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Global Accountants'
Liability Update
December 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 The Netherlands, the United States, and Hong Kong, which are summarized in the pages that follow.



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Recent Court Decisions

Accountant is not liable for an overly optimistic liquidity forecast in relation to a takeover

Introduction and facts

A decision rendered by the Court of Appeal Arnhem-Leeuwarden on 21 September 2021 involved an Accounting firm's (Accountant) claim for payment and a counterclaim by one of the Accountant's clients (the Company). In the counterclaim, the Company claimed the Accountant had breached its contract by preparing a liquidity forecast for the second part of 2018 that proved to be too optimistic.

A shareholder of the Company sold Company shares to two purchasers in September 2018 and issued a guarantee in favor of the two purchasers that the result for the second part of 2018 would be at least € 300,000. Prior to this sale, and at the request of the Company's management, the Accountant prepared a liquidity forecast for the second part of 2018 and interim figures for the whole of 2018.

The Accountant remained the Company's accountant for some time after the sale. At the instructions of the new Board of Directors, the Accountant prepared draft financial statements for 2018 and closed the annual accounts of 2018. The annual accounts for 2019 were prepared however by the Company's new auditor (the New Auditor).

The Accountant subsequently sent invoices to the Company for services rendered, ten of which were not fully paid leaving an outstanding balance of € 21,263.34.

The claim and grounds of the judgment

In the lower court, the Accountant prevailed on its claim seeking payment for unpaid invoices, plus interest. The Company appealed. Although the Company did not dispute the (original) liability to pay the invoices, it asserted a breach of contract counterclaim (for the first time on appeal) alleging that the Accountant's liquidity forecast for the second half of 2018 was too optimistic and was by no means achieved.

The core of the dispute is whether the Accountant made mistakes in the preparation of the share sale and whether the Company suffered damages as a result.

It is therefore important to establish what activities the Accountant performed based on the instructions of the Company. According to the Company, the Accountant not only prepared the annual accounts, but was involved in the Company's internal administration. The Company thus asserts, the Accountant was "the spider in the web" and fully aware of what was going on in the Company. The Accountant



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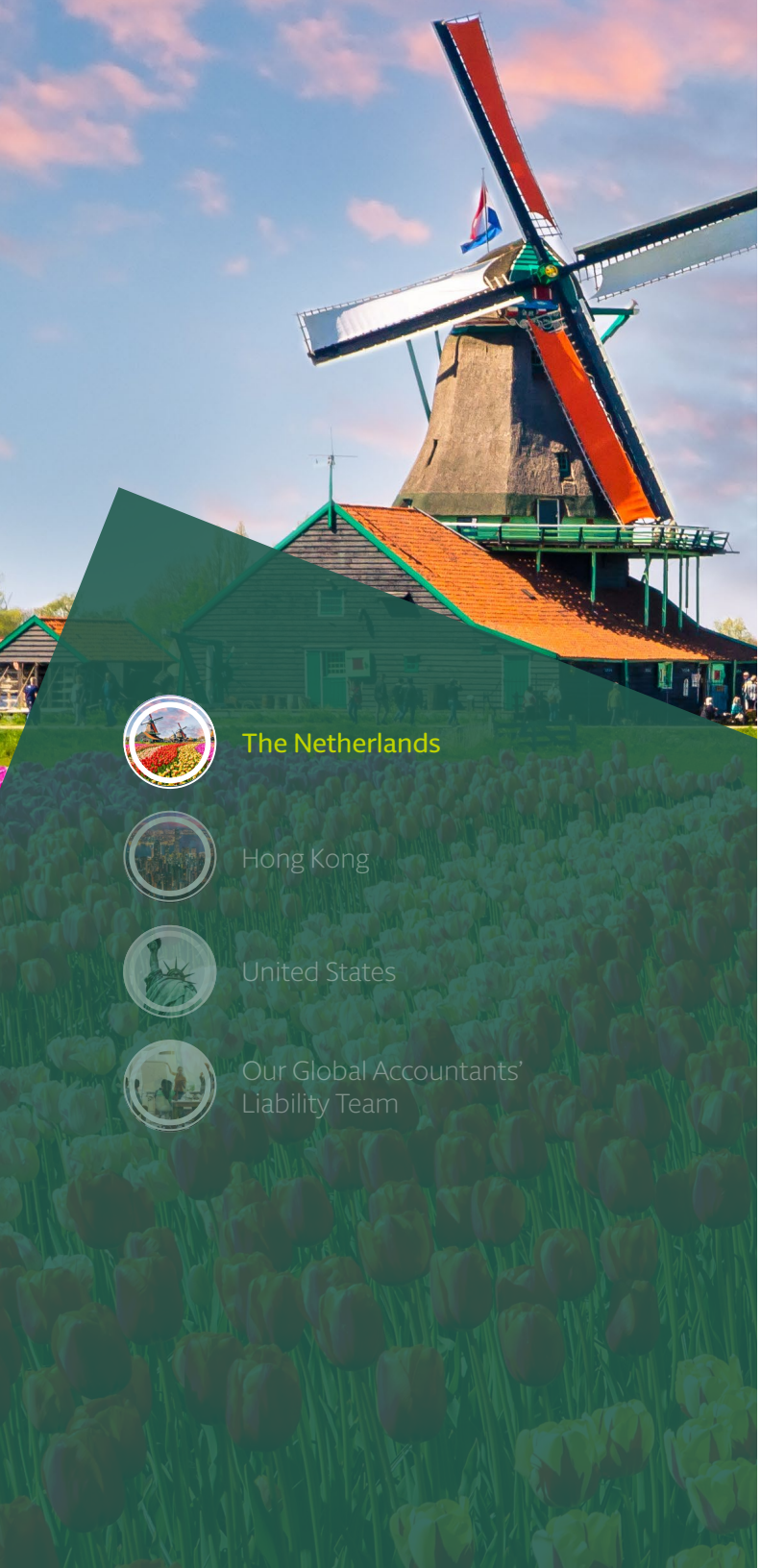


