Hogan Lovells

Global Accountants' Liability Update

March and April 2017

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A legal practice
for a changing world

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. Our team recently researched legal and regulatory developments related to auditors' liability in England, Hong Kong, the Netherlands, Spain, and the United States. We have experienced lawyers in each of these jurisdictions 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. This month, our team identified developments of interest in England, Hong Kong, Italy, Spain, and the United States, which are summarized in the pages that follow.

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Recent Court Decisions

England

English Supreme Court rules on damages and accountants' duty to third parties

In the underlying litigation, the claimant (C), a lending company, made three loans to a borrower (B) relying on a due diligence report prepared by the defendant firm of accountants. After B failed to repay the loans, C claimed damages from the accountants for breach of contract in negligently preparing a due diligence report. Specifically, C alleged that the accountants had failed to report that there was a substantial adverse difference between B's actual and forecast working capital and that it would not have extended the loans to B had the due diligence report been accurate.

It was established at trial that the accountants were negligent in their report. However, by the time the Judge was due to assess the amount of damages payable by the accountants, B had repaid the first two loans, using money lent to it as part of a refinancing by H, an individual who owned and controlled C.

The accountants asserted that C's damages ought to be reduced to reflect the repayment of the two loans. C contented that the amount lent by H to B was a "collateral matter" and did not affect the amount of C's recoverable loss from the accountants. C also argued that if the loss was not recoverable by them, then it was recoverable by H on the basis that the accountants owed him a duty of care. Alternatively, C argued that the accountants had been unjustly enriched by H's provision of funds to B and thus H had a claim against the accountants. The trial court ruled that the refinancing was a "collateral matter," which did not affect the amount of damages recoverable from the accountants. The Court of Appeal agreed and the defendant accountants appealed to the Supreme Court.

The Supreme Court allowed the appeal by the accountants and reduced the amount of damages explaining that the loss arising from the first two loans had been made good when the loans had been repaid by B. The fact that the monies for repayment had come from H, the owner of C, was irrelevant. Credit for the repayment would still be given if the monies had been lent by an unrelated party. It was clear from the loan documentation that the money lent to B was not an indirect payment to C, even though that was ultimately where the monies had ended up. H's agreement to lend to B was a separate and distinct transaction from the C's loan to B. H's decision to lend money to B was not attributable to the defendant accountants' breach of duty. H made the new loan for commercial reasons and not to mitigate any loss which C was suffering.

The Supreme Court further held that the accountants did not owe H a duty of care - the losses arising out of the refinancing had nothing to do with their due diligence report. The accountants were not retained by H for any part of the refinancing transaction. The accountants had not been unjustly enriched at H's expense although it was correct that the accountants had benefitted from H's actions. H had made a fundamental mistake by assuming that his making of a new loan to B would not affect the claim which C had against the accountants. Nonetheless, H had got precisely what he bargained for in the transactions in question. His loan enabled B to repay C and H retained a right to recover the new loan from B. Whilst this came with a benefit for the defendant accountants, it was one which was wholly due to an oversight on H's part.

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Hong Kong

Hong Kong's highest court to review accountant disciplinary action

Hong Kong's highest Court is set to hear an appeal in a case addressing the standard for judicial review of professional disciplinary committee decisions. In our Sep/Oct 2016 edition, we reported that an appeal by accounting firm RSM Nelson Wheeler and partner Wong Tak Man Stephen, which challenged a decision of the Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants ("HKICPA") was dismissed. The Court of Appeal held that it should not interfere with the professional judgment of a disciplinary committee unless its conclusion was plainly wrong.

In a new development, on 27 April, RSM Nelson Wheeler and Mr. Wong successfully obtained leave to appeal to the Court of Final Appeal (Hong Kong's highest court). The appeal will be heard on 4 December 2017 and will consider the appropriate standard or review in cases involving the exercise of professional judgment. It will also address the construction of Hong Kong Accounting Standard 39, as it relates to an impairment adjustment made after a significant or prolonged decline in the fair value of an available-for-sale asset.

