Hogan Lovells

Global Accountants' Liability Update

UPDATED CONTENT
November 2020

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

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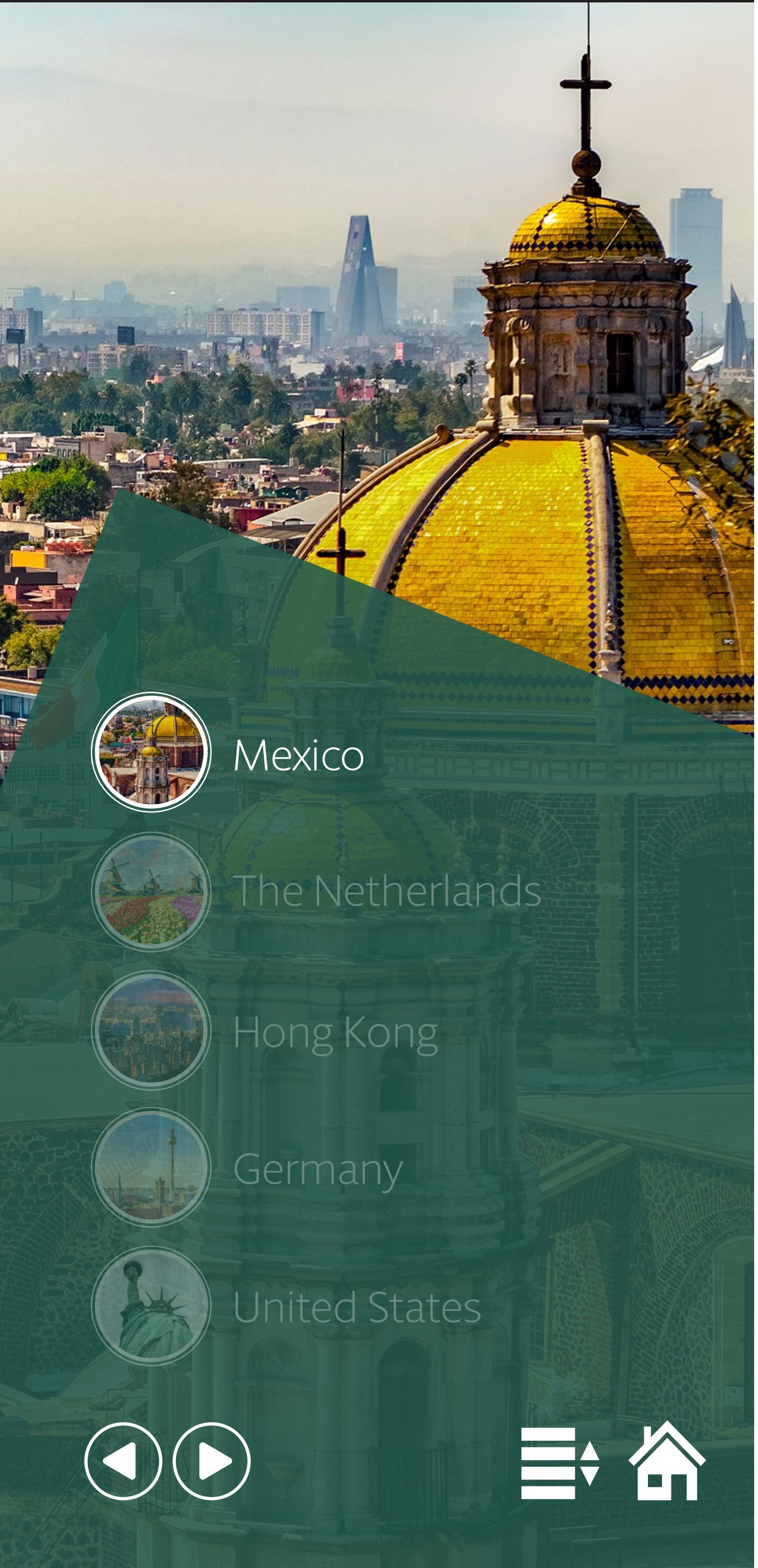


Mexico

Legislative reforms and Supreme Court opinion shape Federal Tax Code

Reform of the Federal Tax Code

On 8 September 2020, the Federal Executive submitted the 2021 Economic Package, which includes changes to the Federal Tax Code (CFF) that, if approved by Congress, will become effective as of 1 January 2021.

Currently, article 52-A of the CFF establishes the Tax Authority's power to require an accountant to file all information used in the elaboration of their opinion. It has also become a common practice in recent years for the Authority to demand that accountants appear in person, so the Authority can make further inquiries regarding the analysis of taxpayers' accounting information. However, the legal authority to request such appearances is not set forth in the CFF, and the Federal Administrative Court has issued contradictory precedents regarding the legality of these requests.

The Executive has therefore proposed revising article 52-A of the CFF to grant the legal authority to the Tax Authority to request in person appearances of accountants in addition to the filing of information.

It is important to note that the revised article 52-A establishes that the audit will take place exclusively with the accountant, which means there will be no room for legal representation.

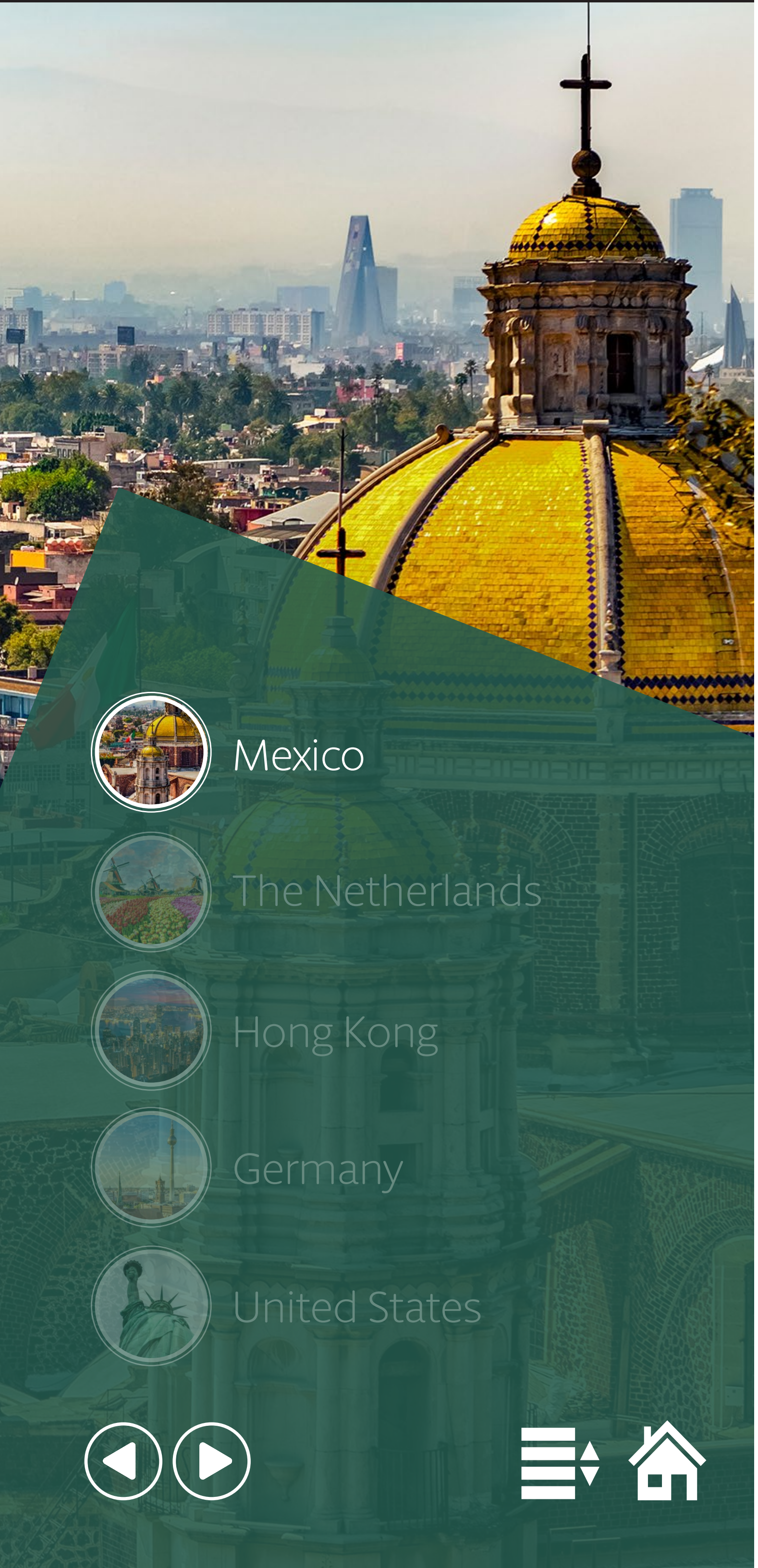
Jurisprudence issued by the Supreme Court

