Our Global Accountants' Liability Update

August 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 Germany, The Netherlands, Spain, and Hong Kong, which are summarized in the pages that follow.

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Recent court decisions

Germany

German court clarifies standards for accountants' liability for statements made in an investment prospectus

In recent years – in particular in the aftermath of the financial crisis of 2007 – investors in German funds have increasingly sought compensation for failed investments. Such claims often assert that the prospectus advertising the investment contained false or misleading information that concealed certain risks of the investment. These claims typically name not only the issuer of the prospectus as a defendant but also its accountants. The German Federal Court of Justice recently clarified the circumstances under which accountants may be held liable in these cases (decision of 21 November 2018, docket no: VII ZR 232/17).

This decision is related to an investment made in 2013. The claimant had granted a German partnership limited by shares [Kommanditgesellschaft auf Aktien, ("Investment Entity")] a subordinated loan in the amount of € 10,000. In 2014 the Investment Entity became insolvent and the claimant lost his entire investment. He subsequently sued the Investment Entity's accountant alleging that the accountant had breached his duties by certifying the Investment Entity's annual financial statements were accurate, when in fact they were not. The accountant's confirmation that the financial statements were accurate was incorporated into the prospectus advertising the investment. The claimant alleged he had therefore relied on the audited annual financial statements and sued the accountant in order to recover his financial loss. The German Federal Court of Justice dismissed the claim.

In its decision, the court first analysed whether the accountant was liable under the provisions of the German Civil Code (Sec. 311). The court held that accountants may not be held liable for statements made in a prospectus if they merely audited the annual financial statements even if the audited annual financial statements were re-printed in the prospectus. This is because in such cases the accountant's audit did not create sufficient trust on part of the investor in relation to the investment advertised in the prospectus (as opposed to the level of trust created by, e.g., the issuer of a prospectus, the management or other persons who were substantially responsible for its content). Accountants can only be held liable if they issue statements that specifically relate to the investment and that were made specifically in order to be published in the prospectus.

Even though the case does not interpret several new statutes including the Capital Investment Code [Kapitalanlagegesetzbuch] and Securities Prospectus Act [Wertpapierprospektgesetz] that have recently come into force and specifically regulate liability in relation to investment prospects, it remains relevant. This is because the new statues do not address accountants' liability, which is therefore still controlled by Sec. German Civil Code (Sec. 311). Consequently, it is important that accountants take note of this decision's guidance about when accountants can be liable for statements in a prospectus.

The German Federal Court of Justice also held that the accountant was not liable pursuant to the German law principles of contracts for the benefit of third parties [Vertrag mit Schutzwirkung zugunsten Dritter]. This is because it is the prevailing view among German courts that Sec. 323 German Commercial Code [Handelsgesetzbuch] generally bars third parties (i.e. parties other than the entity for which the annual statement has been issued) from bringing claims based on an audit of annual financial statements according to the German GAAP [Handelsgesetzbuch, HGB]. However, one question which is particularly relevant in cross-border cases has not yet been decided by the higher German courts: Can third parties be entitled to damages in relation to financial statements drawn up according to the International Financial Reporting Standards? Some German legal scholars have taken the view that this should be the case. The German courts have not yet decided this question. Consequently, it is advisable for accountants to closely monitor how the German case law will evolve on this point.

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The Netherlands

No breach of duty of care for EY and PwC for the misconduct of their external accountants

On 18 June 2019 the Dutch Trade and Industry Appeals Tribunal (College van Beroep voor het bedrijfsleven, CBb) – the highest court for social-economic administrative law in the Netherlands – ruled that EY and PwC did not breach their duty of care with regard to the misconduct performed by some of their external accountants. Several external accountants (which are defined as accountants that either work for the accounting firms or are associated with the accounting firm) had improperly granted a certificate of approval relating to the financial statements of their clients. The question before the court was whether EY and PWC (as the accounting firms at hand) had breached their duty of care because of that misconduct.