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The Netherlands

Obligation for disciplinary courts to impose disciplinary measures

Introduction

In March 2017 the Commission for Appeal for business and industry ("Commission for Appeal"), the highest disciplinary court for accountants in The Netherlands, addressed the discretion of a disciplinary court to forego disciplinary measures when a complaint against an auditor is well-founded. The Commission for Appeal issued two separate rulings.

Statutory background

Based on the Accountancy Profession Act the accountant is subjected to disciplinary proceedings in case of (i) actions or omissions by the accountant in breach of this Accountancy Profession Act and (ii) any other actions or omissions that are in breach with the correct execution of his profession.

In article 2 of the Accountancy Disciplinary Proceedings Act, the Dutch legislature sets out the sanctions that can be imposed by a disciplinary court. They include – in degrees of severity:

(a) official warning;
(b) reprimand;
(c) monetary fine;
(d) temporary deregistration of the accountant not exceeding three years; and
(e) deregistration of the accountant.

Discretion of disciplinary courts to impose sanctions

In general each individual case deserves its own legal assessment with due consideration of all interest involved. Thus, a disciplinary court has a certain degree of discretion to impose sanctions on a party.

The Commission for Appeal limited this discretion March 2017 ruling, which explained that article 2 of the Accountancy Disciplinary Proceedings Act requires a disciplinary court to impose a sanction if it finds that a complaint is well-founded. This act does not grant the disciplinary court discretion to forego all sanctions under these circumstances.

Thus, the Commission for Appeal held that in a case involving a well-founded complaint, disciplinary sanctions are in principle mandatory. The disciplinary court has discretion to forego sanctions only in cases in which there is insignificant culpability or the culpable act is of such insignificance that a disciplinary measure would not be appropriate.

In its ruling, the Commission for Appeal explains that disciplinary courts must consider the facts and circumstances and subsequently determine an appropriate disciplinary sanction. Only in exceptional cases, the disciplinary court is allowed to note that certain rules were in fact breached, but the lack of severity of the action or omission does not justify a sanction.

Conclusion

The explicit limitation of the discretion of disciplinary courts should result in the imposition of more disciplinary sanctions. However, a warning or reprimand, which is merely a notification to the accused accountant, is a sanction available to the disciplinary court. Thus, this decision may not materially change the disciplinary practice.

Increased imposition of sanctions may, however, impact civil proceedings that follow disciplinary actions against accountants. Although a disciplinary court's findings will not establish civil liability, it may nonetheless shape the civil litigation. Counsel representing accountants involved in disciplinary and subsequent civil proceedings should take care to adequately inform the civil courts of the meaning of the disciplinary ruling and the low-threshold that mandates sanctions in disciplinary actions.

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Spain

Bankia IPO's pre-trial phase concludes with indictment of former Managing Director of the IMF and 33 other senior positions - including top partner of Deloitte

The Spanish National Court has concluded its investigation of the merger and subsequent listing of Bankia and has issued a writ of transformation - equivalent to indictment - against 34 persons who were directors or advisers of Bankia and its parent company BFA in 2010 and 2011. The indictments relate to crimes stemming from falsities in Bankia's annual accounts and investor fraud.

The judge affirmed an earlier decision to indict the external auditor, a Deloitte partner, for his favourable reports on Bankia's financial statements but agreed with an acquittal of the Deloitte firm, as a legal person (although Deloitte may remain civilly liable). In the case of the Deloitte partner, the judge took into account two favourable reports in which he elaborated on Bankia's financial statements, during the months of the IPO. As for Deloitte, the judge found that the firm: (i) complied with the quality control system established in its Compliance Manual designed to prevent partners and employees from committing crimes; and (ii) according to law it is a limited liability partnership where its partners, as in this case, have full autonomy in relation to the firm.

