Hogan Lovells

Global Accountants' Liability Update

March 2020

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Hogan Lovells has a global team of securities and professional liability lawyers uniquely positioned to monitor legal developments across the globe that impact accountants' liability risk. We have experienced lawyers on five continents ready to meet the complex needs of today's largest accounting firms as they navigate the extensive rules, regulations, and case law that shape their profession. We recently identified developments of interest in Spain, Hong Kong, The Netherlands, and the United States, which are summarized in the pages that follow.

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Spain

The Spanish High Court charges Abengoa and the audit firm Deloitte for a possible fraud against Abengoa's investors

In February 2017, the Spanish High Court (*Audiencia Nacional*) ruled on the admission of a criminal complaint against Abengoa's former president and the former CEO. Abengoa, a Spanish multinational company, entered into bankruptcy proceedings and is being investigated for altering its annual accounts from 2014 to 2016. The investigation relates to whether Abengoa's financial statements and the company's financial situation, as disclosed by its directors prior to its financial collapse, were misleading. Abengoa investors have now requested that the investigation extend to include charges against the company's audit firm, Deloitte, and directors and members of Abengoa's audit commission as defendants.

The Spanish High Court recently granted that request after reviewing a report (submitted by the victims' platform) that asserts there was a systematic effort to conceal substantial losses and mask the real economic-financial situation of Abengoa. The judge also took into account a resolution of the Spanish Institute of Accounting and Auditing (ICAC), issued in February 2018, which sanctioned Deloitte for not verifying the accuracy and reliability of Abengoa´s 2014 revenues.

The court's order extends the criminal investigation to include an investigation of Deloitte and individual directors and audit commission members. The court identified possible criminal offenses of accounts' falsification and fraud to investors under articles 290 and 282 bis of the Spanish Criminal Code. Regarding the offense of accounts' falsification, the judge explained that regulations prevent legal persons from being charged with this offence and therefore this charge is brought only against the natural persons charged in the proceeding.

The ongoing criminal investigations will require testimony of four witnesses, as well as document requests from Abengoa and Deloitte.

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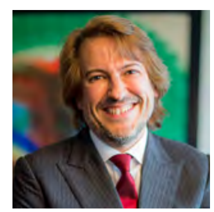

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Recent regulatory and enforcement developments

Hong Kong

Understanding but no waiver – reporting requirements in the time of COVID-19

The COVID-19 outbreak has caused extensive disruptions to business and auditors operating in Hong Kong and throughout the region, and has imposed significant challenges to listed companies in meeting the reporting requirements imposed by the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the Listing Rules).

In response to these disruptions, the Securities and Futures Commission (the SFC) and The Stock Exchange of Hong Kong Limited (the Exchange) issued a joint statement on 4 February 2020 (the Statement) announcing that they will consider accepting preliminary announcements of results and financial statements that have not yet been approved by auditors. The announcement is intended to provide guidance to listed companies and their auditors in relation to the disclosure of financial information in light of the disruption caused by travel and other restrictions.

Guidance to listed companies

Listing Rule 13.49(1) requires listed companies to publish their preliminary results not later than three months after the end of the financial year. The preliminary results announcement must be based on the issuer's financial statements, which have been agreed with the company's auditors (Listing Rule 13.49(2)).

Around half of the listed companies in Hong Kong are based in Mainland China, accounting for 73% of the Exchange's market capitalisation. Many of these companies have 31 December as their financial year-end and are, therefore, required to publish their preliminary results by 31 March 2020 and their audited financial statements and annual reports, by 30 April 2020.

In the statement, the SFC and the Exchange advise that, if an issuer believes there is a real possibility that, as a result of the disruptions caused by COVID-19, it will be unable to publish a preliminary announcement of results (or issue audited financial statements, as appropriate) in accordance with the Listing Rules, it should contact the Exchange as soon as possible to discuss the situation.

The issuer will need to provide the Exchange with a description of the travel and other disruptions caused by the COVID-19 outbreak that have affected its reporting process, the financial information that it is still able to report on together with a statement as to whether the accuracy or completeness of the information have been adversely affected.

Where an issuer is unable to obtain agreement from its auditors, but is otherwise able to publish its preliminary results in full compliance with the other

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reporting requirements, it should publish the preliminary results on or before the applicable deadline and include cautionary statements as appropriate. In such cases, the Exchange will "normally allow trading in the securities of the issuer to continue."

The Exchange will consider the circumstances of each on a case-by-case basis. The SFC and the Exchange have stated their intention to "minimise disruptions to trading while ensuring that the investing public continues to receive sufficient information to make informed investment decisions" ahead of the 31 March deadline.

