Hogan Lovells

Global Accountants' Liability Update

September and October 2016

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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 France, Germany, Hong Kong, Italy, Mexico, 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 Hong Kong, Italy, Spain, and the United States, which are summarized in the pages that follow.

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Hong Kong

Recent Court Decisions

Ex-partners found in contempt of court over non-compliance with third party disclosure order

In a judgment handed down on 18 October 2016 , the Hong Kong High Court found two ex-partners of accounting firm JBPB & Co. (formerly known as Grant Thornton) in contempt of Court for non-compliance with a third party disclosure order made by the Court in March 2015.

Mr. Tang and Ms. Wong were appointed as joint and several liquidators of a company known as CWT in 2011, shortly before the split of the JBPB & Co. partnership. Following the split, the partners of JBPB became engaged in a partnership dispute.

In a separate action, in 2015, third party disclosure orders were made against Mr. Tang and Ms. Wong, in their capacities both as joint and several liquidators of CWT and as minority partners of JBPB following the split. They did not comply with the disclosure orders, claiming that they did not have possession, custody or power over the documents after the JBPB & Co. break up.

The court dismissed this argument finding that Mr. Tang and Ms. Wong were the handling partners and the most appropriate persons from whom disclosure should be sought. The court further found that they had simply ignored the order and found that their non-compliance was deliberate. A sentencing hearing was scheduled for late October but no further information is publicly available.

Court of Appeal upholds HKICPA disciplinary committee decision

The Hong Kong Court of Appeal has dismissed an appeal by accounting firm RSM Nelson Wheeler and a partner of that firm challenging a decision of the Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants (HKICPA).

The decision on appeal found that the firm failed to meet professional standards by failing to ensure that a decline in the value of shares of a company, HKAS39, were accurately reflected in the audited consolidated financial statements.

In dismissing the appeal, the court referred to its own precedent holding that when hearing appeals from a professional disciplinary committee, every professional body is entitled to apply its own professional judgment. The court should second-guess the professional judgment of a disciplinary committee only if the committee has plainly misread the evidence and came to a conclusion which is plainly wrong.

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First significant judgment in connection with Act 22/2015, on Accounts Auditing

Spain

The Spanish Supreme Court published its first significant judgment (dated 1 July 2016, but published more recently) applying the new regime of liability provided for in the Act 22/2015, on Accounts Auditing. This judgment held that two auditors were jointly responsible for the violation of both their contractual and their non-contractual obligations.

The Supreme Court explained that the new regime of auditor's liability is designed to provide compensation for damage or harm caused to society as a result of an intentional or negligent fulfilment of obligations by the auditor. The relevant auditor obligations are the legal ones assumed by the auditor as part of the contractual undertakings and others, which are contractually assumed provided they are not incompatible with the legal ones.

The decision indicates that auditor liability requires the following:

(i) An unlawful action by the auditor related to the contractual relationship between the auditor and the audited company;

(ii) The auditor acted intentionally or negligently;

(iii) The audited company suffered an injury or damage; and

(iv) A causal link between the damage and injury suffered by the audited company and the auditor's unlawful conduct.

