Hogan Lovells

Global Accountants' Liability Update

September 2021

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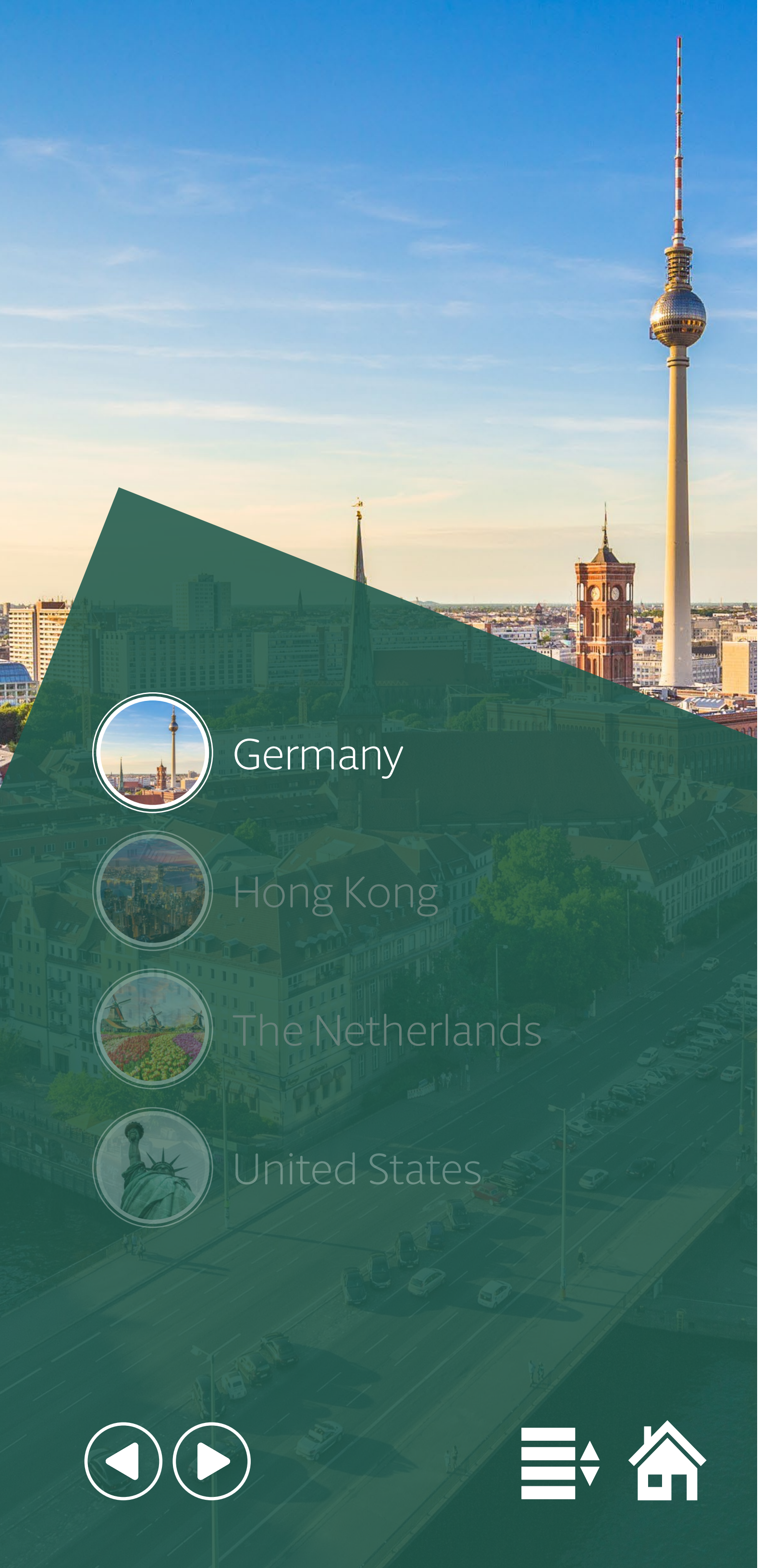
Our global team of securities and professional liability lawyers at Hogan Lovells is uniquely positioned to monitor legal developments across the globe that impact accountants' liability risk. We have experienced lawyers on five continents ready to meet the complex needs of today's largest accounting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

George A. Salter
Partner, New York
T +1 212 918 3521
george.salter@hoganlovells.com

Dennis H. Tracey, III
Partner, New York
T +1 212 918 9524
dennis.tracey@hoganlovells.com

Recent regulatory and enforcement developments



Germany

New legislation reshapes oversight of accounting sector

On 1 July 2021 a new bill came into force in Germany that substantially reshapes the legal framework for accountants ("Gesetz zur Stärkung der Finanzmarktintegrität – (Finanzmarktintegritätsstärkungsgesetz -FISG)", "FISG", see here in German). Certain provisions are subject to a transitional period.

The first draft of this bill was introduced in the wake of the Wirecard scandal, which has caused heated discussions among politicians, interest groups, and scholars as to the necessity to improve the quality of audits. In the previous editions of this newsletter (see here and here) we already informed readers about the most important proposals made in the course of the legislative process. Since then, the provisions in the finalized bill have – again – been slightly revised. The major contents of the FISG are as follows:

