Hogan Lovells

Our Global Accountants' Liability practice

August 2018

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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. We recently identified developments of interest in Germany, The Netherlands, The United Kingdom (England and Wales), and The United States, which are summarized in the pages that follow.

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Recent court decisions

Germany

German District Court holds that accountants can be obliged to inform their clients about potential reasons for insolvency

In the January/February 2017 Accountant's Liability Update we reported that a judgment of the German Federal Court of Justice had significantly increased liability risks for tax advisors who prepare financial statements. In that judgment, the Federal Court held that tax advisors are obliged to assess whether the information they have been provided indicates a negative going concern prognosis. When that is the case, tax advisors have a duty to inform their clients that the company is at risk for insolvency. This duty applies regardless of whether the tax advisor was instructed to give such advice. [1]

When we reported on this decision last year, we expected that its holding would be extended to professionals other than tax advisors. Now, as predicted, a German court has extended the duty to inform of insolvency risk to accountants. This recent judgment was handed down in connection with a claim for damages brought by an insolvency administrator against the accountant who audited the financial statements of the now-insolvent company. The insolvency administrator asserted that the accountant had failed to inform the company that it was unable to pay its due liabilities – specifically loss compensation claims of two subsidiaries. Under German law a company is deemed to be insolvent in such a case.[2] Consequently, the insolvency administrator sought EUR€12 million in compensation for all losses caused by the delay in filing for insolvency.

The court confirmed that an accountant has a duty to assess whether the information it has been provided indicates a negative going concern prognosis. Under such circumstances, the accountant is not allowed to certify the financial statement before conducting a detailed going concern analysis.

Nevertheless, the District Court of Dusseldorf dismissed the claim for other reasons which are also of general interest in relation to accountants' liability. In the case at hand only a detailed legal examination would have revealed that certain liabilities were owed. The District Court of Dusseldorf held that an accountant is generally not obliged to conduct a comprehensive legal analysis with respect to the individual financial figures. The scope of an accountant's duty to conduct a legal analysis often is a decisive question in negligence claims against accountants in German courts and this judgment provides some clarity about the scope of this duty.

The judgment has been appealed and is now pending before the Higher Regional Court of Dusseldorf (docket no: I-10 U 70/18). We will continue to monitor this matter and report on further developments.

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1 Judgment of January 26, 2017, docket no: IX ZR 285/14

2 Sec. 17 para. 1 German Insolvency Code [InsO]

The Netherlands

Rules of professional conduct apply to accountants acting in private (unpaid) capacity and accountants may not threaten litigation to discourage a potential complainant from filing disciplinary complaint

On 15 June 2018, the Accountancy Division ruled on a complaint relating to actions taken by an accountant who was acting as an unpaid treasurer for a foundation. The accountant had authorized payment of a suspicious payment request, which turned out to be a case of 'spoofing': the use of fraudulent email addresses.

In its decision, the Accountancy Division addresses two questions:

a) Is the accountant subject to rules of professional conduct while acting as an unpaid treasurer in his private capacity (without involvement of his audit firm)?

b) Is an accountant permitted to threaten a potential complainant with a suit for damages resulting from filing an unfounded disciplinary complaint?

Facts

A registered accountant fulfilled the role of treasurer for a foundation that organises private concerts. In April 2017, he received an urgent email request seeking payment of EUR€9,500 to a foreign bank account. The email appeared to have been sent by the chairman of the foundation, who was on holiday in a foreign country at the time. After the accountant had transferred the money, he received a second email asking whether the payment was successful and if the accountant could transfer an additional amount. At this point, the accountant called the chairman, and learned that the chairman had not requested either payment. The accountant then suspected fraud and reported the event to the police. It was then, however, too late for the bank to block the payment he had authorized.

The foundation threatened to file a disciplinary suit against the accountant asserting he was liable for the payment made to the fraudster because he failed to comply with the foundation's standard practice of seeking board resolution before approving payment of any invoice.

The accountant's lawyer's responded and asserted that because the accountant was not paid for his work as treasurer he was not acting in his capacity as an accountant. He further indicated that the accountant would seek to hold the foundation liable for any damage the accountant would suffer as a result of having a disciplinary complaint was filed against him.

The foundation nevertheless filed a complaint against the accountant.

