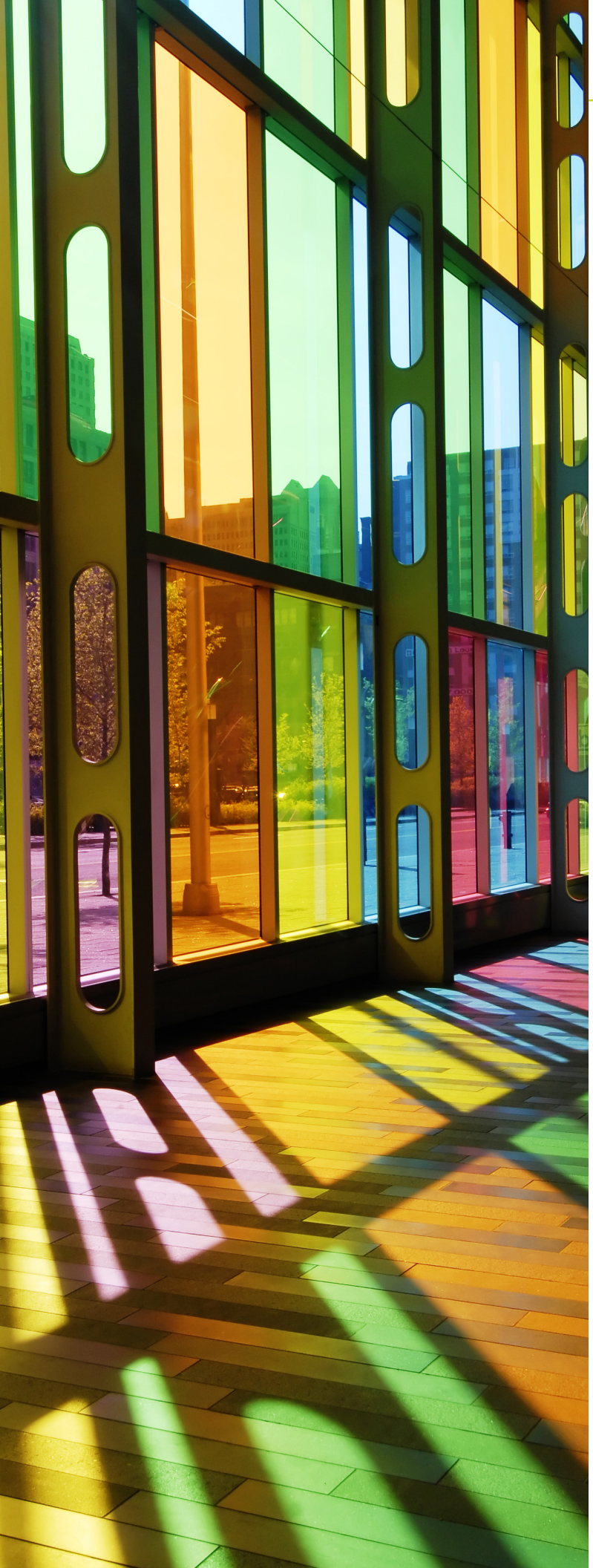
Hogan Lovells

Global Accountants' Liability Update

Contents

DECEMBER 2015



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

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

Recent Court Decisions

France

Two French courts of appeal address the unauthorized practice of statutory accounting

The Grenoble and Aix-en-Provence Courts of Appeal recently issued decisions addressing the unauthorized practice of the statutory accounting profession.

In both cases, the defendant was not registered with the Statutory Accountants' Order, but was providing advice on management, accounting and other administrative matters to natural persons, associations and companies. After receiving complaints from the defendants' customers, the Statutory Accountants' Order brought claims for unauthorized practice.

