Hogan Lovells

Global Accountants' Liability Update

Contents

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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. Our team recently researched legal and regulatory developments related to auditors' liability in China, England/Wales, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Singapore, 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 China, England, France, Germany, Hong Kong, Mexico, Spain, and the United States, which are summarized in the pages that follow.

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China

There have been three developments in accountants and accounting firms' regulations in China in November.

On 6 November 2014, the Ministry of Civil Affairs (MCA) and the Ministry of Finance (MOF) of the People's Republic of China jointly issued the *Opinions on Strengthening the Anti-corruption Work of Social Organizations*. Under this new regulation, once the local branch of the MCA where the social organization is registered discovers that an accounting firm has violated the Certified Public Accountants Practice Code, has assisted an audited social organization in falsifying accounts or statements, or has issued a false audit report, the local branch of the MCA is required to notify the local branch of the MOF and the Chinese Institute of Certified Public Accountant. Those authorities could then sanction the accounting firm as appropriate.

Also on 6 November, the MOF issued the *Notice on Adjusting and Improving Relevant Administrative Matters Concerning the Profession of Certified Public Accountants* (Notice). The Notice announces three changes regarding the establishment of branch/representative offices of accounting firms:

1. The Provincial-level Finance Bureau will be responsible for accepting applications to establish new branches by the Big Four (i.e. Ernst & Young Hua Ming, KPMG Hua Zhen, Deloitte Hua Yong, and PricewaterhouseCoopers Zhong Tian). The Big Four entities in China were originally formed as Sino-foreign contractual joint ventures and were later restructured to become domestic special general partnerships. The Provincial-level Finance Bureau will examine and approve such applications in accordance with the *Interim Measures for the Examination and Approval and Supervision of Accounting Firms* (Order No. 24, issued by the MOF and effective 18 January 2005).
2. In order to establish or renew a resident representative office in Mainland China, an applicant need only apply to the local branch of the Administration of Industry and Commerce (AIC). Prior to the Notice, such applications required prior approval from the Provincial-level Finance Bureau before an application could be made to the local branch of the AIC.
3. To establish an accounting firm, an applicant is no longer required to submit a capital verification certificate or a partner capital contribution verification report to the relevant provincial finance department.

On 17 November, the MOF and the General Office of China Insurance Regulatory Commission (CIRC) issued the *Interim Measures on Professional Liability Insurance of Accounting Firms* (Draft for Comment) for public comments (Interim Measures). The deadline for comment submission is 20 December 2014. The Interim Measures consist of 14 articles, prescribing the terms of required professional liability insurance of accounting firms, the minimum accumulative insurance amount to be purchased by the accounting firms, and certain important contract clauses. The Interim Measures also include guidance on the settlement mechanism for insurance contract disputes, and encourages accounting firms to transition from funding a "professional risk fund[1]" to purchasing professional liability insurance.

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[1] A "professional risk fund" was first mentioned in the *Law of the People's Republic of China on Certified Public Accountants*, and thereafter has been specifically regulated by the *Measures for the Administration of Professional Risk Funds of Accounting Firms*, effective 1 March 2003 (Measures). According to Articles 3 and 4 of the Measures, an accounting firm is required to allocate no less than 5% of its annual income from audit services to its professional risk fund. Professional risk funds can be used to pay (a) civil compensation caused by professional liabilities, and (b) litigation cost, attorney fees, and other legal expenses relating to civil compensation.

England

On 18 November 2014, the Chancery Division of the High Court of Justice in England ruled in *Renewable Power & Light Ltd v McCarthy Tetrault & Ors [2014] EWHC 3848 (Ch) Morgan J* that a claimant which had discontinued, mid-trial, its professional negligence claim against a firm of accountants was liable under its contract with the accountants to reimburse them on an indemnity basis for all costs, charges and expenses incurred in defending the aborted claim.