The decision

The payment transaction

The Accountancy Profession Act establishes rules accountants must comply with and subjects accountants that fail to do so to disciplinary proceedings.[1] In this instance, the accountant was not paid for his work as a

treasurer of the foundation and claimed to be acting as an executive rather that an accountant. The Accountancy Division nonetheless found the accountant was practicing his profession and his conduct was therefore subject to the disciplinary laws.[2]

To comply with the disciplinary laws, the accountant should have reacted meticulously to the request for payment.[3] The Accountancy Division found the accountant failed to exercise due care when he transferred funds to a foreign bank account to the benefit of the chairman personally on the mere basis of one email. The Accountancy Division noted that the payment request was atypical and that the accountant should have at least contacted the chairman before transferring the money. In failing to do so, he failed to act with professional competence and due care. The Accountancy Division also found that the accountant's actions did not violate a requirement that he refrain from discrediting the office of accountancy.[4]

Threat of suit to recover damages flowing from unfounded disciplinary complaint

With regard to the accountant's assertion (through counsel) that he would seek to hold the foundation liable for any potential damage resulting from an unfounded disciplinary complaint, the Accountancy Division explained that an accountant should only take positions that are verifiable. Therefore, accountants must refrain from pressuring others not to file disciplinary complaints against them. Such pressure in effect raises the threshold for filing a disciplinary complaint. The Accountancy Division explained that by doing so, the accountant acted contrary to correct execution of the office of accountancy.[5]

Conclusion

The Accountancy Division ruled that both complaints lodged against the accountant were well-founded and issued a formal warning. Specifically, the accountant was found to have acted improperly by transferring substantial funds to a foreign bank account and subsequently taking a stance relating to a potential disciplinary complaint that was not verifiable. Although the standards discussed in this decision are not new, their application to an accountant's professional conduct even where the accountant is not paid for his or her work is noteworthy.

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1 Article 42 Accountancy Profession Act.

2 Article 3 Code of Conduct and Professional Practice for Accountants Regulation.

3 Article 13 (2) Code of Conduct and Professional Practice for Accountants Regulation.

4 Article 4 Code of Conduct and Professional Practice for Accountants Regulation.

5 Article 42 (2) (b) Accountancy Profession Act.

The United Kingdom (England and Wales)

Negligence without liability

The case of *Manchester Building Society v. Grant Thornton UK LLP* [2018] EWHC 963 (Comm) is a striking example of how an accountant might minimize liability despite a finding of negligence. The 2 May 2018, judgement of the High Court of England and Wales in this matter relates to a negligence claim against Grant Thornton LLP (Grant Thornton) and addresses the extent to which financial loss can be recovered from a negligent professional advisor.

The claim

In early 2006, the Claimant, Manchester Building Society (MBS), began hedging fixed-interest lifetime mortgages by purchasing interest rate swaps. Shortly after doing so, however, the accounting framework that applied to MBS changed and as a result MBS was required to include derivatives, such as interest rate swaps, on its balance sheets at "fair value." This injected a degree of volatility into MBS's accounts, because whereas a change in the value of the swap would be reflected in the profit and loss accounts, a corresponding change to the value of the hedged asset (i.e. the mortgage) would not.

In an effort to overcome this volatility, Grant Thornton approved an accounting practice known as "hedge accounting," which allowed the hedged asset to be shown on MBS's balance sheet. However, hedge accounting is complex and subject to very strict requirements and documentary formalities. In 2013, it became apparent that MBS could not in fact use hedge accounting. This determination had a dramatic effect on MBS accounts and revealed a shortfall in its regulatory capital requirement. As a result, among other things, MBS was forced to close out the interest rate swaps and cease its mortgage lending.

The cost of closing out the swaps in 2013 was very substantial, because interest rates had collapsed during the 2008 financial crisis (and many of the swaps had a 50 year lifespan). The close-out losses exceeded GBP£32 million, and further related losses were in the order of GBP£16 million.

MBS brought proceedings against Grant Thornton in 2015, alleging that:

a) Grant Thornton negligently approved the use of hedge accounting in 2006; and

b) Grant Thornton's audits of MBS's accounts between 2006 and 2011 were negligently conducted, because they approved the use of hedge accounting.

The issues

Grant Thornton admitted its negligence. The issue for determination by the Court was whether, and if so to what extent, Grant Thornton could be liable for the losses incurred by MBS when closing out the swaps against the backdrop of unfavourable market conditions in 2013.