1. The FISG imposes a stricter liability regime on accountants.

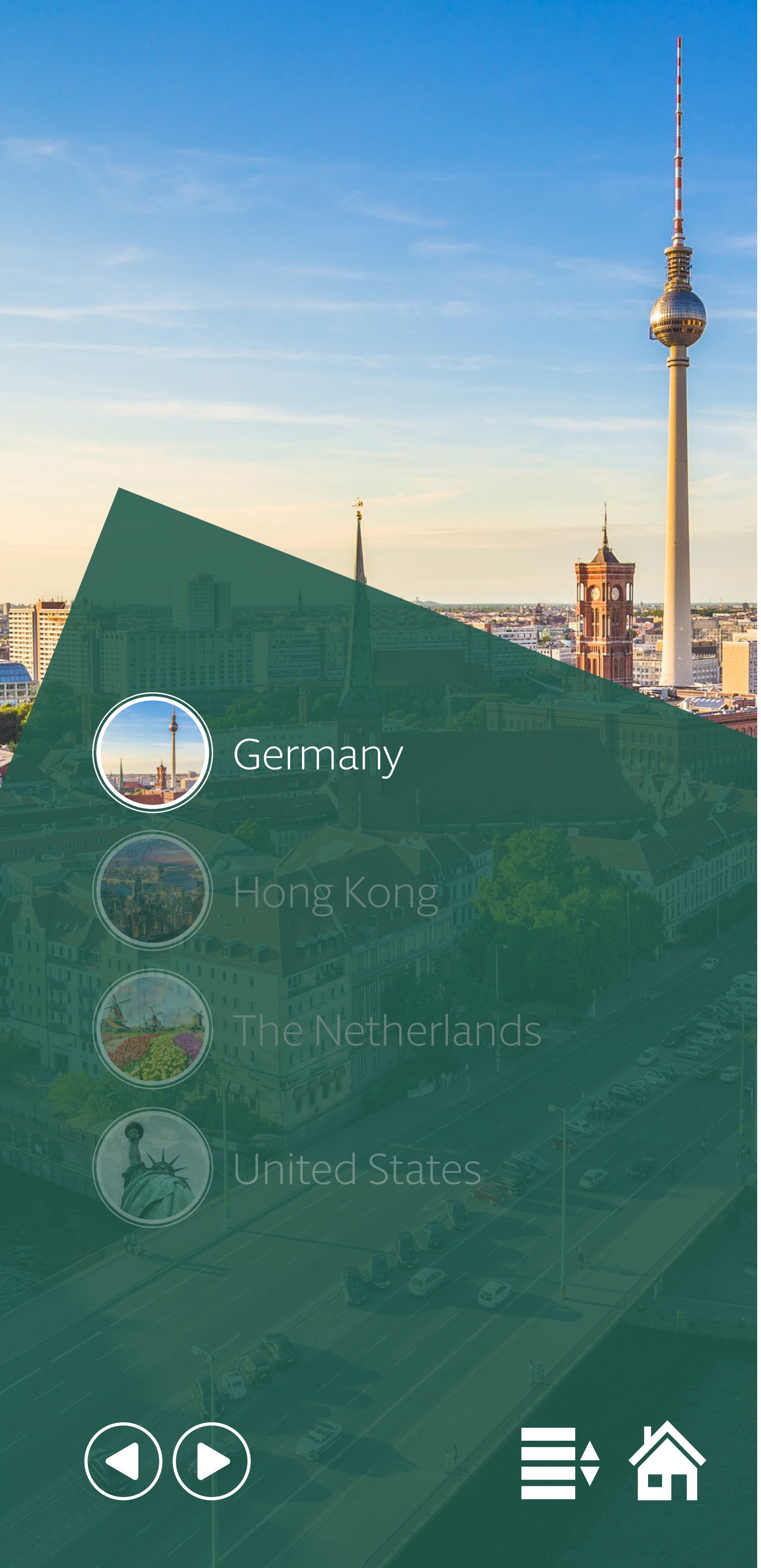
Under the previous legal framework, the liability for gross negligent breaches by accountants was limited to an amount of EUR 1 million for each audit carried out, and to an amount of EUR 4 million for stock-listed companies. These liability caps have been substantially increased. However, the original plans to broadly introduce unlimited liability not only for intentional behavior but also for gross negligence were not realized. In detail, the current liability caps are:

- Up to EUR 16 million for capital market-oriented public-interest companies; in case of gross negligence an unlimited liability applies.
- Up to EUR 4 million for other public interest companies; in case of gross negligence up to EUR 32 million.
- Up to EUR 1.5 million for all other companies; in case of gross negligence up to EUR 12 million.

In case of intentional behavior no liability caps apply.

2. Duration limits on engagement for public-interest entities

The FISG provides for strict rules regarding the duration of an audit engagement for public-interest entities, i.e., accountants shall not be commissioned for more than 10 years. This period may only be extended by two additional years in case of a joint audit or in case a public tendering process for the audit has been conducted (Art. 17 para. 1 and para. 6 Regulation (EU) No 537/2014). Under the prior regime it was possible to extend this period to up to 24 years. This option has been eliminated. Furthermore, the FISG provides that the



key audit partner responsible for carrying out the audit of a public-interest entity shall cease her participation after five years (as opposed to after seven years under the prior regime).

Further to this, the FISG stipulates similar provisions for those non-public-interest companies that are subject to the supervision of the German Federal Financial Supervisory Authority (BaFin), e.g., certain financial institutions or insurance companies. However, insofar as the FISG does not provide for strict engagement periods, it is presumed by virtue of law that in order to fulfill the purpose of an audit it is generally necessary to change an accountant after 11 years. The BaFin will have the authority to request such a change.

3. Prohibition on non-audit advice

It is now prohibited for accountant firms to provide so called non-audit advice to those public-interest entities for whom the accountant firm is appointed as audit firm. The exemption under the previous regime from Art. 5 regulation (EU) No 537/2014 according to which accountant firms are generally barred from providing so called non-audit services has been eliminated.

4. Expansion of BaFin authority

Finally, the BaFin has been equipped with further authorities to investigate companies which include, among others, the authority to request the production of documents and other evidence and to conduct dawn-raids.

These new regulations have been pushed through the legislative process shortly before the national elections will take place in September of this year. Some of the originally proposed rules have been modified following criticism voiced by interest groups. Notwithstanding this, the FISG contains numerous provisions that increase the liability risks for accountants and will have an impact on the internal compliance organization of accountant firms.

