Hogan Lovells

Global Accountants' Liability Update

September 2020

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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 the United States, Hong Kong, and the Netherlands, 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

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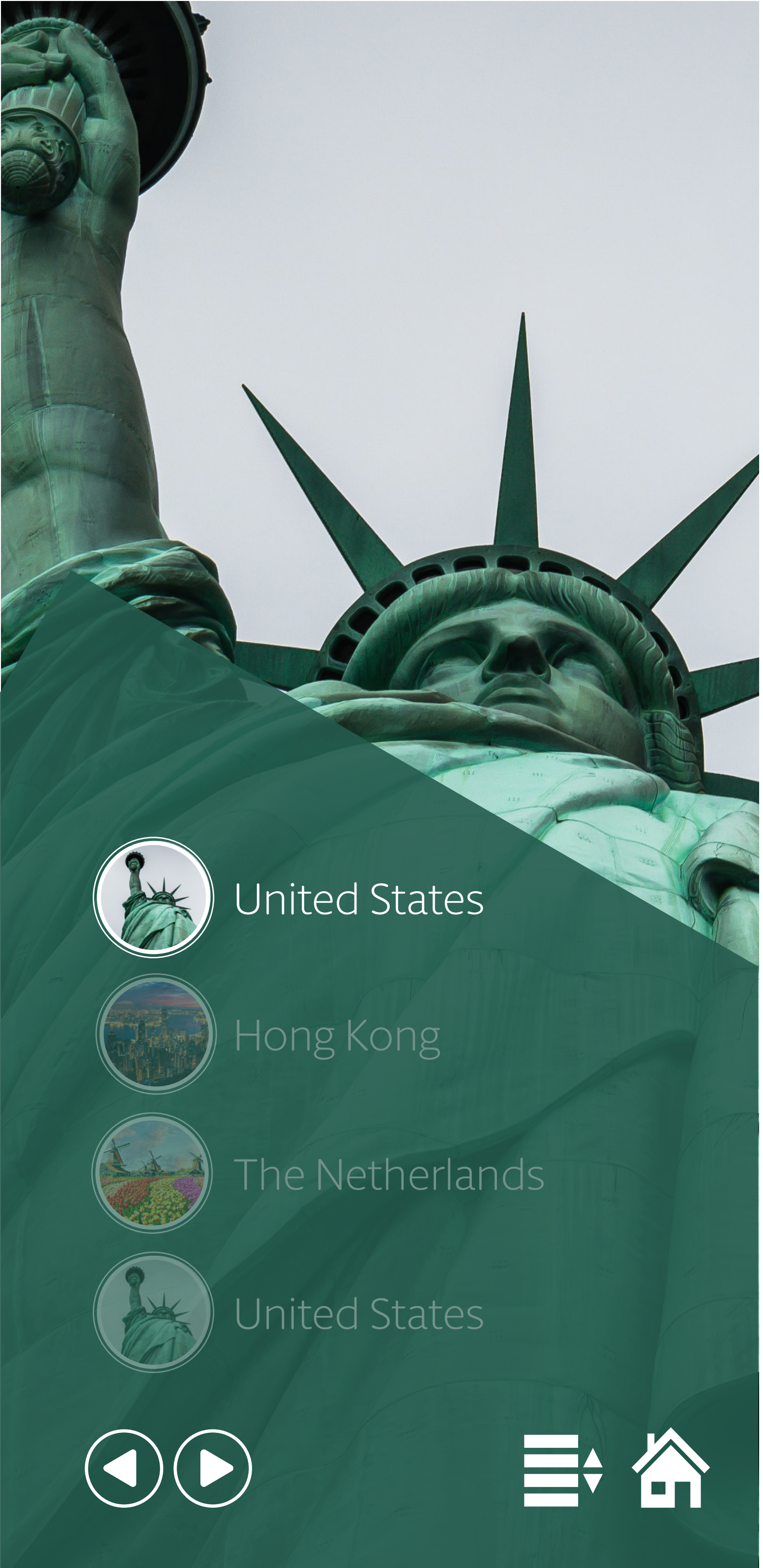