According to the Dutch national supervisory authority (Autoriteit Financiële Markten, AFM), if the external accountants had performed better research, they would have discovered that some material assets were missing in the financial statements. After initiating investigations in April 2013, the AFM concluded with respect to the work performed by the external accountants of EY that three out of ten reviewed financial statements were improperly approved. For the external accountants of PwC the AFM concluded the same in four out of 10 cases.

Based on its conclusion, the AFM imposed a fine of € 2,230,000 upon EY and a fine of € 845,000 upon PwC. EY and PWC challenged the fines in proceedings before the District Court of Rotterdam. That Court annulled the fines and ruled that the AFM had failed to establish that the nature, gravity and the quantity of the inadequate auditing procedures would leave no space for any other conclusion than that EY and PwC had breached their duty of care. Subsequently, the AFM appealed before the CBb.

Subject of appeal

Article 14 of the Dutch Audit Firms Supervision Act stipulates that audit firms are not only responsible for their own practice, but also for the practices of external accountants who are associated with them. The subject matter of the appeal was whether the AFM had rightly sanctioned EY and PWC after finding that external accountants associated with those firms had breached their duty of care by failing to conduct adequate research and subsequently inappropriately approving the financial statements in question.

The District Court of Rotterdam had concluded that a finding that the certificates of approval were improperly issued was alone sufficient to support a conclusion that the supervising audit firm breached its duty of care. The CBb disagreed.

Judgment

The CBb started its analysis by asserting that both the accounting firms and the external accountants linked to or associated with the accounting firms have their own responsibilities. The accounting firms are responsible for quality control, the expertise and integrity of the audit practice; the external accountants carry out this practice. In addition to these responsibilities, article 14 of the Dutch Audit Firms Supervision Act stipulates a duty of care for accounting firms to guarantee that the external accountants perform adequately. In order to comply with this duty of care, the accounting firms have to establish conditions their external accountants must comply with. Furthermore, if an external accountant fails to comply with such conditions, the accounting firm must take all measures necessary to ensure the quality of the accounting practice.

The CBb ruled that in order to conclude that the accounting firms failed to ensure the quality of the accounting practice, the discovered shortcomings of the external accountants must have their origins in the acts or omissions by the accounting firms. The ACM's supervision should therefore be mainly focussed on the system of quality control that is established by the accounting firms. Thus, any misconduct of an external accountant is only one factor in such an analysis.

Applying this reasoning, the CBb held that the fact that external accountants associated with the accounting firms failed to properly perform audits and, as a result, improperly approved financial statements, was an insufficient basis for a fine. Moreover, the CBb noted that it was hardly imaginable that a fine could be legitimately imposed when the improper approval by the external accountant could not be traced back to the accounting firm's practice. Thus, accounting firms are not strictly liable for an external accountant's conduct.

Conclusion

Accounting firms and the external accountants linked to or associated with such accounting firms have their own responsibilities. The sole fact that an external accountant associated with an accounting firm fails to properly perform an audit and improperly approves the financial statements of a client, doesn't automatically mean that the accounting firm has thus breached its duty of care.

Even though accounting firms are not strictly liable for the conduct of their external accountants, pursuant to Dutch law they do have a duty of care to implement an appropriate quality control system. Where the supervisory authority can prove that the misconduct of external accountants can be traced to flaws in an accounting firm's quality control system, the firm can be fined. It is therefore important that firms establish an appropriate quality control system and take reasonable steps to ensure such conditions are enforced.

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Spain

The Spanish Supreme Court affirms the highest fine ever imposed: PwC's breaches in Aena's audit

The National High Court (the Spanish Audiencia Nacional) recently affirmed a €10.5 million fine that was originally imposed by the Institute of Accounting and Audit of Accounts (known as ICAC in Spanish) against PwC in 2016. The fine followed a finding of "very serious infringements" related to services PwC provided to Aena – the partially-owned-by-the-State company that manages airports in Spain.

