



Exchange Rate

Currency		BID
AUD	SGD	1.1017
AUD	USD	0.8374
EUR	USD	1.2368
AUD	JPY	100.6300
USD	JPY	120.1700
AUD	CNY	5.1525
AUD	EUR	0.6765
USD	HKD	7.7513
AUD	GBP	0.5351
	NZD	1.0784

delayed market rates sourced from

# Global Accountants' Liability Update

## October 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. 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. During July and August 2017 we identified developments of interest in China, Hong Kong, Italy, Mexico, The Netherlands, and The United States, which are summarized in the pages that follow.



[Dennis H. Tracey, III](#)

Partner, New York

T +1 212 918 3524

[dennis.tracey@hoganlovells.com](mailto:dennis.tracey@hoganlovells.com)



## Recent Court Decisions

# Hong Kong

### Hong Kong court suggests contempt proceedings against auditor who failed to disclose documents from PRC branch

Hong Kong litigators routinely struggle to obtain documents from entities in mainland China due to custody and control issues as well as Chinese state secrets laws and other laws. These, and other obstacles to disclosure, pose a particular challenge for liquidators and audit companies litigating in Hong Kong.

Parties to the *China Medical Technologies* liquidation proceedings have engaged in a long-running battle over documents located in mainland China. In a recent decision in that matter, a Hong Kong court suggested that liquidators bring contempt proceedings against the company's former auditor (HK Auditor). Such a proceeding would allege that HK Auditor failed to comply with a court order to produce documents held by a mainland entity (PRC Auditor) that is part of the HK Auditor's global firm.

The decision was handed down in July 2017 and we are closely monitoring the next steps in these proceedings.

#### **Background**

Following a 2014 winding-up order, the liquidators for China Medical Technologies (Company) sought disclosure of every document that the HK Auditor, and other associated entities, had in their possession concerning the Company and its subsidiaries.

The HK Auditor opposed the application on the grounds that some documents were in the possession of the PRC Auditor in mainland China and could not be transferred to the liquidators without infringing mainland laws and regulations. The trial court disagreed and ordered disclosure.

The HK Auditor appealed arguing that it would be oppressive to grant the order for the production of documents, as it would expose the PRC Auditor to potential sanctions. The Court of Appeal attempted to balance the liquidator's reasonable need for the documents against the interest in avoiding an unreasonable, unnecessary, or oppressive order. Given that the order, made in 2016, was amended in a subsequent decision to allow for sensitive information to be redacted, the Court of Appeal concluded that there was no real risk of serious sanctions against the HK Auditor or

PRC Auditor. Thus, the court dismissed the appeal, and ordered the HK Auditor to comply with the earlier order.

The HK Auditor nonetheless still failed to comply.

In July 2017, the liquidators made further applications for the HK Auditor to disclose the desired documents. These summonses were dismissed because the judge found he could not issue any order that was not substantially similar to those already issued, which would not practically advance the matter. The judge indicated that one option was for the liquidators to seek to enforce compliance with the previous orders through contempt proceedings.

## Comment

The Court of Appeal, in April 2017, acknowledged the difficulties with disclosure of documents located in the Mainland, and the need for a formal protocol or arrangement to be put in place. However, in the absence of such a protocol, Hong Kong courts and practitioners continue to struggle to find creative ways to obtain required information while adopting measures to satisfy the authorities in the Mainland where possible.

For more information on Hong Kong, contact:



[Chris Dobby](#)

Partner, Hong Kong

T +852 2840 5629

[chris.dobby@hoganlovells.com](mailto:chris.dobby@hoganlovells.com)

# The Netherlands

## Court declines to order disclosure of confidential information contained in a decision to fine auditor

### Introduction

On 21 July 2017, the Court of Amsterdam rendered a judgment on the obligation to disclose information, included in a decision of the Netherlands Authority for the Financial Markets (Authority), that had imposed a fine on an auditor. This judgment provides guidance on the confidentiality of the information concerning audits contained in decisions of the Authority.

### Facts

KPMG, then auditor (Auditor) of Royal Imtech N.V. (Company), had provided a statement on the fairness of the Company's annual accounts. Subsequently, the Authority imposed a fine of EUR 1,245,000 on the Auditor based on a finding that the Auditor failed to properly perform the audit of the accounts for 2011. A redacted version of the decision (Decision) was published by the Authority after the Authority provided the Auditor an opportunity to identify certain parts of the Decision as confidential.

Following the bankruptcy of the Company, the trustees requested that the Authority disclose an un-redacted version of the Decision and the Authority declined. The trustees filed a claim seeking an un-redacted copy from the Auditor pursuant to article 843a of the Dutch Code of Civil Procedure.

## Legal framework

In order to assess this case, it is important to note two related statutory provisions of the Audit Firms (Supervision) Act (Act).

Article 51 of the Act stipulates that the Authority may demand information for its supervisory duties. Article 63a of the Act prescribes that the Authority is not allowed to disclose any confidential information obtained on the basis of the Act, unless such disclosure is necessary for the performance of its duties and permitted by the Act. The Authority is only allowed to disclose such information when it cannot be linked to a specific audit firm.