United States

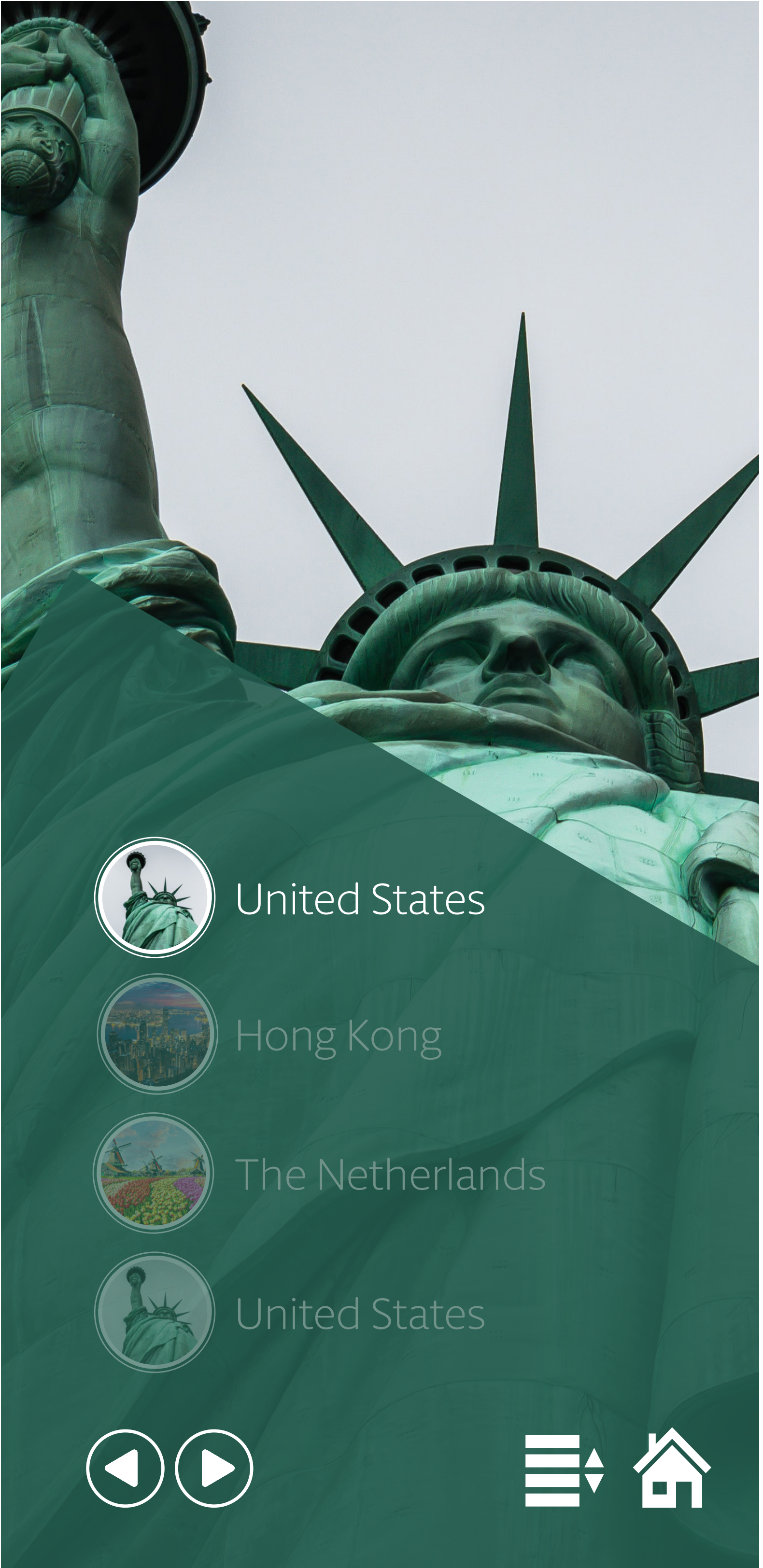
KPMG U.S. defeats claim seeking to hold it liable as agent for KPMG Mexico

On 21 August 2020, the court of Chancery of the State of Delaware granted a motion brought by three Defendant KPMG firms to dismiss a cause of action seeking to hold KPMG LLP (KPMG US) liable as the agent of KPMG Cardenas Dosal, S.C. (KPMG Mexico). While the opinion only dealt with a single claim brought by one of the plaintiffs in the action, Oceanografía S.A. de C.V. (OSA), the court rejected at least one plaintiff's theory that the Defendants should be held liable under a "one global firm" theory of liability.

OSA was one of several plaintiffs that brought a $1.1 billion negligent misrepresentation claim against KPMG US, KPMG Mexico, and KPMG International Cooperative (KPMG International) (collectively, the KPMG Defendants), alleging they failed to detect OSA's fraud. In February 2019, the court had dismissed the other claims brought against the KPMG Defendants, and only OSA's cause of action remained before the court. In essence, OSA's claims revolved around its assertion that if KPMG Mexico had complied with generally accepted auditing standards, its audit would have detected OSA's underlying fraud. OSA also asserted that KPMG US and KPMG International should be liable due to the agency relationship between the firms and because those firms were engaged in a joint venture with KPMG Mexico. The complaint alleged that KPMG International exercised significant control over its member firms and, because KPMG Mexico was such a member firm, KPMG International should likewise be held accountable for KPMG Mexico's alleged negligent misrepresentations.