The second to last paragraph of article 52 of the CFF establishes the procedure the Tax Authority must follow in order to impose a sanction on registered accountants who issue an opinion that does not comply with all the applicable legal dispositions. These include a requirement that proper notification of the alleged irregularities be made, the accountant have an opportunity to render evidence and present arguments for dismissing such irregularities within the next fifteen days, and that notification of the result of the procedure be issued within twelve months of the closing of the period during which evidence and arguments can be presented.

However, the text of the law in force in years 2013 and 2014 contained a mistake, which would cause uncertainty regarding when the twelve month period the Authority has to issue a final resolution begins to run.

As a result, on 9 October 2020, the Supreme Court issued an opinion establishing that article 52, second to last paragraph; section c) of the CFF in force in 2013 and 2014 is unconstitutional because it causes uncertainty as to when this twelve month period the authority has to issue a final resolution in a sanction procedure begins to run.

Please keep in mind that such irregularity has been corrected in the current text of the law.



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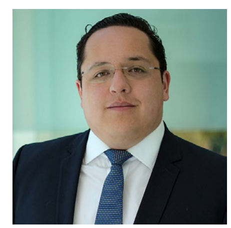

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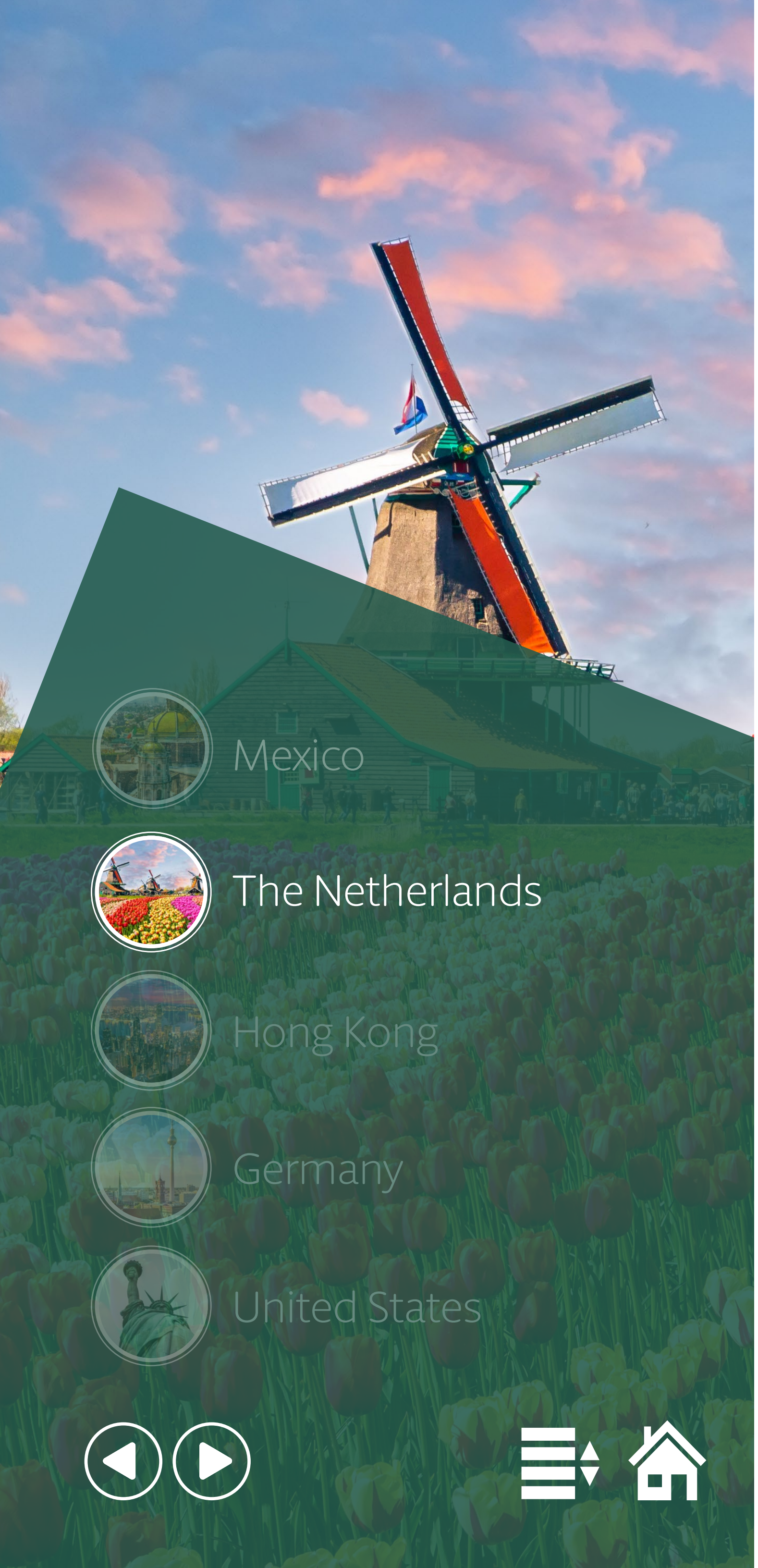


The Netherlands

Accountancy Division decision addresses interaction between a criminal conviction and disciplinary procedures