The statutory accountant's missions

The Statutory Accountant's profession is regulated by French law to ensure that only professionals having the requisite qualifications, abiding by a code of ethics and in possession of professional insurance are entitled to work as statutory accountants. Article 2 of the Order of 19 September 1945 regulates the qualifications of the profession and defines the statutory accountant's missions to include:

- reviewing and assessing the accounts of companies and associations to which he/she is not bound by an employment contract. The statutory accountant can also certify the regularity and the accuracy of income statements;
- keeping, centralizing, opening, closing, monitoring, rectifying and consolidating the accounts on behalf of companies and associations to which he/she is not bound by an employment contract.

Unauthorized practice of the profession

Only professionals registered as statutory accountants may carry out the abovementioned missions. Article 20 of the abovementioned Order defines unauthorized practice as:

- the lack of registration with the Statutory Accountants' Order;
- the act of carrying out, on a regular basis and under one's own name and responsibility, the abovementioned missions or the act of overseeing the abovementioned missions by directly intervening in the conduct, review, evaluation or adjustment of the accounts; and
- the knowledge that the intervention has an accounting nature.

These conditions are cumulative. This means, for example, that despite not being registered with a Statutory Accountants' Order, an individual that acts as a statutory accountant only once will not be punished for unauthorized practice. Nor can an individual be held liable in the event that he/she carries out accounting missions under an employment contract. In this respect, the French Courts have ruled that an association was guilty of unlawful

practice of the profession for monitoring the accounts and establishing the tax statements of its members without being bound to them by an employment contract. On the other hand, the Courts found no unlawful exercise of the profession by the employees of an Economic Interest Group (EIG) who had only monitored the accounts of the EIG's members by collecting and classifying the supporting documentation.

Penalties for unauthorized practice

Pursuant to the French Criminal Code, unauthorized practice of the profession is punishable by a 1-year prison sentence and a fine of up to EUR 15,000 for natural persons and EUR 75,000 for companies. Disciplinary sanctions may also be imposed.

In the case submitted to the Grenoble Court of Appeal, the court found that the defendant regularly acted as a statutory accountant, did not belong to a Statutory Accountants' Order, and was thus liable for unauthorized practice of the profession. The defendant was therefore ordered to pay an EUR 2,000 fine. In contrast, the Aix-en-Provence Court of Appeal found that the defendant in the case before it had not illegally practiced the profession because she had only provided administrative assistance (i.e. invoicing clients, processing data and providing other administrative support) to her customers.

Although these decisions do not establish new principles, they reflect a growing concern that companies increasingly fulfil accounting missions without lawful authorizations. Indeed, these decisions are in line with current efforts to prevent such practices and deter companies from engaging unauthorized individuals or companies for statutory accounting missions in order to pay lower fees or circumvent the tax system.

For more information on this subject, contact:

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

Recent Court Decisions

Germany

German courts reluctant to allow third-party claims against accounting firms

As reported in our June 2015 Accountants' Liability update, third-party liability claims against accounting firms have become increasingly common in German courts.

In a case similar to the decision of the Higher Regional Court of Dusseldorf which was covered in the June edition, the Higher Regional Court of Karlsruhe considered a bank's suit against an accounting firm. In this case a bank was considering whether to issue a loan to a borrower. It therefore asked the borrower's accounting firm to provide it with the borrower's accounts. Based on the accounts the bank granted a loan to the borrower and the borrower subsequently filed for insolvency and was therefore unable to repay the loan. The bank later learned that the accounts, which had been prepared by the company's directors, contained fake receivables and assets.

The bank asserted that the loan default was caused by the failure of the borrower's accounting firm to detect the fraud and sued the accounting firm for damages.

The Karlsruhe Court dismissed the lawsuit. It held that the strict requirements (for details see our June update for the bank to fall within the "protective scope" of the contract between the accounting firm and the audited company (Vertrag mit Schutzwirkung zugunsten Dritter) were not met for the following reasons:

According to the Court, a third party only falls within the protective scope if the accounting firm's client makes it clear from the outset that it expects the accounting firm to go beyond the scope of ordinary accounting in order to serve interests of a third party. Here, the Court held that the bank did not show sufficient evidence to prove that the client had made such a demand. Furthermore, the Court concluded that the audited company did not want the accounting firm to act in the bank's interest, which would have caused it to reveal its directors' manipulations.