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disputed this assertion. Referring to the engagement letter and the statements on the invoices, the Accountant argued that besides drawing up the annual accounts, it only had the task of taking care of the payroll administration and the financial administration.

The Court of Appeal held that, based on the foregoing, the Company's assertion that the Accountant was "the spider in the web" and aware of the Company's full risk profile was not persuasive.

The Court of Appeal then considered that pursuant to Section 7:401 of the Dutch Civil Code, a contractor shall exercise the due care of a good contractor in performing an assignment. With regard to professionals, such as accountants, this standard is interpreted to demand the care that may be expected from a reasonably competent and reasonably acting professional. The Court of Appeal explained that the mere fact that the liquidity forecast made by the Accountant was not achieved does not mean that this forecast was faulty. It noted that results can also be disappointing due to causes that were not foreseeable at the time of the forecast. The Court of Appeal noted it is important to know what data the Accountant had at his disposal at the time the forecast was made and noted that it had

not been established that the Accountant handled the project administration. Thus, the court concluded he cannot be seen as "the spider in the web" who was fully aware of what happened within the Company. The Accountant has also asserted that (i) the Company's results were disappointing due to causes such as postponement of delivery, extra costs within the projects, (ii) most of the project costs were incurred after the share transfer and (iii) after the share transfer, a new director was appointed who did not perform properly.

The Court of Appeal further noted that just like in the proceedings before the District Court, it the Company had not adequately explained what damages it suffered because the Company was not a party to the sale of shares, but rather the "direct object."

Decision of the court of appeal

In view of the above, the Court of Appeal ruled that the Company had not shown the Accountant failed to act as a reasonably competent and reasonably acting accountant. Therefore, the alleged breach of contract (or wrongful act) in respect of the liquidity forecast (and the 2018 semi-annual financial statements) was found to be insufficiently substantiated. The Court of Appeal upheld the judgment of the district court.

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Recent Regulatory and Enforcement Decisions Regulator gets new powers, new name

In the September edition, we reported on the introduction of the Financial Reporting Council (Amendment) Bill 2021, which sets out the legal framework for transferring the regulatory powers currently vested in the Hong Kong Institute of Certified Public Accountants (HKICPA) to the Financial Reporting Council (FRC).

On 22 October 2021, the Bill was passed by the Legislative Council as the Financial Reporting Council (Amendment) Ordinance 2021 (FRCAO). The FRCAO will take effect on a date to be announced by the Secretary for Financial Services and the Treasury.

Under the new legislation, the FRC will be renamed the Accounting and Financial Reporting Council, and will become an independent regulatory body for the accounting profession. The FRC's statutory functions will expand to include issuing practicing certificates, as well as registration, inspection, investigation and discipline of practice units and certified public accountants. The FRC will also oversee the HKICPA's performance in its various statutory functions.

The next step in the legislative process is the proposal and enactment of the subsidiary legislation, which provides for the transitional arrangements and technical details of the transfer of functions to the FRC.