Introduction and facts

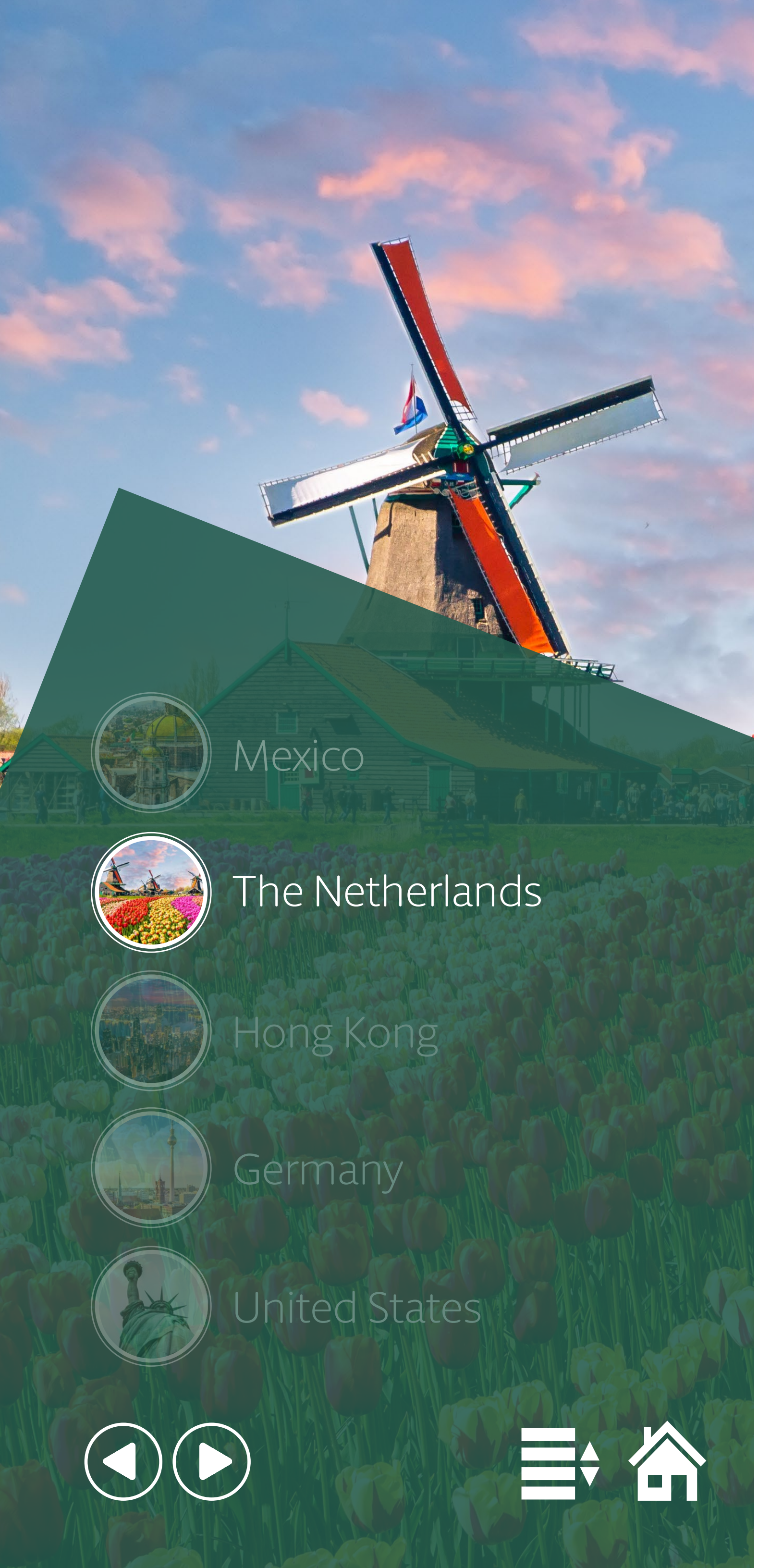
A registered accountant served as the financial director of a public limited company, which held a few subsidiary companies. He administered a private limited company within this group. In 2003, the private limited company filed a corporate tax return for the fiscal year from 1 June 2001 to 31 March 2003, which incorrectly claimed €5,010,583 in random depreciation (willekeurige afschrijving) on an office building that was sold in September 2002.

Article 23 of the Random Depreciation Implementation Regulations (Uitvoeringsregeling willekeurige afschrijving 2001) stipulates that random depreciation on designated assets is only possible if the commitments undertaken are notified within a period of three months (the depreciation regulation). The accountant submitted a form entitled "Notification of random depreciation of new buildings" to the Tax and Customs Administration along with a cover letter dated 10 December 2002, which identified 18 September 2002 as the date of occupation of the office building. However, according to the notarial deed (and as confirmed by the lessee), the premises was actually occupied beginning on 5 July 2002. Moreover, according to the "posting report," the cover letter was actually sent to the Tax and Customs Administration on 8 January 2003. The Tax and Customs Administration thus concluded that the building did not qualify for application of the depreciation regulation. In a letter dated 28 March 2003, the Tax and Customs Administration informed the accountant that the "Notification of random depreciation of new buildings" form could not be processed as timely.

In October 2017, the Court of Appeal concluded that the accountant had "actual control of intentionally making a false corporate tax return in 2003" and imposed imprisonment, community service and a fine. This decision prompted the Netherlands Institute of Chartered Accountants (de Nederlandse Beroepsorganisatie van Accountants or the NBA) to file a complaint against the accountant asserting he breached the rules of professional conduct.

Legal framework

The accountant previously deregistered himself from the NBA register. However, the conduct complained of took place in 2003 when he was still registered as an accountant, which is why he is still subject to disciplinary proceedings. Article 22(2) of the Disciplinary Rules for Accountants (Wet tuchtrechtspraak accountants or the Wtra) stipulates that the chairman of the NBA may file a complaint with the Accountancy Division in cases in which



an accountant has been convicted of a criminal offense that concerns the work performed by accountants. The complaint must be filed with the Division within three years of the conviction.

Decision of the Accountancy Division

Filing a tax return concerns work performed by an accountant and therefore falls within the scope of Section 22(2) of the Wtra. The NBA's complaint to the Accountancy Division filed pursuant to this provision asserted that the accountant's conduct violated Article 5 of the Registered Accountants Code of Conduct Regulation 1994 (in force at the time of the offense), which requires registered accountants to refrain from anything that is detrimental to the honor of the position of registered accountants. The Accountancy Division agreed that the conduct of the accountant was detrimental to the honor of the position of registered accountants and upheld the claim. In doing so, the Accountancy Division noted that knowingly and willingly stretching the truth and acting dishonestly in matters with the tax authorities was detrimental to the honor of the profession.

The Accountancy Division further concluded that the accountant has shown he is unworthy of the public trust, so only a removal from the registers is an appropriate penalty. It therefore ruled that he should not be reinstated in the registers for the maximum period of ten years. The Division also notes that the fact that the accountant already was deregistered (at his own request) does not preclude the imposition of a removal order that will insure the accountant may not be re-registered for a period of 10 years. Because of important public interests, this judgment was even declared provisionally enforceable, which means that any appeal by the accountant will not frustrate the execution of the decision.

Key takeaways

Typically under Article 22(1) of the Wtra, a complaint must be lodged within 10 years from the time of the act or omission at issue. In case of a criminal conviction however, the NBA can file a complaint within 3 years of the conviction. A complaint to the Accountancy Division may therefore be timely more than 10 years after the act or omission at issue – 17 years later in the case at hand. Also, the fact that an accountant has already deregistered himself, does not stand in the way of removing the accountant from the register for the maximum period of 10 years.