## Judgment

The court was asked to order the Auditor to surrender a copy of the original un-redacted version of its Decision. In declining to do so, the court noted that the Authority redacted the Decision after consulting with the Auditor and that the Decision was imposed based on the supervisory relationship between the Authority and the Auditor—a relationship the Auditor did not enter into voluntarily.

The court explained that it is in the interest of the Authority's supervisory mission that audit firms communicate freely with the Authority. Such open communication also serves the public interest because if the Authority's judgment is based on all facts and circumstances, the quality of audits will improve. Moreover, an audit firm is obliged to disclose correct and complete information to the Authority, if requested, based on article 51 of the Act.

The court reasoned that an audit firm can only provide the Authority with all relevant information and avoid undermining its own interests if information remains confidential where appropriate.

Taking into account all of the above, the Court ruled that the Auditor is not obliged to disclose the information provided to and censored by the Authority to third parties in relation to a subsequent claim. The court explained that granting the trustees' claim would interfere with the Authority's ability to perform its supervisory duties and therefore rejected the claim.

## Conclusion

The Court attaches great importance to the supervisory task of the Authority. It found that safeguarding the quality of the performance of the Authority's supervisory duties required preserving the Auditor's interest in truthfully disclosing all information it desires to the Authority. According to the Court of Amsterdam, these interests justify preserving the confidentiality of the censored parts of an Authority decision, even when a third party has formally requested that the Court order the release of an un-redacted version.

For more information on the Netherlands, contact:

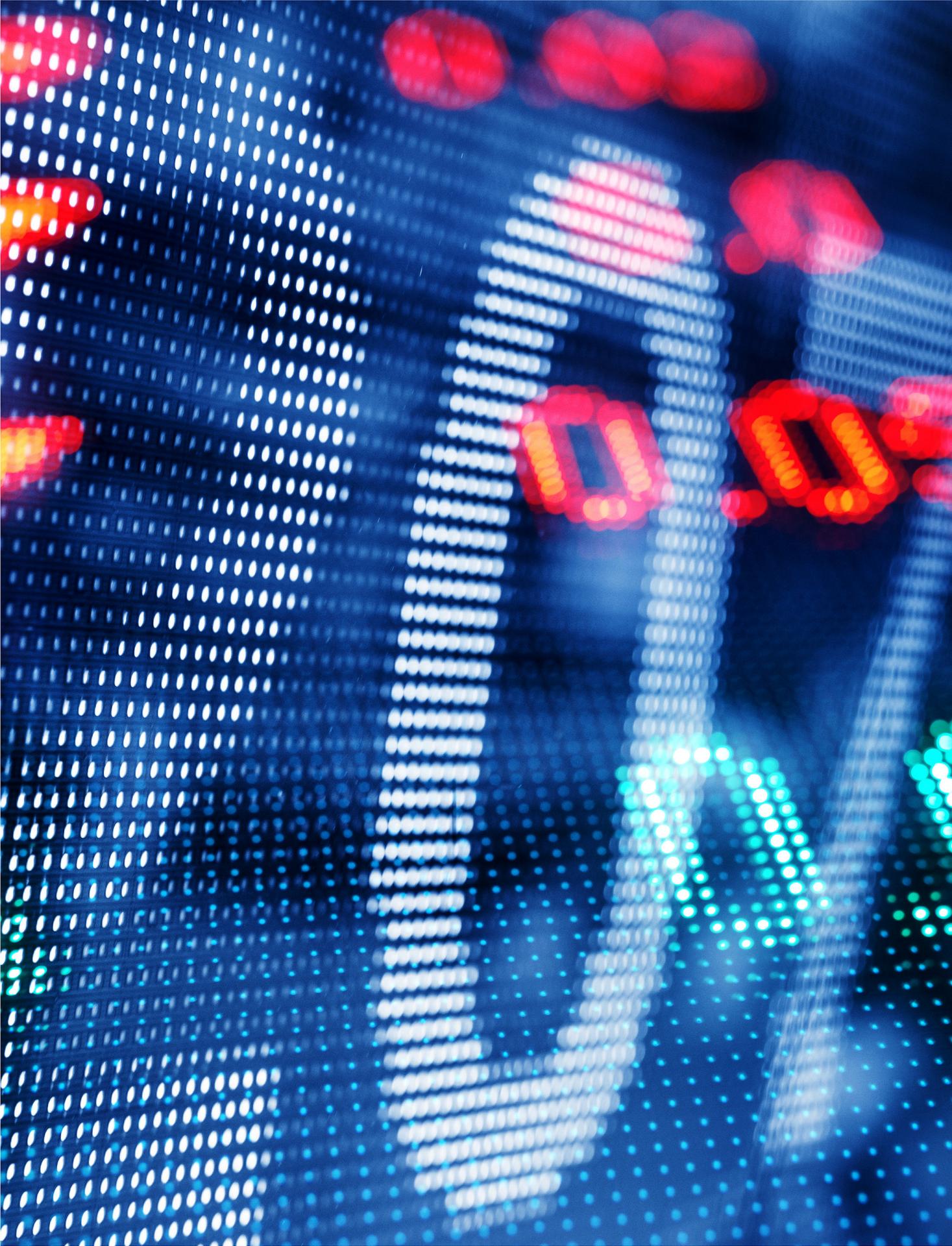


[Manon Cordewener](#)

Partner, Amsterdam

T +31 20 55 33 691

[manon.cordewener@hoganlovells.com](mailto:manon.cordewener@hoganlovells.com)



# The United States

## Alabama court rejects defenses asserted by auditors against FDIC, receiver of Colonial Bank

On 18 August 2017, an Alabama federal judge rejected defenses asserted by PwC and Crowe Horvath LLP (Crowe Horvath) that imputed the fraudulent conduct of bank employees to the Federal Deposit Insurance Corp. (FDIC), the bank's receiver.