This fine was the highest ever imposed in Spain on an audit firm and was in response to a finding that PwC failed to comply with its duty of independence since, in addition to auditing Aena's accounts in 2015, the year of its listing, it also provided advisory services. The firm appealed the sanction but on 21 June 2019 the Supreme Court dismissed the appeal stating that the regulation has been correctly applied and that the audit firm did not have sufficient grounds for its appeal.

A spokesperson for PwC has stated that the firm will continue to appeal the case to the Spanish Constitutional Court.

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Recent regulatory
and enforcement
developments

Hong Kong

New Memorandum of Understanding between Hong Kong and PRC Mainland regulators

On 3 July 2019, Hong Kong's Securities and Futures Commission (SFC) signed a joint memorandum of understanding (MOU) with the Ministry of Finance of the People's Republic of China (MOF) and the China Securities Regulatory Commission (CSRC).

The arrangement will facilitate the SFC's access to working papers produced by Hong Kong accounting firms while auditing Hong Kong-listed Mainland companies and which are kept in the PRC Mainland. This cooperation will take effect when the SFC conducts investigations into PRC Mainland-based listed companies or related persons.

Financial Reporting Council completes two investigations into listed company audits

On 8 July 2019, the Financial Reporting Council (FRC) released the results of two investigations relating to the audit of two listed companies' consolidated financial statements for the years ending in 31 December 2014 and 31 December 2015 respectively.

In both cases, the FRC concluded that the auditor, the engagement partner and the engagement quality control reviewer neglected to observe, maintain or otherwise apply certain professional standards in the relevant audits.

The FRC referred the findings of both investigations to the Hong Kong Institute of Public Accountants to determine whether disciplinary actions are warranted.

Company put in third stage of delisting after failing to address audit issues

On 4 July 2019 the Hong Kong Stock Exchange (HKEX) placed a company into the third delisting stage after it failed to comply with the requirement to maintain sufficient operations or assets under Listing Rule 13.24 and to undertake a forensic investigation into its accounts.

In April and May 2015, the company announced its auditors discovered bank balance discrepancies of RMB 374 million in two of its PRC Mainland subsidiaries. The subsidiaries subsequently ceased operations. As a result, the company was placed in the first delisting stage on 25 November 2016, and subsequently the second stage on 14 November

2018, which expired on 14 May 2019. If no viable resumption proposal is produced by the end of the third stage on 3 January 2020, the company's listing will be cancelled.

Listed company directors censured for inadequate disclosure

In June 2019, the HKEX censured and sanctioned the directors of a listed company for violating Listing Rule 13.49 (among others), which requires that auditors must approve financial statements before they are included in the preliminary announcement of annual results.

Specifically, the company published its 2016 preliminary results on 2 April 2017, before its newly appointed auditors could complete their review, the previous auditors having resigned the month before.

The HKEX said the directors' conduct raised questions about their attitude towards the company's financial reporting obligations and had damaged, or had the potential to damage, the integrity of the market. In addition to being censured, the directors were directed to attend compliance training.

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Spain

Deloitte and a partner of the firm sanctioned by Spanish supervisory authority

The ICAC has sanctioned the auditing firm Deloitte and one of its partners for failing to meet audit standards in relation to auditing Abengoa, one of the biggest engineering groups in Spain, which is currently in bankruptcy. The ICAC imposed a fine of € 1.48 million on the firm and € 8,700 on the partner and disqualified both Deloitte and the partner from auditing Abengoa for the next three years.

The conduct that prompted the fines related to the absence of sufficient documentary evidence in working papers to support the conclusions in Deloitte's auditing reports, specifically in the area of financial debt and in the area of income from Abengoa's engineering and construction activity. According to the resolution issued by the Spanish ICAC, liability also extended to the partner who was the signatory of the audited Abengoa accounts.

Deloitte previously requested that the National High Court revoke the fine but that request has been dismissed. Deloitte has appealed that decision to the Spanish Supreme Court.