Are the measures sufficient?

The Vice President of the Business Accountants Association, Ernest Ip, has stated that while he views the measures as a positive step, a blanket extension of the deadline is still needed to minimize disruptions to trading and to avoid the requirement for boards to sign off on unaudited financial statements. The Hong Kong Institute of Certified Public Accountants (HKICPA) has expressed concern that auditing work will be "seriously delayed" due to staff being prevented from travelling to Mainland China.

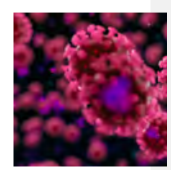
The Exchange has said they are "closely monitoring developments, and are working with our regulator and other stakeholders to consider the circumstances of the issuers in fulfilling their obligations to publish financial results under the listing rules." In the meantime, the Exchange has encouraged issuers to engage with their auditors with respect to audit plans and timetables.

Obligation to disclose material disruption resulting from COVID-19

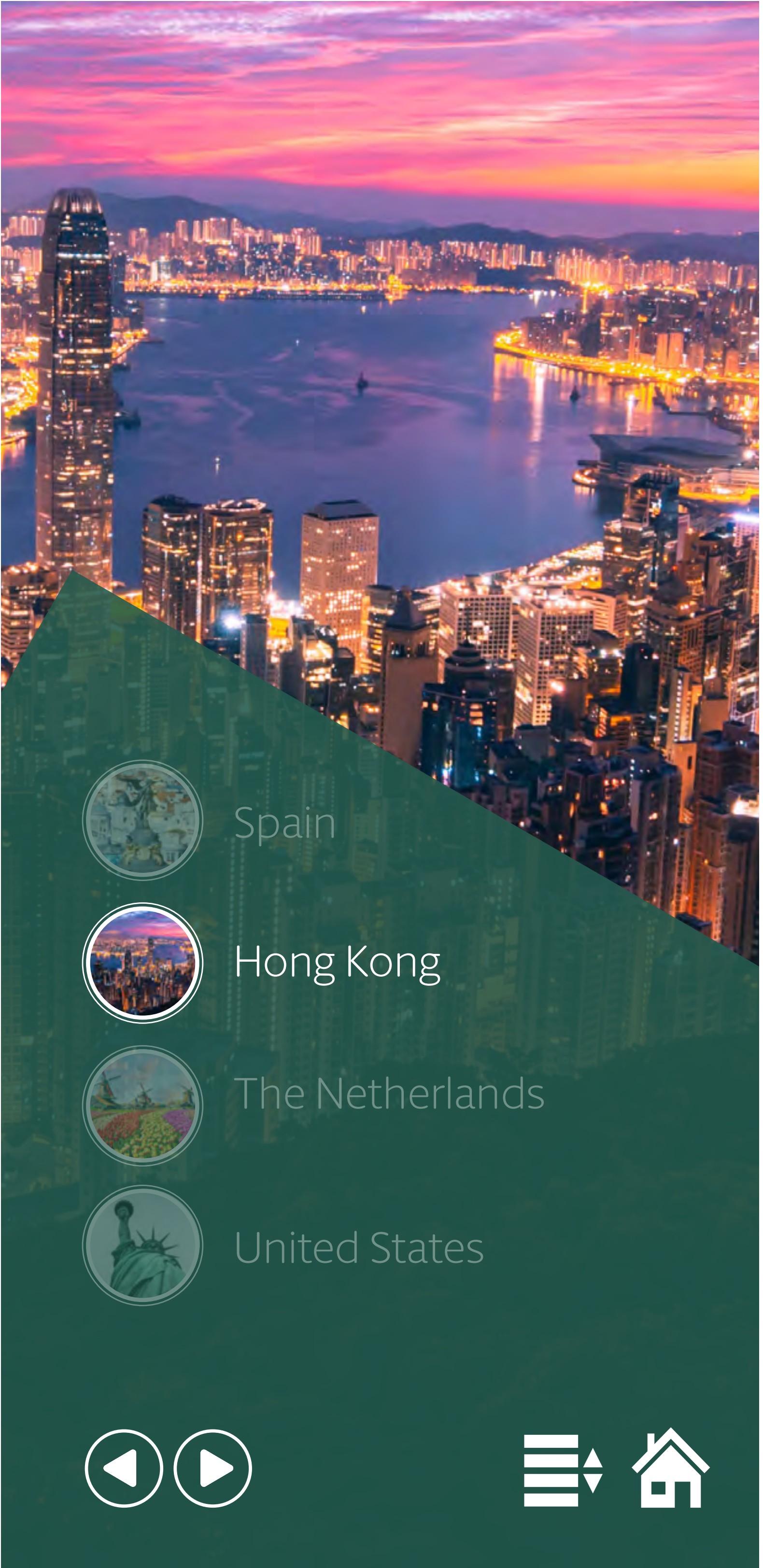
The Statement also notes that if a listed issuer's business is materially disrupted by the COVID-19 outbreak, management should assess whether inside information has come to its knowledge and, if so, should disclose the information to the public as soon as reasonably practicable. Such information may include material changes to a company's business plan or strategy (for instance, due to supply or staffing constraints) or a reduction in consumer demand.