In this transitional period, the FRC has indicated in its November newsletter that it will apply the principle of proportionality in the discharge of its new functions and will largely adopt the approach currently taken by the HKICPA.



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Regulator highlights non-compliance in financial reporting in complex transactions

On 3 November 2021, the FRC published its first Annual Investigation and Compliance Report, which covers common examples of non-compliance in the financial statements of listed entities and misconduct of auditors of listed entities identified in the course of the investigations and enquiries conducted by the FRC from 1 October 2019 to 31 March 2021 (the reporting period). The report also sets out an overview of the enquiry and investigation functions of the FRC and the FRC's plans for the coming year.

Financial reporting non-compliance, both potential and actual, in the financial statements of listed entities was commonly found in complex transactions where those preparing financial statements are required to make significant judgements or estimates and apply complex financial measurement techniques.

These complex transactions involve exchanges of non-financial assets, contracts for the provision of goods or services, financial instruments or changes in their terms, or business combinations in equity interests that affect the ability of investors to control or exert significant influence over the investee.

Potential and actual auditing irregularities were also identified in ongoing and completed investigations conducted by the FRC during the reporting period. Common auditing irregularities involved failures to perform engagement quality control review, to obtain sufficient appropriate audit evidence, or to exercise appropriate professional skepticism and judgement.

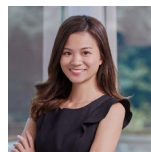
To avoid the above mentioned non-compliance and auditing irregularities, those preparing financial reports should ensure that appropriately competent financial reporting resources, which include assistance from appropriate internal or external experts, are available for the proper application of financial reporting principles. Auditors should also evaluate the risks of material misstatement and respond sufficiently and appropriately.

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United States

Recent Regulatory and Enforcement Decisions

SEC appoints new chairperson and board members to PCAOB

On November 9, 2021, the Securities and Exchange Commission (the SEC) **announced** the appointments of Erica Y. Williams as Chairperson and Christina Ho, Kara M. Stein, and Anthony (Tony) C. Thompson as Board members of the Public Company Accounting Oversight Board (the PCAOB). Current Board member and Acting Chairperson Duane DesParte will continue his service as a Board member and will remain Acting Chairperson until Ms. Williams is sworn in.

The new slate of appointees to the Board includes a securities litigator (Erica Williams), a former SEC commissioner (Kara Stein), a former Treasury official with a background in audits and data (Christine Ho), and an administrator at the Commodity Futures Trading Commission (Anthony Thompson).

Observers have predicted that the PCAOB will be more aggressive in its oversight of auditors going forward because the new Board has fewer ties to the Big Four and many of the Board members have strong enforcement backgrounds. Just one member has a background focused on public company financial reporting — Duane DesParte, who was a corporate controller before joining the PCAOB in 2018. Mike Shaub, an accounting professor at Texas A&M University, **noted** that the

SEC chose new appointees who come with a reputation for integrity and have limited ties to the Big Four accounting firms and are likely to deliver more muscular oversight of auditors, which has been expected under SEC Chair Gary Gensler's leadership.

PCAOB Board Members

Erica Y. Williams (Chairperson) spent more than a decade in various roles at the SEC, including as Deputy Chief of Staff to three former SEC Chairs and Assistant Chief Litigation Counsel in the SEC's Division of Enforcement trial unit, where she worked on cases involving accounting fraud among other issues. At the SEC, she also managed legal and operational functions and managed workflow relating to recommendations from the Division of Enforcement and Office of Compliance, Inspections and Examinations (now Division of Examinations). After leaving the SEC, she served as Special Assistant and Associate Counsel to President Obama with a focus on financial and economic policy issues. Ms. Williams joins the PCAOB from Kirkland & Ellis LLP, where she is a litigation partner. Ms. Williams earned both a J.D. and a B.A. from the University of Virginia.