The Colonial BancGroup, Inc., Colonial Bank's parent company (CBG) and Kevin O'Halloran, as plan trustee acting on behalf of CBG, and the FDIC each filed lawsuits against PwC and Crowe Horvath, Colonial Bank's outside auditors, seeking to recover for the auditor's alleged failure to detect fraud at Colonial Bank. The lawsuits concerned a fraud centered in Colonial Bank's Mortgage Warehouse Lending Division (MWLD). Beginning in 2002, the MWLD's largest customer, Taylor Bean & Whitaker Mortgage Corporation (Taylor Bean), began to be overdrawn on its accounts at Colonial Bank. Taylor Bean's Chairman, several other Taylor Bean insiders, and Colonial Bank employees conspired together to hide the overdrafts. In the lawsuits, PwC and Crowe Horvath asserted defenses arguing that the Colonial Bank employees' fraud should be imputed on the FDIC, barring the Plaintiffs' claims.

Applying Alabama law, Judge Barbara Jacobs Rothstein of the U.S. District Court for the Middle District of Alabama, rejected PwC's and Crowe Horvath's arguments as to the FDIC. The Court's decision acknowledged the general principle that a receiver of a defunct bank stands in the shoes of the bank and has no greater rights or favored position than the bank it represents. However, the Court concluded that the FDIC's lawsuit warranted an exception to this general rule. The Court reasoned that the defenses asserted by the auditing firms are applied only in situations where allowing a plaintiff relief would contravene public morals, and thus should not be extended to the FDIC, which commenced the action on behalf of innocent third parties who did not participate in the underlying fraud.

Subsequent efforts to stay the action and upcoming trials pending appellate review of the Court's August 18 decision by either the Eleventh Circuit Court of Appeals or the Alabama Supreme Court, were rejected by Judge Rothstein. Trial was set to begin against PwC on 18 September 2017. A separate trial concerning the claims against Crowe Horvath is scheduled to start on 6 November 2017. Plaintiffs seek US\$2 billion in damages.

For more information on the U.S., contact:

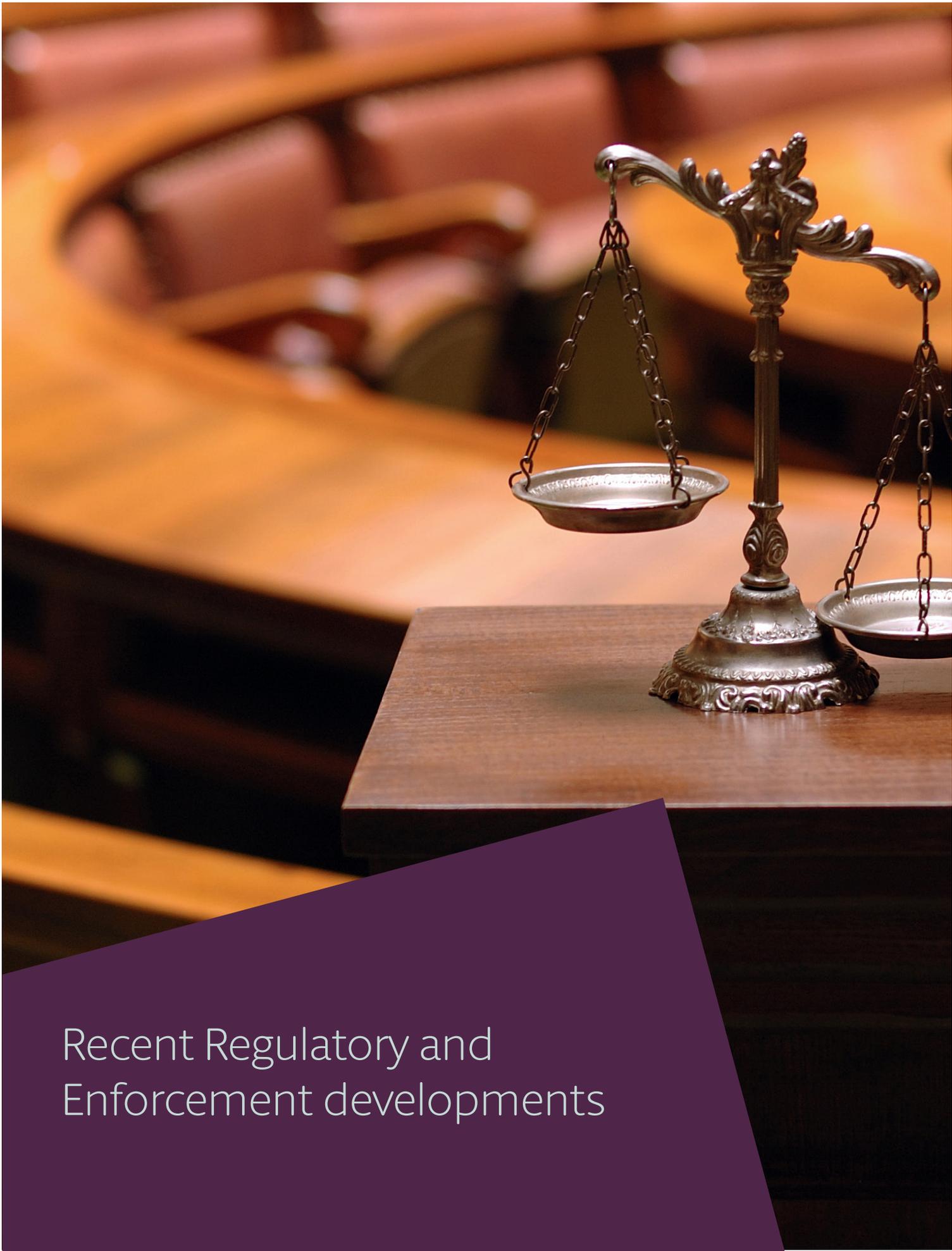


[Dennis H. Tracey, III](#)

Partner, New York

T +212 918 3524

[dennis.tracey@hoganlovells.com](mailto:dennis.tracey@hoganlovells.com)



Recent Regulatory and  
Enforcement developments



## Ministry of Finance issues a circular to insurance companies on accounting standards for new financial instruments

### China

Following the release of a series of accounting standards on financial instruments, on 22 June 2017, the Ministry of Finance of PRC (MOF) issued the [\*Circular on the Transitional Measures for Insurance Companies to Implement Relevant Accounting Standards for New Financial Instruments\*](#) (Circular). The Circular covers three topics:

1. Timetable for insurance companies to implement the new accounting standards;
2. Conditions under which an insurance company may postpone implementation of the new accounting standards; and
3. Supplementary disclosures required from insurance companies that postpone implementing the new accounting standards.

All insurance companies must implement the new accounting standards by 1 January 2021. However, insurance companies that are listed both at home and abroad, as well as insurance companies

that are listed abroad and prepare financial statements in accordance with International Financial Reporting Standards (IFRS) or enterprise accounting standards must start implementing the new accounting standards by 1 January 2018, unless they meet specified conditions that permit them to postpone implementation until 1 January 2021.

Insurance companies whose business activities are deemed mainly “insurance-related” as of 31 December 2015, may postpone implementation. The Circular identifies criteria for determining whether “an insurance company’s activities are mainly insurance-related.” These include a requirement that the total book value of all debts arising out of insurance contracts represent a material proportion of the total book value of the company’s debts.

Insurance companies that postpone implementing the new accounting standards beyond 1 January 2018, must disclose that they have done so

in their annual financial statements and provide justification for postponing implementation. They must also cite the proportion of the company's debts associated with insurance activities in relation to its total debts.

## MOF promulgates the Regulations on Internal Control of Small Enterprises (For Trial Implementation)

On 29 June 2017, the MOF promulgated the [\*Regulations on Internal Control of Small-sized Enterprises \(For Trial Implementation\)\*](#) (the Regulation), which aims to strengthen the internal control systems at small enterprises and improve their business and risk management.

The Regulation is modeled after the Basic Regulations on Enterprise Internal Control but lowers internal control requirements for small enterprises. Small enterprises must comply with one of these regulations and are encouraged to follow the more stringent Basic Regulations on Enterprise Internal Control if they are capable of doing so. According to an official interpretation issued by the MOF, small enterprises that have already adopted the Basic Regulations on Enterprise Internal Control may not now switch to comply only with the Regulation.

The Regulation is organised into four chapters.

**General Rules:** identifies the scope of the Regulation's application, defines the general requirements for internal controls at small enterprises, and defines the responsibilities of the person-in-charge of small enterprises.

**Establishment and Implementation:** mainly specifies the general requirements for the establishment and implementation of internal control at small enterprises and identifies several requirements for risk assessment.

**Supervision of Internal Control:** specifies what type of supervising system should be in place at small enterprises to supervise the implementation of internal controls.

**Supplementary Rules:** mainly provides that micro and small enterprises may also benefit from guidance provided in the Basic Regulations on Enterprise Internal Control.

## MOF revises No.14 Accounting Standards for Business Enterprise – Revenue

On 5 July 2017, the MOF promulgated the revised version of [\*No.14 Accounting Standards for Business Enterprise – Revenue\*](#).

The main revisions include:

1. Incorporating current revenue principle and construction contract principle into the uniform revenue recognition model;
2. Replacing transfer of risk remuneration with transfer of control right to act as the judgment standard for the time point of revenue recognition;
3. Clarifying guidance on accounting process of contracts containing multiple transactional arrangements; and
4. Providing explicit stipulations on recognizing and measuring revenues from certain types of transactions and matters.