Authors:

Kim Lars Mehrbrey
Partner, Dusseldorf
kim.mehrbrey@hoganlovells.com

Sophia Jaeger
Senior Associate, Hamburg
sophia.jaeger@hoganlovells.com

Germany

Hong Kong

The Netherlands

United States

Hong Kong

A unified approach - wide-ranging new powers proposed for auditors' regulatory body

The auditors' chief regulatory body, the Financial Reporting Council (FRC), will acquire greatly extended powers of oversight, regulation and discipline under a sweeping new reform currently being considered by Hong Kong's Legislative Council, LegCo.

As proposed in the Financial Reporting Council (Amendment) Bill 2021 (the Bill) gazetted on 16 July 2021, the FRC will develop into a fully-fledged independent regulatory body for the accounting profession, with the intention being to rationalize the roles of the Hong Kong Institute of Certified Public Accountants (HKICPA) and the FRC "to enhance efficiency and consistency, ease the compliance burden on practice units and [Certified Public Accountants (CPAs)] and align with international practices". [1]

At present, the FRC primarily functions as an independent oversight body for Public Interest Entities (PIE) auditors, and is responsible for the inspection, investigation and discipline of PIE auditors and registered responsible persons of the same.

The HKICPA, meanwhile, retains responsibility for the registration of Public Interest Entity (PIE) auditors, which results in a "fragmented approach" in regulation as described in the [Legislative Council Brief](). In addition, under the current regime, practice units and CPAs are subject to separate regulations under the Financial Reporting Council Ordinance (Chapter 588) (FRCO) and Professional Accountants Ordinance (Chapter 50) (PAO) (except for certain engagements under the PIE regime), which in itself leads to duplicative regulatory efforts and unnecessary compliance burdens.

The Bill, if passed, will transfer the regulatory powers currently vested with the HKICPA to the FRC, with a view of extending the FRC's regulatory jurisdiction to cover all CPAs. The key proposed amendments include:

1. Renaming the FRC to become the Accounting and Financial Reporting Council (AFRC);
2. Expanding the FRC's functions to include registration of CPA firms and issuance of CPAs practicing certificates, as well as inspection, investigation, discipline and sanctions in relation to CPAs and practice units;
3. Subjecting all registration and disciplinary decisions made by the FRC to the review and appeal mechanism set out under the FRCO;

[1] "Further reform of regulatory regime of accounting profession", HKICPA, available at: https://www.hkicpa.org.hk/en/About-us/Governance/Further-reform-of-regulatory-regime-of-accounting-profession

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4. Providing for transitional arrangements to be made by way of subsidiary legislation; and
5. Other miscellaneous amendments, including the establishment of a new Advisory Committee to provide advice to the AFRC, and the ability for the AFRC to charge various fees.

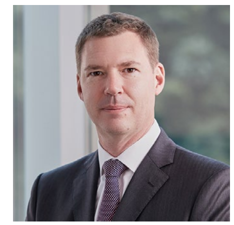
In transferring these powers to the AFRC, the scope of investigatory powers and levels of relevant sanctions will continue to follow those provided in the PAO and currently implemented by the HKICPA and the HKICPA Council.

The HKICPA will continue to discharge various functions including ascertaining qualification for registration as CPAs, registering CPAs, setting standards on professional ethics, accounting, auditing and assurance and setting requirements for continuing professional development, etc. Ultimately, such functions of the HKICPA will be put under the AFRC's oversight.

The proposed reform aims to align the regulatory regime of the accounting profession in Hong Kong with international standards and practices in, for example mainland China, the United Kingdom, the United States, Singapore and Australia. The Government has already engaged in extensive consultations with various stakeholders including the FRC, HKICPA, major accounting bodies, and accounting professionals and practices, and they are generally supportive of the direction outlined.

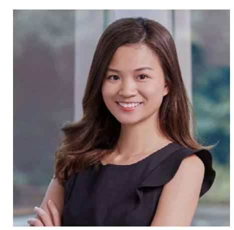
The Bill was introduced into LegCo for its first reading on 21 July 2021, and LegCo's Legal Services Division is currently scrutinizing the legal and drafting aspects of the Bill. We will monitor the Bill's passage closely and provide further updates as and when they become available.

Authors:



Chris Dobby
Partner, Hong Kong
chris.dobby@hoganlovells.com

Yolanda Lau
Senior Associate, Hong Kong
yolanda.lau@hoganlovells.com



Hazel Law
Associate, Hong Kong
hazel.law@hoganlovells.com

Nigel Sharman
Sr. Knowledge Lawyer, Hong Kong
nigel.sharman@hoganlovells.com

The Netherlands

The future of accounting: sustainably improving quality

In our March 2020 Update we updated you about the report issued by the Committee Future Accountancy Sector *(Commissie toekomst accountancysector)* (Cta), which identified measures to improve the quality of statutory audits in the Netherlands. A number of recommendations from the Cta report will now be converted into new legislation. On 9 July 2021 a consultation version of the legislative proposal, The Future of the Accountancy Sector Act *(Wetsvoorstel "Wet toekomst accountancysector")* was published.

Below we highlight the key points of the legislative proposal.

Audit Quality Indicators

In our March 2021 Update we discussed the progress report of the quartermasters on the Audit Quality Indicators (AQIs). Pursuant to the legislative proposal, the Minister of Finance determines the AQIs. The audit firms are required to report periodically to the NBA *(Koninklijke Nederlandse Beroepsorganisatie van Accountants)* on the quality of the audits they perform on the basis of these AQIs. The Netherlands Authority for the Financial Markets (Authoriteit FinanciËle Markten) (AFM) supervises compliance with this obligation and can also take enforcement action in the event of a violation. The AFM is authorized to impose an order subject to penalty *(Last onder dwangsom)* or an administrative fine *(Bestuurlijke boete)* if the obligation to report the AQIs is not complied with.