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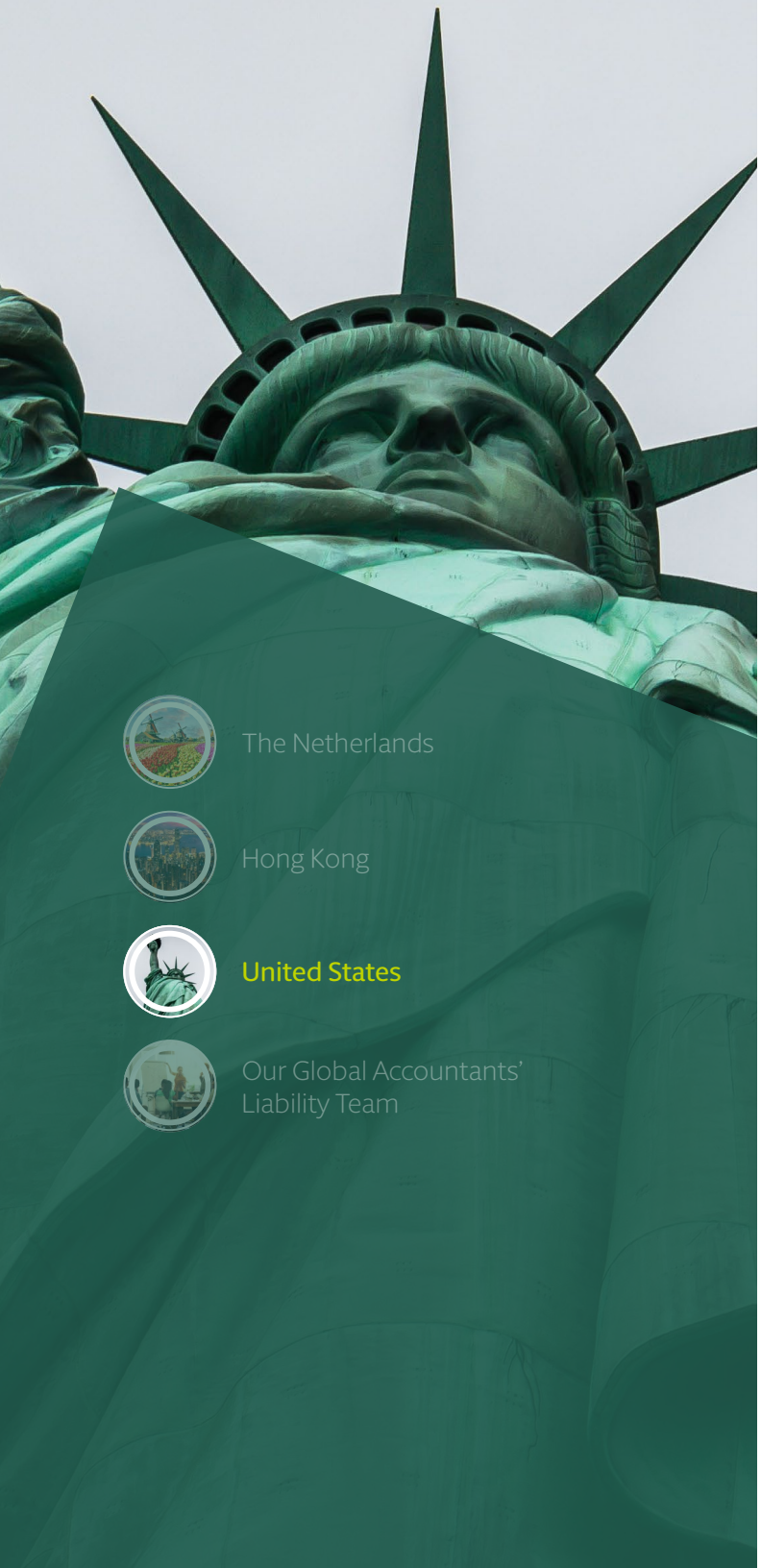


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Duane M. DesParte, a CPA, has served as the PCAOB’s Acting Chairperson since June 4, 2021. He was appointed as a member of the PCAOB by the SEC in December 2017 and was sworn in on April 9, 2018. He joined the Board after retiring from Exelon Corporation, where he served as chief accounting officer and corporate controller and in other financial roles for 15 years, following an 18-year career in the audit assurance profession. He graduated with highest honors from the University of Illinois at Urbana-Champaign with a B.S. in accountancy.

