Our Global Accountants' Liability Update

October 2019

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Welcome

Hogan Lovells' global team of securities and professional liability lawyers 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, Mexico, Spain, Hong Kong, and the United States, which are summarized in the pages that follow.

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Recent court
decisions

The Netherlands

Breach of an accountant's duty of care does not always lead to civil liability

In the period of 2001-2002, two accountants drafted a company's financial statements at the request of the owner who intended to sell the shares in the company. When drafting the financial statements, the accountants made several significant mistakes. For example, the accountants attributed the company's turnover to the wrong year. As a result, on 4 January 2011 the Dutch Trade and Industry Appeals Tribunal (College van Beroep voor het bedrijfsleven, CBb) found the two accountants had grossly neglected their duty of care. Thereupon the CBb issued an official reprimand.

In the meantime, the company was sold and the initial purchasers subsequently transferred a third of the company shares to a group of investors. When the CBb issued its decision, the initial purchasers and the investors initiated civil proceedings against the accountants seeking over € 4,000,000 in damages.

Judgment in first instance

In 2015, the court of first instance dismissed the claims reasoning that the purchasers did not rely on the financial statements when they decided to acquire the company but rather decided to buy the shares before the financial statements were produced.

The investors appealed this decision arguing that even if the court were correct with regard to the initial purchaser, the court's reasoning should not extend to the investors because the financial statements were drawn up before the investors decided to enter into the transaction to acquire a third of the shares in the company. Thus the investors argued they had relied on the legitimacy of the company's financial statements produced by the defendant accountants and were entitled to compensation.

Judgement on appeal

The Court of Appeal of Arnhem and Leeuwarden (the Court of Appeal) began its analysis by confirming the reprimand issued by the CBb could lead to civil liability for the reprimanded accountants. With regard to such civil liability, the Court of Appeal distinguished liability arising from "statutory obligations" from that arising from "non-statutory obligations." In the case of statutory obligations – for example auditing the financial statements – third parties (such as the investors) should be able to rely on the legitimacy of the accountants' reports. For non-statutory obligations – such as drawing up the financial statements in the present case – the accountants typically only have a duty of care to their client.

However, with regard to non-statutory obligations, the Court of Appeal ruled that under special circumstances accountants must take the interests of third parties into consideration as well. This could be the case if the accountant knows or should know that a third party will rely on an accountant's report to decide whether or not to enter a transaction. In such instances, an accountant who grossly neglects his or her duty of care can be liable for damage suffered by a third party.

In the present case, the Court of Appeal also rejected the investors' claim. According to the Court of Appeal, the two accountants did not have to consider the possibility that the initial purchasers would subsequently transfer a third of the shares in the company to the investors and that therefore the investors would rely on the financial statements because the accountants were not aware of the future transaction with the investors when they handed over financial statements to their client, the owner of the company.

Conclusion

In principle, accountants only have a duty of care towards third parties for statutory obligations, not for non-statutory obligations. However, if an accountant was or should have been aware that a third party might rely on an accountant's report to decide whether or not to enter a transaction, the accountant must take the interests of the third party into account as well. In such circumstances, a breach in the duty of care towards third parties could potentially lead to civil liability.

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Mexico

Unconstitutionality of article 64 of the Supervision Regulations of the National Banking and Securities Commission

The Federal Collegiate Court in Administrative Matters has declared for the first time that article 64 of the Supervision Regulations of the National Banking and Securities Commission (CNBV) is unconstitutional. This is a very important precedent because this article provides the foundation for the CNBV's powers to sanction external auditors (as individuals) and accounting firms that perform audit services for clients in the financial sector.

The court reasoned that article 64 violates the constitutional legal certainty and due process requirements because it does not provide a reasonable timeframe in which the CNBV must impose any sanction. Absent a reasonable term limit for sanctions, article 64 allows the CNBV to indefinitely extend the duration of the "Sanction Imposition Procedure."

The case arrived before the Federal Collegiate Court after the CNBV appealed a ruling issued by the recently created Specialized Chamber in Regulatory Matters of the Administrative Court. The administrative court's ruling was issued in the course of a nullity trial advanced by Hogan Lovells on behalf of an accounting firm that was sanctioned by the CNBV for alleged shortcomings in auditing the financial statements of a financial institution. Exercising its authority to review constitutional questions when a plaintiff proves a violation of constitutional rights, the administrative court declared article 64 unconstitutional.