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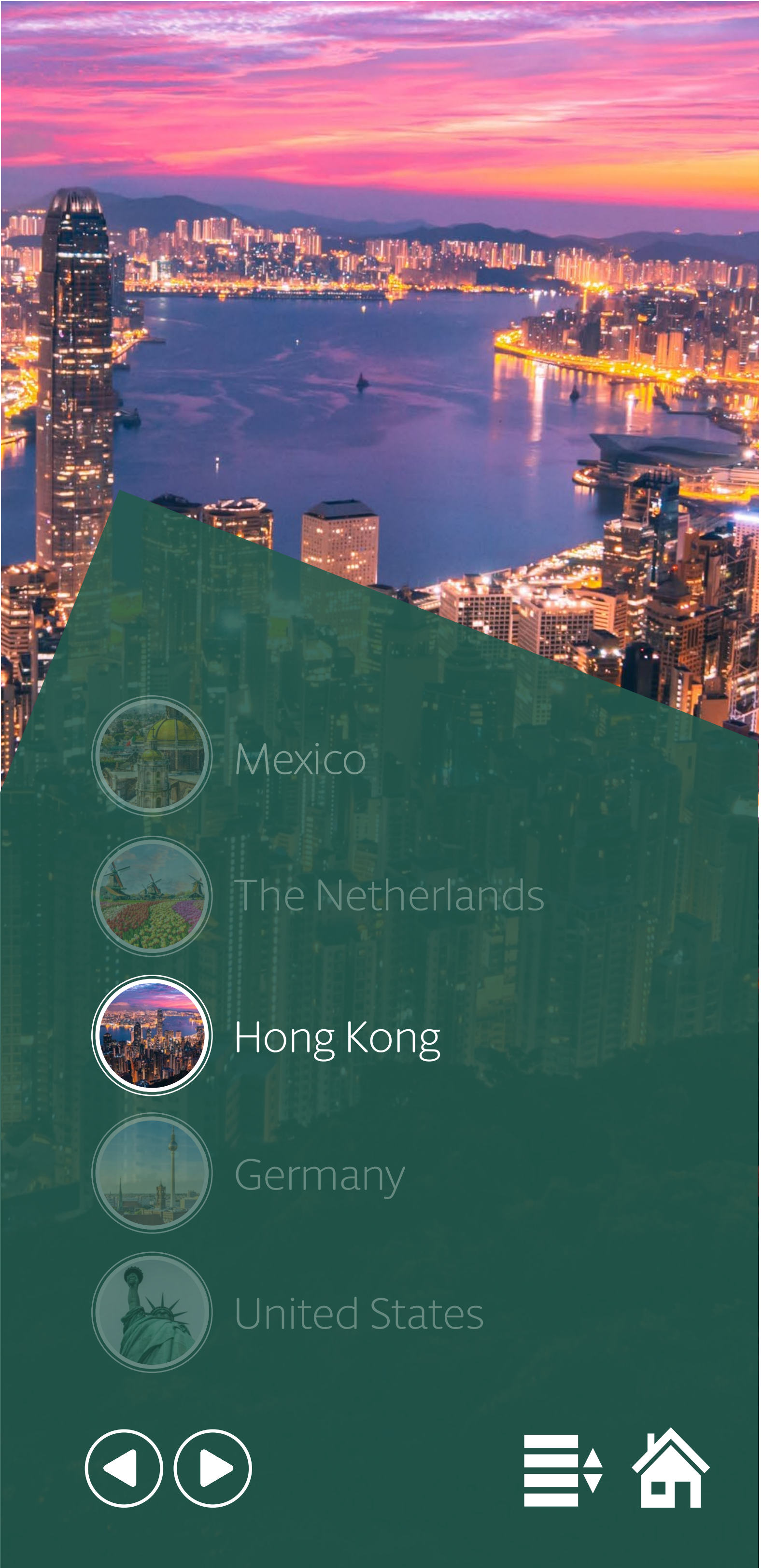


Hong Kong

A broader reach – Hong Kong Stock Exchange proposes to strengthen disciplinary powers

On 7 August 2020, the Stock Exchange of Hong Kong Limited published a consultation paper on proposals to make its regulatory regime more robust by means of, amongst other things, introducing secondary liability for breaches of the Listing Rules and extending its sanctioning reach to employees of professional advisers, including financial advisers and accountants.

Introducing secondary liability for Listing Rule breaches

The current framework does not impose secondary liability for non-compliance, meaning that professional advisors including accountants (and their employees and employees of any of their subsidiaries) may be let off the hook despite their conduct contributing significantly to breaches of the Listing Rules by a listed issuer and/or its directors. "Secondary liability" is the responsibility that arises when the person directly liable fails to discharge the obligation.

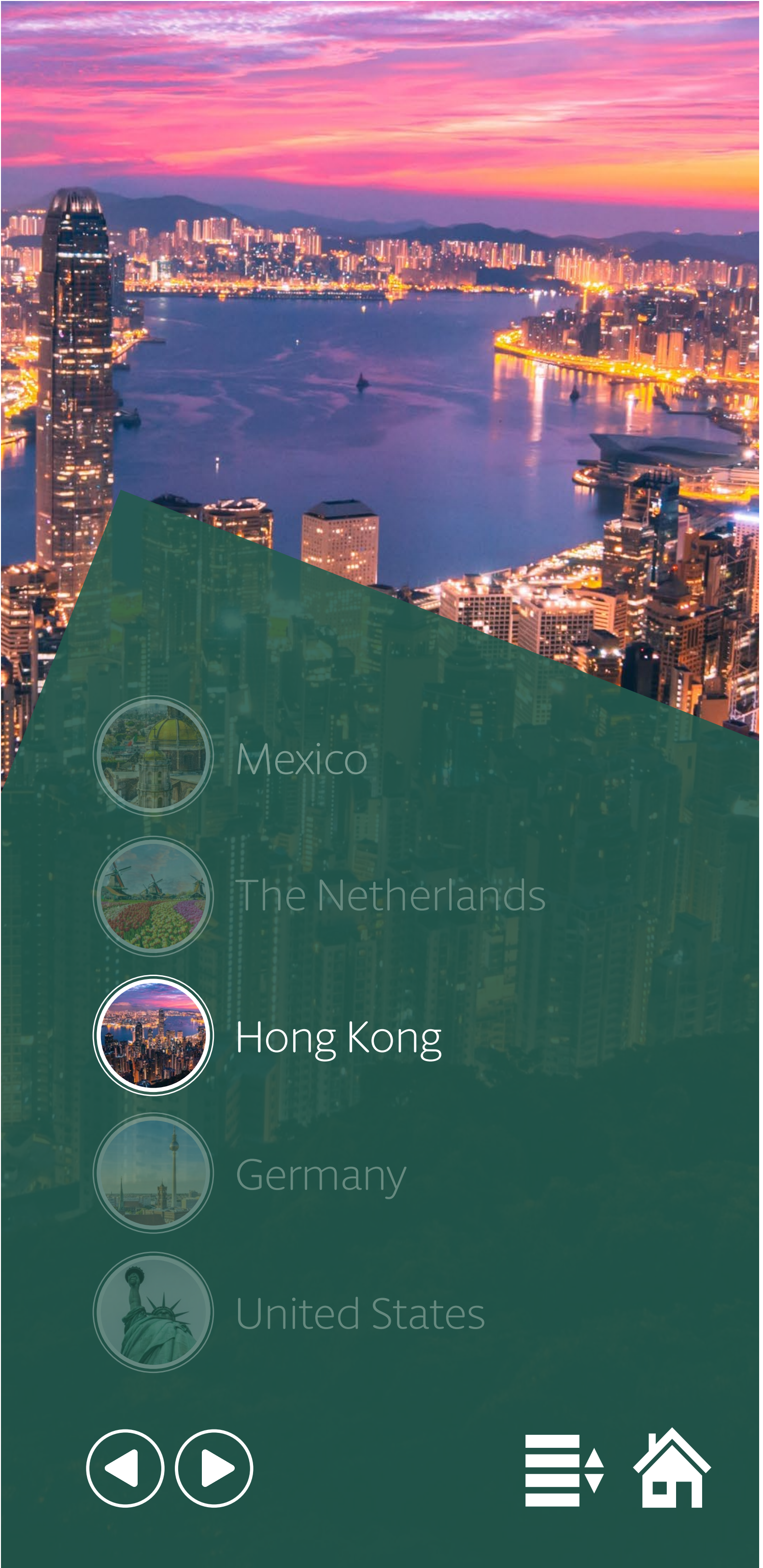
The Exchange is now proposing that relevant parties be subject to secondary liability for breaches of Listing Rules in circumstances where the Exchange determines that the person "...has caused by action or omission or knowingly participated in a contravention of the Listing Rules."

In practice, this could mean that financial advisers may be held secondarily liable if a company fails to disclose in its circular the significant deteriorating financial performance of a target in an acquisition and the financial adviser knowingly agrees with the listed company and its director to withhold such information.

Explicit sanctions imposed

The consultation paper also attempts to clarify certain ambiguities and fix gaps in the current regime. For example, while Listing Rule 2A.09 currently allows the Listing Committee of the Exchange to impose sanctions if it finds there has been a rule breach by any of the relevant parties, the Exchange proposes to add an additional provision targeting occasions where the requirements imposed by the Listing Division, the Listing Committee or the Listing Review Committee of the Exchange are not properly complied with.

Similarly, the Exchange proposes to include a provision to make explicit, and to raise awareness of the duty on parties to provide complete, accurate and up-to-date information when interacting with the Exchange in respect of its enquiries and investigations. This expectation would apply to financial advisers, independent financial advisers and accountants, provided that the provision does not



contravene the relevant requirements of professional conduct.