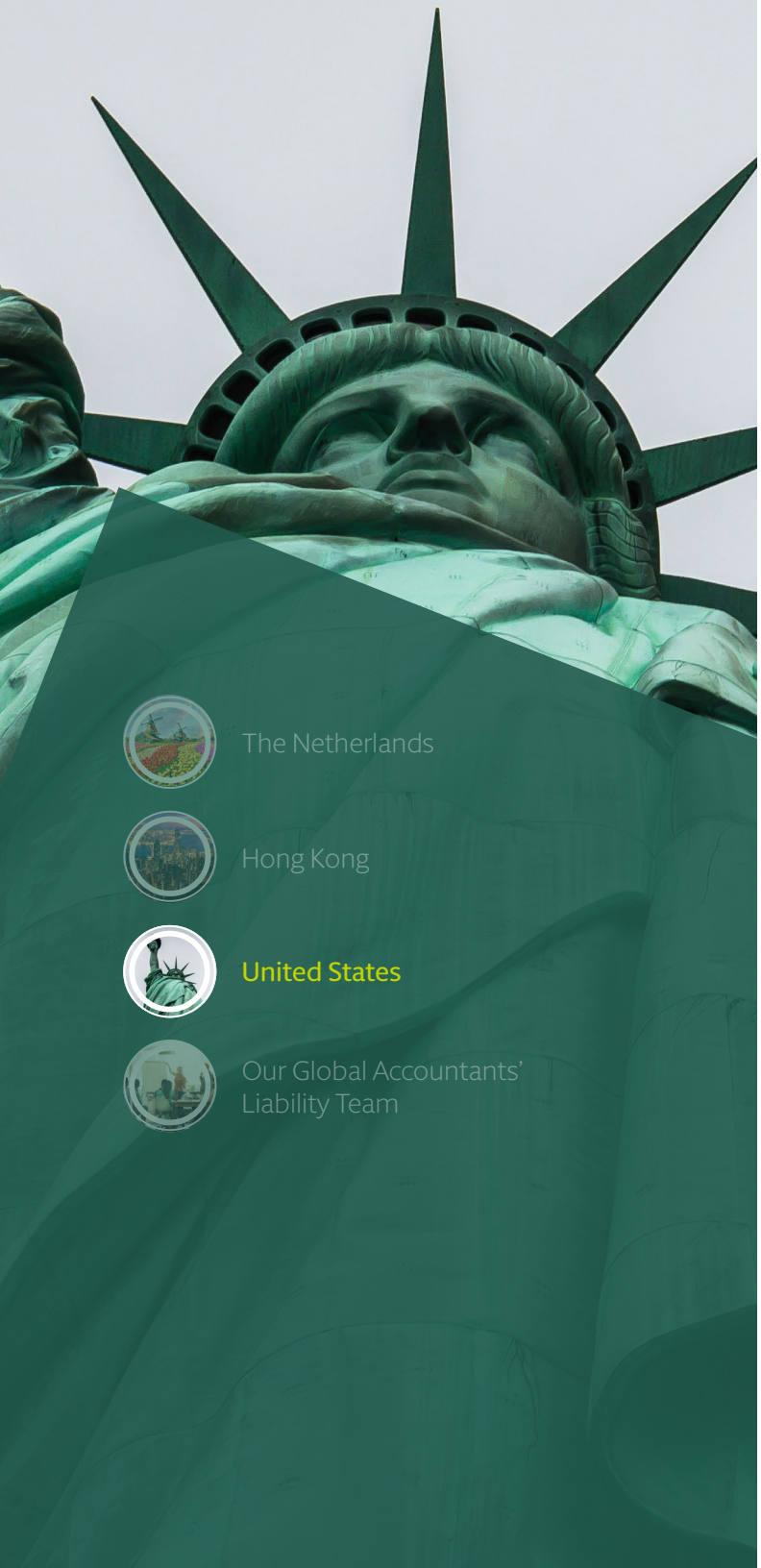
Christina Ho, a CPA, has 28 years of broad experience in public finance, policy development, accounting and auditing, disclosure modernization, data analytics, and technology innovation. She most recently was Vice President of Government Analytics and Innovation at Elder Research. Ms. Ho previously served as the Deputy Assistant Secretary for Financial Transparency & Accounting Policy at the U.S. Department of the Treasury and as Controller and Interim Chief Financial Officer for the University of Maryland College Park. Ms. Ho has held other senior positions with the U.S. Department of the Treasury and was a Senior Manager with Deloitte & Touche LLP. She earned a B.S. from Edinboro University of Pennsylvania.

Kara M. Stein served as a Commissioner of the SEC from 2013 to 2019, during which time she was known for supporting investor concerns. She currently serves as a Distinguished Policy Fellow and Lecturer-in-Law at the University of Pennsylvania

Carey Law School and is Director of the AI, Data, and Capital Markets Initiative at the Center on Innovation, University of California Hastings Law. Earlier in her career, she was Senior Policy Advisor for securities and banking matters for U.S. Senator Jack Reed and Majority Staff Director of the Securities, Insurance, and Investment Subcommittee of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. Ms. Stein earned a J.D. from Yale Law School and a B.A. from Yale College.