Reinforcing internal governance of the largest audit firms

The proposed legislation requires that firms that hold licenses to audit public interest institutions (PIEs) operate under the supervision of internal supervisory boards. It further expands the responsibilities of those internal supervisory boards to include: (i) mandatory approval prior to profit distribution, (ii) right of approval regarding decisions concerning a number of other subjects that are part of the structure regime, (iii) pursuant to the Audit Firms Supervision Decree (Besluit toezicht accountantsorganisaties) the internal supervisory board must, annually, draw up a report on the fulfilment of its role and (iv) the AFM will determine the suitability of the natural persons who are members of the internal supervisory board at the large audit firms.

Appointment of an audit firm by the NBA in cases where an audit client does not find an audit firm willing to perform the statutory audit

As also mentioned in our September 2020 Update, it remains difficult for small listed companies to find an accountant to approve their annual accounts.

The proposal now includes a power of designation on the basis of which an audit firm is assigned to an audit client.

This proposal prescribes the information that must be provided by an audit client that wishes to be assigned to an audit firm because – despite reasonable efforts – it did not find an audit firm willing to perform the statutory audit. The client must, among other things, provide a substantiated description of the efforts made to date to find an audit firm. The client must also provide a substantiated explanation of the reason(s) why the audit firms approached are unwilling to perform the audit. The board of the NBA then decides whether the company is eligible for a designated audit firm.

Lower threshold for audit firms to report to the AFM on deficiencies in statutory audits

The proposal provides for a lowering of the threshold for audit firms to report potential deficiencies in a statutory audit to the AFM. A limitation of the duty of confidentiality will be included to the effect that the obligation of an audit firm to maintain confidentiality does not apply if information is exclusively provided to the AFM in connection with the reporting of a possible violation of EU regulations or the Audit Firms (Supervision) Act (Wet toezicht accountantsorganisaties) identified by the audit firm.

Streamlining auditors disciplinary law

The proposal expands the disciplinary measures with respect to auditors. The Accountancy Division may impose a new measure: a binding to special conditions (Binding aan bijzondere voorwaarden). These special conditions are intended to bring the professional practice of the auditor who does not meet certain quality standards to an acceptable level. The auditor will then be obliged, for example, to add a certain subject to its permanent education activities. It is also possible to impose conditions preventing an auditor from carrying out certain activities in the future.

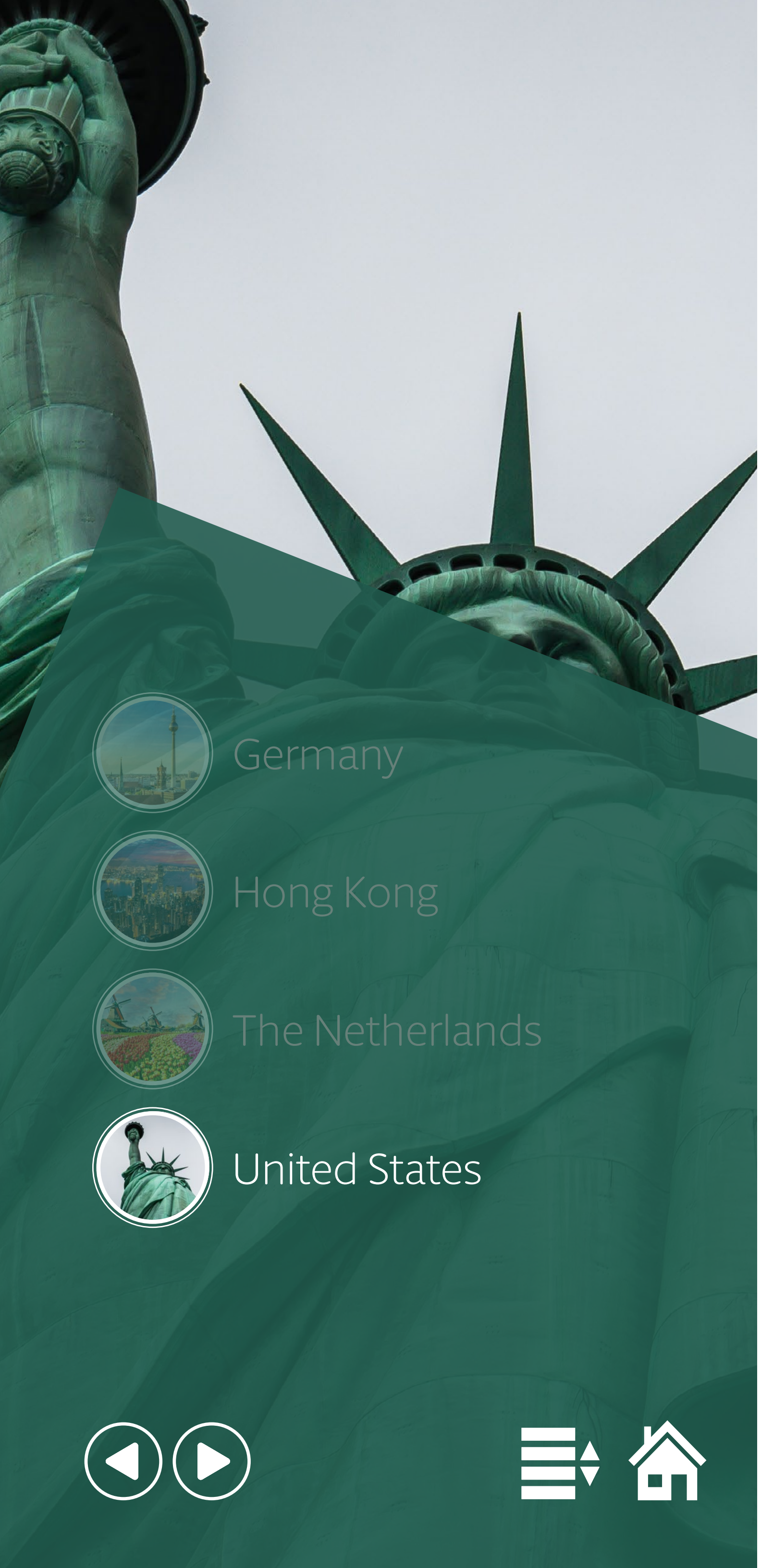
Concluding remarks

Interested parties were able to comment on the legislative proposal until 4 September 2021. The legislative proposal and the explanatory memorandum are available here.