Broader power of bans on professional advisers

The Exchange can currently ban any professional adviser or a named individual employed by the same from representing a named party in relation to a stipulated matter or matters coming before the Listing Division or the Listing Committee for a specified period pursuant to the existing Listing Rule 2A.09(5).

In view of the limited deterrent value of the current formulation, the Exchange proposes to expand its current powers such that:

1. the ban in Rule 2A.09(5) can be imposed upon general employees of professional advisers; and

2. the scope of the ban can be extended to representation of any party (as opposed to a stipulated party).

Overall, the proposed changes strengthen the Exchange's ability to impose more stringent sanctions against a broader spectrum of persons involved in breaches of the Listing Rules, which is overall consistent with the Exchange's aim of enhancing its regulatory regime and promoting market integrity.

A procedural point worth noting is where an accountant breaches the Listing Rules which may also breach the rules relating to professional conduct imposed by the Hong Kong Institute of Certified Public Accountants, the Exchange will refer the case to the relevant professional body for determination of disciplinary actions or penalties.

The deadline for responding to the consultation paper was 9 October 2020. We are expecting to see market's reaction in the form of a consultation conclusion by the first quarter of 2021.

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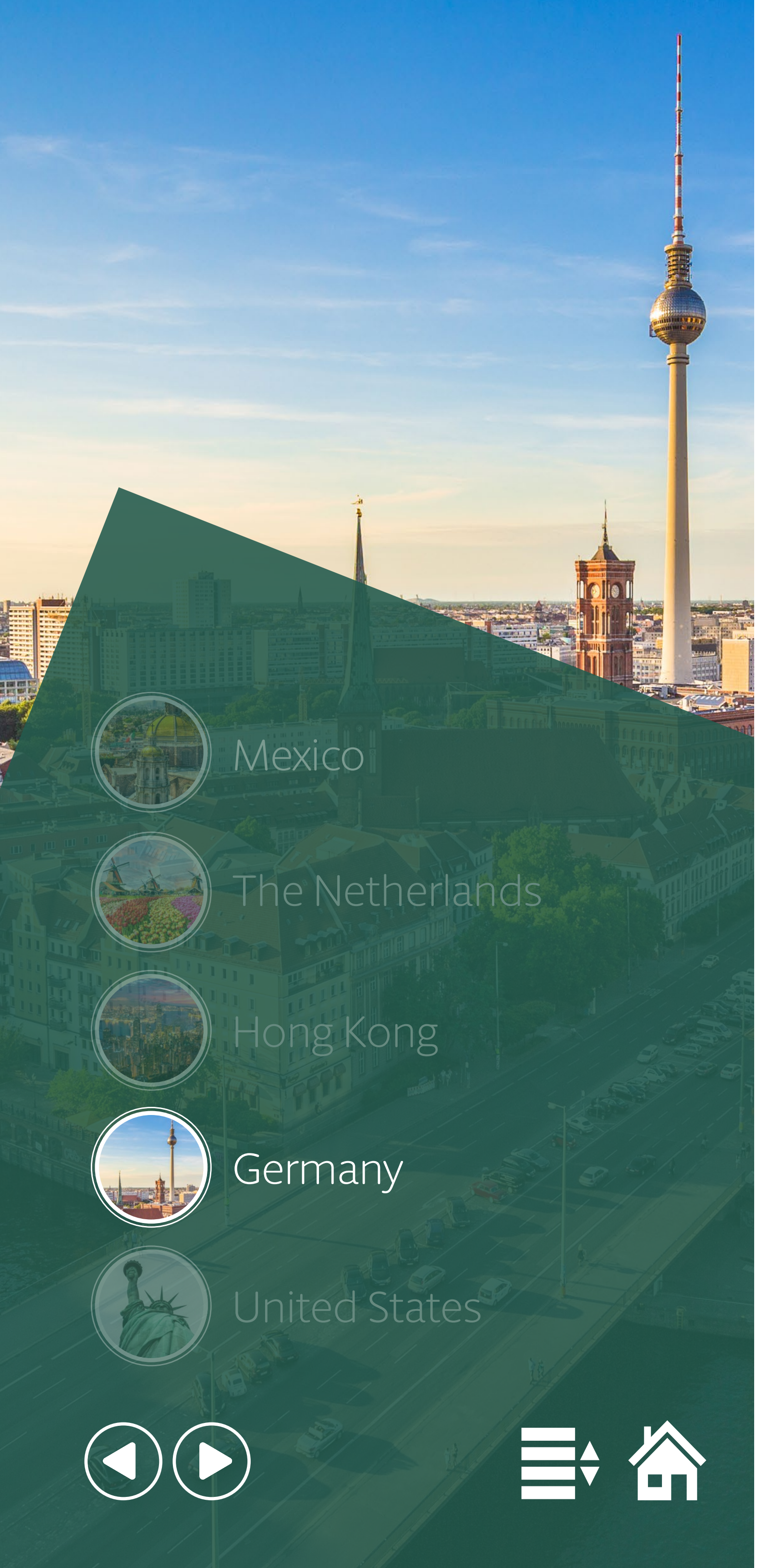


Germany

Proposed legislation would tighten accounting regulations and raise liability limits

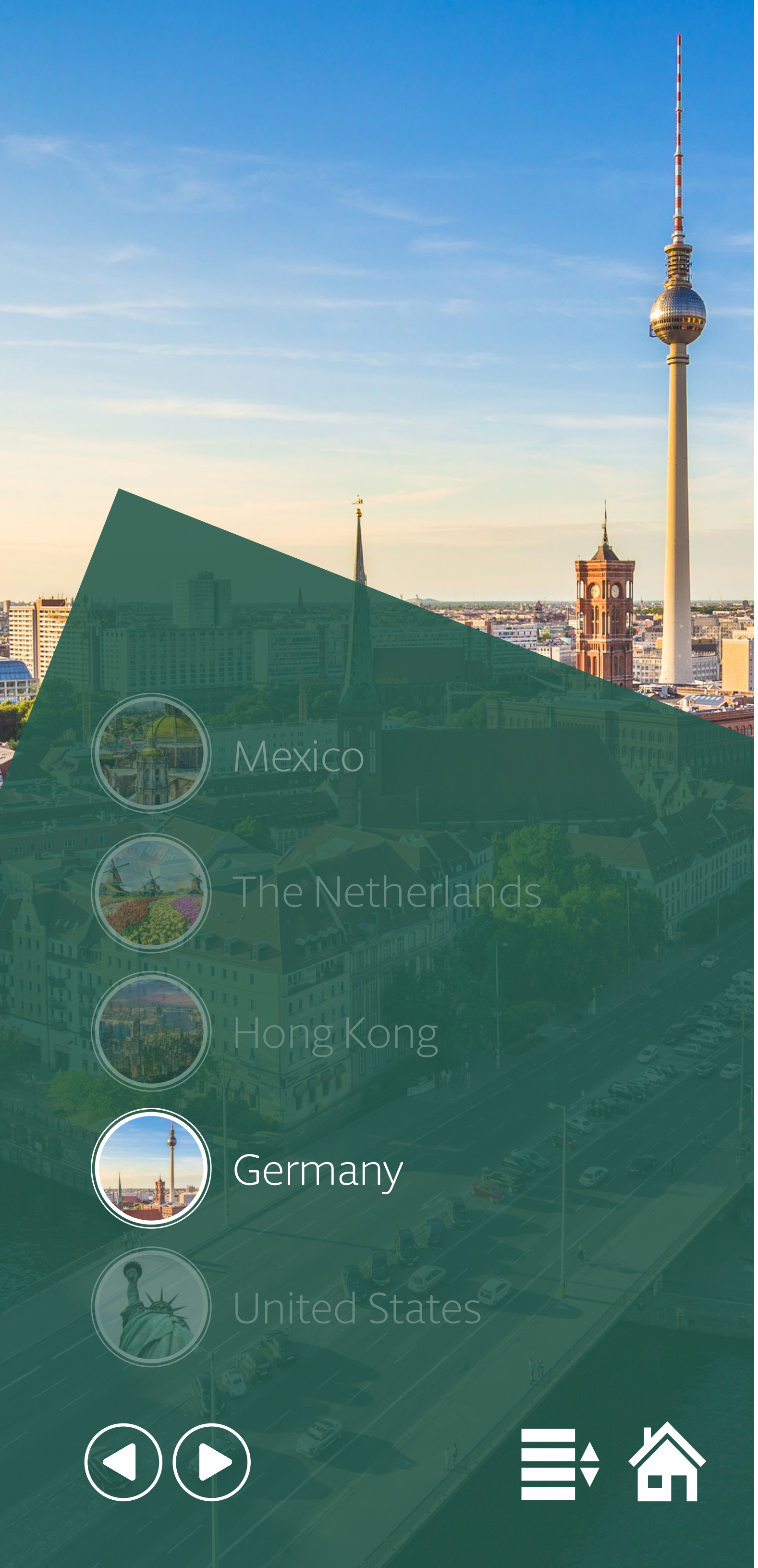
In the wake of the Wirecard scandal, on 26 October 2020 the German Federal Ministry of Finance and the German Federal Ministry of Justice introduced a draft bill which proposes several changes to the legal framework for accountants [Entwurf eines Gesetzes zur Stärkung der Finanzmarktintegrität - Finanzmarktintegritätsstärkungsgesetz].