Anthony (Tony) C. Thompson currently serves as the Executive Director and Chief Administrative Officer of the Commodity Futures Trading Commission (CFTC), where he oversees the Division of Administration. Before joining the CFTC in 2011, Mr. Thompson held senior positions at the U.S. Department of Agriculture, where he was responsible for leading a workforce of more than 400 personnel and a broad range of programs, including budget and financial management. Before entering civilian government service, Mr. Thompson served in the United States Air Force for 32 years, reaching the rank of Colonel, where he served as the Chief Budget Officer for the service branch after previously serving as Chief Financial Officer for a number of U.S. Air Force Bases. He earned a B.S. from Regis University, an M.B.A. from Golden Gate University and an M.S. from Air War College.





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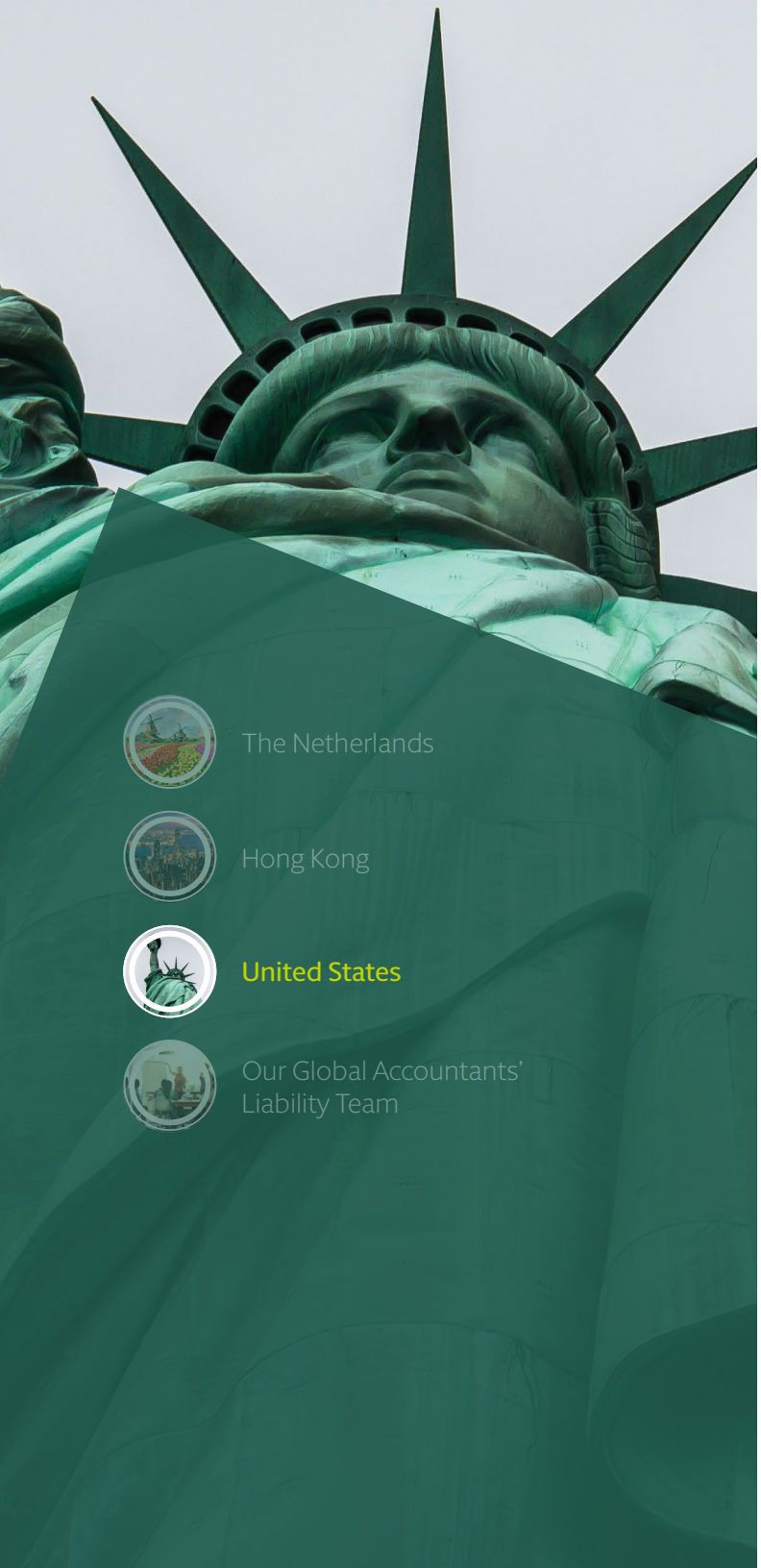
SEC Chief Accountant issues statement on the importance of auditor independence and risks associated with non-audit services