In addition, the Court relied on case law established by the German Federal Court of Justice (Bundesgerichtshof), which states that a third party cannot base its claim on the protective scope of a contract if there is no need for such protection. This is the case where the third party has a

claim for damages against the audit client even if this claim is economically inferior to a direct claim against the accounting firm. The Court held that the bank was entitled to such a claim against the audited company under contract law. Therefore the Court saw no reason to protect the bank by granting the bank an additional direct claim against the accounting firm.

Finally, the Court held that the accounting firm's liability was outweighed by the fault of the audited company. According to German case law, the misconduct of an audited company is imputed to the third party, which is relying on the protective scope of the audit contract. This is because the rights of the third party are derived from the contractual rights of the audited company against the auditor. Therefore, the third party cannot have any greater claim against the accounting firm than the audited company has against the accounting firm. Because the audited company manipulated the audit process, the accounting firm was not liable.

The judgment, which is final, confirms the increasing trend of filing third-party liability claims against accounting firms especially in situations of insolvency. However, it shows once again that German courts are reluctant to award damages on this basis.

For more information on this subject, contact:

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

Recent Court Decisions

The Netherlands

Chamber of Accountants takes disciplinary action against auditor who failed to exercise sufficient professional judgment

On 30 November 2015, the Chamber of Accountants disciplined an auditor after extensively examining the professional scepticism the auditor employed during a 2010 audit of a group of real estate development companies (the Eurocommerce Group).

Complaint

The Eurocommerce Group predominantly financed its real estate investments through bank loans. The auditor provided an unqualified audit opinion in 2010 and almost all companies belonging to the Eurocommerce Group declared bankruptcy in 2012 and 2013. The assigned bankruptcy trustees, three banks and the public prosecutor then filed complaints asserting that the auditor lacked the legal foundation to provide the 2010 unqualified opinion. Specifically, the complaints alleged defects with:

(a) the valuation of real estate projects and investments;

(b) the valuation of rental guarantees;

(c) the presentation of short-term debts; and

(d) the annual accounts, which did not correspond to reality.

The complaints further claimed that the auditor did not have the necessary and suitable control-information required by regulations. Standards 500 and 230 of the Further Regulations for Audit and Other Standards require that an auditor timely receive control-information sufficient to support the drafting of audit documents and the conclusions upon which an audit opinion is based. The complaint also alleges that the auditor was insufficiently independent.

Chamber of Accountants Opinion

Independence

The Chamber of Accountants noted that the accountant should not only be conscious of the fundamental principles of objectivity and independence, but should also take measures to prevent the appearance of conflicts of interest. In this matter, a real estate lease agreement between the auditor's firm and a company belonging to the Eurocommerce Group called the accountant's objectivity into question. The Chamber of Accountants ruled that although the lease could jeopardize the independence of the auditor, the auditor could have restored his independence by employing sufficient safeguards. The auditor claimed he added an independent partner to the audit team to provide oversight. However, the Chamber of Accountants could not establish that the partner acted as a reviewer rather than a regular member of the audit team.

Therefore, the chamber concluded that independence of the audit was not sufficiently safeguarded.

Valuation of real estate

Complainants asserted that the auditor incorrectly valued the real estate on the balance sheet. Noting that proper valuation of real estate was particularly important given the audit client's business, the Chamber of Accountants found that sufficient and suitable audit control-information was essential.

The auditor based the valuation of the real estate primarily on a report provided by a real estate agent. According to the regulatory framework for accountants, when relying on an expert, the auditor should have:[1]

(a) checked the competency, capacities and objectivity of the expert;

(b) gained insight into the work of the expert; and

(c) evaluated the eligibility of the work of the expert as control-information.

Here, the auditor relied on the real estate agent's opinion without conducting any of the research described above and thus did not meet professional standards.