OSA advanced two theories of vicarious liability in an attempt to hold KPMG US and KPMG International liable for KPMG Mexico's audit. The court rejected both theories, regardless of which law governed them (Mexico, Delaware, or New York).

First, OSA alleged that there existed an agency relationship between KPMG US, KPMG Mexico, and KPMG International such that all should be held liable for the actions of KPMG Mexico. That theory relied on the allegations that KPMG Mexico was the agent of KPMG US, which in turn acted as the agent of KPMG International. Thus, two agency relationships would need to be established. However, the court determined that neither agency relationship was supported by the allegations in the complaint. For one, the court rejected the theory that membership within KPMG International imputed any sort of joint liability upon the firms. Additionally, the court described the allegations tying together KPMG US and KPMG Mexico as "sparse" and, therefore, no agency relationship between the two had been pleaded.



Second, OSA advanced a theory that the KPMG Defendants acted as part of a joint venture, but the court also rejected that theory of liability. OSA's allegations attempted to again characterize KPMG International as a single global enterprise that encompassed both KPMG US and KPMG Mexico. Yet, the court found those allegations lacking in the joint venture context as well because the alleged "control" by KPMG International was not sufficient to create a joint venture. Instead, the court cited to numerous cases in which theories seeking to impose liability under a "one global firm" theory had been rejected. Moreover, the allegations in the complaint were insufficient to establish that there was either joint control or a share in profits.

As a result, the KMPG Defendants' motion to dismiss was granted, dismissing OSA's claims and defeating the "one global firm" theory of liability in this instance.

Authors:

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

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

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

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

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Harvesting bad apples

The Hong Kong Monetary Authority (HKMA) has concluded a three-month industry consultation on the implementation of a Mandatory Reference Checking (MRC) scheme to address the "rolling bad apples" phenomenon – where individuals who engage in misconduct during previous employment at a financial institution fail to disclose their earlier misconduct to the new employer.

According to the HKMA, "individuals who are not held accountable for misconduct at one firm and surface at another firm could have a higher likelihood of repeating their misconduct." Repetition may give rise to potential systemic risks, undermining public confidence in the banking sector.

Under the scheme, prospective employees will be required to disclose employment records before an employment relationship commences. In the initial stages, the scheme would apply to future employees of Authorized Institutions (AIs) regulated by the HKMA, including local banks, restricted-licence banks and deposit-taking institutions.

Prospective employees of these AIs will be required to disclose ten years of their employment history using a standard protocol. It is proposed that prospective employees should provide written consent to the recruiting AI to conduct reference checks and also to authorize current and previous AIs to disclose employment records. Prospective employees will have the opportunity to be heard where negative information is uncovered and the prospective employer may still offer employment at its discretion despite the negative information.

The scheme will operate in two phases - phase 1 for senior management position (s.71, 72B and 71C Banking Ordinance); followed by Phase 2 for AI employees who lead key supporting functions or client-facing or sales responsibilities.

Waivers and principles

The Hong Kong Stock Exchange on 28 August 2020 published the conclusions to its consultation on the Codification of General Waivers and Principles relating to IPOs and Listed Issuers. The Exchange has said it will adopt many of the consultation proposals with the changes coming into effect on 1 October 2020.

Key changes include codification of general principles underpinning a number of waivers, which have been granted to new applicants and/or listed issuers, relating to financial disclosure matters, incentive schemes and working capital statements in listing documents.

The Exchange also published a new guidance letter on the experience and qualification requirements of company secretaries, and factors the Exchange will consider when granting a waiver to the conditions.

Robust risk management in times of uncertainty

The Hong Kong Institute of Certified Public Accountants (HKICPA) has urged boards of directors to commit to good disclosure and ensure robust risk management in times of uncertainty.

Given the ongoing COVID-19 pandemic, the HKICPA said that times of uncertainty "create challenges for the operations of organizations. At such times, for listed companies in particular, corporate governance plays an especially important role in protecting investors' and stakeholders' interests." The HKICPA urged boards of directors to ensure that companies review their risk management and reporting systems.

The HKICPA noted that auditors play a key gatekeeper role during an economic downturn, when there may be a greater incentive for companies to engage in financial misconduct and fraud. Auditors exercising professional scepticism can help to identify gaps in an organization's financial reporting and internal control systems.

Boards should also review their business contingency planning to ensure it addresses how to maintain effective operations in different scenarios, such as when facing major resource constraints or heightened vulnerability to cyberattacks.

