Hogan Lovells

Our Global Accountants' Liability practice

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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. During February 2018 and March 2018 we identified developments of interest in Hong Kong, The Netherlands, Spain, 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

Recent court decisions

Hong Kong

Registrar of Hong Kong Institute of Certified Accountants v. Wong Tak Man Stephen, RSM Nelson Wheeler (FACV 10/2017)

The Court of Final Appeal (Hong Kong's highest court) resolved two important questions in a recent case that addressed auditors' reporting duties relating to the treatment of available-for-sale financial assets (AFSFAs). The applicable professional standard is the 2009 Hong Kong Accounting Standard (HKAS).

First, the Court held that objective evidence of impairment loss in AFSFAs does not require a showing that such loss had an impact on the estimated future cash flow of the AFSFA in question.

Second, the Court found that the Professional Accountants Ordinance (PAO) (Cap. 50) does not provide any defense based on "reasonable excuse" concerning the charge that an accountant "failed or neglected to observe, maintain or otherwise apply a professional standard." [1]

Facts

The audit in question was for Heng Tai Consumables Group Limited (Heng Tai), a company listed on the Hong Kong Stock Exchange, for the year ended 30 June 2009.

The 2009 HKAS require that AFSFAs be measured at fair value. Gains and losses of such assets must be expressly reflected in a "statement of changes in equity" until the asset is derecognized. If the fair value of an AFSFA drops such that **objective evidence** of impairment loss can be shown, the HKAS requires the cumulative loss to be *removed* from equity and instead reported in the company's profit or loss even if the financial asset had not been derecognized.

As auditors, RSM was required to evaluate Heng Tai's financial statements and form an opinion as to whether Heng Tai's treatment of the AFSFA was in accordance with the applicable HKAS. The AFSFA in question was a large parcel of shares held by Heng Tai. The market price of those shares fell substantially over a period of time and RSM first noted a cumulative loss of over HK$22 million in their value. RSM then conducted an impairment review, but after discussions with Heng Tai, the cumulative loss was not removed from equity and not reported in the company's profit and loss statements included in Heng Tai's 2009 financial statements. In its audit, RSM did not require any adjustment of the financial statements for the impairment. The HKSAR Audit Investigation Board undertook an investigation and concluded that there was objective evidence of impairment loss because the value of the shares had dropped more than 60 percent from their purchase price.

1. Section 34(1)(a)(vi) of the Professional Accountants Ordinance (Cap. 50) provides that "[a] complaint that— a certified public accountant— failed or neglected to observe, maintain or otherwise apply a professional standard; shall be made to the Registrar who shall submit the complaint to the Council which may, in its discretion but subject to section 32D(7), refer the complaint to the Disciplinary Panels."

The Board found that the HK$22 million should have been removed from equity and recognized in the profit or loss of Heng Tai's 2009 financial statements. Consequently, the Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants found that RSM breached statutory obligations under the PAO. The Hong Kong Court of Appeal subsequently dismissed RSM's appeal and the matter went before the Court of Final Appeal.

The Court of Final Appeal's ruling

In ruling that objective evidence of impairment loss did not require a showing that the said loss would have an impact on cash flow, the Court found that objective evidence of significant or prolonged decline in the fair value of equity instruments, to levels below its purchase price, was sufficient to show objective evidence of impairment loss.

Having affirmed that RSM was in breach of its duties under the PAO, the Court of final Appeal held that the PAO does not provide for a defense of "reasonable excuse" to exonerate the auditors from liability.

However, the Court also emphasized that the charge that auditors "failed or neglected to observe, maintain or otherwise apply a professional standard" under the PAO was not intended to be punitive but rather to enforce applicable published standards in the interests of a uniform and predictable practice without implying fault, moral blame, or misconduct. Thus, such complaints would only merit commensurate minor sanctions.