The recent decision also indicates that no officials at the Bank of Spain or CNMV– Spain's stock market watchdog – will be prosecuted.

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The United States

PwC Settles with MF Global

In late March, PricewaterhouseCoopers LLP settled a $3 billion lawsuit with the administrator of the bankrupt MF Global Holdings Ltd, a futures and commodities brokerage once run by former New Jersey governor Jon Corzine. MF Global holdings alleged that errors by PwC, especially allowing MF Global to keep certain bonds off its balance sheet, played a major role in its 2011 collapse. In contrast, PwC argued that Corzine's management mistakes coupled with the downgrading of U.S. debt and growing instability in the market for peripheral Euro bonds caused MF Global's downfall.

The parties have not disclosed the amount of the settlement. In 2015, PwC reached a settlement with investors of MF Global for $65 million

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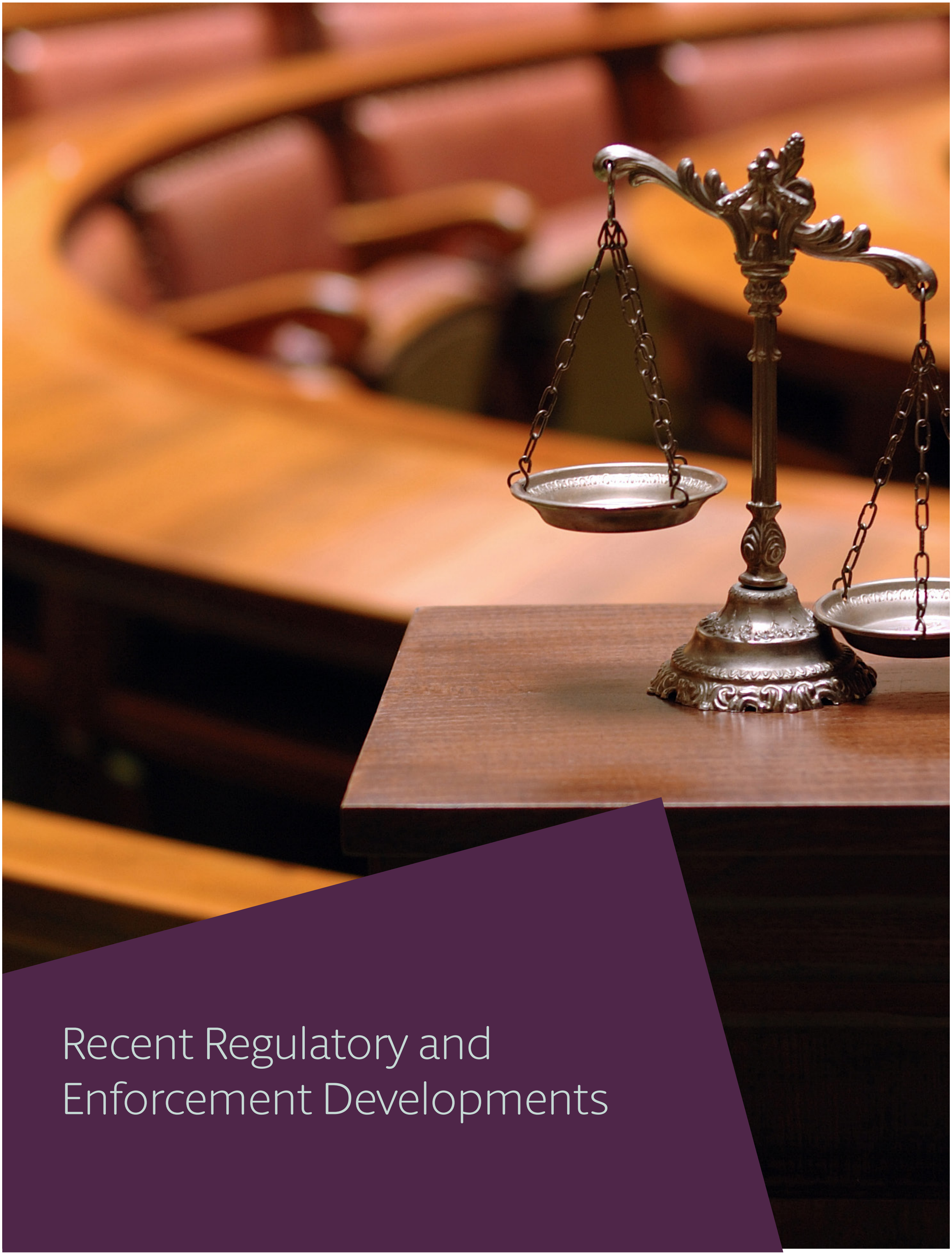