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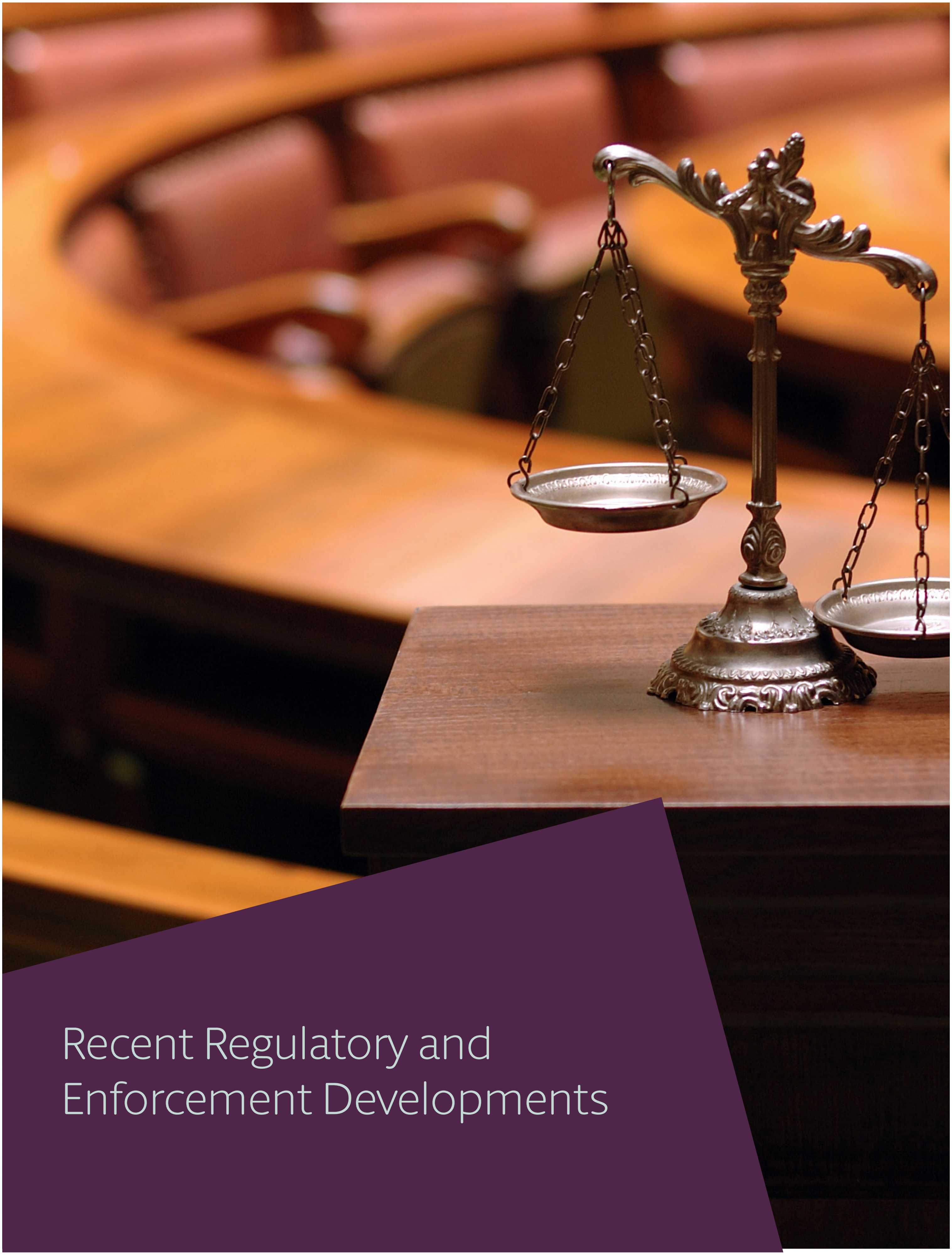
PwC settles $5.5 Billion Taylor Bean Lawsuit

PricewaterhouseCoopers LLP ("PwC") reached a mid-trial settlement with the trustee for now-defunct mortgage lender Taylor, Bean & Whitaker Mortgage Corporation ("Taylor Bean") in what has been considered one of the largest lawsuits ever brought against an audit firm. The suit was settled for an undisclosed amount in Miami-Dade County Circuit Court in late August 2016. Taylor Bean & Whitaker Plan Trust v. PricewaterhouseCoopers, LLC, No. 2013-33964-CA-01.

In this case, PwC did not perform an audit of Taylor Bean but, instead, the case stemmed from PwC's auditing work for Colonial BancGroup Inc., ("Colonial Bank"), where Taylor Bean—then one of the nation's largest privately held mortgage lenders—was a significant customer. The lawsuit alleged that PwC failed to detect a fraud conducted by Taylor Bean Chairman and others that eventually led to the bankruptcy of Taylor Bean in 2009. Taylor Bean argued at trial that PwC had certified the existence of over $1 billion in Colonial Bank assets that allegedly did not exist, were worthless, or had been sold.

PwC maintained that it complied with auditing standards and that, as the professional auditing standards make clear, even a properly designed and executed audit may not detect fraud—particularly in instances where there was collusion, fabrication of documents, and the override of controls that occurred at Colonial Bank.