The judgement

The Court found that Grant Thornton's advice caused the losses complained of by MBS, as a matter of both fact and law, and that those losses were foreseeable. On the face of it, therefore, it is difficult to see how Grant Thornton could not be found liable for those losses.

However, the Court went on to find that the most critical component of the negligence claim – the duty of care to prevent the close-out loss – was missing. The court held that losses which flow from market forces (e.g. a collapse in interest rates following a financial crisis) cannot in truth be matters for which Grant Thornton assumed responsibility. In reaching this conclusion, the Court explained:

> *"it seems to me a striking conclusion to reach that an accountant who advises a client as to the manner in which its business activities may be treated in its accounts has assumed responsibility for the financial consequences of those business activities. I do not consider that the objective bystander, or indeed the parties themselves, viewing the matter in 2006 would have concluded that the Defendant had assumed responsibility for the Claimant 'being out of the money' on the swaps in the event of a sustained fall in interest rates"* [179]

The fact that the need to close out the swaps flowed directly from Grant Thornton's negligence was not therefore enough to establish liability for all close-out loss and the recoverable losses were confined to the relatively immaterial termination and penalty costs of breaking the swaps (which amounted to some GBP£400,000), reduced by 25 percent to reflect the contributory fault of MBS.

Implications

This is not the first case of its kind, but it is a very stark example of how, despite clear-cut negligence resulting in very substantial losses, a professional might walk away from proceedings relatively unscathed. It is also an excellent illustration of the sort of circumstance in which a professional's liability for its advice – despite being critical to the client's commercial decision – will be confined to the consequences of that advice being wrong, rather than extending to the wider-reaching financial consequences of the transaction.

Cases of this kind will always be highly fact sensitive. Teare J. remarked in the judgment, "It is not possible to lay down hard and fast rules as to how to determine whether the losses were within the scope of the defendant's duty." In practical terms, therefore, accountants and auditors should not underestimate the importance of carefully delimiting their duties and responsibilities at the stage of agreeing to engagement terms.

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The United States

KPMG reaches settlement in Wilmington Trust Securities class action

On 25 May 2018, counsel for the Plaintiffs in the class action I*n re Wilmington Trust Securities Litigation*, Case No. 10-cv-00990, filed a request with the U.S. District Court for the District of Delaware seeking approval of a US$210 million class-wide settlement. If approved, the settlement would resolve all claims asserted against Wilmington Trust Corp. (WTC), and its former auditor KPMG LLP (KPMG).

In the underlying litigation, plaintiffs allege that false and misleading statements regarding WTC's loan portfolio, underwriting procedures, and overall financial health were included in public SEC filings made by the company in 2008 and 2009. In November 2010, WTC revealed that it had failed to report ~US$800 million in losses in its loan portfolio. This disclosure led to the filing of multiple civil lawsuits, which were ultimately consolidated in the District of Delaware action. In addition, criminal charges were filed against WTC and some of its former managers and directors.

Under the settlement, WTC and KPMG admit no wrongdoing. WTC is to pay US$200 million, with KPMG agreeing to pay the remaining US$10 million.

On 10 July 2018, the Court preliminarily approved the class-wide settlement. And a settlement fairness hearing has been scheduled for 5 November 2018, at the U.S District Court for the Eastern District of Pennsylvania. At the November 5 hearing, the Court will determine whether the proposed settlement is fair, reasonable, and adequate and whether judgments should be entered dismissing the claims against WTC and KPMG.

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Recent regulatory and enforcement developments

The United States

PCAOB censures and fines Deloitte for material accounting errors missed in consecutive audits of Jack Henry

On 23 May 2018, the Public Company Accounting Oversight Board (the PCAOB) issued a disciplinary order against Deloitte & Touche LLP, imposing a civil money penalty of US$500,000, for missing material accounting errors in the 2012, 2013 and 2014 audits of Jack Henry & Associates Inc. (Jack Henry), a Missouri-based provider of information processing solutions for banks and credit unions.

Deloitte served as Jack Henry's independent auditor from May 1997 to December 2015. In each of the FY14, FY13, and FY12 audits, Deloitte identified risks of material misstatement (including fraud risks) concerning software license revenue which, due to its high gross profit margins, could have had a material impact on Jack Henry's reported net income and earnings per share. The engagement team, however, failed to adequately execute their planned responses to those risks. The audit procedures did not adequately address certain of the identified and assessed risks of material misstatements. Among other issues, the engagement team failed to obtain sufficient appropriate evidence to support Deloitte's unqualified opinions on Jack Henry's financial statements and management's assessment of the effectiveness of internal controls over financial reporting. The engagement teams also failed to exercise the requisite due professional care and skepticism.