The Statement makes clear that the SFC and Exchange do not plan to make exceptions as a result of the outbreak and that issuers should therefore be mindful of the need to identify, manage and if necessary, disclose inside information relating to the impact of COVID-19.

To ensure timely disclosure in accordance with the Listing Rules and other regulations, listed companies should review their systems and processes and be on the look-out for issues that must be disclosed.



Hogan Lovells' suite of resources to assist existing and potential clients to navigate the disruptions caused by the COVID-19 coronavirus is available here.



Hong Kong

Stock exchange explores artificial intelligence in reviewing annual reports

The Exchange has published a review of issuers' annual reports for the financial year ended between January and December 2018 (the Report). The Report, issued on 31 January 2020, expresses general satisfaction with issuers' reports, whilst making a number of specific recommendations for future best practice.

The Report advises that issuers should make clear disclosure about any risk areas, such as major regulatory or governmental policy changes, includ-ing details of the impact of the changes to their financial performance. Issuers are also warned not to apply overly optimistic assumptions when valuing material intangible assets.

In a novel development, the Exchange said it is exploring the use of artificial intelligence (AI) to assist in its review of issuers' annual reports, with the long term objective of boosting efficiency in its other vetting processes.

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The Netherlands

Reports call for audit improvements

Introduction

In January, the Committee future accountancy sector (Commissie toekomst accountancysector) (Cta) and the Monitoring Committee Accountancy (Monitoring Commissie Accountancy) (MCA) published reports about the accounting industry in the Netherlands. Both reports pointed out that the accounting sector still doesn't comply with legal standards and make recommendations to improve the quality of and confidence in accounting practices. The reports prompted headlines in Dutch newspapers that included "Accountants are not capable of self-regulation" and "Politics must intervene with the accountants."

The Cta report

The Cta, which was appointed by the Minister of Finance in response to concerning reports from the Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*) (AFM), was instructed to identify measures to sustainably improve the quality of statutory audits. In its report "Trust in Control" ("*Vertrouwen op controle*"), the Cta makes 22 recommendations. The report makes clear that there is no "silver bullet" and that audit quality can be improved only through a combination of measures that relate to all the parties involved. These recommendations include:

- Introducing Audit Quality Indicators (AQI) and requiring all accounting firms to periodically report on the quality of their audits by utilizing these AQI's. The Cta further recommends that these reports be publicly accessible in one place to facilitate comparison between accounting firms.
- More transparency about the degree of assurance that can be derived from examination of non-financial information, and that auditing of non-financial information not be exclusively reserved for accountants.
- Further research into alternative structural models including structural models such as joint audit, audit only, and intermediaries. The Cta also recommends that large accounting firms, not just those that hold licenses to audit public interest institutions (PIEs), employ a two-tiered board supervision system. The Cta believes a number of important decisions that are not currently subject to supervisory board approval, such as decisions relating to profit distribution, investments or the partners' remuneration policy, should become subject to approval. Moreover, the Cta would like supervisory boards to be instructed to pay particular attention to the public duty and responsibility of the accountant and the accounting firm.


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- The Cta would also like auditors to pay close attention to issues of financial fraud and (dis)continuity when performing statutory audits.
- The commission also proposes reviewing the supervisory system. It recommends organizing the supervision in such a manner that it is *de jure* and *de facto* exercised by the AFM and recommends establishing a mechanism through which accountants and accounting firms can report shortcomings in the performance of audits by other accountants or accounting firms.
- Lastly, the Minister of Finance should - as an *ultimum remedium* - have the power to assign an entity subject to audit to an accounting firm if the entity has not contracted with an accounting firm of its choice.