This holding, now affirmed by the CNBV, provides a new tool that accounting firms and external auditors may employ to protect their rights when the CNBV imposes a sanction.

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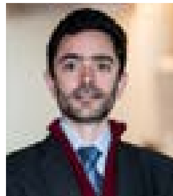

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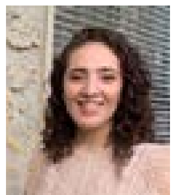

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Spain

Bankia's IPO trial: the public prosecutor considers Deloitte a "necessary cooperator" and sees deficiencies in the work of the Bank of Spain

The trial related to Bankia's initial public offering is currently taking place before the Criminal Court of the National High Court. During the trial, the Public Prosecutor asserts that Bankia's directors and officers are ultimately responsible for the wrongdoing at issue in the trial because they decided to integrate the seven savings banks, and drafted the prospectus that led to the public listing of the integrated entity. The Public Prosecutor also asserts that Deloitte was a "necessary cooperator" in Bankia's IPO. According to Spanish law, a necessary cooperator is one who cooperates in the execution of a criminal offence by performing an act without which the offense would not have been committed and, therefore, its contribution is considered essential.

In this case, the fact that the accounts and the brochures were backed "without reservations" by Deloitte led both the CNMV (the Spanish National Securities Market Commission) and the Bank of Spain to rely on Deloitte's financial statements. The Public Prosecutor therefore asserts that Deloitte is responsible for creating false confidence in the bank's records despite knowing its true financial situation after auditing the business as a whole.

As for the performance of the Bank of Spain, the Public Prosecutor asserts that the central bank cannot be responsible as long as it did not intervene in the IPO decision despite a series of administrative deficiencies relating to the verification of the institution's own resources and the cost of early retirements as a result of the integration of the seven savings banks that were merged into Bankia.

The trial ended October 2, 2019 and the National High Court is expected to issue a ruling on the matter in the coming months.

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Recent regulatory and enforcement developments

Hong Kong

Financial Reporting Council (Amendment) Ordinance 2019 now in effect

Effective from 1 October 2019, regulatory powers over auditors of listed companies transferred from the self-regulating Hong Kong Institute of Certified Public Accountants (HKICPA) to the independent Financial Reporting Council (FRC). Under its new remit, the FRC is vested with direct powers of inspection, investigation, as well as discipline concerning auditors of listed entities. Former FRC Chairman, Dr. John Poon BBS JP recently explained:

> "The introduction of this legislation is in the best interest of the investing public. This much awaited reform for auditors of publicly listed entities, i.e. from self-regulation to independent oversight, will bring Hong Kong's auditor regulatory regime in line with other major capital markets worldwide, such as New York and London."

The FRC was established in 2006 and its remit has historically been narrow compared to that of similar regulators in other jurisdictions. The new ordinance will enable the FRC to become a member of the International Forum of Independent Audit Regulators and will enable Hong Kong to meet the "adequacy" requirements of the European Commission. While all regulatory powers will pass to the FRC in respect of auditors of listed companies, the HKICPA will continue to be responsible for registration, training, auditing and maintaining professional ethics, albeit under the supervision of the FRC.

The transition to independent regulation of auditors has been met with widespread approval, but key stakeholders have expressed concern that the FRC may struggle to fulfill its enlarged responsibilities with a limited budget, which in 2019 was only HK$34 million (US$4.3 million) and with a limited headcount, numbering just 22 as of 2016. While the FRC's budget is set to treble to HK$90 million (US$11 million), it remains small compared to that of the Insurance Authority, which has a budget of HK$650 million (US$83 million) and a projected staff of 300 staff, and the Securities and Futures Commission, which has a budget of HK$400 million (US$51 million) and a staff of 860.

Stock Exchange consults on principles relating to IPO waivers

The Hong Kong Stock Exchange (HKEx) has concluded a consultation into "Codification of General Waivers and Principles Relating to IPOs and Listed Issuers and Minor Rule Amendments" regarding a significant number of General Waivers it has granted over the last few years with the consent of the SFC. As part of its ongoing effort to streamline the listing process, HKEx proposes to codify these General Waivers and some general principles into the Main Board Rules. The consultation concluded on Friday 27 September 2019.