Deloitte's audit deficiencies were discovered after the firm received notice from the PCAOB that the Jack Henry FY14 audit would be reviewed during the PCAOB's annual inspection of the firm. To prepare for the PCAOB inspection, the then-engagement partner asked another Deloitte partner, who had more auditing experience in the software industry, to review the relevant work papers. This review raised questions about Jack Henry's accounting for software license revenue and Deloitte's corresponding audit work. Ultimately, Deloitte identified a number of audit and accounting issues and promptly reported the deficiencies to the PCAOB. Remedial audit procedures were performed that led Jack Henry to have to restate its FY 12, FY 13, and FY 14 financial statements.

The PCAOB concluded that a primary cause of Deloitte's oversight was the firm's failure to include as part of the Jack Henry engagement teams an auditor who possessed sufficient industry-specific experience and knowledge to properly evaluate and audit Jack Henry's accounting for software license revenue.

In addition to the US$500,000 fine, Deloitte also implemented the following changes to its quality control processes and procedures:

— Deloitte enhanced its process to more effectively assess the match between the industry expertise of its engagement partners/engagement quality reviewers and the issuer audits to which they are assigned. The enhanced process includes identifying issuer audit clients that utilize complex accounting for material revenue streams other than their primary revenue stream, and ensuring that appropriate personnel have been assigned to address any related industry-specific risks.

— Deloitte enhanced its internal inspection process to more effectively assess the industry experience of inspection reviewers when assigning them to review specific areas of complex accounting for issuer audit engagements. Among other things, Deloitte specifically assesses whether the internal inspection team has appropriate industry experience regarding all issuer revenue streams subject to inspection procedures.

Deloitte is to provide prompt written notice to the PCAOB if either of these two processes is rescinded within the next three years.

PCAOB sanctions former KPMG auditor for improperly altering audit documentation

On 23 May 2018, the PCAOB issued a disciplinary order censuring and barring Elliot D. Kim from being an associated person of a registered public accounting firm. Kim was employed by KPMG LLP (KPMG) from October 2013 through December 2017 and worked as a senior associate on KPMG’s audit of the 2016 year-end financial statements and internal controls over financial reporting of an issuer (Issuer A).

AS 1215 (formerly, Auditing Standard No. 3), *Audit Documentation*, requires that “[a] complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date [the “Document Completion Date”). After this date, audit documentation must not be deleted or discarded from the audit file, but additional documentation may be added as long as the auditor documents the date the information was added, the name of the person who prepared the information, and the reason for adding it. In addition, PCAOB Rule 4006 requires that registered public accounting firms and their associated persons “shall cooperate with the [PCAOB] in the performance of any [PCAOB] inspection.” This duty to cooperate includes an obligation not to provide misleading or incorrect information to the PCAOB, or otherwise interfere in the PCAOB’s inspection process.

Kim failed to comply with both of these rules. During the PCAOB’s inspection of KPMG’s audit of Issuer A, and after the Document Completion Date had passed, Kim engaged in the following improper conduct:

1. Added information to a control testing document without indicating the date the information was added, the person who prepared the additional documentation, or the reason for the additional documentation;
2. Provided a screenshot of metadata that inaccurately indicated that the control testing document had last been modified during the audit; and
3. Failed to disclose the alterations during discussions with the PCAOB’s inspection staff concerning the control testing document.

In addition to censuring and barring Kim from being associated with a registered public accounting firm, the PCAOB’s order also requires Kim to complete 40 hours of continuing education. At least 20 of these hours are required to be in the subject of ethics. After one year from the date of the order, Kim is permitted to file a petition, pursuant to PCAOB Rule 5302(b), for PCAOB consent to associate with a registered public accounting firm.