The court explained that the contract would not have enabled the accounting firm to recover its costs if it were found to be negligent. Nonetheless, the accounting firm prevailed on its claim for costs without a finding that it was not negligent. The court reasoned that it was not appropriate to continue the trial to make a negligence finding purely for the purpose of addressing the counterclaim for costs. The court held that the phrase "all costs" meant "reasonable costs reasonably incurred" with the burden of establishing unreasonableness being on the paying party. The court concluded that the costs incurred by the accountants fell within the contractual provisions and the firm was therefore entitled to indemnity for the proper costs of defending against the Claimant's claim. The court decided that the appropriate procedure for quantifying the amount of the indemnity was, first, to make a declaration of the accountants' entitlement to an indemnity, then to make an order for costs reflecting that entitlement, and finally to direct a detailed assessment of the costs on the indemnity basis.

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France

On 4 November 2014, the French Supreme Court handed down an interesting decision regarding the professional privilege between attorneys and statutory accountants. This decision does not establish a new principle but is a significant interpretation of the existing rule.

In this case, several companies from Luxembourg and France were suspected of tax fraud. As a consequence, agents of the tax administration conducted a visit at their offices and private apartments in order to seize potentially relevant documents. Following this visit, the companies sought to invoke Article 8 of the European Convention on Human Rights which provides that "[e]veryone has the right to respect for his private and family life, his home and his correspondence". The lawyer accused the agents of breaching this Article because they seized a very high number of documents without differentiating them. However, the French Supreme Court considered that the documents seized were precisely those that proved that the companies had committed tax fraud. Therefore, it ruled that Article 8 had not been breached by the agents.

The companies also claimed that the agents had improperly seized documents entitled "counsel letter" and "confidential" without sealing and cataloguing them, and further claimed that the documents were covered by professional privilege. Pursuant to established case law, under Article 66-5 of the Law of 31 December 1971, only communications between attorneys and clients or between attorneys are covered by professional privilege. In this case, the companies tried to argue that the documents which confirmed their tax fraud were covered by professional privilege because they were communications between attorneys and statutory accountants. However, the French Supreme Court ruled that the First Presiding Judge of the Court of Appeal correctly decided that the privilege did not extend to communications between an attorney and his/her client's statutory accountant.

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Germany

On 22 October 2014, the German Federal Government forwarded a draft bill to the Federal Parliament seeking to amend the German law on Insurance Regulation (VAG). The draft implements the EU Solvency II Directive of 2009 into national law. The EU Solvency II Directive imposes certain capital requirements for insurance companies to reduce the risk that insurance companies will become insolvent.

With respect to the duties and liabilities of auditors, Art. 35 of the draft bill (duties of auditors) addresses an auditor's liability when auditing solvency balance sheets of insurances companies. Currently, audits of insurance companies' solvency balance sheets are performed by the German Federal Financial Supervisory Authority (BaFin). According to the draft bill, auditors would be responsible for this work and would have to report their results to BaFin. Under existing German law, auditors can be held liable for breaching their duty to accurately report to the BaFin. When submitting their reports, auditors also face the risk of violating confidentiality obligations they owe to the audited company or third parties. The draft bill limits the auditor's liability in this regard by stating explicitly that auditors will not be held liable for a breach of confidentiality claim as long as they were acting in good faith. However, the draft bill is silent on the extent to which an auditor may be liable for negligence claims other than those arising from confidentiality obligations. This affords auditors less protection than the EU Solvency II Directive[2], which protects an auditor from all liability connected to its report to the BaFin (not only claims relating to confidentiality obligations) as long as the auditor acts in good faith.

The German Chamber of Public Accountants (WPK) recently issued a public statement criticizing the draft bill and calling for amendments to extend liability protection to all claims arising from audits of insurance companies' solvency balance sheets. Given the clear wording of the EU Solvency II Directive, it seems likely that such amendments will be enacted.

[2] An EU directive obliges member states to implement the directive into national law but has no direct effect until implemented.

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Hong Kong

There have been no significant developments in the area of accountant's liability law in Hong Kong this month. While there have been proposals of regulatory reform to introduce stricter disciplinary measures for auditors (see our November report), currently this falls under the responsibility of the Hong Kong Institute of Certified Public Accountants (the HKICPA).

