
Relations with negligence claims and disciplinary offences

*Peter PF Chan v Hong Kong Society of Accountants CACV 469/2000*

- Court held that it was clearly wrong to describe financial statements as being prepared in accordance with accounting principles when they were in breach of the SSAP and the CO.

- The auditor was found to be negligent.

- Appeal dismissed.
Relations with negligence claims and disciplinary offences

• Where the element of knowledge/recklessness under s.408 CO cannot be proved, there may be two alternative ways to hold an auditor accountable:

  1. negligence claim provided that loss is suffered; and

  2. disciplinary proceedings under PAO.
Relations with s.21 Theft Ordinance (Cap.210)

S.21(1) Theft Ordinance

Where an officer of a body corporate…with intent to deceive members or creditors of the body corporate…about its affairs, publishes or concurs in publishing a written statement or account which to his knowledge is or may be misleading, false or deceptive in a material particular, he shall be guilty of an offence and shall be liable on conviction upon indictment to imprisonment for 10 years.

- Knowledge that a written statement is misleading, false or deceptive in a material way is required
Relations with s.21 Theft Ordinance (Cap.210)

_HKSAR v Rahman & Ors. CACC 302/2008_

- In early 2002, Chau, a Mainland Chinese businessman, wished to acquire imGO, a Hong Kong listed company and proposed to BOC a financing arrangement which involved him injecting Mainland Chinese real estate holdings he owned into imGO for the purpose of drawing funds from imGO’s reserves to repay BOC the funds which he had obtained from BOC to acquire imGO (the “asset injection plan”).

- In April 2002, Chau signed the principal loan agreement with BOC, which made no mention of the asset injection plan.

- BOC took steps to protect its interests by requiring, inter alia, procuring the appointment of 2 directors nominated by BOC to the board of imGO. Fan and Koo were nominated to be the 2 directors and were duly appointed.
Relations with s.21 Theft Ordinance (Cap.210)

_HKSAR v Rahman & Ors. CACC 302/2008_

- In early 2003, the asset injection plan was executed, 2 sales took place resulting in more than $700m of imGO’s reserves being drawn from imGO’s reserves to pay for assets effectively owned by Chau, the money being used to pay BOC.

- In May 2003, Chau was arrested in Shanghai and imGO was subsequently placed under receivership and eventually into liquidation.
Relations with s.21 Theft Ordinance (Cap.210)

*HKSAR v Rahman & Ors. CACC 302/2008*

- In October 2003, imGO’s annual report for the year ended 30 June 2003 was compiled and approved by its board. Fan and Koo both gave approval to the report at the meeting. The report contained a statement declaring that during the year under review, none of the directors of imGO had had a material interest in any contract of significance to which the company was a party. In fact, Chau had been a director of imGO in the year under review and had had a significant interest in the 2 sales.

- At trial, both Fan and Koo were convicted of making false statements, contrary to s.21 of the Theft Ordinance.
Relations with s.21 Theft Ordinance (Cap.210)

_HKSAR v Rahman & Ors._ CACC 302/2008

- On appeal to CA, Fan’s conviction was quashed.

- CA held that based on the evidence, it was clear that Fan had knowledge that Chau had had a material interest in the 2 sales of Mainland property to imGO and that the 2 sales were contracts of significance to imGO.

- The real issue was
  (1) whether, if it is proved that Fan read the statements, she knew that they were misleading, false, or deceptive in some material way;
  (2) whether, possessed of such knowledge, concurred in their publication by approving the annual report intending to deceive the members of the company about its affairs.
Relations with s.21 Theft Ordinance (Cap.210)

*HKSAR v Rahman & Ors. CACC 302/2008*

- CA found that Fan only had her first opportunity to read the annual report on the morning of the Board meeting. She did not have the leisure to look at it in detail and she was not alerted by way of any note or instruction to read any particular part of the report.

- To comprehend the statements in question, one had to read them in conjunction with a note placed elsewhere in the report by way of cross-referencing.

- Fan should have been given the benefit of doubt in respect of extending that inference that given that Fan knew about imGO’s history, she must have gone straight to the sections dealing with that history and must have read and fully digested the meaning of the part of the annual report concerning ‘director’s interests in contracts’ (i.e. understanding that the statements were false in a material way).
Relations with s.21 Theft Ordinance (Cap.210)

HKSAR v Rahman & Ors. CACC 302/2008

• However, CA upheld Koo’s conviction on s.21.

• Although Koo, similar to Fan, only had the opportunity to consider the report on the day of the Board meeting and that he had not considered the report in detail, he gave evidence that he did remember seeing the statements in question and admitted being concerned about the issue of “material interest”.
Relations with s.21 Theft Ordinance (Cap.210)

- Where knowledge is an element of an offence, the court will not impute knowledge on the person in question. Rather, the court will ascertain knowledge from evidence, including evidence given by the person in question as to what he actually knew.

- In *HKSAR v Rahman & Ors.*, Koo’s evidence that he remembered seeing the statements in question and admitted being concerned about the issue of “material interests” was crucial for CA in holding that he had the requisite knowledge under s.21.
Relations with s.21 Theft Ordinance (Cap.210)

*Fan & Ors. v HKSAR FACC 6/2010*

- On appeal to CFA, Koo’s conviction on s.21 was quashed on the ground that CA failed to review the trial judge’s findings against Koo on the charge of false statements when it quashed his conviction on conspiracy to defraud.
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