Taylor Bean's auditor, Deloitte & Touche, and the trustee reached a confidential settlement in 2013.



Recent Regulatory and Enforcement Developments

Italy

Brand new rules for Italian audits

As we reported in our last update, 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. This new legislation modifies the obligations of auditors and auditing firms in a number of ways.

Professional scepticism

Article 9 requires that auditors act not only in accordance with the applicable professional code of conduct but also with "professional scepticism," i.e. with a critical and questioning approach. Such scepticism requires that auditors recognize the possibility that material misstatement (due to errors or frauds) may exist and take steps to identify potential inaccuracies, especially vis-à-vis assessments from the audited company concerning fair value, depreciation, future cash flow, reserves, and qualification of the audited company as a going concern.

Confidentiality and professional secrecy

Confidentiality and professional secrecy obligations are now addressed under article 9-bis, which clarifies that these obligations: i) attach to all information and documents analysed in the audit and ii) extend beyond the conclusion of the audit. Article 9-bis also governs the transfer of information between auditing firms (within Italy or abroad).

Auditor independence

This legislation also re-shaped the fundamental principles and duties of auditors, enhancing the principles of independence and objectivity which, pursuant to amended Article 10 apply to auditing firms, auditors, and any individual who might "influence directly or indirectly the outcome of the audit" during either the audit period or the period to which the audited financial statements refer. To this end, auditing firms must implement reasonable measure to guarantee their independence and even resign in the event of a personal conflict or if their independence is threatened due to financial, personal, or business relationships with the audited company. Auditing firms are also prevented from holding financial instruments issued or granted by the audited company or linked companies.

With articles 10-bis, 10-ter, 10-quater and 10-quinquies, the Italian legislature has reshaped the audit process and set new rules and procedures designed to promote auditor independence and objectivity.

— Article 10-bis establishes that before accepting appointments, auditing firms and auditors shall verify and document: (i) their independence and impartiality; (ii) any threats to this independence any measures taken to reduce such threats; (iii) availability of adequate personnel, time and resources; (iv) possession of required qualifications by the supervising auditor.

— Article 10-ter requires that auditors implement a salary policy aimed at encouraging quality audits and internal control protocols. The latter must be conveyed to all the auditing firm's employees and aim to ensure (i) auditors' independence, (ii) compliance with any internal decision and established procedure; (iii) appropriate employee knowledge and experience, (iv) capacity to deal with incidents possibly affecting integrity of the audit, and (v) compliance with laws, rules and regulations.

— Article 10-quater regulates the organization of work providing that (i) within an auditing firm, one (or more) supervising auditor(s) shall be designated for each audit; (ii) auditors/auditing firms shall keep records of clients, audits and any complaints relating to the audits.

— As to consolidated financial statements, article 10-quinquies establishes, inter alia, that auditors are fully liable for the audit and the relevant reports even when they are retained to review audits conducted by other auditors or auditing firms.

Relevant standards and other rules

Article 11 explicitly establishes that audits are conducted in accordance with the accounting standards to be adopted by the EU Commission (pursuant to art. 26, para. 3, Directive 2006/43/EC as amended by Directive 2014/56/EU) and, in the absence of relevant EU standards, with the transitory accounting standards set by the Italian Ministry of Economy and Finance with the cooperation of the Italian Securities and Exchange Commission ("CONSOB"), and professional associations.

With regard to auditors' appointment, revocation and resignation, amended article 13 now establishes, inter alia, that (i) the choice of auditors cannot be limited by a company's by-laws, (ii) when the audited company is of 'public interest', 5% of the shareholders, a supervising body or CONSOB can request that a competent court revoke an auditor.

Amended article 14 now dictates required content of audit reports, and requires that such reports also indicate any possible significant error identified in the company annual report and include a statement expressing any doubts that the company is a going concern. If several supervising auditors are appointed, they must jointly sign the audit report and, in case of disagreement, they are allowed to include separate opinions.

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Former auditors of Afinsa could face two or three years of imprisonment

In a 18 October 2016 indictment, Spanish prosecutors announced they will seek two and three years prison terms for external auditors of Afinsa. The auditors are accused of fraud and falsification of the annual accounts of Afinsa. The Spanish company was at one time the world's third largest collectibles company and is accused of operating a pyramid scheme. The prosecution considers the external auditors culpable in the fraud and falsification of the accounts.