The announcement came on 6 July 2020 as the HKICPA was celebrating the 20th anniversary of Hong Kong's Best Corporate Governance Awards. The HKICPA noted that over the two decades since the inception of the awards, the bar for corporate governance had been raised "steadily and progressively" in Hong Kong and that more asset managers are now considering a company's environmental, social and governance (ESG) practices when assessing investment potential. The HKICPA encouraged companies to develop clear strategies and objectives from the top down, as well as to set benchmarks with key performance indicators and targets.

The HKICPA encourages companies to refer to its Guide on Better Corporate Governance Disclosure, for suggestions on best practice.

Authors:

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

Byron Phillips
Senior Associate, Hong Kong
byron.phillips@hoganlovells.com

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

The Netherlands

Legislative and regulatory changes continue to take shape

We previously reported on a letter the Minister of Finance sent to the House of Representatives in March this year. In this letter the Minister of Finance, Mr. W.B. Hoekstra, introduced measures in response to reports issued by the Committee future accountancy sector (Commissie toekomst accountancysector) (Cta) and the Monitoring Committee Accountancy (Monitoring Commissie Accountancy) (MCA), which called for improvements to the quality of and confidence in accounting practices in The Netherlands. Some of the measures mentioned by the Minister of Finance required legislative and regulatory changes. An update on those efforts follows.

Quartermasters appointed

The Minister of Finance has appointed two quartermasters, Marlies de Vries (Nyenrode) and Chris Fonteijn (former board chairman of the ACM). They are to play a connecting, facilitating and stimulating role in the implementation and follow-up of a number of measures mentioned in the letter. These measures include the establishment of audit quality indicators (AQIs) and the further investigation of new structural models such as audit only, joint audit and the intermediaries. The quartermasters are currently working on the AQIs with the accountancy sector and other stakeholders.

Forced audit

In search of cost savings, several accounting firms have handed in their license to audit public interest institutions (PIEs). Only six accounting firms currently provide PIE services. And, a new decree came into force 1 January 2020 imposing higher auditing requirements on electricity grid operators, larger housing corporations and a handful of scientific institutions. These companies now also qualify as PIEs and therefore fall into the same category as banks, pension funds, insurers and listed companies.

It remains difficult for small listed companies to find an accountant to approve their annual accounts. The Dutch Financial Daily Newspaper (Financieel Dagblad or FD) reports that multiple companies have indicated they are not even able to get an offer for such accounting services. The CEO of one “small” company told the FD that the accounting firms may report they are very busy. However, his company was told on the phone that the firm would not review the company’s accounts because the company was too small. The impact of this challenge is illustrated by Alumexx, which was placed on the penalty bench by the Euronext stock exchange operator in June after failing — despite extensive efforts — to find a PIE accountant to audit its annual accounts for 2019. There are no fines attached to this

action, but it is problematic because it can make it more difficult to raise capital. As discussed in our earlier report, the MCA recommends the introduction of a mechanism/authority that would appoint an accounting firm to any entity that has failed to contract one. The Minister of Finance is currently preparing legislation that will make it possible to force auditors to audit the annual accounts of companies listed on the stock exchange. Technical details are not yet available as the legislative amendment is still a "work in progress."

NBA letter

On the 19th of August the Royal Nederlandse Beroepsorganisatie van Accountants (NBA) sent a letter to the Minister of Finance suggesting certain provisions be included in new legislation including:

- An obligation to include a report on non-financial information (NFI) in management reports. A certain level of assurance on NFI, such as the effects of the activities relating to environmental issues and human rights, helps further increase transparency and reliability.

- Management reports now only communicate about continuity if there is significant uncertainty in this respect. Fear that every reference to continuity is thus seen as a red flag has created a great reluctance to explicitly communicate on this subject. In order to detect fraud (risks) and continuity issues sooner, a company should, according to the NBA, be obliged to report on fraud risks and continuity in the management report even in the absence of significant uncertainty.

What is next?