The MCA report

On 14 January 2020 the MCA, a committee appointed by the Netherlands Institute of Chartered Accountants *(Nederlandse Beroepsorganisatie van Accountants)* (NBA), published its report “Mirror for the accountancy sector” (*Spiegel voor de accountancysector*). This report emphasizes that accounting firms are socially indispensable and underscores the importance of efforts to guarantee a reliable, solid and robust financial infrastructure. The MCA notes that the accounting sector is now in better shape than it was five years ago, but still falls short of expected and sufficient quality standards. The MCA further explains that due to insufficient interventions by the sector and parties involved, problems keep occurring and calls on the accounting sector to do its part in order to improve the quality of the sector. To tackle the problems, the MCA came up with 30 recommendations including:

- The supervision of the sector should be concentrated with the AFM, instead of the current fragmented system (supervision by AFM, NBA and the SRA, an accountancy network organization). The MCA also recommends intensifying the supervision of PIE and non-PIE license holders, by introducing a new committee. This new committee would have a broader role and field of work than the AFM does.
- The MCA is of the opinion that there are an insufficient number of PIE license holders. To tackle this, it recommends lowering the entry barrier for new license holders. It also advises to experiment with alternative structural models such as *joint audit, intermediaries, audit only and government auditor*.
- To avoid harmful incentives, risks and vulnerabilities in the concurrence between advice and control services, the MCA calls for a clearer distinction between advisory and auditing specialists. The MCA also advises distributing revenues in a different manner; it suggests *ring fencing* instead of *profit pooling*. The MCA also recommends setting legal requirements regarding a buffer capital in order to strengthen the equity capital of the firms.

- Furthermore, the MCA recommends categorizing corruption, money laundering, cartel formation, and other forms of non-compliance as fraud; so that these matters fall within the scope of the Audit Firms (Supervision) Act (*Wta*) and the Audit Firms (Supervision) Decree (Bta). The MCA also advocates for requiring that PIE license holders, at least when carrying out assignment for PIE clients, use forensic expertise in their fraud risk analysis.
- The MCA also advises to experiment with a second opinion when fraud is suspected.
- The MCA also calls for modifyingthe position and role of the NBA noting that the NBA should be more independent of the Big4 and have an independent chairman of the board, who is preferably appointed after nomination of the Minister of Finance.
- Moreover, the MCA recommends the introduction of a mechanism/ authority that will appoint an accounting firm to audit an entity that has failed to contract an accounting firm on its own.

Looking foward

In the **cover letter** of the Cta report, the Minister of Finance, Mr. W.B. Hoekstra, emphasizes that proper statutory audits are of great importance. Therefore the accounting sector must be well-functioning. Despite the efforts already made, various reports conclude that the quality of the accounting sector is problematic. In a cabinet response, the Minister of Finance will set out how he will follow up on the recommendations of the Cta. In doing so, he will also take into account the recommendations laid out in the reports of the MCA and the AFM. It is expected that the report will be sent to the House of Representatives at the end of March. If the Minister follows up on the aforementioned recommendations, this will result in legislative changes of substantial consequence for the accounting firms.

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SEC targets corporate executives in criminal probe

A recent SEC investigation demonstrated that executives at auditing firms must be careful to maintain their independence throughout the auditor bidding and engagement process. The Commission's independence rules were bolstered in the wake of the 2001 Enron scandal, and include provisions mandating that the oversight of the engagement of a company's independent auditor shall be entrusted to an independent audit committee. While corporate executives do routinely help facilitate these engagements – especially where the executives' "repeat business" relationships drive efficiencies – they should do so only under the direction of the independent audit committee and the authority it delegates.

Last year the SEC opened up an inquiry into the accounting practices of Sealed Air Corp., a packaging company which holds the trademark for Bubble Wrap, focused on the packaging company's use of tax write-offs related to an asbestos-claims settlement. During their investigation, SEC officials reviewed a body of emails, some of which suggested that Seal Air executives may have rigged the company's 2014 bidding competition, for a multi-million dollar auditing contract, in favor of Big Four firm Ernst & Young, specifically when the CFO allegedly tipped Ernst & Young off to the details of its rival auditor KPMG's own bid. Concerned that this engagement process violated rules on auditor independence, the SEC and state prosecutors launched a criminal investigation against the CFO and another former Sealed Air executive. Sealed Air terminated the CFO, citing the SEC investigation, and replaced Ernst & Young with PricewaterhouseCoopers.

Although the SEC has taken nearly 100 enforcement actions for alleged breach of independence rules over the last two decades, only a few involved charges against corporate executives. Here, the Commission's investigation focused not only on the fact that the former CFO allegedly tipped off Ernst & Young to the contents of a rival's bid, but that the former Sealed Air executives each had longstanding professional relationships with Ernst & Young's local auditors, dating back over a decade. Both former Sealed Air executives worked as senior executives at a separate company, Carlisle Cos., at the time Carlisle appointed Ernst & Young as its auditor in 2005.