Investigations continue regarding the Bankia IPO

A Spanish Judge overseeing prosecutions relating to the Bankia IPO recently heard testimony from Deloitte that it ratified the financial statements of the Bankia IPO by following "at all times" the instructions of the Bank of Spain and the National Securities Market Commission.

The Union Confederation of Credit ("Confederación Intersindical de Crédito"), acting as prosecutor, asserts that Deloitte its partner, Francisco Celma, failed to exercise proper diligence when the accounting firm issued a final report ratifying the financial statements upon which the Bankia IPO was based. The prosecution has asked the Judge to call the former governor of the Bank of Spain, the former vice-president of the National Stock Market Commission and others in high positions to testify. Their testimony is sought after the discovery of four emails in which the former head of supervision of the Bank of Spain declared that the Bankia Group "was unfeasible" before the IPO such that the bank's shares "would lose value day by day."


EQUAL

The United States

EY settles charges brought by SEC in first-ever enforcement action for auditor independence failures due to personal relationships

EY agreed to pay $9.3 million to settle U.S. Securities and Exchange Commission charges that two of the firm's audit partners became too close with executives of its audit clients. EY settled with the SEC without admitting or denying the Commission's findings.

The charges involved two separate instances in which the SEC said the auditing firm did not do enough to prevent its auditors from becoming too close to their clients.

In one case, the SEC said an audit partner had a romantic relationship with real estate investment trust Ventas Inc.'s then-chief accounting officer from March 2012 to June 2014, during which time EY was the company's auditor. The CAO has allegedly since left the company due to the "inappropriate personal relationship" with the EY partner. In addition, the SEC said another EY partner became aware of the possible romantic relationship and failed to inquire or raise concerns internally with EY. See In re Ernst & Young, et. al., Exchange Act Release No. 78873 (Sept. 19, 2016), available at https://www.sec.gov/litigation/admin/2016/34-78873.pdf.

In another related case, the SEC said an EY partner tasked with improving the relationship with a client that was considering switching auditors had an "inappropriate friendship" with the client's then-chief financial officer ("CFO"). The SEC said the audit partner took the CFO to at least seven out-of-town personal trips and gave the CFO and his family tickets to expensive sporting events. See In re Ernst & Young LLP and Gregory Bednar, Exchange Act Release No. 78872 (Sept. 19, 2016), available at https://www.sec.gov/litigation/admin/2016/34-78872.pdf. Certain EY partners also apparently became aware of the entertainment spending, but took no action to confirm that the EY partner was complying with independence obligations.

According to the SEC's orders, while EY required audit engagement teams to follow certain procedures to assess their independence, the procedures did not go far enough to ensure compliance with independence requirements. In particular, the procedures did not specifically inquire about close personal relationships—outside of familial relationships—that could impair the firm's independence.

The SEC found that the EY partners and EY violated Regulation S-X Rule 2-01(b), which determines whether an accountant is independent. EY was also found to have violated 2-02(b)(1) by falsely certifying its reports for the client companies involved in both cases when it lacked independence.

EY agreed to pay the SEC a total of $9.3 million to settle the SEC's charges, and the EY partners agreed to pay fines ranging from $25,000 to $45,000. All four individuals were barred from practicing as accountants in front of the SEC with the right to apply for reinstatement after a set time period.

SEC increases ALJ's sanctions in TierOne Mortgage case

The U.S. Securities and Exchange Commission ("SEC") increased the sanctions imposed by an administrative law judge on two former KPMG LLP ("KPMG") auditors in connection with their roles in auditing now-defunct TierOne Bank's mortgage holdings in 2008. In re Aesoph, SEC, Admin. Proc. File No. 3-15168 (August 5, 2016). While the administrative law judge had issued a one-year suspension for the KPMG audit partner and a six-month suspension for the KPMG senior manager, the SEC increased the engagement partner's suspension to three years and the manager's suspension to two years. Both will have to apply for reinstatement once their terms are up.