FRC publishes four investigation reports in September

The FRC has published the results of investigation reports into the audits of consolidated financial statements of four listed entities. In each case, the FRC found that the auditor, engagement partner and engagement quality control reviewer failed or neglected to observe, maintain or otherwise apply certain professional standards in the relevant audits. In one case, the failure concerned the impairment assessment of the exploration and evaluation assets and the intangible assets relating to the drilling, exploration and production of oil and/or natural gas. All four reports have been reported to the HKICPA to determine if disciplinary actions are warranted.

HKEx Listing Committee censures listed company for misleading financial disclosures

In September 2019, the HKEX censured a dual listed company for breaching Listing Rule (LR) 2.13(2), which requires information contained in any announcement or corporate communication to be accurate and complete in all material aspects, and not misleading or deceptive. In particular, the HKEx found that the company's financial information disclosed in 2015 and 2016 was not only misleading but deceptive, as the discrepancies between the disclosed amount and actual amount were significant.

Several directors and supervisors of the Company were criticized and / or censured for approving the 2015 and 2016 disclosures in circumstances where the HKEx determined they either knew, or should have known, that information disclosed to the market was incorrect; and for failing to ensure that the Company had put into place an effective audit and internal control system for the purposes of compliance with LR 2.13(2).

Separately, the China Securities Regulatory Commission found the above parties to be in breach of the PRC Securities Law by reason of the false records.

The Listing Committee concluded that the breaches were serious due to the magnitude of misleading financial information provided over a prolonged period and the likely damage to the integrity of the market. The Committee ordered the company to appoint an independent compliance adviser who will provide ongoing consultation for two years. The directors were also required to attend training on financial reporting obligations.

Disciplinary action against certified public accountant

On 14 August 2019, the Disciplinary Committee of the HKICPA reprimanded a certified public accountant (practicing) for his failure or neglect to observe, maintain or otherwise apply professional standards issued by the HKCIPA in relation to the audit of a listed company.

In particular, the Disciplinary Committee found the accountant failed to properly evaluate and account for a transaction through which a customer settled payment by interest-free installments over ten years and that the non-compliance affected the opening balances and comparative information in the 2014 financial statements. The accountant also failed to appoint an engagement quality control reviewer for the audit. Because the accountant had previously been subject to regulatory proceedings on two occasions, the Disciplinary Committee considered it necessary to impose sufficient sanctions as a deterrent. He was ordered to pay a penalty of HK$100,000 and costs of the FRC.

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United States

Ex-KMPG employee sentenced to 8 months in prison for role in PCAOB inspection plan theft

On 9 August 2019, a federal judge in the U.S. District Court for the Southern District of New York sentenced a former KPMG accountant to eight months in prison for disclosing confidential inspection plans from the PCAOB to KPMG executives.

The former accountant, Cynthia Holder, worked briefly as an FBI agent before working as an accountant for the PCAOB. She moved to KPMG in 2015 and was arrested along with two other former PCAOB employees and accused of providing stolen PCAOB information to KPMG executives, including the then: (1) national managing partner for audit quality and professional practice; (2) the national partner in charge of inspections; (3) the firm's banking and capital markets group co-leader.

Holder pled guilty in October 2018. In issuing the sentence the Court noted that Holder did not benefit financially from the scheme. Instead, the motive for the illegal conduct, according to prosecutors, was to enable KPMG to improve its performance in PCAOB inspections. The Court sentenced Holder to eight months in prison and denied the government's request for a longer term, in the range of four years. In addition to jail time, Holder will also have to pay restitution in an amount to be determined.

In June, the U.S. Securities and Exchange Commission (SEC) fined KPMG $50 million for its role in the alleged scheme.

SEC enters order against PwC regarding violations of auditor independence rules

On September 23, 2019, the SEC entered an Order, pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the SEC's rules of practice, against PricewaterhouseCoopers LLP (PwC), concerning alleged improper professional conduct committed by the firm in connection with nineteen different engagements for fifteen SEC-registrant issuers (the Order). The allegations concern violations of auditor independence rules, including PCAOB Rule 3525.