The Wirecard scandal involves German stock corporation Wirecard AG (Wirecard), which was listed as one of the 30 largest publicly listed companies in Germany on the DAX index. In June 2020, Wirecard made a public announcement that it was unable to verify the existence of €1.9 billion in cash reserves that were supposed to be held in an escrow account in the Philippines. Apparently, for many years, the corresponding bank statements had been falsified. As a consequence, Wirecard had to file for insolvency on 25 June 2020. Since then, many more irregularities have come to light.

This scandal has cast a shadow over the German regulations for accountants. German politicians and the press broadly discussed why this fraud was not detected earlier and what can be done to identify similar fraud schemes in the future at an earlier stage. This has prompted the German government to propose the introduction of more stringent requirements for accountants. The major contents of the draft bill are as follows:

- Companies shall be obliged to replace their accountant on a more regular basis. Today, according to Art. 17 Regulation (EU) No 537/2014 (Regulation on specific requirements regarding statutory audit of public-interest entities) capital market-oriented companies and certain companies from the financial and the insurance sector (€ public-interest entities) are already obliged to appoint a new accounting firm after ten years. However, for capital market-oriented companies, German law stipulates the possibility to extend this term up to 20 or – in case of a joint audit – even up to 24 years. Pursuant to the draft bill, this option would be eliminated, and all public-interest entities including capital market-oriented companies would generally be obliged to replace the accounting firm every ten years.

- The draft bill proposes to prohibit accountant firms from providing non-audit advice to those public-interest entities for whom the accounting firm is appointed as audit firm. According to Art. 5 regulation (EU) No 537/2014, accounting firms are generally barred from providing so called non-audit services. The corresponding list in



Art. 5 regulation (EU) No. 537/2014 identifies a wide range of services typically offered by accounting firms. However, German law currently provides an exemption and imposes less restrictive rules. Sec. 319 German Commercial Code [HGB] identifies only a few cases in which accountants are barred from providing non-audit related advice. These include cases in which an accountant provides services that are considered to result in a "self-audit" – e.g. when the accountant has assisted in the preparation of accounting records, of the annual financial statement, or in an internal audit. See Sec. 319 para. 3 no. 3 HGB. Furthermore, with regard to public-interest entities, accountants shall not provide tax advice or valuation services. However, this prohibition applies only if these services have a relevant impact on the annual financial statements. See Sec. 319a para 1 HGB. According to the draft bill, these exemptions from the stipulations in Art. 5 regulation (EU) No 537/2014 would be lifted. As a consequence, accounting firms would largely be barred from providing non-audit related advice to audited public-interest entities.

- According to the draft bill, a stricter liability regime shall be imposed on accountants. Under the current legal framework, unlimited accountant liability is in principle limited to instances of intentional acts. If the accountant acts negligently (which also includes gross negligence), the liability is limited to an amount of €1 million for each audit carried out, or to an amount of €4 million in the case of companies where the shares are admitted to trading on the regulated stock market. The draft bill proposes that not only in cases of intentional breaches, but also when the accountant acted gross negligently, no liability cap shall apply. Furthermore, the draft bill provides that in case of ordinary negligence the accountant shall be liable for up to €20 million (i.e. instead of only €4 million) in relation to audits of public-interest entities. For other companies the liability cap would be increased from €1 million to €2 million.

These proposed revisions have been criticized by the press and by accountant associations. In particular, there is criticism that the proposals of the draft bill would not reduce the risks of fraud schemes such as the Wirecard scandal. The discussion has just started and further revisions to the draft bill are likely. We will provide you with an update in further editions of this newsletter.

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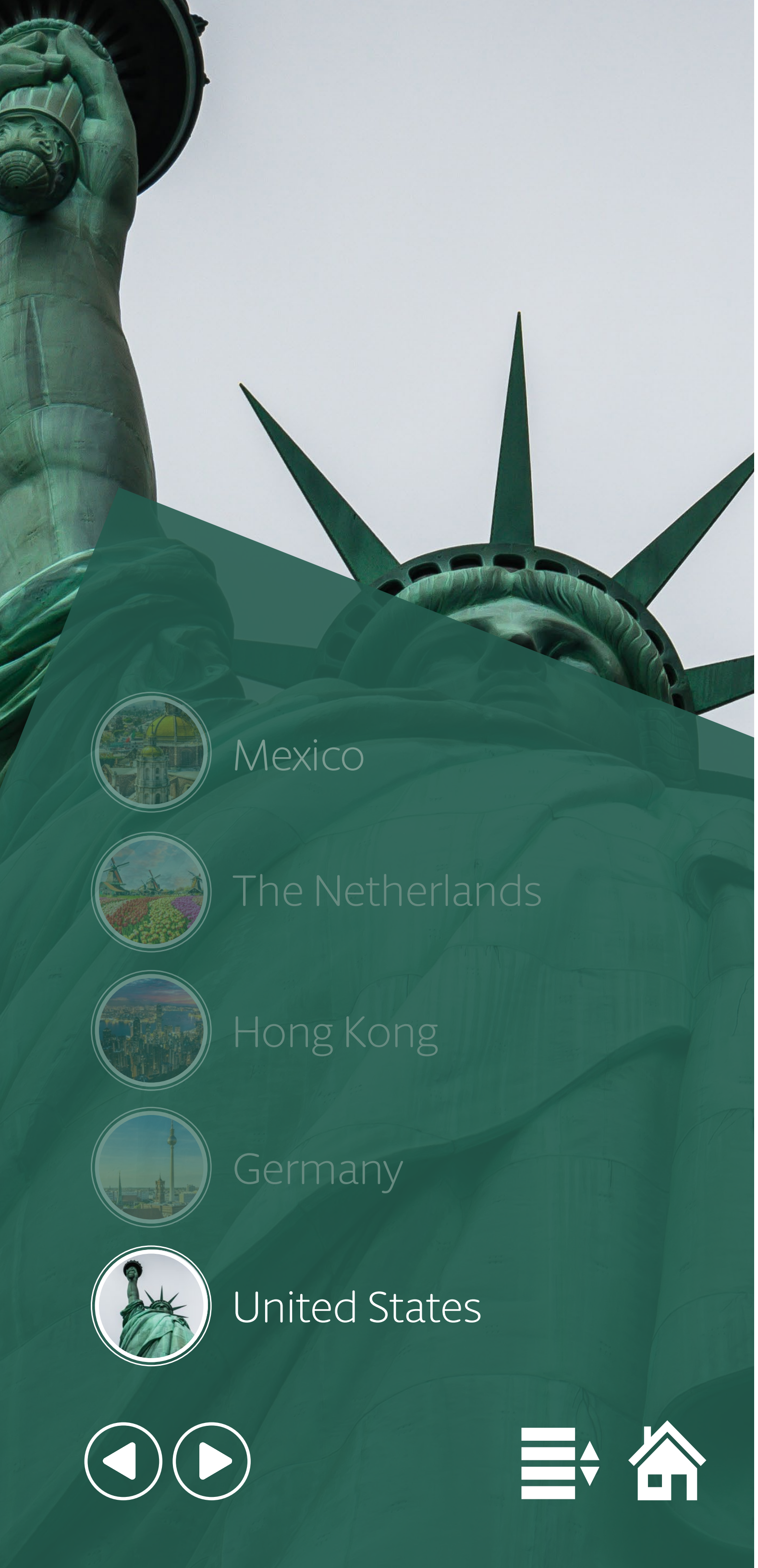