Chris Dobby
Partner, Hong Kong
T +852 2219 0222
chris.dobby@hoganlovells.com

The Netherlands

Auditor's audit file must be turned over in civil liability proceeding

In 2012, housing association Vestia nearly went bankrupt after suffering great losses as a result of speculating on interest rate derivatives. Vestia filed proceedings seeking damages from Deloitte for losses allegedly caused by inaccurate and negligent auditing practices.

In order to substantiate its claim, Vestia demanded access to Deloitte's audit files relating to the audit reports. The Court of Rotterdam ruled in a preliminary judgment dated 7 February 2018, that Deloitte must hand over a copy of the audit file to Vestia.[2]

The claim

Vestia claimed, before the District Court of Rotterdam, that Deloitte breached its duties in relation to audits for the years 2006 to 2009 and must compensate Vestia for ensuing damages.

In order to substantiate these claims, Vestia sought an order requiring Deloitte to turn over a copy of the audit files relating to Vestia's annual accounts in order to establish the scope of Deloitte's failure to perform and the scope of Deloitte's liability. Dutch procedural law does not provide for "discovery" of documents but does provide for a "duty of exhibition" under certain circumstances. Vestia's claim for exhibition is based on two statutory provisions.

First, article 843a of the Dutch Code of Civil Procedure (DCCP) stipulates that a party may request the Court to order the counterparty or a third party to allow inspection or to provide a copy of exhibits. In order for such a request to be granted, the following requirements must be met:

a) the requesting party must have a legitimate interest in gaining access to the exhibits;

b) the exhibits the requesting party wishes to inspect have to be described in a sufficiently precise manner; and

c) the exhibits have to relate to a legal relationship to which the party claiming the inspection of documents is a party.

If the request complies with these statutory requirements, it will be granted unless:

a) an important reason (e.g. preserving attorney confidences) warrants denying it; or

b) the proper administration of justice does not require the exhibition of documents (e.g. if the requesting party's legal position is also safeguarded without the order to produce documents).

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2 District Court of Rotterdam 7 February 2018, ECLI:NL:RBROT:2018:820.

Second, Vestia made a claim based on article 7:403 of the Dutch Civil Code (DCC), which requires a contracted party to account for the way it performed its contractual assignment. This obligation applies to all contracts for the provision of services, including the audit services contract at issue here.

Judgement

The Court noted that the statutory obligation to account for a contracted party's performance to a client as stipulated in article 7:403 of the DCC does not include a general obligation to turn over all documents related to a particular assignment. Instead, the Court held that the scope of the duty to produce documents is based on article 843a of the DCCP and the contractual service provider's obligations under article 7:304 of the DCC.

The Court explained that Deloitte, as the assigned auditor, should have kept an audit file documenting the way in which the audit was conducted. Because the information in such file relates to the auditing and approval process of Vestia's annual accounts and Vestia claims Deloitte is liable for failures in exactly that process, Vestia has a legitimate interest in obtaining the information in the audit file.

However, the Court held that Deloitte was not required to produce the entire audit file because the scope of article 7:403 DCC and the proper administration of justice do not require that the entire audit file be subject to the exhibition order. The extent to which a contracted party must account for the performance of its assignment depends on the circumstances of the case, the mutual interests of the parties, the nature of the assignment and the nature of the parties. In this case, only certain parts of the audit file were deemed relevant to the claims submitted by Vestia. Therefore, Vestia's legitimate interest in the production of documents was limited to the parts of the audit file relevant for the substantiation of its claims.