On October 26, 2021, Paul Munter, the Acting Chief Accountant for the U.S. Securities and Exchange Commission (the SEC or Commission), issued a **statement** titled “The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors” (the Statement). Munter issued this statement due in part because, while he acknowledged that all “gatekeeper roles” played a role in “producing high quality financial disclosures,” it was especially important that public accountants remain independent. In particular, Munter’s Statement highlights the risks of an accounting firm providing non-audit services to a client that is actively acquiring businesses, because such transactions may impact, in fact and appearance, the independence of existing audit engagements. As a result, Munter stresses the importance of audit firms closely monitoring their independence from the audit clients, and also to prioritize oversight from audit committees, management, and audit firms.

Munter’s concerns were overlaid on two broad principles that contribute to high quality audits: (1) “the importance of auditor independence” and (2) the “importance of audit committee oversight of the independent auditor.”

First, Munter begins by highlighting that a financial statement’s “credibility” would be largely impacted by the “independence of the auditor, in both fact and appearance.” As the range of services provided by auditing firms grows, especially multi-year non-audit service contracts, this concern appears to animate much of the positions adopted by Munter in the Statement. To achieve a sufficient degree of independence, Munter encourages issuers, audit committees, and auditors to ensure compliance with the applicable auditor independence rules. “As part of this responsibility, all gatekeepers in the financial reporting ecosystem should be especially mindful of the nature and the scope of any other services provided by the independent auditor,” the Statement reads.

Audit committees, management, and audit firms each hold responsibilities in ensuring the independence of audits. Munter stresses that each of these entities should “proactively” remain abreast of any potential appearance of or actual conflict with third parties. This proactive approach requires that audit committees, management, and audit firms monitor and consider “the potential effects of the auditor’s existing business and service relationships with other companies on the auditor’s ability to remain independent of the issuer if a contemplated transaction is consummated.”



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In order to assess potential conflicts, the Statement highlights that 17 C.F.R. 210.2-01(b), generally referred to as “Rule 2-01(b),” provides guiding principles to determine whether there is sufficient independence when conducting an audit.

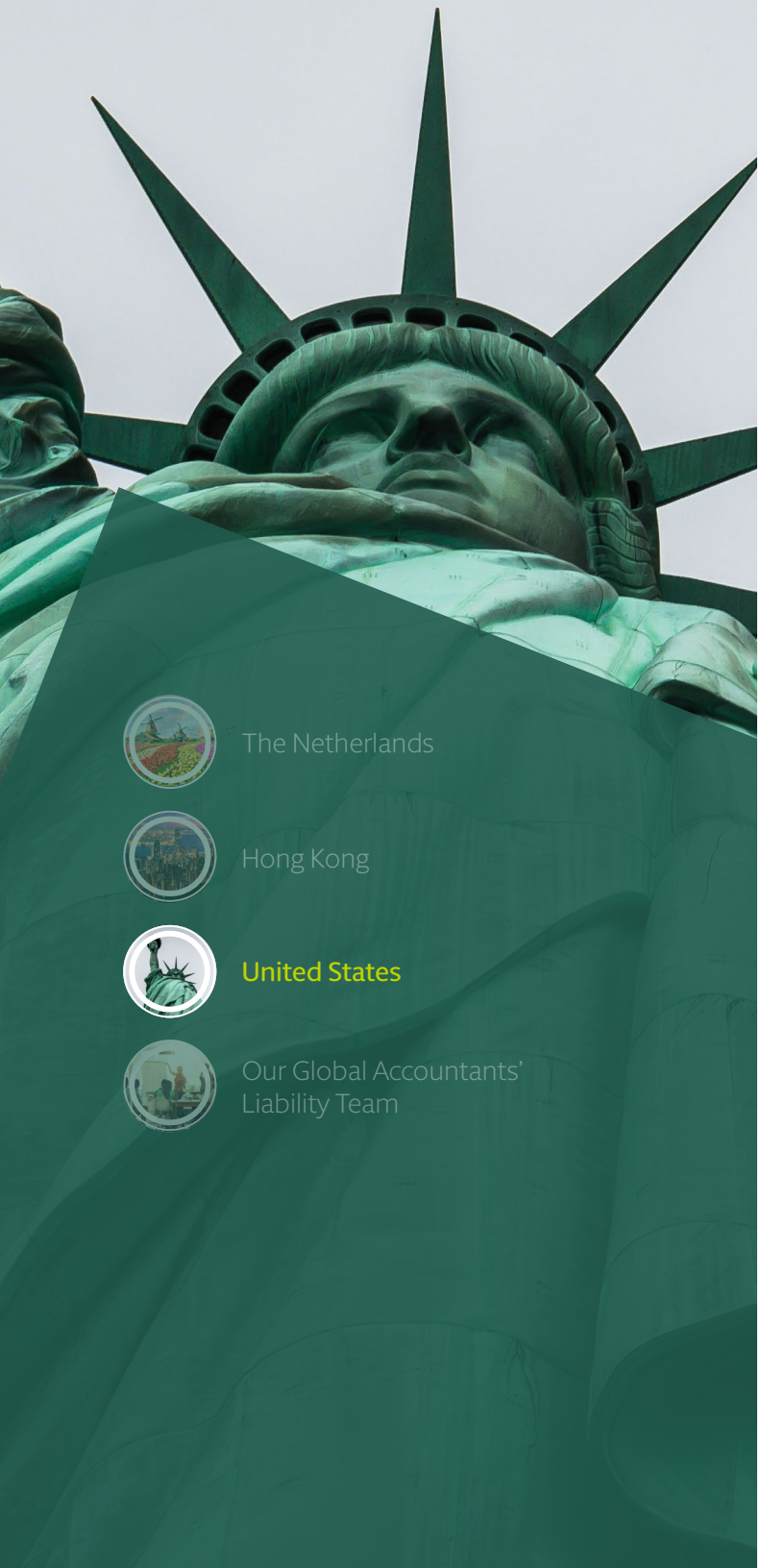
In full, the SEC’s regulations, promulgated as Rule 2-01(b), provide:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