Recently, the HKICPA took disciplinary action against a CPA for breaching professional ethical standards in failing to report her employer's unlawful acts to the appropriate level of management or to the relevant third party authorities, and to take action where she had been aware that information provided to auditors was misrepresented or false. In the Reasons for Decision, the Disciplinary Committee noted that the CPA "might most probably" have been a participant in the fraud and did not just fail to blow the whistle. Despite this, the Disciplinary Committee only ordered that the CPA be removed from the register of CPAs for 24 months and pay the costs of the proceedings.

Despite the apparent trend to impose greater liability on accountants and auditors (from the new Company Ordinance and legislative proposals), the CPA in this case did not receive unduly harsh disciplinary treatment from the HKICPA.

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Mexico

Background
In early July of this year, the [Federal Tax Code] was amended to include "e-accounting" requirements that seek to increase tax collection and decrease tax evasion. The new regulations require individuals and companies to record and process their financial information electronically and require that this information must be uploaded to a government data base on a monthly basis.

Businesses have objected to these amendments because, among other things, in order to comply with these rules businesses must incur additional expenses such as software, hardware, staff, training, and maintenance. The harshest critics of these provisions argue that, in its effort to increase internal revenue, the government is harming small businesses that work under reduced budgets and are currently struggling to survive in a stagnant economy.

Individuals and businesses alike challenged this new set of rules through hundreds of *amparo* proceedings. Amparo is a type of proceeding through which citizens seek relief from acts or decisions taken by the government that they allege violate human rights. In *amparo* proceedings, petitioners may be granted a stay order that will prevent the government body from carrying out or enforcing the challenged act or decision until a final decision about its constitutionality is rendered. *Amparo* requests are heard by federal district courts.

The core argument of those requests for *amparo* relief was that the e-accounting rules violate the fundamental right to be levied with proportional burdens only as enshrined in section 31 subsection IV of the Constitution. Petitioners sought to have these rules declared unconstitutional and most requested stay orders deferring their obligation to upload their accounting records on a monthly basis until a final decision is reached

Recent developments
In early November, [a binding precedent] was issued indicating that stay orders relieving petitioners from their obligation to deliver e-accounting data on a monthly basis could not be granted because granting them would hamper the efficiency of tax enforcement proceedings thus affecting the collective interest intrinsic to the State's activities. Federal Circuit Collegiate Courts explained that allowing businesses to neglect their obligation to upload their financial records to the government's data base would have more severe effects than requiring them to comply with the obligation. In short, the courts conclude that tax enforcement and collection is of high value and must be protected. Because the information in the database is one of the key sources of information for the enforcement agency, the flow of information must not be interrupted for the sake of efficiency.

This binding decision means that businesses must comply with this new obligation despite the fact that its constitutionality is still in doubt. If businesses do not comply with the rules, they could be subject to fines and tax enforcement proceedings. Thus, in our opinion, this binding precedent regarding stay orders has virtually mooted the challenges to the e-accounting requirements, at least for the current reporting period.