Companies listed both at home and abroad, as well as companies listed abroad that prepare financial statements in accordance with IFRS or enterprise accounting standards shall start implementing the new standards by 1 January 2018. Other companies listed at home are required to implement the new revenue standards by 1 January 2020. Unlisted companies that adopt enterprise accounting standards shall implement the new revenue standards by 1 January 2021.

## MOF starts revision of the Accounting Law

On 17 August 2017, the Accounting Law revision team of the MOF convened its first meeting to begin a comprehensive review and revision of the *Accounting Law*, which was adopted in 1999.

## MOF issues Measures for the Administration of Practice Permission and Supervision of Certified Public Accountants

On 20 August 2017, the MOF released the [Measures for Administration of Practice Permission and Supervision of Certified Public Accountants](#) (Measures), which will replace the *Interim Measures for the Examination, Approval and Supervision of Accounting Firms* (Interim Measures) and go into effect 1 October 2017.

The Measures mainly differ from the Interim Measures as follows:

1. The Measures relax barriers to entry for accounting firms by relaxing the requirements for partner/shareholder qualification. The measures also simplify procedures for accounting firms to secure practice permission or to change domiciles to another province. The Measures also require local MOFs to digitize approval and record-filing procedures.
2. The Measures strengthen the supervision and management of certified public accountants (CPAs) by providing for a regular examination system and a random examination system. In reaction to certain recent CPA practices, the Measures identify activities that violate the Measures, and specify and augment concrete punishment clauses.
3. The Measures allow foreigners who are qualified as CPAs to act as partners/shareholders of domestic accounting firms. Meanwhile, in consideration of the fact that there are Chinese citizens who act as partners residing abroad, the Measures make equivalent residence requirements for both (1) foreigners acting as partners and (2) citizens residing abroad (i.e. they should both reside in China at least six months a year and have been a continuous residence in China for five years).
4. The Measures set parameters for the business lines accounting firms may engage in and introduce “special general partnership” as a new form for accounting firms (the Interim Measures provided only for “general partnerships” and “limited liability companies”). The Measures also dictate special regulations for accounting firms that engage in securities services and other business lines relevant to public interests as provided by laws and regulations.

The Measures indicate that the “special general partnership” form, which is commonly adopted by big and medium-sized international accounting firms, is permitted at firms that:

- Have at least 15 partners and 60 certified public accountants;
- In accordance with the *Partnership Enterprise Law of PRC*, have partners who shall bear unlimited or unlimited joint and several liability for debts incurred to the accounting firm due to such partner’s intentional or serious wrongful act, and shall be liable to compensate for such losses incurred to the firm;
- Have only a small number of un-certified accountants as partners involved in internal management or engaging in a consulting business.

For more information on China, contact:



[Roy G. Zou](#)

Partner, Beijing

T +86 10 6582 9488

[roy.zou@hoganlovells.com](mailto:roy.zou@hoganlovells.com)

# Italy

## Italy adopts legislation to protect whistle blowers and enhance auditor supervision

Through Legislative Decree no. 135/2016 amending Legislative Decree no. 39/2010, Italy implemented the Directive (EU) 2014/56/EU on statutory audits of annual accounts and consolidated accounts and specifically enhanced private and public control.

Article 26-*bis* requires that auditing firms adopt specific policies and procedures aimed at protecting whistle blowers. These policies shall ensure, *inter alia*: (1) anonymity of the whistle blower and of the person that has allegedly committed the wrongdoing; (2) adequate protection of the reporting person from possible unfair treatment after whistleblowing; (3) a dedicated “channel” to report wrongdoings; and (4) the right of the accused person to be heard.

According to Article 26-*ter*, the Ministry of Economy and Finance (MEF) and the Italian Securities and Exchange Commission (CONSOB) may directly receive reports of breaches of rules applicable to auditing services and rely on such reports in carrying out their supervisory functions. In this regard, MEF and CONSOB shall adopt specific regulations aimed to ensure that audit firms comply with the whistle blower protections set forth by Article 26-*bis*.

The new law also enhances the supervisory powers of the MEF and CONSOB, specifically with regards to quality control supervision, which shall be performed on all registered auditors (including members of boards of statutory auditors performing audits within companies). Such quality control supervisions shall be conducted by persons who (i) are independent from the persons or entities subject to quality control, (ii) possess an adequate level of education and professional experience in specific areas (i.e. auditing services, financial information and statements), (iii) and have received specific training in quality control.

The supervision of quality control shall be performed by CONSOB on auditors of entities of public interest (EPI) and - the newly introduced category of - entities subject to the intermediate regime (EIR) and by MEF for other auditors. Quality control supervision of auditors of entities, other than EPI, is performed at least every six years, based on an analysis of risk.

Article 20 specifies that quality control supervision shall be conducted directly on the auditors when they are members of a board, are statutory auditors, or have been personally entrusted with at least one audit. Otherwise, the quality control will be achieved by supervision of the auditing firms of which auditors are partners, managers, or collaborators. Quality control supervision shall assess compliance with accounting principles and requirements of independence, the quantity and quality of resources used, remuneration, and quality of internal control systems.