For more information on the Netherlands, contact:

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

Bas Keizers
Associate, Amsterdam
T +31 20 55 33 760
bas.keizers@hoganlovells.com

Spain

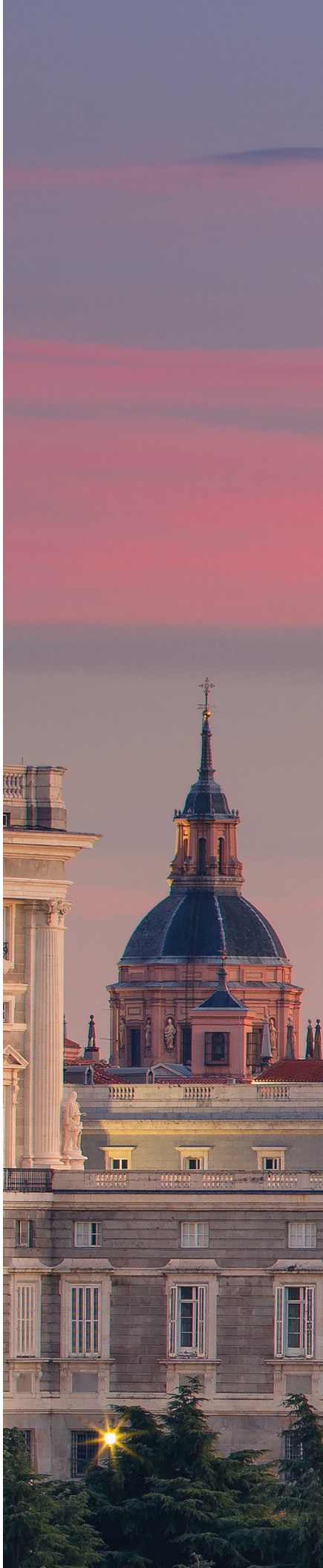
Pescanova case: criminal proceedings initiated for audit firm BDO Auditores, S.L. and one of its partners

On 5 February 2018, the Investigating Central Court of the Spanish National Court (*Juzgado Central de Instrucción de la Audiencia Nacional*) announced it would move forward with a criminal prosecution by opening oral hearing proceedings against BDO Auditores, S.L. (BDO), a Spanish audit firm, and its partner who issued favorable audit reports on the financial statements of Pescanova and its subsidiaries. BDO audited Pescanova's accounts in the years preceding the Spanish company's bankruptcy and the accounts have now been discredited and drastically revised by Pescanova's bankruptcy administrator, Deloitte.

The court decided to open oral hearing proceedings after finding that the BDO auditor signed inaccurate financial statements despite knowing that Pescanova employed irregular accounting practices. To reach this conclusion, the judge relied on the findings of a disciplinary investigation initiated by the Institute of Accounting and Audit of Accounts (ICAC), which concluded that Pescanova's fraud would not have been possible without the auditor's collusion.

For more information on Spain, contact:

Joaquín Ruiz Echauri
Partner, Madrid
T +34 91 349 82 74
joaquin.ruiz-echauri@hoganlovells.com




EQUAL JUSTICE UNDER

The United States

Big four firm settles auditing claims in Petrobras litigation

PricewaterhouseCoopers' Brazilian firm, PricewaterhouseCoopers Auditores Independentes ("PwC Brazil"), reached a US$50 million settlement deal with the plaintiffs' court-appointed class representatives in the consolidated fraud litigation against Brazilian petroleum giant Petrobras.

The Petrobras litigation, which was first filed in the Southern District of New York in December 2014, alleged fraud schemes involving billions of dollars in kickbacks, overstated assets, and losses to investors. PwC Brazil was added as a defendant in March 2015. Plaintiffs alleged that the firm's auditors ignored "obvious red flags" of Petrobras' fraud, such as inflated values stated for Petrobras' assets. Plaintiff further alleged that PwC Brazil failed to detect Petrobras' illegal acts, issued clean audit reports without sufficient investigation, and issued certified opinions that Petrobras maintained effective internal control over financial reporting without sufficient evidence to "afford a reasonable basis" for those opinions.

PwC Brazil filed a motion to dismiss the Section 10(b) and 11 claims against it and the court dismissed without leave to amend the Section 10(b) claim. PwC Brazil then entered into a settlement on the Section 11 claim for US$50 million, bringing the total amount recovered in the Petrobras litigation to nearly US$3 billion. Judge Rakoff of the Southern District of New York issued preliminary approval of the consolidated proposed settlement on 1 March 2018. In settling, PwC Brazil denied any wrongdoing or liability and noted that it was "keen to put this protracted legal matter behind us, and a settlement was the best way to achieve this."