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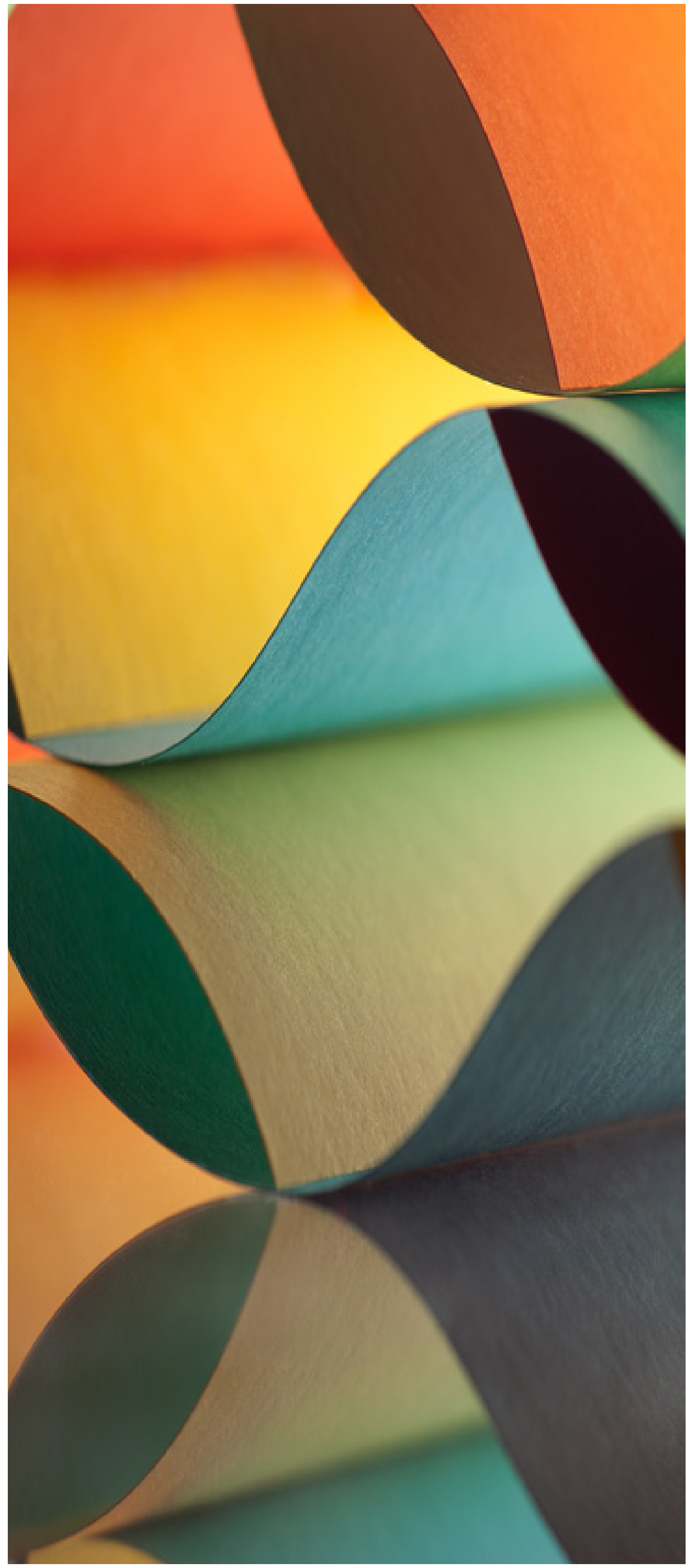
Spain

As we reported in our November Update, the Spanish Institute of Accountants and Auditors (ICAC) has published a Preliminary Draft of the Spanish Audit Act. When effective, this Act will significantly affect Accountants' Liability in Spain. The Act continues to progress through the Parliamentary process. The Spanish Institute of Chartered Accountants (ICJCE) has indicated that the Spanish Government intends to adopt the Act as soon as possible before upcoming elections can disrupt its progress. If successful, this early adoption will occur before the deadline of 17 June 2016 for EU Member States to comply with EU directives regarding statutory audits of annual accounts and consolidated accounts. The government's commitment to moving this Act quickly into law is also influenced by several high profile cases in which directors at Gowex, Pescanova, Aena, and Bankia are either being investigated or accused of criminal fraud. In each of these cases, the auditors failed to identify any accounting irregularities. The Draft Act is not without detractors. Several critics have suggested that the penalties imposed by the Act are excessive. In addition, critics have complained that the Act's definition of independence sets too high of a bar in requiring auditors to avoid incompatible engagements.



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United States

SEC sees disappointing results from fraud-fighting "Robocop" tool

The SEC's fraud-fighting "Robocop" tool — formally known as the Accounting Quality Model (AQM) — is in "limbo" now due to disappointing initial results, according to a former Commission senior staffer.

The SEC originally rolled out Robocop as part of its Financial Reporting and Audit Task Force designed to strengthen the Commission's hand in fighting financial fraud. The tool was supposed to be a central part of the Enforcement Division's "ongoing efforts to concentrate resources on high-risk areas of the market and bring cutting-edge technology and analytical capacity to bear in its investigations." Robocop analyzes companies' public filings and produces a risk score to assess the likelihood that fraudulent activities are occurring. This score is derived in substantial part from "a comparison with the filings of companies in the filer's industry peer group," thereby enabling the SEC — in theory — to identify and investigate outliers.