During the relevant period, PwC served as the independent accountant for the fifteen SEC-registrant issuers. "Under the Commission's auditor independence rules, external accountants are required to be independent—in fact and in appearance—of their audit clients." Order ¶ 8. Rule 2-01(b) of Regulation S-X sets forth a general standard of independence and Rule 2-01(c) of Regulation S-X contains a "non-exclusive list of circumstances, including certain relationships, that are inconsistent with the general standard in Rule 2-01(b), including where the auditors provide certain specified non-audit services to their audit clients." Id. "Subject to certain enumerated exceptions, independent auditors are prohibited from engaging in the design or implementation of systems that are significant to the audit client's financial statements or other financial information systems taken as a whole, to perform any internal audit service related to the internal control over financial reporting, or to perform management functions for audit clients." Id.

In 2014, PwC performed non-audit services relating to the design and/or implementation of software for a SEC-registrant issuer (Issuer A). First, PwC implemented and designed a Governance Risk and Compliance (GRC) software program for Issuer A. "GRC systems are used by companies to coordinate and to monitor controls over financial reporting, including employee access to critical financial functions. Issuer A intended to use the GRC software to generate information as part of the company's control environment and to provide data to assist personnel in forming conclusions regarding the effectiveness of internal controls related to financial information systems." Id. ¶ 9. PwC oversaw the implementation of the project, performed substantial design work, "configured the design on a non-production server, and provided oversight and direction for the implementation to a live environment." Id. ¶ 21. In addition, PwC had decision-making authority over Issuer A's own internal personnel "in designing and configuring the GRC module."

Though the GRC was not utilized in connection with the preparation of Issuer A's 2014 financial statements, the SEC concluded that PwC's implementation of the software system triggered independence issues as the firm "audit[ed] Issuer A's financial statements and internal control over financial reporting for fiscal year 2014." Id. ¶ 14. In addition, the partner who negotiated and oversaw the GRC project, "also participated in PwC's audit of Issuer A as an information technology specialist on the audit engagement team." Id.

Second, PwC provided services related to Issuer A's upgrade of its enterprise software and related programs (the EProgram). "Companies use enterprise software to manage their overall businesses, including a wide array of day-to-day activities such as accounting, procurement, and manufacturing. PwC performed services on the [EProgram] project with Issuer A's Internal Audit group." Id.¶ 26. Among other things, PwC developed audit work programs used by Issuer A's internal auditors for their fiscal year 2015 internal audit of the EProgram and other software programs and "provided its proprietary frameworks on settings and configurations to Issuer A."

In addition, the SEC found that PwC had failed to comply with PCAOB Rule 3525. "PCAOB Rule 3525 provides that, in seeking audit committee pre-approval to perform non-audit services for an audit client related to internal control over financial reporting, an auditor must describe in writing to the audit committee the scope of the work, discuss with the audit committee the potential effects of the work on independence, and document the substance of the independence discussion." Id. ¶ 43. From 2013 through 2016, PwC failed to meet these requirements. On numerous engagements—including in connection with the work for Issuer A described above—PwC described non-audit services as audit work and failed to disclose to the audit committees for fifteen issuers "the scope of the services and the implications of performing the work on PwC's independence." This, in turn, deprived the internal audit committees of the various issuer entities of "their responsibilities to evaluate fully the provision of non-audit services, and to assess the potential effect of those services on auditor independence." Id. ¶ 45.

PwC entered into a settlement agreement with the SEC related to the Order. Pursuant to the settlement, PwC agreed to, among other things: (1) undertake certain actions, including the implementation of new internal policies; and (2) pay disgorgement of $3,830,213, plus prejudgment interest of $613,842, and a civil money penalty in the amount of $3,500,000.

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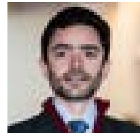

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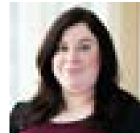

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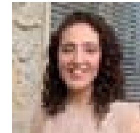

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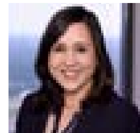

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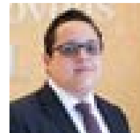

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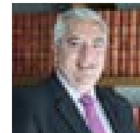

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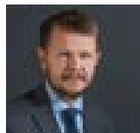

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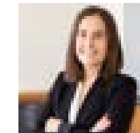

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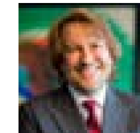

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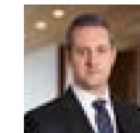

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