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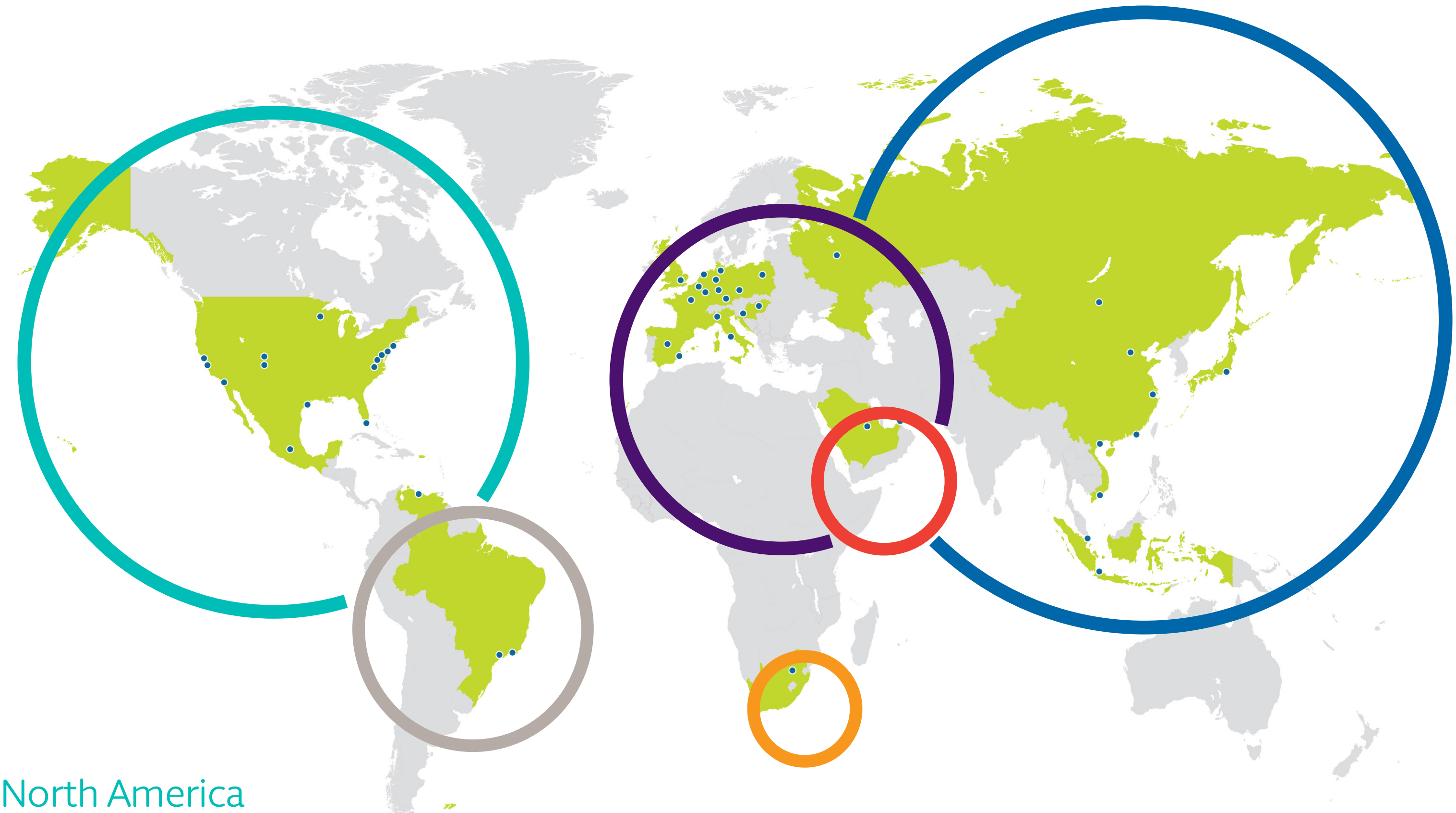

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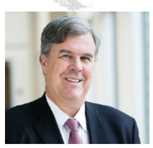

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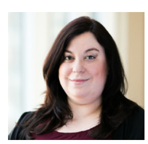

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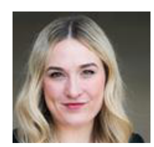

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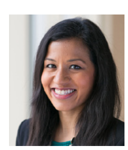

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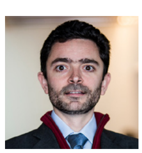

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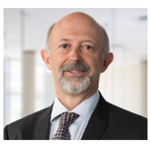

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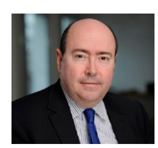

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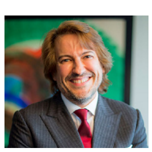

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