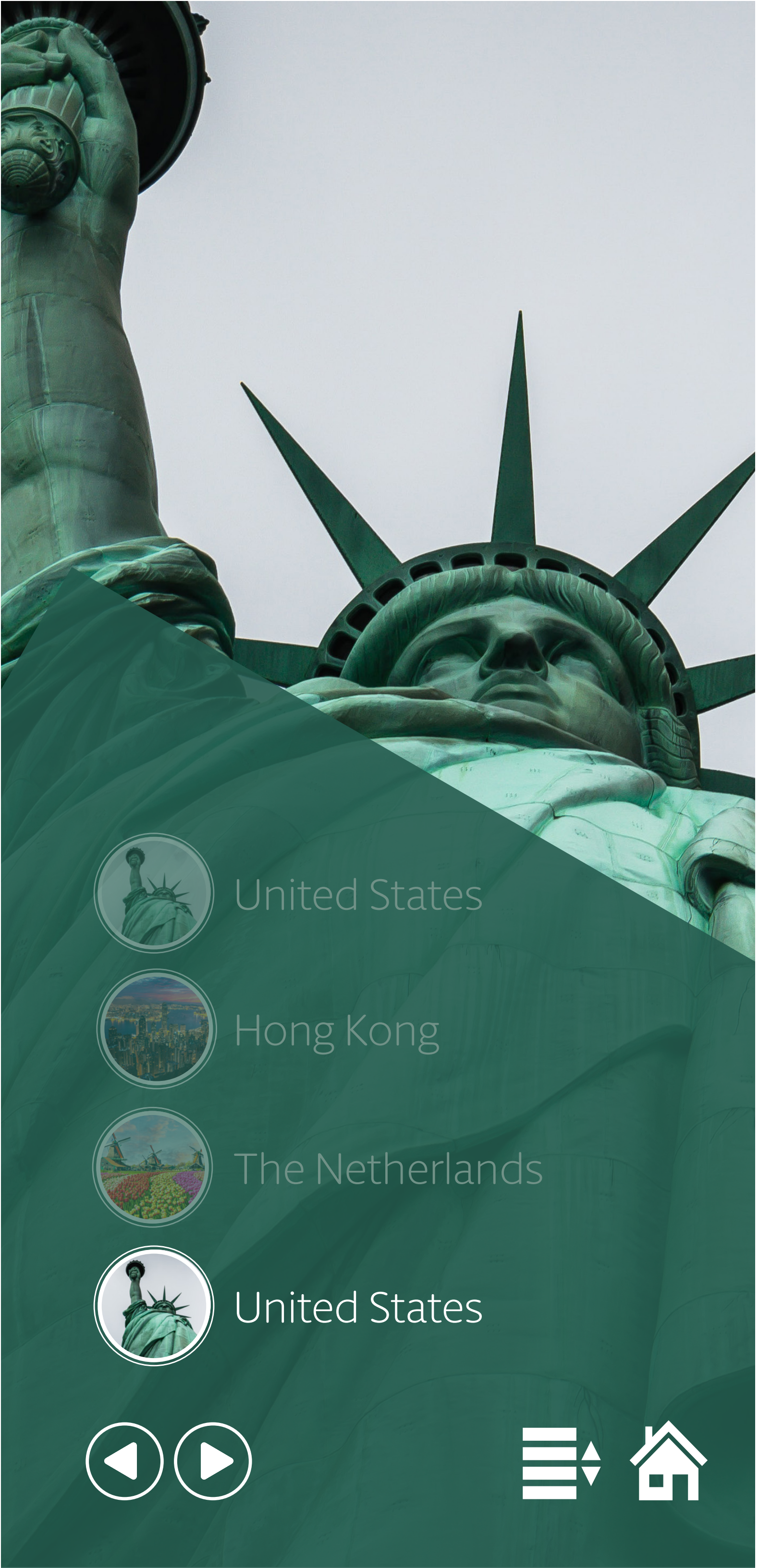
We will update you on the new legislation covering forced audits as soon as we receive information. It is expected that the Minister of Finance will discuss the topic with the House of Representatives after the summer and will start preparations for a legislative proposal after those discussions.

Authors:

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

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

Bas Keizers
Associate, Amsterdam
bas.keizers@hoganlovells.com



United States

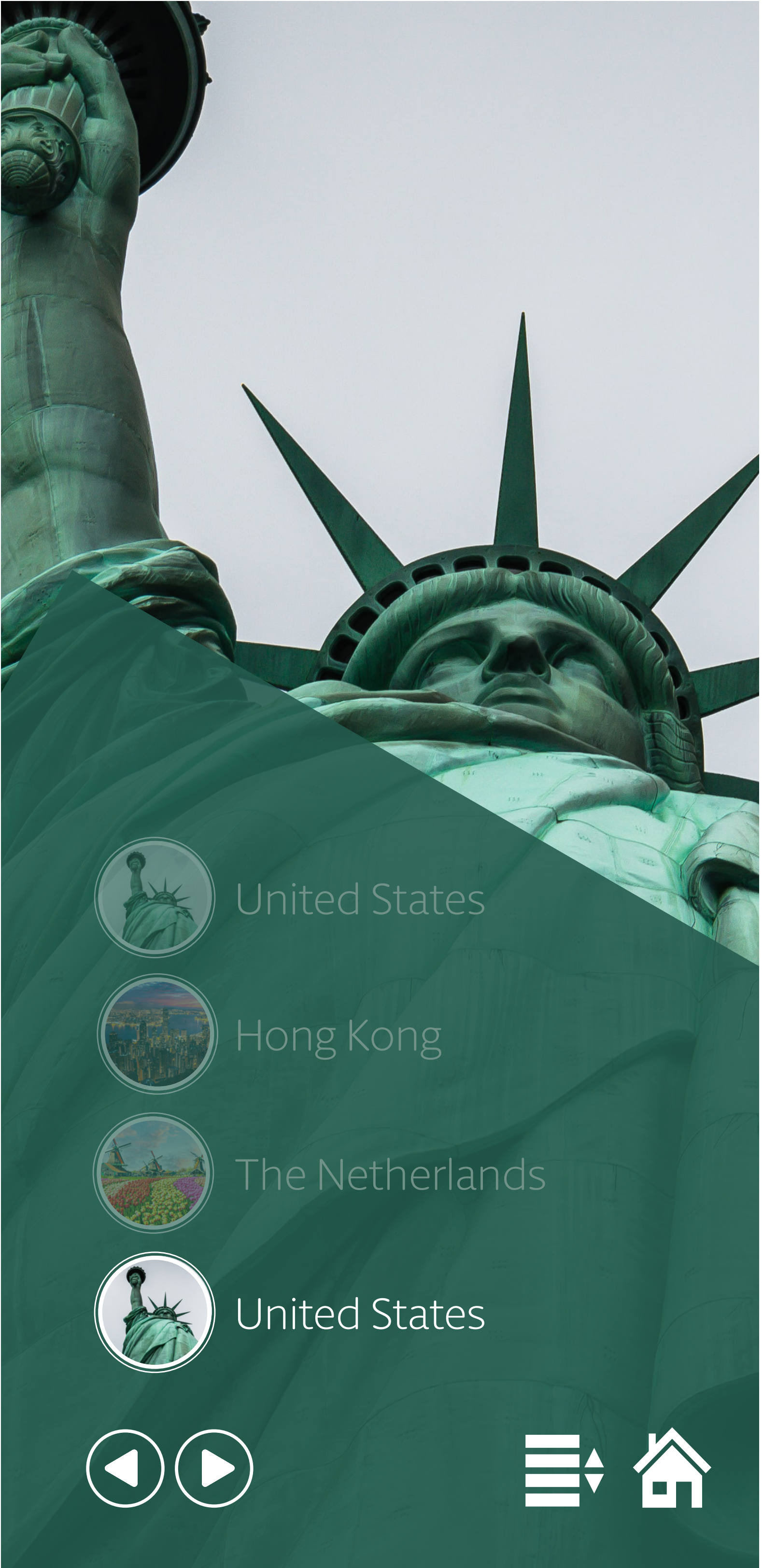
Chinese companies listed in the U.S. face potential delisting over lack of access to audit papers

Chinese companies listed in the U.S. are finding themselves in an increasingly difficult regulatory environment, including the possibility of being delisted from U.S. stock exchanges, a situation which may have significant implications for the global audit firms that they engage to perform their audit work. A series of actions by the Trump administration, Congress, and Nasdaq over the past few months may soon force these companies to make some difficult decisions in regard to their U.S. listings. At the heart of this scrutiny is the regulatory impasse between the United States and China over the inability of the Public Company Accounting Oversight Board (PCAOB) to conduct inspections and investigations of Chinese auditing firms.

China-based accounting firms that audit U.S.-listed companies have consistently refused to allow the PCAOB to inspect their work papers, which is required by the Sarbanes-Oxley Act for all companies listed on U.S. exchanges. The firms, which include the Chinese branches of the Big Four accounting firms, have long maintained that the production of their audit papers would violate Chinese laws prohibiting anyone from providing documents and materials related to securities business activities to regulators in foreign jurisdictions.

The longstanding international dispute may be coming to a head, as the Trump Administration announced in late July that Chinese companies could be forced to delist from U.S. stock exchanges by January 2022 if they do not comply with a series of new rules recommended by a group of top U.S. financial regulators in a report dated July 24, 2020. The President's Working Group on Financial Markets, which includes the heads of the U.S. Treasury Department, the Federal Reserve, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), recommended in its report that the SEC order U.S. exchanges to adopt new rules for foreign issuers, including a requirement they provide access to their audit working papers in order to sell new shares or keep their existing listing in the U.S. China was specifically named as a non-cooperating jurisdiction in the report.