Recent Regulatory and Enforcement Developments

Hong Kong

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Anti-money laundering law to be extended to accountants

In April 2017, the government issued its consultation conclusions on its proposals to extend anti-money laundering and counter-terrorist financing ordinance (AMLO) customer due diligence (CDD) obligations and other relevant record-keeping requirements to accounting firms and other designated non-financial businesses and professions.

The AMLO was implemented in April 2012 and imposed a statutory obligation on specified financial institutions, including banks, securities firms, insurance companies, and others, to conduct CDD on their customers and keep the relevant records for a specified period. Non-compliance may subject institutions to supervisory and criminal sanctions.

The current proposal is to extend the AMLO to cover accountants, lawyers and others engaged in specified transactions. The intention is to build on existing regulatory regimes applicable to these sectors, including under the professional accountants ordinance (Cap. 50).

An amendment bill is expected to be introduced into the legislative council in July 2017. The Government's consultation conclusions can be found here.

Italy

Italy enhances continuing education requirment for auditors

As we have previously reported, Italy recently implemented Directive (EU) 2014/56/EU on statutory audits of annual accounts and consolidated accounts through Legislative Decree no. 135/2016, which amended existing Legislative Decree no. 39/2010.

Education

Article 5 of Legislative Decree no. 135/2016 as amended has strongly enhanced auditors' continuing education requirements. While the previous version imposed generic education duties upon auditors, the revised Article 5 provides a detailed set of rules that requires, among other things, that at least half of the professional training courses that auditors must attend address management of risks and internal control, domestic and international auditing standards, professional ethics, independence and techniques for professional auditing.

Training courses shall be delivered by the Ministry of Economy and Finance (MEF)) or by private or public entities authorized by MEF.

Auditors are requested to gain 60 training credits in a three-year period (20 per annum). Professional associations and auditing firms shall annually inform the MEF of the status of compliance with continuing education duties by their members and associates.

MEF shall verify fulfilment of such duties by auditors and possibly sanction non-compliant auditors. Article 24 of Legislative Decree no. 135/2016 authorizes sanctions ranging in severity from warnings to cancellation of the relevant auditor from the register of auditors.

Article 5-bis (newly introduced) of the Legislative Decree no. 135/2016 establishes that the MEF shall set by decree the requirements for authorization of private or public entities to deliver training courses to individuals performing quality assurance reviews, as well as the content and minimum standards of such courses.

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Spain

KPMG questioned in the so-called Operación Lezo

The role of KPMG has been questioned by parliamentary groups of the Assembly of the Community of Madrid, especially since Operación Lezo – an investigation of the illegal financing of a political party via diversion of funds from public entity Canal de Isabel II – led to imprisonment of the former president of the Community of Madrid. The network of subsidiaries that made up the Canal allegedly diverted tens of millions of euros to a political party and the parliamentary groups are seeking information concerning why the auditors did not detect this diversion.

A spokesperson from KPMG – which has audited the accounts of Canal since 2008 – asserted that their role was never to detect this type of allegedly illegal operations. Instead, they note that audit work has a different scope and purpose – to ensure the veracity of the accounts presented and that they are well accounted for. In addition, KPMG spokespersons have explained that their work was always done at market price and after winning public tenders managed by the Public Administration.