Authors:

Manon Cordewener
Partner, Amsterdam
manon.cordewener@hoganlovells.com

Jessica Booij
Associate, Amsterdam
jessica.booij@hoganlovells.com



United States

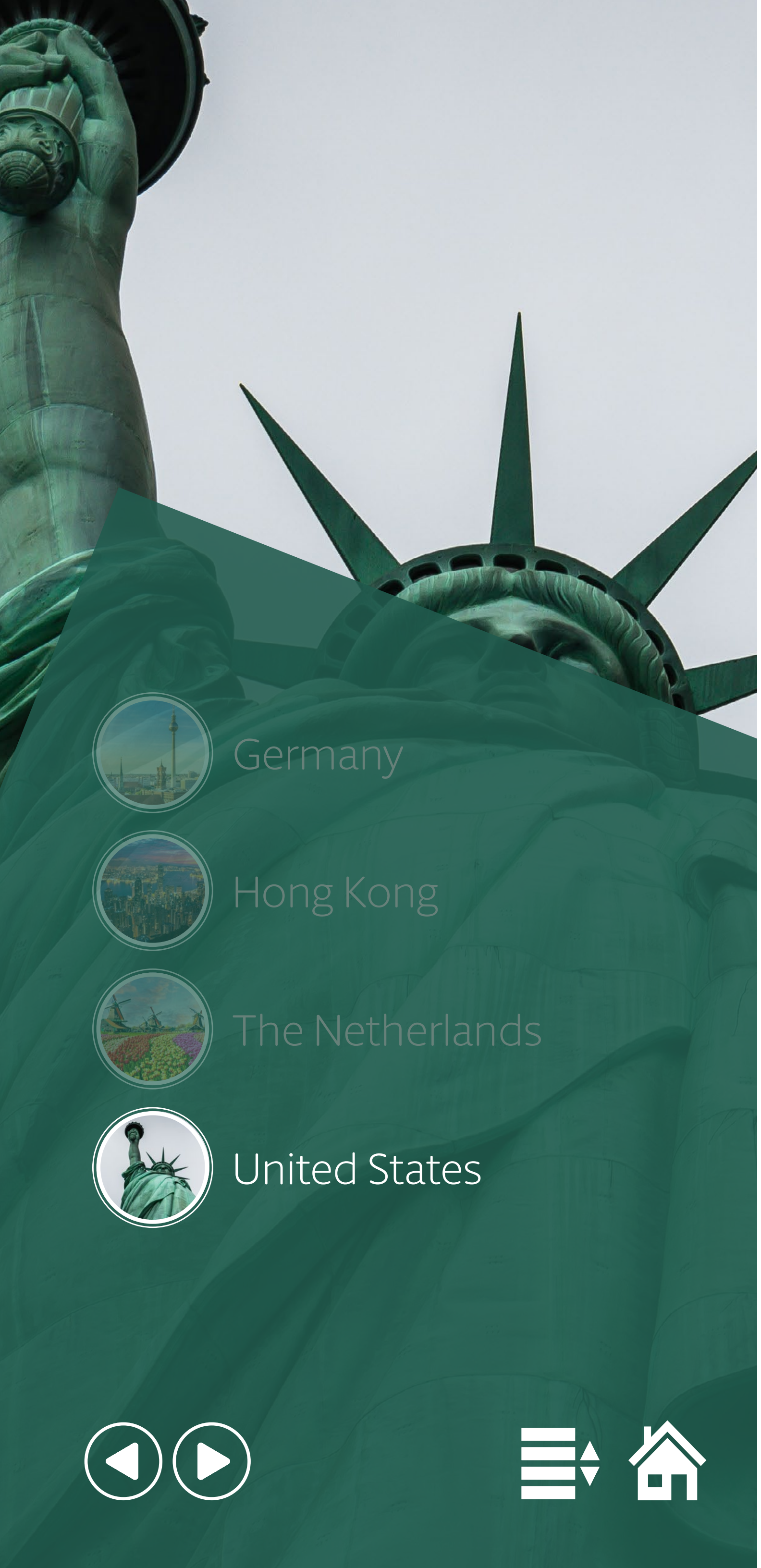
Auditor fails to rectify quality control standards, despite repeated warnings

Pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002, and Public Company Accounting Oversight Board (PCAOB) Rule 5200(a)(1), the PCAOB sanctioned RBSM LLP, a firm with its headquarters in McLean, Virginia (the Firm), on 9 August 2021 by imposing: 1) a censure; 2) a $50,000 civil penalty; and 3) a requirement that the Firm hire an independent consultant for three years to revamp the RBSM's quality control procedures. The Firm repeatedly violated PCAOB rules and quality control standards from 2014 through 2019, despite receiving repeated notifications of significant audit deficiencies during previous PCAOB inspections.

RBSM's system of quality controls was inadequate. Under the PCAOB rules, every firm must implement a system that assures the firm is in compliance with professional standards. *See* PCAOB Quality Control Standard 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice. This system should include policies and procedures for engagement performance, specifically to ensure that the work done meets quality standards and regulatory requirements. The system should also discuss each step of the engagement process, from preliminary planning to after-the-fact quality reviews.

Firms should also ensure that these policies and procedures are effectively applied. This may require specific monitoring and inspection procedures, standardized reviews of engagements, and steps to take in order to identify and implement any corrective actions that need to be taken within the quality control system to ensure the same kind of mistake is not repeated. *See* PCAOB Quality Control Standard 30, Monitoring a CPA Firm's Accounting and Auditing Practice. Lastly, the PCAOB requires firms to show compliance with its internal quality control system by producing sufficient documentation that is properly created and stored.