High-profile accounting scandals involving Chinese companies in recent months have renewed the attention of regulators and policymakers in the PCAOB's lack of access to Chinese audits. In May 2020, the U.S. Senate passed by unanimous consent the Holding Foreign Companies Accountable Act, which would prohibit from U.S. exchange or over-the-counter (OTC) trading the securities of issuers that have used, for three consecutive years, non-US accounting firms that do not permit PCAOB inspection. The bill would also require certain foreign issuers to disclose, among other things, whether they are owned or controlled by a foreign government, and whether they have



any Chinese Communist Party members on their board of directors. A companion bill introduced in the U.S. House of Representatives bill remains under review. During the same month, Nasdaq filed three new rule proposals with the SEC that would impose more stringent standards on Chinese companies considering listing or already listed on the exchange.

There have also been increasing calls for auditors in the U.S. to be held liable for the audit failures of their Chinese colleagues. In written comments to the SEC, Carson Block, founder and chief investment officer of Muddy Waters Capital LLC, a due diligence based investment firm that conducts investigative research on public companies, said that holding U.S. auditors financially responsible for the actions of their Chinese affiliates would improve audit quality and force the firms to be more selective about which clients they work with.

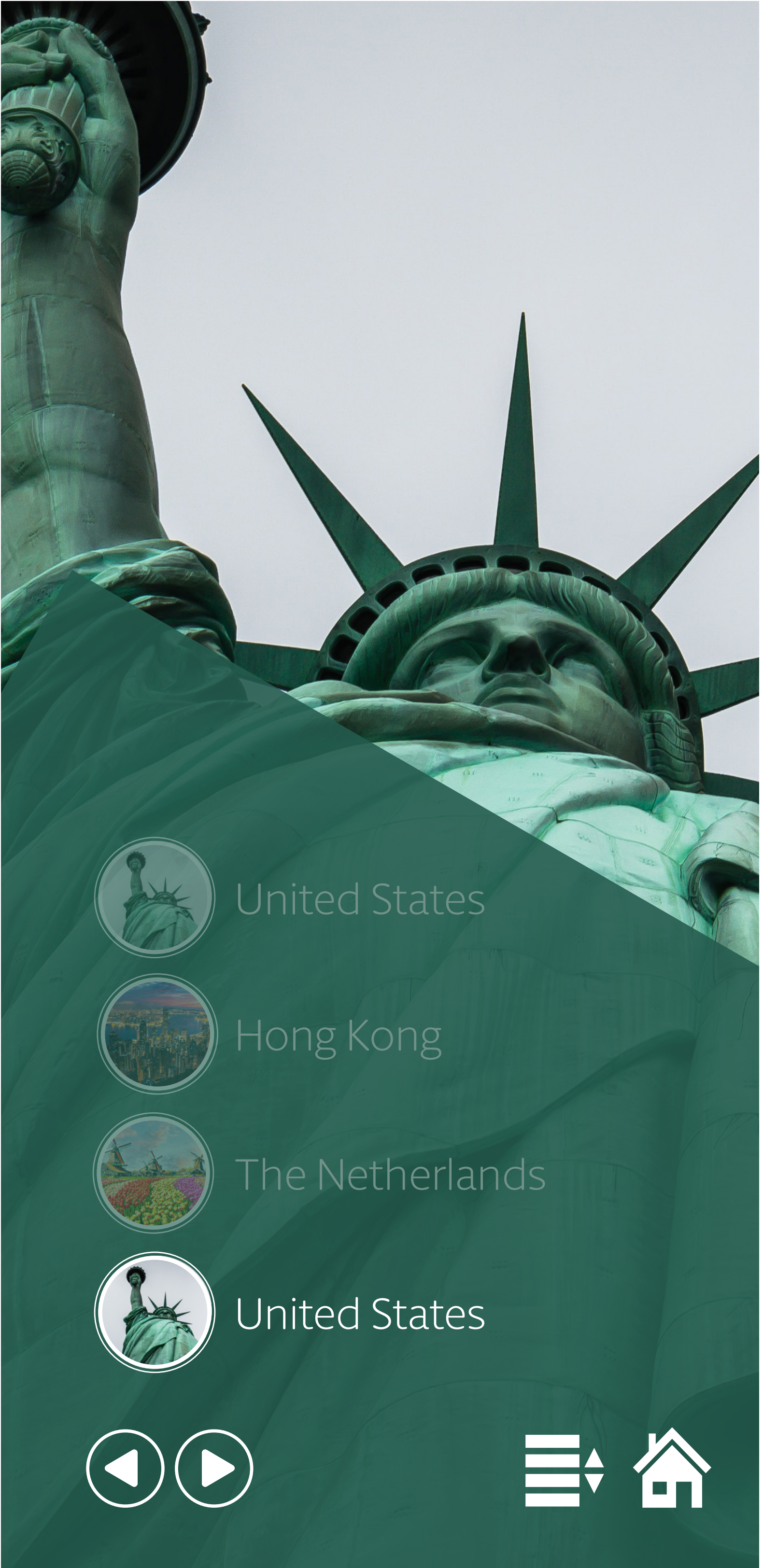
Meanwhile, the PCAOB and the Chinese government remain at an impasse over inspections. At a forum hosted by the SEC to discuss the risks Americans face when investing in China and other emerging markets in July, PCAOB Chairman William D. Duhnke III said that discussions with the Chinese government over audit access and enforcement have not produced any meaningful results despite the Chinese authorities' repeated statements of willingness to chart a path forward.