Pursuant to new Articles 20 and 21-*bis*, MEF is also entrusted with the powers, *inter alia*, to:

- approve control programs and policies;
- to issue recommendations and instructions;
- to supervise compliance with principles of professional ethics, adoption of internal quality control measures; and continuing education requirements; and
- to delegate its powers.

New procedures for cooperation between supervisory authorities (including CONSOB) and MEF are also established by Article 23(1-*bis*). These provisions require these bodies to annually exchange information regarding supervised entities.

For more information on Italy, contact:



[Andrea Atteritano](#)

Counsel, Rome

T +39 06 6758 23 1

[andrea.atteritano@hoganlovells.com](mailto:andrea.atteritano@hoganlovells.com)

## Mexico

### National Banking and Securities Commission revises regulations relating to detection of money laundering and terrorism financing

On 2 October 2014, the National Banking and Securities Commission (Commission) issued a regulation identifying requirements and credentials for auditors and accountants to be certified to aid the Commission with its inspection duties designed to detect money laundering and terrorism financing ([Regulation](#)). The regulation entered into force on 1 January 2015.

On 4 August 2017, the Commission [amended the Regulation](#) in ways that will impact auditors, accountants and the Commission's inspection activities.

Key changes include:

1. Investor's advisors will no longer be subject to supervision related to money laundering and terrorism financing activities.
2. Before the amendments, when a company wanted to be certified by the Commission, all personnel working in inspection duties were required to be certified. Under the amended Resolution, it will be enough that one partner or employee is certified. However, if a certified auditor works for more than one company, his or her certification can only be used once.
3. Provisions were added identifying activities that will cause revocation of a certification. These include falsifying information to obtain the certification and not following the methodology approved by the Commission for performing the inspection duties.

### Central Bank President remarks on "Bitcoin"

On 23 August 2017, Agustin Carstens, Mexico's Central Bank's President, stated in a non-official conference that Mexico's Central Bank rejects "Bitcoin" as a virtual or electronic currency due to the lack of support from a Central Bank or National Government. This implies that "Bitcoin" will not be regulated in the near future in Mexican law.

For more information on Mexico, contact:



[Omar Guerrero Rodriguez](#)

Partner, Mexico City

T +52 55 5091 0162

[omar.guerrero@hoganlovells.com](mailto:omar.guerrero@hoganlovells.com)

# The United States

## PCAOB announces settlement with PwC regarding audit of Merrill Lynch's compliance with SEC customer protection rule

On 2 August 2017, the Public Company Accounting Oversight Board (PCAOB) issued an [order](#) censuring and imposing a US\$1 million civil penalty against PricewaterhouseCoopers LLP (PwC) for violations in its examination and audit of Merrill Lynch, Pierce, Fenner & Smith, Inc.'s (Merrill Lynch) compliance with the Securities and Exchange Commission's (SEC) Customer Protection Rule.

The SEC's Customer Protection Rule requires a broker-dealer to hold certain customer securities in lien-free segregated accounts to protect them from creditor claims should the broker-dealer's business fail. Merrill Lynch reported that it had complied with the rule, including in fiscal year 2014, and that its internal controls over compliance with the rule were effective. However, in 2016, the SEC determined that Merrill Lynch violated the Customer Protection Rule by holding tens of billions of dollars of its customers' fully paid and excess margin securities in accounts subject to liens by third parties.

PwC acted as Merrill Lynch's outside auditor in 2014 and issued an examination report concerning the effectiveness of Merrill Lynch's internal controls over compliance with the Customer Protection Rule. PwC's examination report contained the unqualified opinion that Merrill Lynch's assertions in its compliance reports—namely representations regarding the effectiveness of the broker-dealer's internal control over compliance with the Customer Protection Rule—were fairly stated and that PwC's examination was conducted in compliance with PCAOB standards.

Per the PCAOB's order, PwC violated PCAOB rules and standards when performing its examination by: (1) failing to adequately test Merrill Lynch's key internal controls over compliance with the Customer Protection Rule, and (2) failing to obtain sufficient appropriate audit evidence to support its conclusion regarding Merrill Lynch's compliance with the Customer Protection Rule. Among other items, the PCAOB order discusses PwC's testing of pre-existing Merrill Lynch accounts held at third-party U.S. Banks. These accounts had been previously designated by Merrill Lynch, in prior audit years, as compliant with the no-lien requirements of the Customer Protection Rule. The PCAOB Order contends that PwC never obtained evidence (e.g., custodial

agreements) that confirmed these accounts complied with the Customer Protection Rule.

PwC consented to the PCAOB's order without admitting or denying the order's findings.

## KPMG settles with SEC regarding audit of Miller Energy Resources

On 15 August 2017, the SEC announced a [settlement](#) of proposed charges against KPMG and one of its audit partners arising from the alleged failure to properly audit the financial statements of Miller Energy Resources (Miller), an oil and gas company.