Nevertheless, on 10 May, the Assembly of Madrid requested a new citation of the two partners of the consultancy "in order to report on the so-called Operación Lezo (corruption case of the Canal de Isabel II)."

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The United States

PCAOB Disciplines Brazilian PwC Partner

On March 20, 2017, the Public Company Accounting Oversight Board (PCAOB) announced sanctions against a former partner of PricewaterhouseCoopers Auditores Independentes in Brazil for audit failures and violations of PCAOB rules and standards.

According to the settled disciplinary order, Wander Rodrigues Teles was the lead partner for PwC Brazil's 2010 and 2011 audit work on the Brazilian subsidiaries of Sara Lee Corporation. The PCAOB found that Teles failed to adequately respond to indications that Sara Lee's Brazilian subsidiary Sara Lee Cafés do Brasil Ltda may have overstated its accounts receivable.

In 2012, Sara Lee restated its 2010 and 2011 financial results, citing accounting irregularities in its Brazil operations, including the overstatement of accounts receivable. According to the PCAOB order, Teles knew that a material amount of Sara Lee Cafés' accounts receivable was overdue and disputed by customers. He also was aware that the subsidiary was extending the due dates of overdue receivables, which the PCAOB contended, indicated that Sara Lee Cafés may have overstated its accounts receivable.

The PCAOB found that Teles failed to adequately respond to these risks with appropriate due care and professional skepticism, and failed to obtain sufficient evidence to support his audit conclusions. "Faced with indications of possible material misstatements, the lead partner did not exercise appropriate professional skepticism," said Claudius B. Modesti, Director of PCAOB Enforcement and Investigations. "He repeatedly ignored information suggesting that the company's financial information was materially misstated." In the settled order, Teles was censured, fined $10,000, and barred for two years from associating with a registered public accounting firm.

The PCAOB has stated that audit integrity is an issue of global concern and that it is committed to "investigating and disciplining auditors who present risks to investors in the U.S. markets, regardless of where the audit is conducted." A few months earlier, in February, the PCAOB imposed a fine of $1 million on an Indonesian affiliate of Ernst & Young, alleging that the firm did not obtain sufficient audit evidence and for improperly producing new audit work papers in a subsequent investigation of the same audit.

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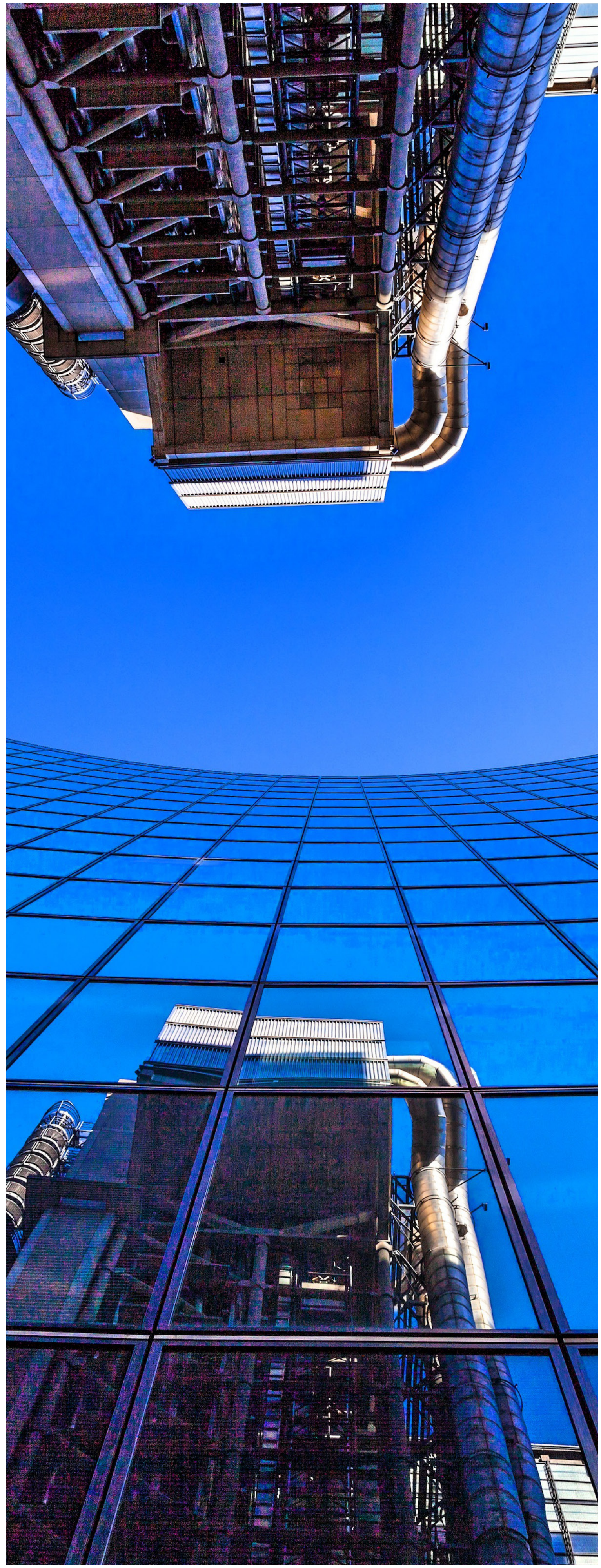
KPMG Fires Six Audit Employees for Breach of Ethical Conduct