However, in a recent development in late August, Chinese authorities announced that they are proposing to allow the PCAOB to inspect audits of the country's state-owned enterprises (SOEs) in an apparent concession aimed at solving the long-running dispute, but would insist on redacting certain information on national security grounds. According to Fang Xinghai, Vice Chairman of the China Securities Regulatory Commission (CSRC), the CSRC sent the PCAOB a new proposal in August that would allow the Board to pick any of China's SOEs for a trial joint inspection. A previous trial inspection done jointly by Chinese and U.S. regulators failed to yield an agreement. Fang has also called for direct talks with U.S. officials to resolve the dispute. It remains to be seen if the Chinese authorities' new proposals will have a material impact on moving discussions forward.

The PCAOB extends audit inspection window to assess impact of COVID-19

The PCAOB is extending the time period of audits to be inspected to ensure that it more timely covers the coronavirus period in order to assess the impact of the pandemic on audit quality. During a panel discussion concerning the impact of COVID-19 on accounting and auditing matters at the American Accounting Association's annual meeting, PCAOB board member Duane DesParte described the Board's plans for 2020 inspection work to review a sample of U.S. audits of public companies whose fiscal year ended on June 30.

The Board has announced that this year's inspection window will cover five quarters instead of four. In addition to the year-end audits, the Board's inspectors will examine reviews of quarterly financial statements from the first and second quarter of 2020.



The Board expects its inspections to continue through the fall and to report on its findings in the first half of 2021.

The PCAOB said the number of inspections this year would be comparable to prior years. The Board usually conducts about 200 inspections of audit firms a year, and has been inspecting accounting firms' compliance with laws and regulations since 2003. Firms that audit more than 100 public companies in the U.S. are inspected annually, while smaller firms are reviewed once every three years.

The Board's 2020 inspections will reportedly consider how auditors are planning for and responding to Covid-19-related risks. Those risks could evolve around judgments that auditors have to make, a process that could be complicated by limited access to financial information due to disruptions caused by the pandemic. PCAOB inspectors will review auditors' workpapers and conduct inquiries in order to assess audit firms' ability to ensure the quality of their work during the pandemic.

The Board previously offered temporary exemptions from inspections to audit firms in recognition of the hurdles the firms faced in assessing inventory, valuations, changes in internal controls and collecting audit evidence. Inspections resumed in May after the PCAOB provided up to 45 days of relief beginning in March.

Authors:

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

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

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

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

Our Global Accountants' Liability Team

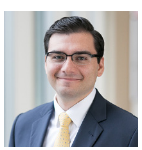
Americas

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

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

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

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



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

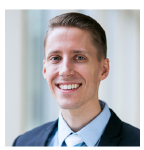
Charles Barrera Moore
Associate, New York
charles.moore@hoganlovells.com

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

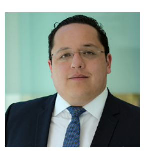
Arturo Tiburcio
Partner, Mexico City
arturo.tiburcio@hoganlovells.com

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

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



Darcy Hansen
Associate, New York
darcy.hansen@hoganlovells.com



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

Asia

Maurice Burke
Partner, Singapore
maurice.burke@hoganlovells.com

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

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

Byron Phillips
Senior Associate, Hong Kong
byron.phillips@hoganlovells.com

Jeremy Forsyth
Registered Foreign Lawyer, Hong Kong
jeremy.forsyth@hoganlovells.com

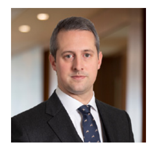
Nigel Sharman
Knowledge Lawyer, Hong Kong
nigel.sharman@hoganlovells.com

Europe

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

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

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



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

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

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

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

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

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

Pablo De la Fuente
Associate, Madrid
pablo.delafuente@hoganlovells.com

Bas Keizers
Associate, Amsterdam
bas.keizers@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rome
San Francisco
Sao Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.
Zagreb*

*Our associated offices
Legal Services Centre: Berlin

www.hoganlovells.com