But Robocop's first year and a half has not gone as planned. According to Howard Scheck, a former chief accountant at the Enforcement Division, the SEC has been unable to use Robocop "in the way that they had hoped and the way it had been talked about at least a year ago." AQM's most significant flaw, according to observers, is "the inevitable high amount of 'false-positives.'" As such, the Robocop tool is unable to perform the originally-intended function of narrowing the SEC's list of firms to be investigated. The SEC has declined to comment on the tool's shortcomings and on its plans to remedy Robocop's functionality.

Islamic accounting standards to converge with international ones?

Accounting standards for Islamic finance may be set to converge with prevailing international standards on conventional finance.

Historically, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) developed separate accounting standards from those provided by the International Accounting Standards Board (IASB). While the IASB's International Financial Reporting Standards (IFRS) apply to conventional finance in over 100 countries, including Muslim nations such as Saudi Arabia and Malaysia, the AAOIFI's book-keeping rules apply solely to Islamic finance transactions, which have traditionally been conducted under the strictures of sharia.

AAOIFI is now "engaging" IASB to determine how AAOIFI can converge its auditing and accounting standards with those of traditional finance. AAOIFI's engagement with IASB is an unprecedented move, coming on the heels of the appointment of a new Secretary-General in September. Thorny issues remain, such as how to deal with Sharia law's prohibition on interest payments and blatant financial speculation. Nevertheless, AAOIFI's "proactive approach" to harmonize its standards signals the converging of Islamic finance accounting standards with those in conventional finance.

IESBA proposes new ethics standards for professional accountants in business

Professional accountants in business (PAIBs) will soon be receiving updated guidance on their ethical responsibilities from the International Ethics Standards Board for Accountants (IESBA).

IESBA has released for comment proposed changes to Part C of the Code of Ethics for Professional Accountants (the Code). The proposal "deals with two matters on which professional accountants in business most often seek assistance in practice — their responsibility to produce financial reports that are faithful representations of the economics of transactions, and pressure to breach the fundamental ethical principles." Among the proposed changes are

- more robust guidance regarding the responsibility of PAIBs to avoid presenting misleading information;
- a broader definition of improper pressure that may lead to a breach of an auditor's ethical principles, as well as concrete examples illustrating situations in which such pressure may arise; and
- guidance to assist PAIBs in responding to such pressure.

IESBA proffered these proposals based on its belief that inappropriate pressure on PAIBs, "especially with respect to the presentation of information," undermines "the quality of information on which users rely." One such proposal would further refine the definition of "fair and honest" auditing, emphasizing that a PAIB may not omit information with the intent to mislead. Another proposed amendment to the Code would provide examples of management bias indicators, such as "selecting or constructing significant assumptions that yield a point estimate favorable for management objectives." The proposals will remain open for comment until 15 April 2015.

PCAOB hopes to revise proposal requiring auditor disclosure of "Critical Audit Matters"

The Public Company Accounting Oversight Board (PCAOB) hopes in the first quarter of 2015 to release a renewed proposal requiring auditors of corporate financial statements to detail "Critical Audit Matters" (CAMs) in their reports, thereby allowing auditors to list potentially risky issues seen in their audits.

PCAOB defined CAMS as those issues "that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor" in forming an opinion on the financials. The Board's original proposal, released in 2013, would have required the auditor's report to identify CAMs "as determined by the auditor." PCAOB believed this proposal would satisfy investors' desires for financial statements that were more in-depth and transparent. Martin Baumann, Chief Auditor of the PCAOB, noted that the United Kingdom has gone even further in its reforms, requiring auditors to detail how they "assess[] whether an issue is material." By contrast, the original PCAOB proposal, according to Baumann, would not require anything other than what has likely been reported to the company's audit committee. Auditors' groups have also voiced concerns regarding the proposed CAM requirement.