United States

Auditor fails to investigate suspected impropriety

On 13 August 2020, the Securities and Exchange Commission (SEC or the Commission) released an order making findings and imposing remedial sanctions in In the Matter of Brian Dee Matlock, CPA. The enforcement action highlights the need for auditors, when they become aware of information that a client may have committed an illegal act, to determine whether it is likely that an illegal act occurred.

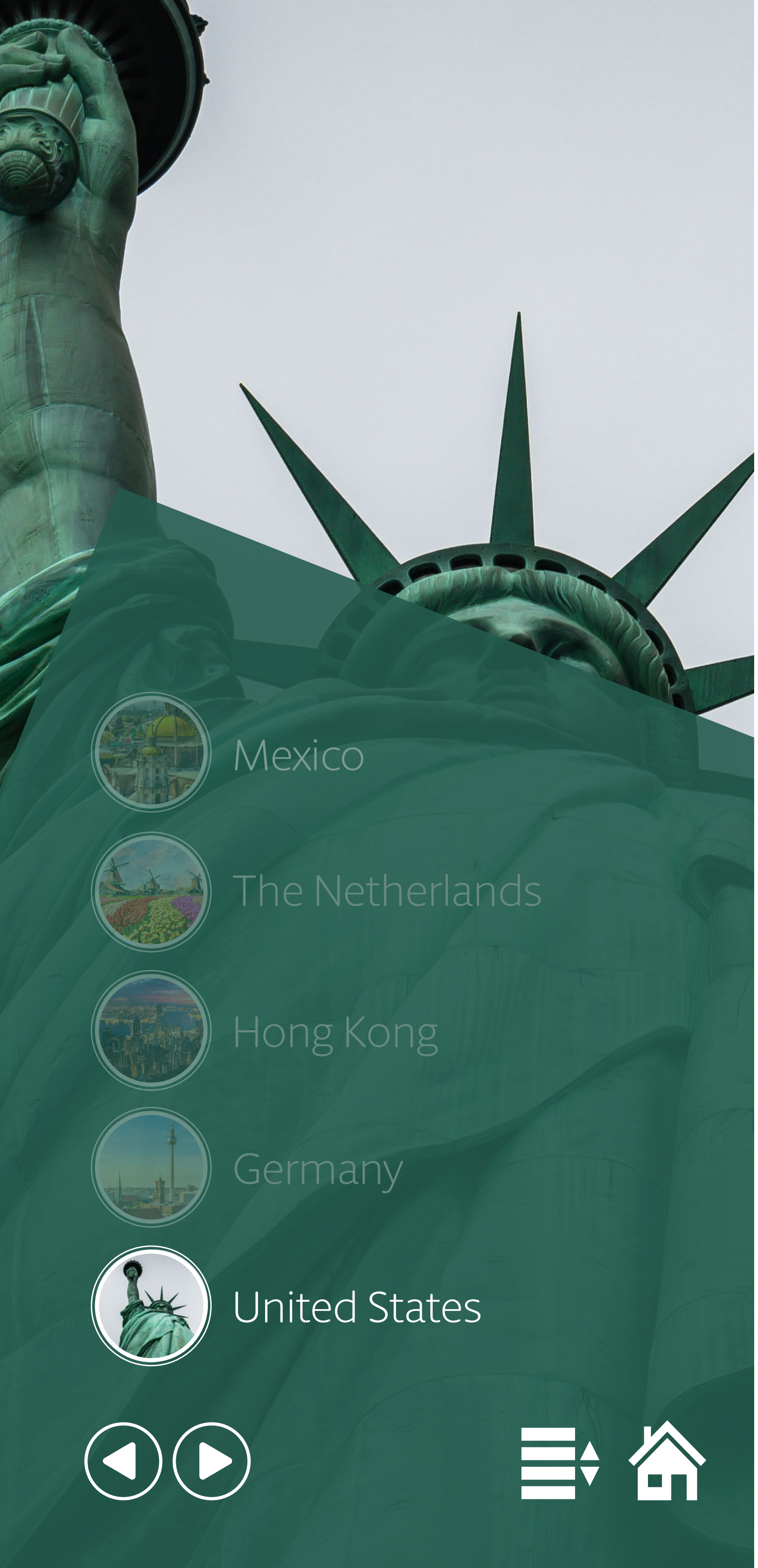
Breitling Energy Corporation, Inc. (Breitling), a Dallas-based energy company, retained Rothstein, Kass & Company, P.C. (RK), formerly a PCAOB-registered auditing firm, to audit its financial statements over a two year period ending 31 December 2013. Brian Dee Matlock served as Breitling's engagement partner during this period. Over the course of the audit, Matlock (and RK) learned of Breitling's improper conduct and accounting practices but failed to take appropriate measures to further investigate these potentially illegal activities.

During the audit, Matlock and RK learned that Breitling's predecessor, Breitling Oil and Gas Corporation (BOG) had engaged in a number of inappropriate actions. First, BOG improperly inflated their projections related to various oil and gas prospects. Investors would pay a certain percentage of the overall projected costs in return for an equity interest in the future profits of these prospects. Not only were these prospects not registered with the Securities and Exchange Commission, they were also far cheaper than BOG represented. This meant that BOG took in much more money than it expended in these prospects, and this difference equated to a large portion of the company's profits.

Second, BOG improperly co-mingled investor funds that were purportedly only to be used for prospect drilling, testing, and completing costs with money earmarked for general business expenses. This resulted in BOG having difficulty paying prospecting bills and even losing investors' interests in prospects when it failed to pay certain bills, even though the company raised more than enough money to cover these expenses.

Third, BOG regularly sold interests in prospects that it had not yet acquired, which also accounted for a significant portion of the company's total revenues. BOG would frequently transfer these non-existent rights to prospects to other prospects that actually existed, even though it had no authority to do so under its agreements with investors.

Fourth and finally, Breitling's CEO Chris Faulkner misappropriated a large amount of the investors' funds for his personal use. He also funnelled money from BOG to his personal accounts through fraudulent expense reimbursements and service fees. Using both these schemes, Faulkner received over $10,000,000 from the company.



The SEC found that during the audit, Matlock and RK learned of these improprieties and failed to take any action to investigate. Specifically, the SEC found they failed to check whether any illegal activity had occurred, a violation of AU § 317.07 and Section 10A(b)(1)(A)(i) of the Exchange Act, and violated Rule 2-02(b)(1) of Regulation S-X by falsely claiming that the audit had adhered to generally accepted accounting standards. Finally, the SEC found these actions (or inactions) amounted to "improper professional conduct" under Exchange Act Section 4C(a)(2) and CRP Rule 102(e)(1)(ii).