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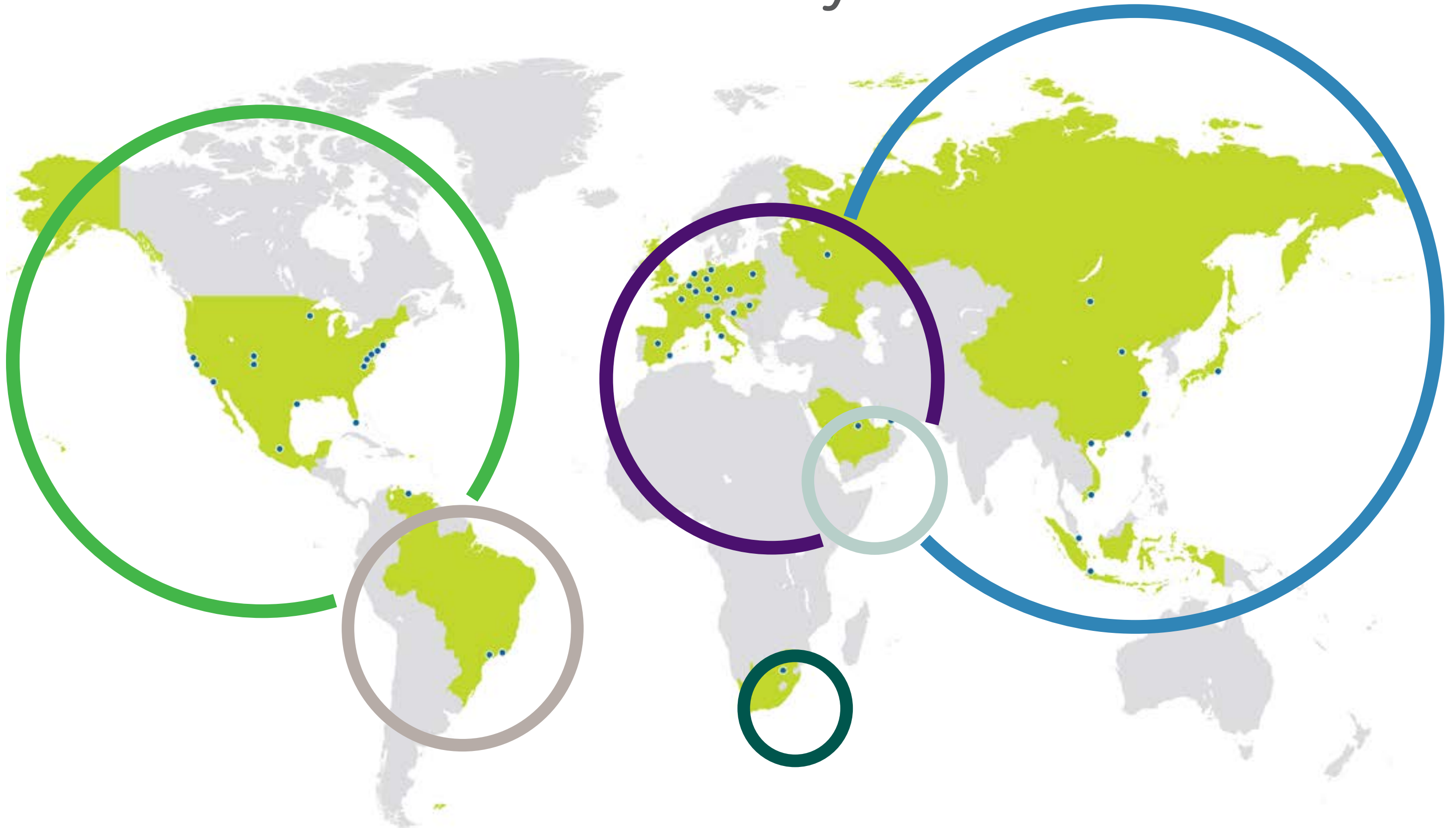

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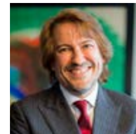

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