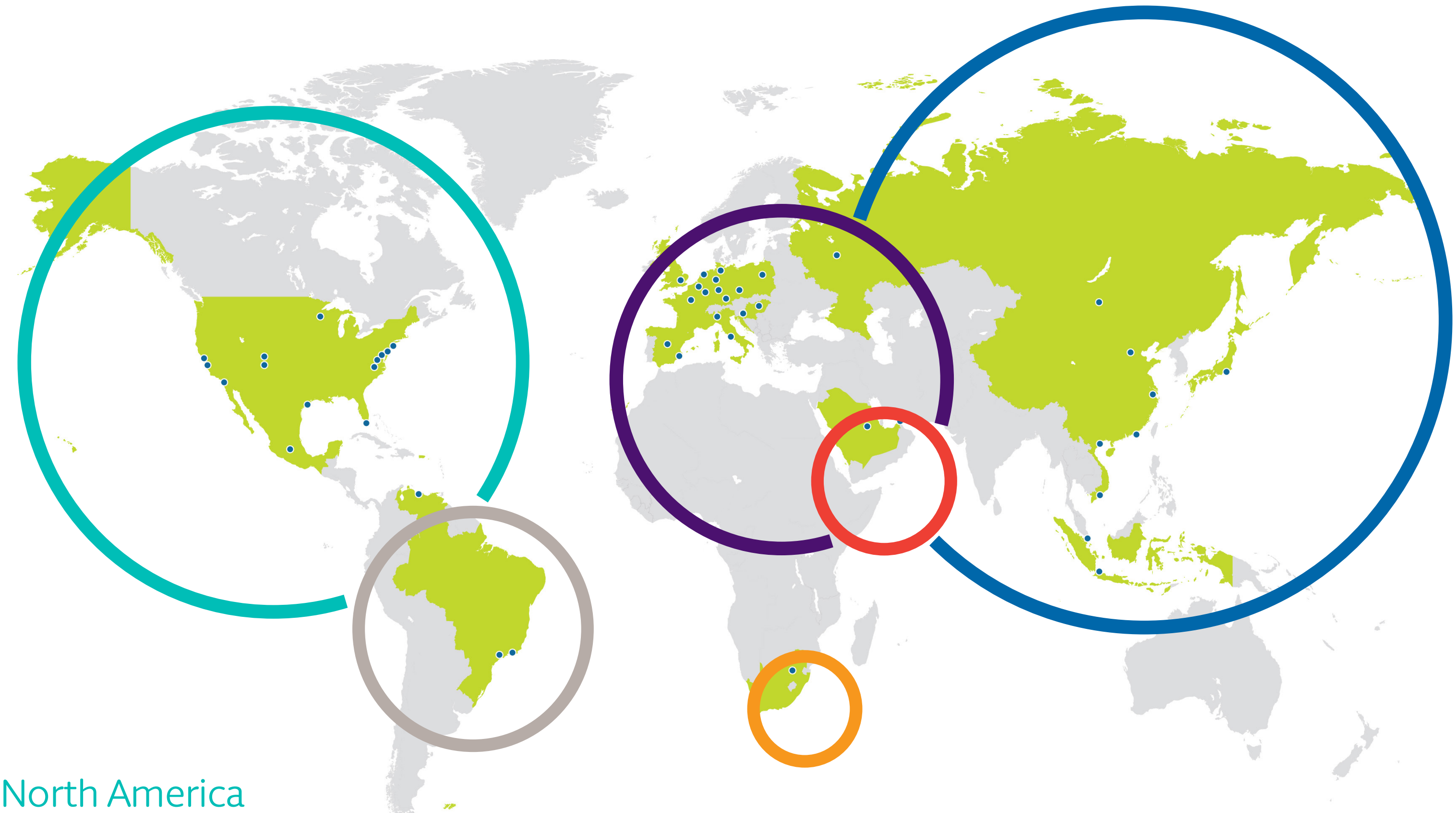
KPMG LLP terminated six people in its Audit practice in April in connection with findings that information was transmitted concerning planned audit inspections by the PCAOB, in violation of KPMG's Code of Conduct. Among those that were fired were five partners and one employee.