As a result, Matlock was barred from practicing as an accountant in front of the Commission with the option of seeking reinstatement after one year.

Gaffey submitted the personal information of von der Goltz's mother to a U.S. bank in Manhattan. Gaffey pleaded guilty to one count of conspiracy to commit tax evasion and to defraud the United States, one count of wire fraud, one count of money laundering conspiracy, four counts of willful failure to file Reports of Foreign Bank and Financial Accounts, and one count of aggravated identity theft.

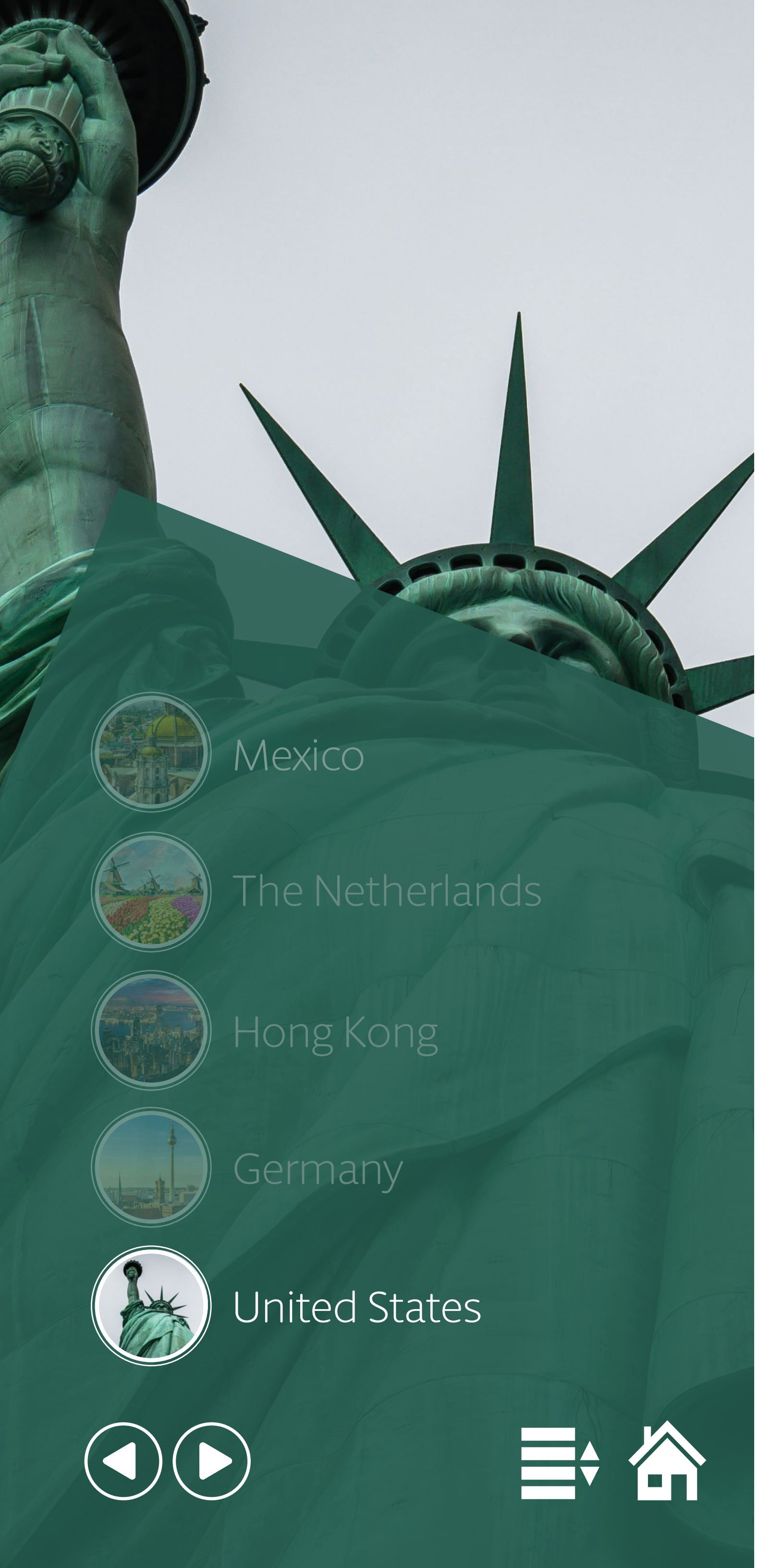
Gaffey and von der Goltz were sentenced to 39 and 48 months in prison respectively.

Recent PCAOB orders find accounting firms failing to file Form 3 under PCAOB Rule 2203

According to PCAOB Rule 2203, registered public accounting firms must complete and file a special report known as a "Form 3" within 30 days of the occurrence of any specified reportable event, including certain legal and licensing matters or disciplinary proceedings. Over the last few months, the PCAOB reported that a number of accounting firms have recently failed to make this required filing.

Zhonghua Certified Public Accountants LLP, a partnership organized under Chinese law and headquartered in Shanghai, did not disclose four reportable events concerning two disciplinary proceedings initiated by the China Securities Regulatory Commission (CSRC). The firm had "become a defendant or respondent in a civil or alternative dispute resolution proceeding initiated by a governmental entity or in an administrative or disciplinary proceeding," one of the events that requires a Form 3 disclosure. The firm was censured by the PCAOB, required to pay a $10,000 fine, and forced to implement internal measures to ensure such an oversight would not happen again.

Similarly, Ruihua Certified Public Accountants, a partnership organized under Chinese law and headquartered in Beijing, did not disclose seven reportable events concerning five disciplinary proceedings initiated by the CSRC. The firm failed to disclose one proceeding for one year after learning it was initiated and did not disclose



another for four years. As a result of these violations, the firm was censured and forced to pay a $10,000 fine.

East Asia Sentinel Limited, a limited liability company registered and headquartered in Hong Kong, also failed to disclose two reportable events concerning one disciplinary proceeding initiated by the Hong Kong Institute of Certified Public Accountants (HKICPA). The firm's internal compliance and reporting systems did not identify the reporting requirement, leading to the violation of Rule 2203. The firm was censured, required to pay a $10,000 fine, and forced to implement internal measures to ensure such an oversight would not happen again.

Finally, Da Hua CPAs (Special General Partnership), a partnership organized under Chinese law and headquartered in Beijing, similarly did not disclose two reportable events concerning one disciplinary proceeding initiated by the CSRC. The firm was censured, required to pay a $10,000 fine, and forced to implement internal measures to ensure such an oversight would not happen again.

These four examples serve as a reminder that firms must understand the PCAOB disclosure obligations and should carefully monitor developments in relevant legal, licensing and disciplinary matters to determine when a Form 3 is required to be filed with the PCAOB.

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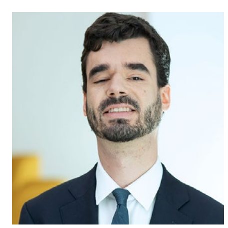

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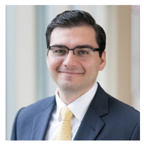

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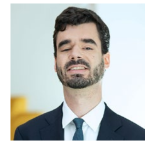

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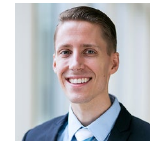

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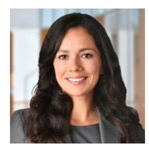

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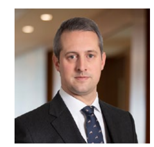

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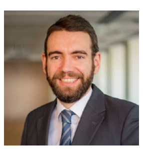

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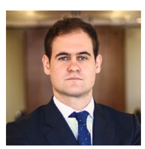

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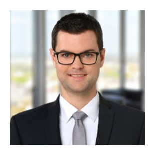

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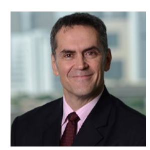

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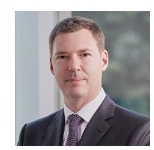

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