

AATB 4 Guidance on section 408 of the Companies Ordinance

Institute document outlines principles and practices relating to members' conduct on audits and audit reporting under revised legislation

The new Companies Ordinance came into force on 3 March. One of the measures introduced is a new offence imposed by section 408 (formerly clause 399 of the Companies Bill) in relation to certain omissions in an auditor's report.

The offence would be committed if an auditor knowingly or recklessly caused certain statements required by section 407(2)(b) and (3) to be omitted from the auditor's report.

In late February, the Hong Kong Institute of CPAs published AATB 4 *Guidance on Section 408 of the Companies Ordinance*. AATB 4 is the culmination of a working group formed in late 2012 with a view to producing practice guidance for members on the conduct of audits and audit reporting, in light of the potential implications of section 408 of the ordinance.

The Companies Registry External Circular No. 10/2014 *Offence Relating to Contents of Auditor's Report*, issued at the same time, sets out the general principles that apply when making decisions on whether a case should be prosecuted under section 408 or section 16 of the Companies (Revision of Financial Statements and Reports) Regulation. AATB 4 should be read in conjunction with the external circular.

The objectives of the guidance contained in AATB 4 are to:

- Set out the relevant sections in the ordinance to which the penalty sanctions apply;
- Consider the implications of those sections; and
- Provide guidance on the auditor's reporting for statutory purposes.

AATB 4 focuses on the penalty sanctions related to section 407(2)(b), (3) and section 408.

As stated in publicly available literature, the policy objective of section 408 is to enhance the reliability and integrity of financial state-

ments. The two statements concerned under section 407(2)(b) and (3) - that the auditor is unable to obtain adequate information or explanation and that the financial statements are not in agreement with the accounting records (when applicable) - were considered by the Hong Kong government to be important pointers to assist the users of a company's financial statements to take an informed view about the financial statements. The criminal sanction is considered by the government to be necessary to enforce the duty to make those two important statements when they are required.

The following highlights the key areas of guidance in AATB 4:

Implication of section 408

If the auditor knowingly or recklessly omits to report a matter required under section 407(2)(b) or (3), the auditor is liable to be prosecuted under section 408.

Test for "knowingly"

In order to successfully prosecute under the "knowingly" threshold in section 408, it will be necessary to prove that the person knew and caused the statement required to be included in the auditor's report to be omitted.

Paragraph 9 of the external circular states that for the mental element of "knowingly," the evidential threshold is quite high. The auditor would be culpable if, at the time of the commission of the offence, the auditor knew and caused the specified statements to be omitted. Such knowledge would be inferred from the evidence, including the evidence given by the auditor as to what the auditor actually knew. Knowledge will not be imputed on the basis of the person's professional qualification.

Test for "recklessly"

To prove that the auditor has acted recklessly, it will be necessary to show that the auditor was aware that an action or failure to act car-

ried risks, that the auditor personally knew that the risks were not reasonable ones to take and, despite knowing that, the auditor went ahead and took the risks.

The government has explained that mere negligence would not constitute recklessness. The evidence considered in a case will be that available at the date of the offence. Hindsight should not play a role in any prosecution taken under section 408.

Other factors to consider for prosecution

The Prosecution Code 2013, published by the Department of Justice, sets out the relevant guidelines for prosecution. Under the code, the decision to prosecute includes two required components. The first is that the admissible evidence available is sufficient to justify instituting or continuing proceedings. The second is that the general public interest would require that the prosecution be conducted.

Paragraph 12 of the external circular states that in considering evidence to support a prosecution, prosecutors will take into account the statutory role of the auditor under the ordinance 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; and
- The nature of the company the financial statements of which were being audited, and the way in which the auditor worked with the company's management and staff.

Persons liable

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:

- 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;
- If the auditor is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company; and
- 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.

Penalty

The offence under section 408 is a summary offence for enforcement against non-compliance with the requirements in relation to the contents of the auditor's report. An auditor who commits an offence under section 408 is liable to a fine not exceeding HK\$150,000. It is a separate and distinct offence that would be enforced independently from any misconduct proceedings pursued under the Professional Accountants Ordinance.

Guidance on the auditor's report for statutory purposes

When an auditor has been engaged to perform an audit of a set of general purpose financial statements of a Hong Kong company under the ordinance's requirements, the auditor should perform that audit in conformity with the Hong Kong Standards on Auditing.

Section 407 of the ordinance, in effect, continues the requirements in section 141 of the predecessor ordinance, with the addition of a materiality component. The requirements in section 407(2)(b) and (3) include the consideration of materiality. As there is no definition of materiality in the ordinance, auditors should apply the principles and requirements in HKSA 320 *Materiality in Planning and Performing an Audit*.

The principles and requirements in HKSAs include performing procedures on accounting records and obtaining sufficient appropriate audit evidence for the audit of financial statements that also address the requirements of section 407(2)(b) and (3). It is important for auditors to prepare audit documentation as required under HKSA 230 *Audit Documentation*.

AATB 4 also provides specific areas of guidance on the following circumstances which auditors should be mindful of in relation to



sections 407 and 408:

- going concern;
- outstanding matters;
- adjustments;
- significant prior year adjustments;
- modified auditor's reports; and
- modified auditor's reports - quantification of material misstatement in the financial statements.

Reporting of matters under section 407(2)(b) and (3)

If the auditor is of the opinion that the financial statements of a company are not in agreement with the accounting records in any material respect or if the auditor has been unable to obtain all the information or explanations that are necessary and material for the purpose of the audit, the auditor must state that opinion or fact in the auditor's report.

The absence of any statement or comment in the auditor's report in respect of these matters is equivalent to a statement that the auditor is satisfied that the financial statements are in agreement with the

accounting records in any material respect and the auditor has obtained all the information or explanations that are necessary and material for the purpose of the audit based on the procedures he or she performed in accordance with HKSAs.

The Auditing and Assurance Standards Committee is in the process of revising the illustrations of auditor's reports in HKSA 700 and HKSA 705 and will issue an update to the members' handbook in due course. More details are provided in AATB 4 and all auditors of Hong Kong companies are encouraged to read it.



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