Valuation of rental guarantees

Complainants further asserted that the auditor relied on insufficient controls with respect to the rental guarantees. The auditor argued that he audited the rental guarantees but that he made no record of the results. Again, the Chamber of Accountants concluded that the auditor did not gather sufficient and suitable control-information.

Presentation of short-term debts

In May 2011, a banker's opinion stated that there was roughly EUR 88 million of short-term debt. This was materially different than the EUR 52 million that was reported in the annual accounts of 2010.

Due to this material difference, the auditor should have examined whether the presented amount of debt was acceptable. The Chamber of Accountants found that the auditor failed to exercise professional judgment here.

Conclusion

The Chamber of Accountants concluded that the auditor's lack of professional judgment caused the audit opinion to be unreliable and directed that the auditor be removed from the accountants' register for six months. This ruling underscores that disciplinary courts attach great value to the professional judgment of auditors.[2]

For more information on this subject, contact:

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

1 Par. 8 of Standard 500 of the Further Regulations for Audit and Other Standards.

2 See also the Accountancy Liability Report of last month where reference is made to professional judgment:: Commission for Appeal for business and industry 18 November 2015, ECLI:NL:CBB:2015:362.

Recent Regulatory and Enforcement Developments

Hong Kong

Draft Hong Kong legislation to streamline and modify corporate insolvency law

A bill rewriting Hong Kong's corporate insolvency law (Bill) has been published and debated in the Legislative Council. The Bill follows a major overhaul of the Companies Ordinance, which came into effect in March 2014 but left the corporate insolvency provisions untouched. Although publication of the Bill it is a major development, the Bill is expected to be amended further before becoming law.

As currently drafted, the Bill does not include a statutory corporate rescue procedure or address cross border issues, which are insufficiently addressed in the current legislation. Despite the fact that stakeholders have repeatedly raised these issues, they will not be addressed in the current Bill. The current Bill includes provisions that will:

- Allow aggrieved parties to enforce liabilities against a liquidator notwithstanding that he has been released by the court;
- Require prospective provisional liquidators and prospective liquidators to disclose certain relationships between him or his immediate family members and the company being wound up;
- Expand the list of persons disqualified for appointment as liquidator or provisional liquidator to include persons with potential conflicts of interest, including current and past auditors;
- Restrict the powers of a provisional liquidator appointed by members;
- Clarify the definition of 'associate' for the purpose of claw back provisions.

The Bill streamlines the current provisions. However, we anticipate more substantive reforms to address corporate rescue and cross border matters in 2017-2018.

For more information on this subject, contact:

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

Recent Regulatory and Enforcement Developments
The United States

Contributions by:
Kevin Baumann
Cecilia Bernstein
Shawna MacLeod

SEC settlement with Grant Thornton

On 2 December 2015, the United States Securities and Exchange Commission (SEC) announced that Grant Thornton LLP and two of its partners agreed to settle charges that they allegedly ignored red flags and fraud risks while conducting audits of Assisted Living Concepts, Inc. (ALC), a publicly traded senior living company, and Broadwind Energy, Inc. (Broadwind), a publicly traded alternative energy company. As part of the settlement, Grant Thornton agreed to admit wrongdoing, to forfeit approximately $1.5 million in audit fees and interest, and to pay a $3 million penalty.

Last December, the SEC announced fraud charges against two former ALC executives accused of making false disclosures and manipulating internal books and records by listing fake occupants at some senior residences in order to meet lease covenant requirements. Earlier this year, the SEC charged Broadwind and senior officers with accounting and disclosure violations that prevented investors from knowing that reduced business was damaging the company's long-term financial prospects. The settlements with Grant Thornton involved those same issues.

For the ALC engagement, the SEC found that Grant Thornton failed to identify a fraud perpetrated by ALC's CEO and CFO. That long-running fraud was designed to mask ALC's defaults on certain occupancy and revenue covenants that had significant financial consequences for ALC in the event of noncompliance. As a result, for three years, ALC falsely represented to its investors that it was meeting the covenants and avoiding the serious ramifications of the defaults.