In December 2009, Miller purchased at auction certain oil and gas assets located in Alaska, including leases covering 602,000 acres of mostly unproven exploratory oil and gas prospects (Alaska Assets). Miller's winning bid consisted of US\$2.25 million in cash plus the assumption of certain liabilities (a reported value of US\$2.22 million). Applicable accounting principles required Miller to record the Alaska Assets at fair value, which the company failed to do. Instead, relying on a reserve report prepared by a third-party petroleum engineering firm and an insurance report regarding replacement costs, Miller assigned a value to the assets of US\$480 million, comprised principally of US\$368 million for oil and gas properties and \$110 million for fixed assets. Neither of these reports was a fair value estimate. The SEC deemed both reports as improper support for financial reporting purposes.

KPMG was appointed auditor of Miller in 2011. The SEC asserted that KPMG failed to comply with applicable professional standards in the following respects:

- In 2011, KPMG had not established adequate policies and procedures for client acceptance and continuation and, as a result, the engagement team performed an inadequate assessment of the risks associated with the Miller engagement.
- The audit engagement team, including the audit engagement partner, lacked oil and gas industry experience. As a result, the team had insufficient expertise to perform the audit of Miller.
- KPMG failed to obtain sufficient competent audit evidence to provide reasonable assurance that Miller's

fair value measurements and disclosures relating to the Alaska Assets were in conformity with GAAP. For example, the audit engagement team recognized that the two reports the company used to support its fair value determination for the Alaska Assets were not appropriate for ascertaining fair value, yet applied limited procedures to Miller's fair value estimate which relied on these reports.

- KPMG did not obtain sufficient competent evidence regarding the assumption on which Miller's valuation of the Alaska Assets was based.
- KPMG failed to exercise due care and to plan and reasonably supervise the audit engagement team. For example, KPMG and the audit engagement partner gave insufficient consideration to the nature and scope of specialists' (including valuation specialists) work and involvement in the audit, including delineation of assignments across the engagement team.

The SEC concluded that KPMG's work violated Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the SEC's Rules of Practice, and failed to comply with various PCAOB auditing and quality control standards.

Without admitting or denying the SEC's findings, KPMG agreed to be censured and pay US\$4,675,680 in disgorgement of all the audit fees received from Miller, plus US\$558,319 in interest and a US\$1 million penalty. KPMG also agreed to certain undertakings designed to improve its quality control policies and procedures, and to appoint an independent consultant to review and evaluate KPMG's remedial actions.

For more information on the U.S., contact:



**[Dennis H. Tracey, III](#)**

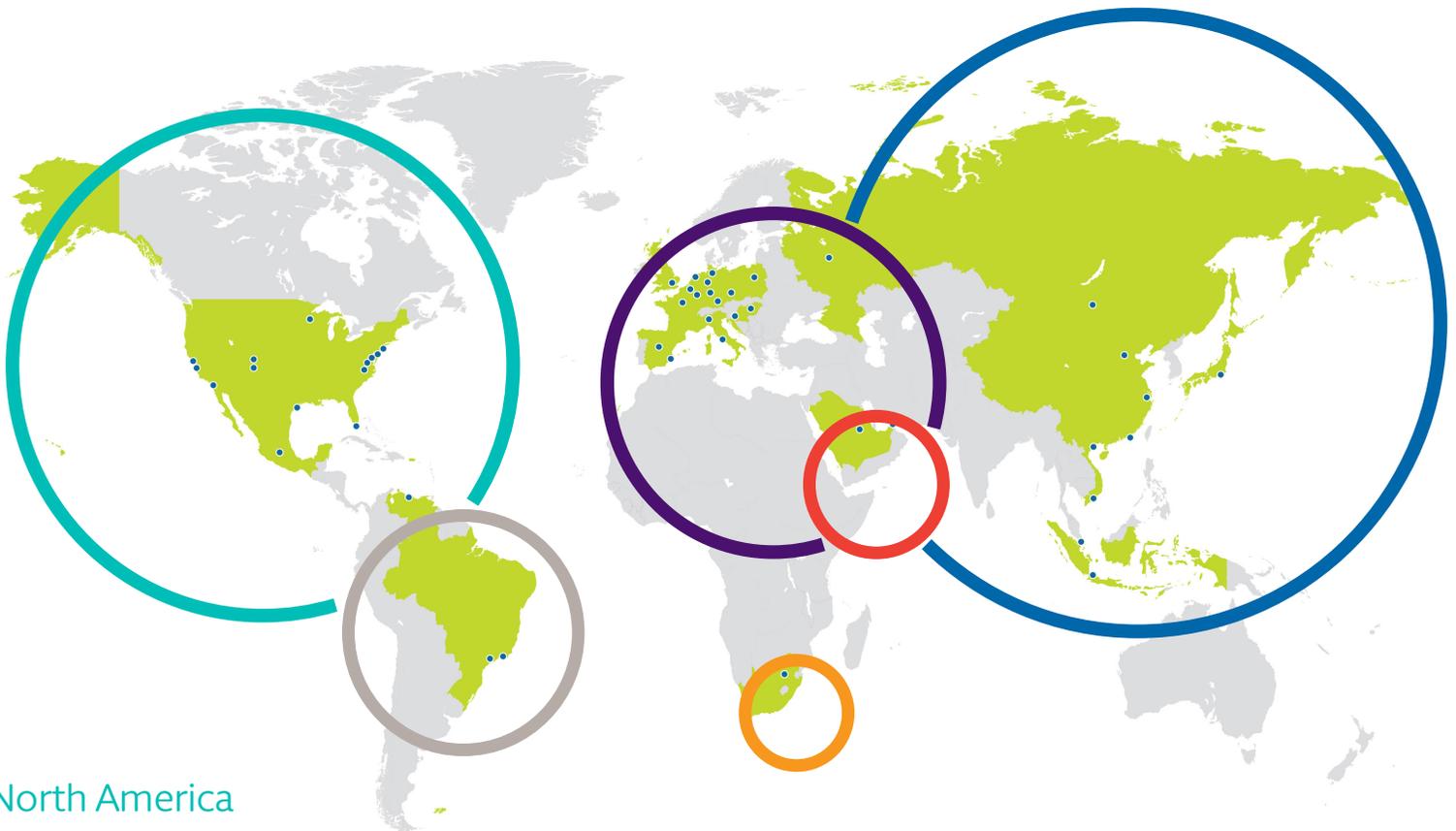
Partner, New York

T +212 918 3524

[dennis.tracey@hoganlovells.com](mailto:dennis.tracey@hoganlovells.com)



# Our Global Accountants' Liability Team



## North America



[Dennis H. Tracey, III](#)  
Partner, New York  
T +1 212 918 9524  
dennis.tracey@hoganlovells.com



[Cristina Rodriguez](#)  
Partner, Houston  
T +1 713 632 1425  
cristina.rodriguez@hoganlovells.com



[Daryl Lian Kleiman](#)  
Associate, New York  
T +1 212 918 3728  
daryl.kleiman@hoganlovells.com



[DeNae M. Thomas](#)  
Senior Associate, New York  
T +1 212 918 3016  
denae.thomas@hoganlovells.com



[George A. Salter](#)  
Partner, New York  
T +1 212 918 3521  
george.salter@hoganlovells.com



[Marisa H. Lenok](#)  
Senior Associate, New York  
T +1 212 918 3253  
marisa.lenok@hoganlovells.com



[Anjum Unwala](#)  
Associate, New York  
T +1 212 918 3783  
anjum.unwala@hoganlovells.com



[Kevin T. Baumann](#)  
Senior Associate, New York  
T +1 212 918 3081  
kevin.baumann@hoganlovells.com



[Omar Guerrero Rodriguez](#)  
Partner, Mexico City  
T +52 55 5091 0162  
omar.guerrero@hoganlovells.com



[Mitra Anoushiravani](#)  
Associate, New York  
T +1 212 918 3739  
mitra.anoushiravani@hoganlovells.com



[Federico De Noriega Olea](#)  
Partner, Mexico City  
T +52 55 5091 0154  
federico.denoriega@hoganlovells.com

## Asia



### Maurice Burke

Partner, Singapore  
T +65 6302 2558  
maurice.burke@hoganlovells.com



### Allan Leung

Partner, Hong Kong  
T +852 2840 5061  
allan.leung@hoganlovells.com



### Roy G. Zou

Partner, Beijing  
T +86 10 6582 9488  
roy.zou@hoganlovells.com



### Chris Dobby

Partner, Hong Kong  
T +852 2840 5629  
chris.dobby@hoganlovells.com

## South Africa



### Clive Rumsey

Partner, Johannesburg  
T +27 11 286 6907  
clive.rumsey@hoganlovells.com

## Europe



### Andrea Atteritano

Of Counsel, Rome  
T +39 06 6758 23 1  
andrea.atteritano@hoganlovells.com



### Manon Cordewener

Partner, Amsterdam  
T + 31 20 55 33 691  
manon.cordewener@hoganlovells.com



### Alexei Dudko

Partner, Moscow  
T +7 495 933 3000  
alexei.dudko@hoganlovells.com



### Ruth Grant

Partner, London  
T +44 20 7296 2207  
ruth.grant@hoganlovells.com



### Jon Holland

Partner, London  
T +44 20 7296 2694  
jon.holland@hoganlovells.com



### Marius Lampen

Senior Associate, Dusseldorf  
T +49 211 13 68 473  
marius.lampen@hoganlovells.com



### Kim Lars Mehrbrey

Partner, Dusseldorf  
T +49 211 13 68 473/476  
kim.mehrbrey@hoganlovells.com



### Thomas Rouhette

Partner, Paris  
T +33 1 53 67 47 47  
thomas.rouhette@hoganlovells.com



### Joaquin Ruiz Echauri

Partner, Madrid  
T +34 91 349 82 00  
joaquin.ruiz-echauri@hoganlovells.com



### Nina Tulloch

Senior Associate, London  
T +44 20 7296 5667  
nina.tulloch@hoganlovells.com

Alicante  
Amsterdam  
Baltimore  
Beijing  
Brussels  
Budapest  
Caracas  
Colorado Springs  
Denver  
Dubai  
Dusseldorf  
Frankfurt  
Hamburg  
Hanoi  
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