Under that rule, Munter says, if an accountant had “provided services in any of the period included in the filing that is contrary to any one of these guiding principles,” it would be unlikely that that accountant would be found to be independent.

Second, Munter specifically emphasizes that audit committees play an important role in ensuring auditors’ independence. “Effective oversight by strong, active, knowledgeable and independent audit committees significantly furthers the collective goal of providing high quality, reliable financial information to investors.” One of the primary functions of audit committees is to provide a “forum” in which accountants may raise potential issues raised by any individual audit or conflict.

Finally, Munter concluded that the independence of auditors is of extreme importance because investors benefit from the availability of “high quality financial information when making capital allocation decisions.” And thus, given the SEC’s role in promoting independence, Munter seeks to promote an independent ecosystem for all involved.



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SEC adopts rule clearing a path to banning foreign companies from U.S. exchanges

On November 5, 2021, the Securities and Exchange Commission (the SEC) **approved a rule** aimed at implementing a law banning foreign companies from U.S. exchanges if their auditors have not been inspected by U.S. regulators.

The rule puts into effect a framework adopted in September by the Public Company Accounting Oversight Board (the PCAOB), as summarized in the **October 2021 Global Accountants' Liability Update**. The Board plans to use the framework to decide whether it is able to inspect or investigate auditing firms in jurisdictions such as China and Hong Kong. The SEC, which oversees the PCAOB, could then require disclosures from companies audited by those firms or take other actions, such as banning the companies from trading their securities on U.S. exchanges.

The rule implements requirements of a law signed by former President Trump in December 2020 that would prohibit certain foreign businesses from trading on U.S. exchanges. The law applies to companies whose auditors have not been inspected by U.S. regulators for three consecutive years.

SEC Chair Gary Gensler issued a **statement** that emphasized the importance of the finalized rules in allowing “investors to easily identify registrants whose auditing firms are located in a foreign jurisdiction that the PCAOB cannot completely inspect.” Gensler noted that the SEC and PCAOB “will continue to work together to ensure that the auditors of foreign companies accessing U.S. capital markets play by our rules.”

The PCAOB, which inspects non-U.S. audit firms in around 40 other jurisdictions, cannot review audit documents in China without approval from the Chinese government, which has consistently refused to allow foreign regulators to inspect audits of companies based in China. Accounting scandals in recent years at China-based companies, such as Luckin Coffee Inc., have drawn attention to the gap in audit inspections at these companies compared with other publicly traded companies in the U.S.

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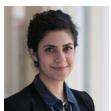
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