Over a period of six years, PCAOB's inspection staff repeatedly warned RBSM that its quality control standards were inadequate. The inspectors first found significant audit deficiencies in RBSM issuer audits related to revenue testing in 2014. Among other issues, the Firm's engagement quality review partner failed to review documents related to engagement quality reviews before granting permission for the issuer to use the Firm's audit reports to satisfy the requirements of AS No. 7. Two years later, another inspection revealed significant audit deficiencies relating – again – to revenue testing. The quality reviews of these audits did not have enough information to show how the engagement quality review partner meaningfully reviewed the engagement. PCAOB investigators identified the same kinds of deficiencies during a third inspection in 2017 and came to a similar On



conclusion in 2019, finding (among other deficiencies) that the engagement quality review partners were still falling short, this time in their assessment of significant risk areas.

From 2015 through 2018, the Firm's internal quality control checks did not sufficiently ensure that the work performed by its engagement personnel met applicable professional standards, regulatory requirements, and the firm's systems of quality controls. There were no effective internal monitoring procedures that could identify problem areas. Though RBSM did conduct annual internal inspections, they were not effective. The Firm's managing partner was the only individual responsible for all internal inspections, including in scenarios where he worked on the engagement that needed to be inspected. In fact, RBSM's inspections largely failed to identify any deficiencies in the engagement performance for any audits that were reviewed, despite the repeated presence and warnings of the PCAOB investigators.

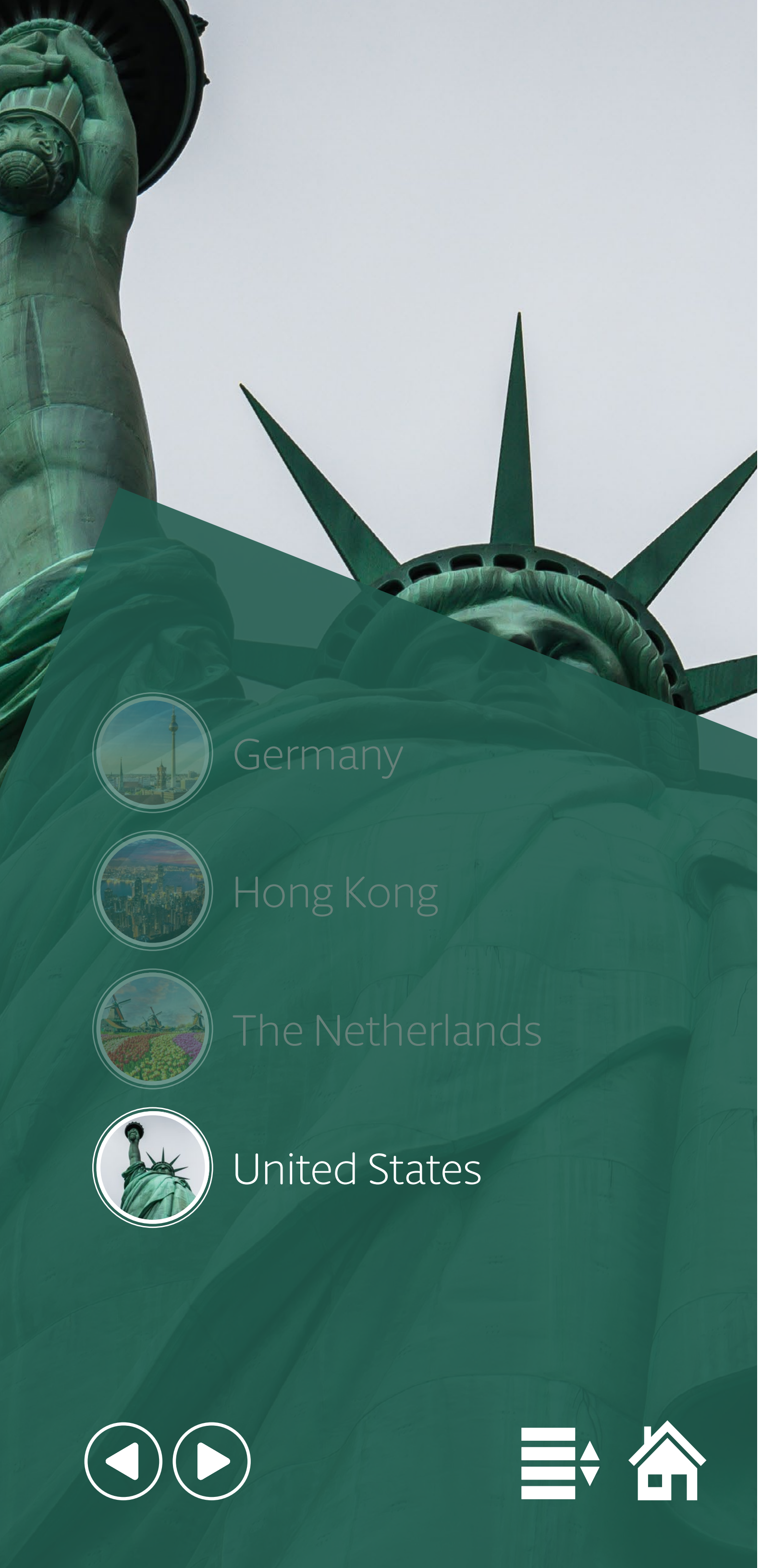
SEC overhauls the PCAOB

On 4 June 2021, the Securities and Exchange Commission (SEC), removed William Duhnke from his chairmanship of the PCAOB (or the Board). Two weeks later, the SEC opened a still-active investigation into whether Mr. Duhnke violated rules while addressing internal complaints during his time at the Board. Shortly after Mr. Duhnke's dismissal, the SEC announced that it would replace the entire five-person Board, but for the time being three of the existing Board members stayed on until their replacements are appointed. The moves came after months of criticism from investor groups and prominent Senators and is the latest in a series of controversies facing the PCAOB.