In response, the Board is working towards issuing a "revamped proposal" by 30 March 2015. The new proposal is supposed to respond directly to criticism received during the first comment period; however, no consensus has emerged on the substance of the updated proposal, and the PCAOB has not yet officially considered the re-proposal.

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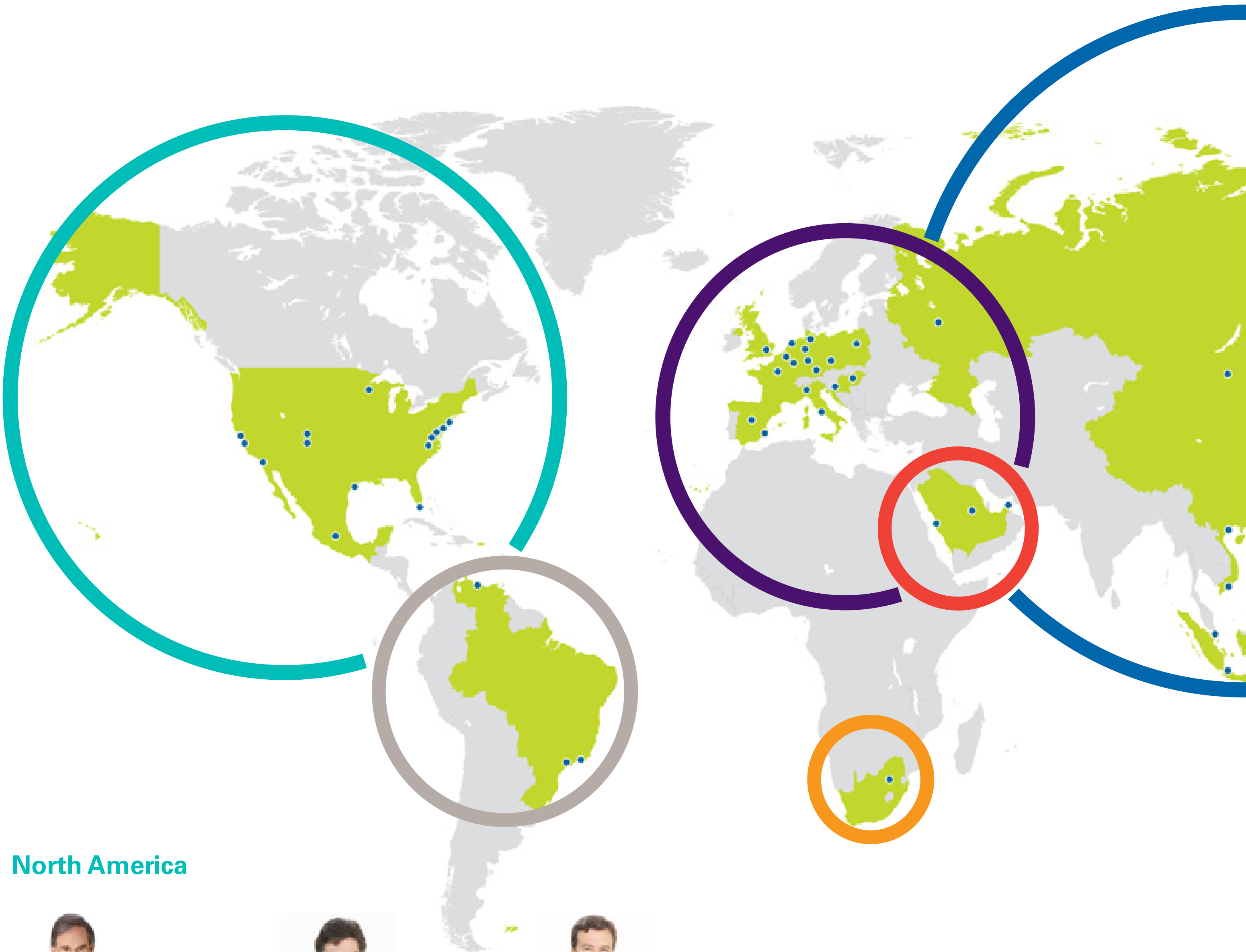

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