In a press release, KPMG said that an individual who had joined the firm from the PCAOB had received confidential information from an employee within the regulatory organization. The accounting firm was tipped off to the unethical behaviour by an internal whistleblower in late February and immediately alerted the SEC and PCAOB and retained outside counsel to begin an investigation. The external investigation revealed that the six people who were fired either had received advance notice of PCAOB inspections or were aware that others had received these warnings and failed to report it in a timely manner. KPMG Chairman and CEO, Lynne Doughtie, said, "KPMG has zero-tolerance for such unethical behavior . . . We are taking additional steps to ensure that such a situation should not happen again."

For its part, the PCAOB has blamed the leaks on a disgruntled employee who formerly worked for the accounting board. The organization has said that it has taken steps to "maintain and reinforce the integrity of the inspection process" since it discovered the leak.



Our Global Accountants' Liability Team



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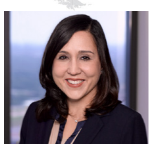

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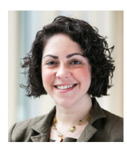

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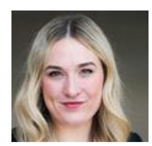

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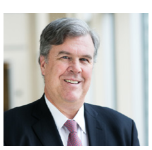

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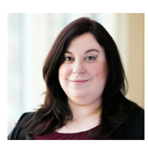

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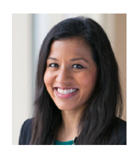

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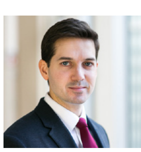

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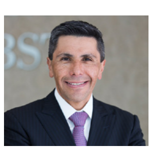

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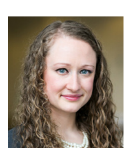

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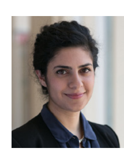

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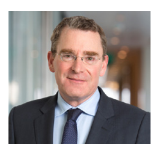

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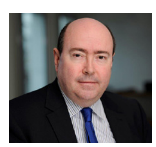

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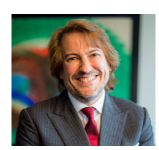

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