The PCAOB was under a cloud of distrust in 2018, when Mr. Duhnke was appointed, after a former inspector tipped off a major accounting firm about which of its clients were going to be inspected. However, attempts to overhaul the Board and increase the public's trust were mostly unsuccessful. Under his predecessor, the PCAOB regularly clashed with the Big Four accounting firms (notwithstanding the above controversy), would levy millions of dollars in fines each year, and would publish dozens of firm inspection reports. However, under Mr. Duhnke's watch, the Board only issued tens of thousands of dollars in fines and published a fraction of the number of inspection reports annually.

Not only was the PCAOB seen as increasingly firm-friendly, but it also struggled with internal conflict. Mr. Duhnke's attempts at an overhaul resulted in a number of whistleblower complaints. Certain staff members were fired and Mr. Duhnke allegedly retaliated against several former employees, sometimes going so far as to impede their ability to get other jobs within government.

The removal of Mr. Duhnke, a Republican appointee, by the Democratically-appointed chairman of the SEC gives the proceedings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a potentially partisan tinge, especially after Senators Warren and Sanders wrote to the SEC chairman requesting a change in PCAOB leadership. However, investor groups lauded the move, and the SEC is allowed to remove members of the Board without cause.

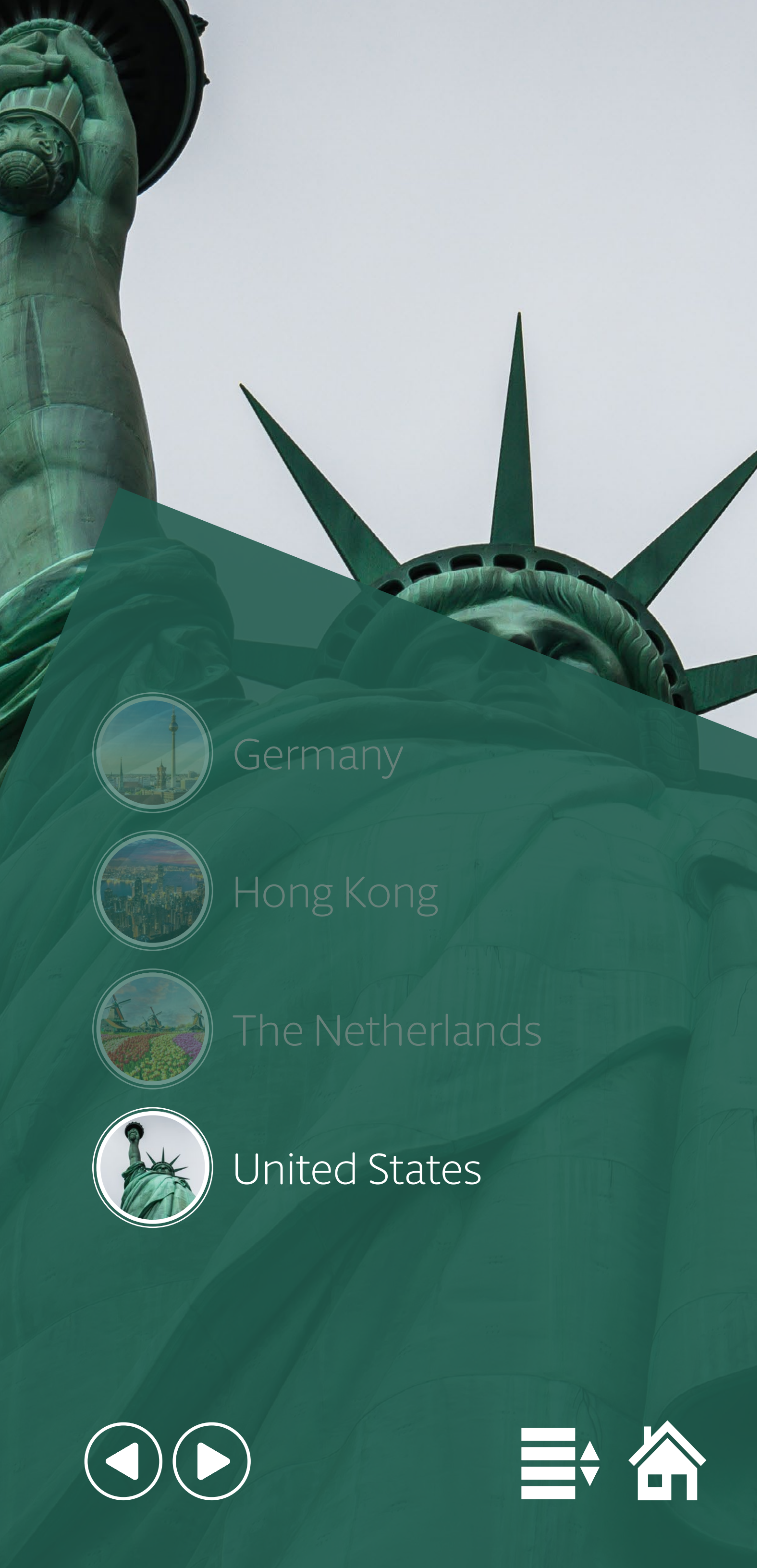
SEC charges EY and three audit partners with audit independence misconduct

2 August 2021, the SEC announced charges against Ernst & Young LLP (EY) and three of its partners (one current partner and two former partners) of improper professional conduct for violating auditor independence rules. As part of the settled charges, EY agreed to pay a civil money penalty of $10 million. The partners also agreed to pay fines. The SEC additionally announced charges against a former public company Chief Accounting Officer (CAO) for misconduct.

The SEC found that EY and the partners improperly interfered with an issuer's selection of an auditor by soliciting and receiving confidential information from the issuer's then-CAO. Information obtained by the EY partners included a draft RFP presentation to the issuer's Audit Committee, which was not provided to any other audit firm. Information obtained by EY allowed it an unfair advantage to create an informed fee estimate for the RFP, due to the information competitors did not have. According to the SEC, the EY partners knew or should have know that they had valuable competitive information that other firms did not have. Furthermore, EY used portions of the information they received in shaping their RFPs to the Audit Committee. The information was also widely disseminated within EY (including an email to at least 180 EY professionals).