See *In re Petrobras Securities Litigation*, No. 14-cv-9662-JSR (S.D.N.Y. 2017) (Dkt. Nos. 765, 770); *PwC Brazil Agrees to Pay $50M in $3B Petrobras Fraud Case*, Bloomberg BNA (Feb. 5, 2018).

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

Dennis H. Tracey, III
Partner, New York
T +212 918 3524
dennis.tracey@hoganlovells.com

Allison M. Wuertz
Senior Associate, New York
T +212 918 3067
allison.wuertz@hoganlovells.com

Darcy N. Hansen
Associate, New York
T +212 918 3707
darcy.hansen@hoganlovells.com

Recent regulatory and enforcement developments

Spain

ICAC fines PwC €10.5 million for Aena work

The Institute of Accounting and Audit of Accounts (ICAC) has fined PricewaterhouseCoopers (PwC) €10.5 million for "very serious infractions" arising from PwC's work for Aena – the partially-state-owned company that manages public airports in Spain.

The ICAC, a public body under the hierarchy of the Ministry of Economy, sanctioned PwC for failing to comply with its duty of independence. Specifically, ICAC alleged that PwC audited Aena's accounts in 2015 while also providing advisory services to Aena. The fine, if it becomes definitive, will be the highest fine ever imposed in Spain on an audit firm (Deloitte initially received a sanction of €12 million for its audit to Bankia's 2011 IPO, but that fine was subsequently lowered to €10.4 million).

A spokesperson for PwC has reported that the sanction has been appealed and noted that the ICAC has not questioned the conclusions of the Aena audit, and that "[t]he work carried out in Aena complied scrupulously with all national and international standards of independence."

For more information on Spain, contact:

Joaquín Ruiz Echauri
Partner, Madrid
T +34 91 349 82 74
joaquin.ruiz-echauri@hoganlovells.com

The United States

SEC and US Attorney's office charge six accountants in PCAOB data disclosure scheme

On January 22, 2018, the Securities and Exchange Commission (SEC) announced charges, and the U.S. Attorney's Office (USAO) for the Southern District of New York unsealed an indictment, in parallel administrative and criminal actions against six certified public accountants for allegedly misappropriating confidential Public Company Accounting Oversight Board (PCAOB) inspection data to bolster KPMG's performance in audit inspections.

Brian Sweet, a former Associate Director with the PCAOB, allegedly copied confidential inspections-related materials from an internal PCAOB database shortly before his departure from the PCAOB. Upon joining KPMG, Sweet allegedly advised three of his superiors that he possessed this information and ultimately provided the information to them. The information was disseminated among a small group of KPMG personnel as well as outside consultants retained by the firm. Sweet allegedly continued to gain access to confidential PCAOB materials through another PCAOB inspector, who later joined Sweet at KPMG; thereafter, a third PCAOB employee allegedly leaked confidential information to the former inspector about planned PCAOB inspections of KPMG.

In early 2017, the scheme allegedly unravelled when a KPMG partner suspected that the firm had received confidential information and reported her concerns to KPMG's Office of the General Counsel, which launched an internal investigation and promptly notified the authorities. Brian Sweet pleaded guilty to counts of conspiracy and wire fraud on 5 January 2018, prior to the unsealing of the indictment, and similarly reached a settlement deal with the SEC on 22 January 2018, the terms of which included a bar from practicing before the Commission as an accountant. The criminal case against the remaining defendants will proceed in the Southern District of New York, with the SEC's administrative proceedings stayed until resolution of that criminal case.