The SEC found that Grant Thornton and two of its partners knew or should have known that heightened scrutiny was warranted with respect to the effects of ALC's calculations of occupancy and coverage ratio covenants. The SEC found that the firm and both partners were aware of red flags surrounding ALC's claim that it had an agreement with the lessor to meet lease covenants by treating ALC employees and other non-residents as occupants of the facilities. The firm and the partners were found to have violated professional auditing standards by failing to take reasonable steps to determine that an agreement with the lessor existed or that ALC employees whom ALC claimed to be occupants of the facilities were actually staying there.

For the Broadwind engagement, the SEC found that Grant Thornton's failure to exercise due professional care and skepticism contributed to Broadwind improperly omitting from its financial statements that it had incurred a $58 million impairment charge caused by the severe deterioration of its relationships with two key customers. The SEC found that this audit failure contributed to Broadwind's public offering of stock, which concealed the impairment charge, and to Broadwind overstating revenue on multiple financial statements.

The SEC found that Grant Thornton and one of its partners relied almost exclusively on unsupported Broadwind management's representations that a $58 million impairment charge had not occurred before the significant public offering, even after the auditors learned of management's own expectation of impairment and other facts establishing impairment. The firm and the partner were found to have failed to obtain adequate audit evidence to support management's conclusion that the impairment had occurred after the offering. They also were found to have failed to exercise due professional care and skepticism or obtain adequate audit evidence related to a significant bill-and-hold transaction. The revenue from this transaction allowed Broadwind to meet its debt covenants.

The SEC found that Grant Thornton's ALC and Broadwind engagements reflected systemic quality issues and a failure of Grant Thornton's Wisconsin practice to adhere to professional standards. In particular, the SEC found that Grant Thornton continued to allow the managing partner of the Wisconsin practice to audit public companies (including ALC and Broadwind) after receiving warnings about the quality of that partner's work.

The SEC further found that Grant Thornton failed to take the appropriate remedial steps that could have stopped ALC's and Broadwind's repeated false and misleading statements to their investors.

As a result, the SEC found that Grant Thornton and its partners engaged in improper professional conduct pursuant to Section 4C(b) of the Securities Exchange Act of 1934 and Rule 102(e)(1)(iv) of the SEC's Rules of Practice. They also were found to have caused violations of Section 13(a) of the Exchange Act and Rules 13a-1, and to have caused violations of Rule 13a-13.