After the initial RFPs were submitted, the Audit Committee selected two RFP finalists, one being EY. The CAO provided information on bidding numbers to EY, allowing it to adjust its fee submission and shape its proposal to the Audit Committee based on the competitor's bid. The CAO then went as far as to delete certain expenses in EY's submitted bid to make its numbers appear lower than the competitor's. Following EY's selection as auditor, the CAO sent a congratulatory email to the EY partners.

The SEC found that EY's quality control system did not effectively provide reasonable assurance that the firm and its personnel maintained independence as applied to current and potential SEC-Registered audit clients during RFP and other pursuits. Furthermore, the SEC found that the firm did not maintain proper independence under Rule 2-02(b)(1) of Regulation S-X, as a reasonable investor would not find that the accountant was capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.



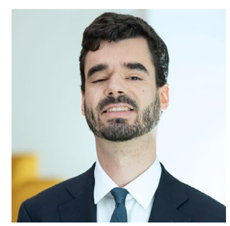
In addition to the civil monetary penalty, the SEC required numerous undertakings by the firm, including reviewing various policies and procedures and reporting on compliance to the SEC. The SEC also suspended the partners from appearing or practicing before the Commission, with ranges from one to three years.

Authors:

George A. Salter
Partner, New York
george.salter@hoganlovells.com

Dennis H. Tracey, III
Partner, New York
dennis.tracey@hoganlovells.com

Jonathan G. Coppola
Associate, New York
jonathan.coppola@hoganlovells.com



Sam Dougherty
Associate, New York
sam.dougherty@hoganlovells.com

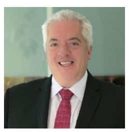
Our Global Accountants’ Liability Team

Americas

Federico De Noriega Olea
Partner, Mexico City
federico.denoriega@hoganlovells.com

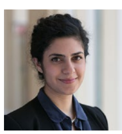
Cristina Rodriguez
Partner, Houston
christina.rodriguez@hoganlovells.com

George A. Salter
Partner, New York
george.salter@hoganlovells.com

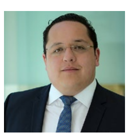


Arturo Tiburcio
Partner, Mexico City
arturo.tiburcio@hoganlovells.com

Dennis H. Tracey, III
Partner, New York
dennis.tracey@hoganlovells.com



Mitra Anoushiravani
Senior Associate, New York
mitra.anoushiravani@hoganlovells.com



Luis Giovanni Sosa
Senior Associate, Mexico City
giovanni.sosa@hoganlovells.com

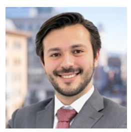
Allison M. Wuertz
Senior Associate, New York
allison.wuertz@hoganlovells.com

Gary Yeung
Senior Associate, New York
gary.yeung@hoganlovells.com

Jonathan G. Coppola
Associate, New York
jonathan.coppola@hoganlovells.com

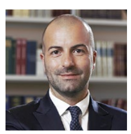
Sam Dougherty
Associate, New York
sam.dougherty@hoganlovells.com

Charles Barrera Moore
Associate, New York
charles.moore@hoganlovells.com



Juan Manuel Moran Sosa
Associate, Mexico City
juan.moran@hoganlovells.com

Europe



Andrea Atteritano
Partner, Rome
andrea.atteritano@hoganlovells.com

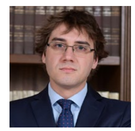
Manon Cordewener
Partner, Amsterdam
manon.cordewener@hoganlovells.com

Alexei Dudko
Partner, Moscow
alexei.dudko@hoganlovells.com

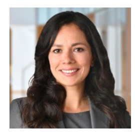
Nicholas Heaton
Partner, London
nicholas.heaton@hoganlovells.com

Jose Luis Huerta
Partner, Madrid
joseluis.huerta@hoganlovells.com

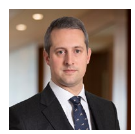
Kim Lars Mehrbrey
Partner, Dusseldorf
kim.mehrbrey@hoganlovells.com



Emanuele Ferrara
Senior Associate, Rome
emanuele.ferrara@hoganlovells.com

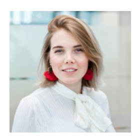


Sophia Jaeger
Senior Associate, Hamburg
sophia.jaeger@hoganlovells.com

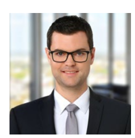


Nathan Sherlock
Senior Associate, London
nathan.sherlock@hoganlovells.com

Eugenio Vázquez
Senior Associate, Madrid
eugenio.vazquez@hoganlovells.com

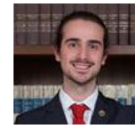


Jessica Booij
Associate, Amsterdam
jessica.booij@hoganlovells.com



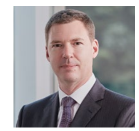
Benjamin Hansen
Associate, Dusseldorf
benjamin.hansen@hoganlovells.com

Blanca Romero de Ory
Junior Associate, Madrid
blanca.romero@hoganlovells.com



Erik Willem Brouwer
Trainee Solicitor, Rome
erikwillem.brouwer@hoganlovells.com

Asia

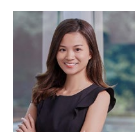


Chris Dobby
Partner, Hong Kong
chris.dobby@hoganlovells.com

Roy G. Zou
Partner, Beijing
roy.zou@hoganlovells.com

Byron Phillips
Counsel, Hong Kong
byron.phillips@hoganlovells.com

Yolanda Lau
Senior Associate, Hong Kong
yolanda.lau@hoganlovells.com



Hazel Law
Associate, Hong Kong
hazel.law@hoganlovells.com

Nigel Sharman
Sr. Knowledge Lawyer, Hong Kong
nigel.sharman@hoganlovells.com

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