The two auditors were charged in 2013 with negligently violating PCAOB auditing standards under SEC Rule 102(e). In March 2009, KPMG had issued an audit report for TierOne containing an unqualified opinion on the company's consolidated financial statements and the effectiveness of its internal controls for the previous year. A month after KPMG issued the audit report, the two former auditors allegedly discovered two new appraisals that TierOne received prior to KPMG issuing its report. The SEC claimed the auditors did not perform any procedures to determine whether the new appraisals affected TierOne's year-end 2008 financial statements.

In a partial dissent from the Commission's opinion, Commissioner Michael S. Piwowar stated "[b]y imposing a permanent bar with the right to apply for reinstatement after three years and two years, the majority of the Commission has imposed a punitive sanction that goes far beyond what the Division requested," said Piwowar. "The reinstatement process, even if successful, can take years to complete after the requisite time period has expired."

Piwowar also noted the U.S. Court of Appeals for the D.C. Circuit's recognition that "[t]he Commission may impose sanctions for a remedial purpose, but not for punishment" under Rule 102(e). McCurdy v. SEC, 396 F.3d 1258, 1264 (D.C. Cir. 2005) (citations omitted).

The majority, however, said that "a bar with the right to apply for reinstatement after a period of years" is the agency's "usual practice."

SEC publishes amendments to rules of practice for administrative roceedings

In part to address post Dodd-Frank criticisms that the U.S. Securities and Exchange Commission ("SEC") brings many more of its enforcement actions as Administrative Proceedings—where the SEC can be seen to enjoy a "home court advantage"—as opposed to filing in U.S. District Courts, the SEC adopted amendments to the rules of practice that govern its Administrative Proceedings. The final rules were effective September 27, 2016.

These amendments have been criticized as not going far enough to even the playing field for respondents. SEC Chair Mary Jo White maintains, however, that the amendments "provide parties with additional opportunities to conduct depositions and add flexibility to the timeliness of our administrative proceedings, while continuing to promote the fair and timely resolution of the proceedings." SEC Press Release, "SEC Adopts Amendments to Rules of Practice for Administrative Proceedings," No. 2016-142 (July 13, 2016).

The amendments, among other things:

Extend the potential length of the prehearing period from the current 4 months to a maximum of 10 months for the cases designated for the longest timelines.

Allow parties in the cases designated for the longest timelines the right to notice three depositions per side in single-respondent cases and five depositions per side in multi-respondent cases, and to request an additional two depositions.

Clarify the types of dispositive motions that may be filed at various stages of proceedings and the applicable procedures and legal standards for the motions.

Make additional clarifying and conforming changes to other rules, including rules regarding the admissibility of certain types of evidence, expert disclosures and reports, the requirements for the contents of an answer, and procedures for appeals.

SEC Press Release, "SEC Adopts Amendments to Rules of Practice for Administrative Proceedings," No. 2016-142 (July 13, 2016).

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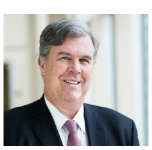

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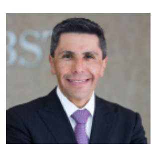

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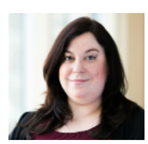

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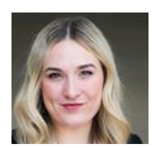

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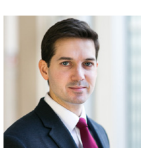

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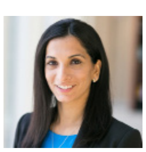

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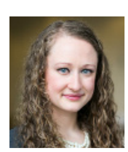

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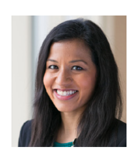

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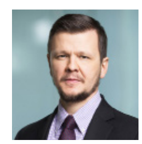

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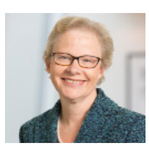

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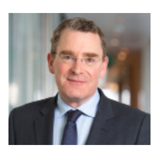

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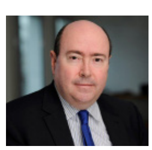

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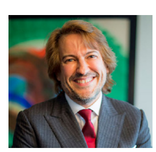

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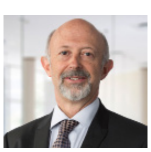

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