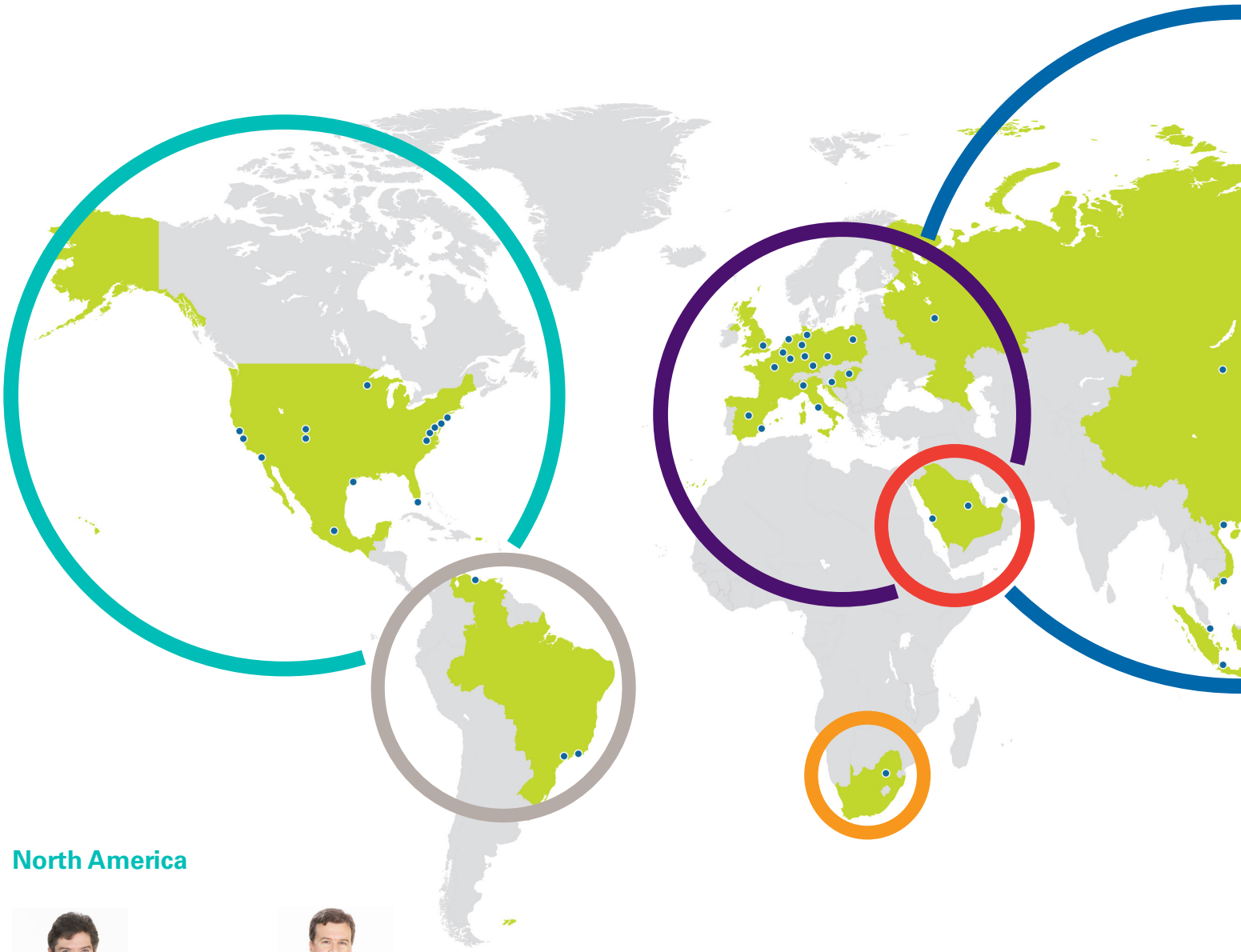
Without admitting or denying the SEC's findings, one audit partner agreed to pay a $10,000 penalty and be suspended from practicing before the SEC as an accountant for at least five years, while the other agreed to pay a $2,500 penalty and be suspended from practicing before the SEC as an accountant for at least two years.

For more information on this subject, contact:

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

Pooja A. Boisture
Associate, New York
pooja.boisture@hoganlovells.com
T +1 212 918 3232

Our Global Accountants' Liability Team



North America

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

George A. Salter
Partner, New York
george.salter@hoganlovells.com
T +1 212 918 3521

Cristina Rodriguez
Partner, Houston
christina.rodriguez@hoganlovells.com
T +1 713 632 1425

Omar Guerrero Rodríguez
Partner, Mexico City
omar.guerrero@hoganlovells.com
T +52 55 5091 0162

Pooja A. Boisture
Associate, New York
pooja.boisture@hoganlovells.com
T +1 212 918 3232

South Africa

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

Asia

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

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

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

Middle East

Mohamed ElGhatit
Senior Associate, Dubai
mohamed.elghatit@hoganlovells.com
T +971 4 377 9211

Europe

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

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

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

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

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

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

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

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

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

www.hoganlovells.com

Hogan Lovells has offices in:

Alicante
Amsterdam
Baltimore
Beijing
Brussels
Budapest*
Caracas
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Jeddah*
Johannesburg
London
Los Angeles
Luxembourg
Madrid
Mexico City
Miami
Milan
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Rio de Janeiro
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar
Warsaw
Washington, DC
Zagreb*

* Associated offices