Based on the investigations involving the former Sealed Air executives, it is

clear that undue executive influence on auditors remains an area of enforcement focus. Corporate executives should heed the strictures of Sarbanes-Oxley and its progeny and abide by the directions of the independent auditor committee when it comes to auditor engagement. Executives' personal relationships and familiarity with auditors can be leveraged operationally to improve the integrity and efficiency of audit results, but the engagement process must be conducted in accordance with the procedural and substantive safeguards set forth in the independence rules.

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Trump budget looks to shake up regulatory landscape

The Trump administration's proposed 2021 federal budget, released on February 10, 2020 (the Budget), contains two proposals that, if adopted by Congress, may substantially impact the composition and operation of the U.S. financial regulatory regime. First, the Budget proposes eliminating the Public Company Accounting Oversight Board (PCAOB or the Board) from the U.S. regulatory landscape, calling for the auditing watchdog to consolidate its "duplicative" responsibilities and functions within the Securities and Exchange Commission (SEC) in 2022. Second, the Budget seeks to slash $50 million from the SEC's mandatory reserve fund, a repository often tapped by the Commission for cybersecurity purposes.

Created by the Sarbanes-Oxley Act of 2002, the PCAOB is a nonprofit corporation created to oversee audits of public companies and broker-dealers registered with the SEC and has become a fixture in the U.S. regulatory scheme. The Board, founded partially in response to the failure of Enron in 2001, promulgates rules and standards for auditing firms meant to promote investor protection. The Board's rules and standards must be approved by the SEC, which also appoints the Board's members and approves its budget. The PCAOB also conducts inspections, investigations, and disciplinary proceedings of registered accounting firms.

The move to shutter the PCAOB comes on the heels of an incident in 2017 in which former PCAOB and employees of a Big Four accounting firm leaked confidential PCAOB audit plans to the accounting firm's auditors ahead of inspections. In December 2017, the Board was entirely replaced and in May 2018, the Board announced the departure of key division and office heads as part of an organizational change. These changes in leadership led to questions of efficacy: In 2018, the number of settled disciplinary orders made public by the PCAOB dropped by 63%. In May 2019, a whistleblower complaint alleged that the PCAOB's work environment was retaliatory. Finally, in September 2019, the nonpartisan Project on Government Oversight published a report finding that, over the PCAOB's entire 16-year existence, the regulator had only brought 18 enforcement actions against the Big Four accounting firms, despite having found during inspections 808 instances in which those firms had performed defective audits.

The Budget further proposes to slash the SEC's mandatory reserve fund, created by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for a fourth consecutive year, this time by $50 million. This reserve fund exists outside the congressional appropriations process but may be utilized as the SEC deems necessary to carry out its functions, and has been tapped by the SEC for cybersecurity purposes in recent years. In its Budget, the administration argues that the SEC's discretion over reserve fund spending renders that fund "an extension of the SEC's regular appropriation" processes, "rather than the emergency fund it was intended to be." The Budget seeks to "restore accountability to the American taxpayer" by diverting the reserve fund resources to the U.S. Treasury for deficit reduction, and imposing a new requirement for the SEC to request any of its "additional appropriations" through Congressional avenues beginning in 2022.

By eliminating the PCAOB and the SEC's reserve fund, the Budget envisions a leaner regulatory framework, one that is nominally more responsive to the electorate due to its increased dependence on congressional appropriations. If approved by Congress, the proposed Budget projects the elimination of the reserve fund would decrease the federal deficit by $148 million through 2025, along with estimated savings of $57 million in 2022 if the PCAOB is folded into the SEC, amounting to a total of $580 million in savings over the next ten years. The Budget forecast does not call for wholesale deregulation, however: the SEC's overall fiscal budget for 2021 is proposed to increase by 5.6%, to $1.9 billion, with an increase in cybersecurity funding from $41.8 to $46.6 million to offset the loss of the reserve fund.

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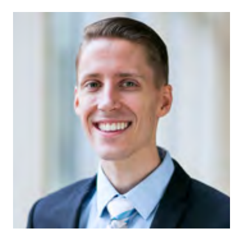

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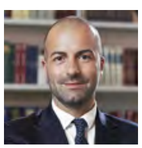

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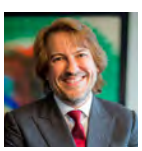

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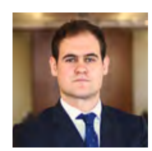

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