See *United States v. Mittendorf, et al.*, No. 1:18-cr-00036-JPO (S.D.N.Y. Jan. 17, 2018); *Six Accountants Charged with Using Leaked Confidential PCAOB Data in Quest to Improve Inspection Results for KPMG, SEC Press Release* (Jan. 22, 2018); *5 Former KPMG Executives and PCAOB Employees Charged in Manhattan Federal Court for Fraudulent Scheme to Steal Valuable and Confidential PCAOB Information and Use That Information to Fraudulently Improve KPMG Inspection Results*, Department of Justice Press Release (Jan. 23, 2018).

SEC charges accountant "gatekeepers" in fraudulent "shell factory scheme"

On 16 February 2018, the SEC announced charges against three Israeli residents, a Washington, D.C. attorney, and an Israeli auditor and his Maryland accounting firm for roles in a fraudulent scheme involving the creation of various public shell companies.

The SEC alleges that Sharone Perlstein, Aric Swarts, and Hadas Yaron (the Perlstein Group) created at least 15 shell companies by filing false and misleading registration statements and periodic reports with the SEC, creating phony business plans, appointing nominal officers, and conducting ostensible initial public offerings of some of those shells. In actuality, the Perlstein Group continued to control the companies' shares, subsequently selling off certain shells and profiting more than US$1.8 million in their ruse.

The SEC also brought civil charges against Alan Weinberg, CPA – as well as Weinberg's firm, Weinberg & Baer LLC – in the United States District Court for the District of Columbia, claiming violations of Exchange Act Section 10A(a)(2), and Weinberg & Baer with violating Rule 2-02(b)(1) of Regulation S-X. The SEC alleged that Weinberg, serving as the engagement partner for his firm's audits of certain of the shell companies' financial statements, knew – or was reckless in not knowing – that the Perlstein Group was committing fraud. Weinberg and his firm allegedly ignored numerous audit failures and red flags, failed to demonstrate a "professional scepticism" regarding the Perlstein Group's role (including a failure to investigate why the Perlstein Group personally retained Weinberg, rather than the shell companies' purported officers), and issued audit reports falsely stating that the audits had been performed in accordance to PCAOB's auditing standards. By doing so, the SEC alleged Weinberg and his firm "substantially assisted the Perlstein Group in perpetrating their fraud."

Weinberg and his firm settled the matter, without admitting or denying the allegations, for disgorgement of US$62,899.82, jointly and severally, and consented to suspension from appearing and practicing before the Commission as accountants.

The SEC also brought settled administrative proceedings against Simcha Baer, another Maryland-based accountant engaged in connection with the Perlstein Group's shells. According to the SEC, Baer failed to properly perform and document numerous engagement quality reviews for audits and interim reviews, and repeatedly back-dated and falsified documentation later produced to the SEC. The SEC's settlement order found that Baer engaged in improper behaviour per Section 4C(a)(2) of the Exchange Act and Rule 102(E)(1)(ii) of the SEC Rules of Practice. Also without admitting or denying the SEC's findings, Baer settled the matter, consenting to a permanent bar from appearing or practicing before the Commission as an accountant.

See *SEC v. Alan Weinberg and Weinerg & Baer LLC*, No. 1:18-cv-00360-BAH (D.D.C. Feb. 16, 2018) (Dkt. Nos. 1, 2, 5); *SEC Obtains Bars and Suspensions Against Individuals and Accounting Firm in Shell Factory Scheme*, Litig. Release No. 24051 (Feb. 16, 2018).

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

Dennis H. Tracey, III
Partner, New York
T +212 918 3524
dennis.tracey@hoganlovells.com

Allison M. Wuertz
Senior Associate, New York
T +212 918 3067
allison.wuertz@hoganlovells.com

Darcy N. Hansen
Associate, New York
T +212 918 3707
darcy.hansen@hoganlovells.com

Key contacts

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
christina.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, Washington, D.C.
T +1 202 637 5538
anjum.unwala@hoganlovells.com

Kevin T. Baumann
Senior Associate, New York
T +1 212 918 3081
kevin.baumann@hoganlovells.com

Omar Guerrero Rodríguez
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
Birmingham
Boston
Brussels
Budapest
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
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www.hoganlovells.com