Hogan Lovells

Global Accountants' Liability Update

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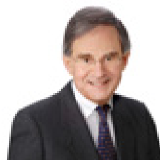
NOVEMBER 2014

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, Egypt, England, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Qatar, Singapore, South Africa, Spain, and the UAE. 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, Mexico, Singapore, South Africa, Spain and the United States, which are summarized in the pages that follow.



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France

On 25 September 2014, the Paris Court of Appeal handed down an interesting decision regarding the limitation period within which one is entitled to file a claim against a statutory auditor, and limitations on the ability of a statutory auditor to fix the price of company shares in the event of a sale.

In this case, a company and the buyer of its shares had agreed upon an initial price, and a price adjustment clause under which the final price of the shares was to be determined based upon an interim statement of account to be drawn up by the seller in view of the purchase. The parties also agreed that the statutory auditors of the seller would audit this interim statement of account.

Following the discovery of some misappropriations by one of the seller's managers, the buyer refused to pay the initial price, claiming the price was too high. The buyer also claimed that the seller did not provide the documents required by the statutory auditors in order to audit the interim statement of account as required by the price adjustment clause. Therefore, the statutory auditors were only able to file an incomplete audit report, which confirmed some of the misappropriations, and may have supported the buyer's conclusion that the initial price was too high. The seller then filed a claim against both its statutory auditors and the buyer, asking for damages to compensate its loss resulting from the lack of payment of the initial price.

In its decision handed down on 25 September 2014, the Paris Court of Appeal held that when statutory auditors have knowledge that their audit will be used to determine the purchase price of shares, the statutory auditors are no longer neutral. Therefore, the statutory auditors should have refused this mission to preserve their independence.

The Court further ruled that the three-year limitation period applicable to the statutory auditors' liability in case of loss arising from their legal mission was not applicable here because any audit linked to the interim financial statement of a company is outside the scope of the statutory auditor's legal mission. Therefore, the Paris Court of Appeal applied the 10-year limitation period and ruled that the claim was not time-barred.

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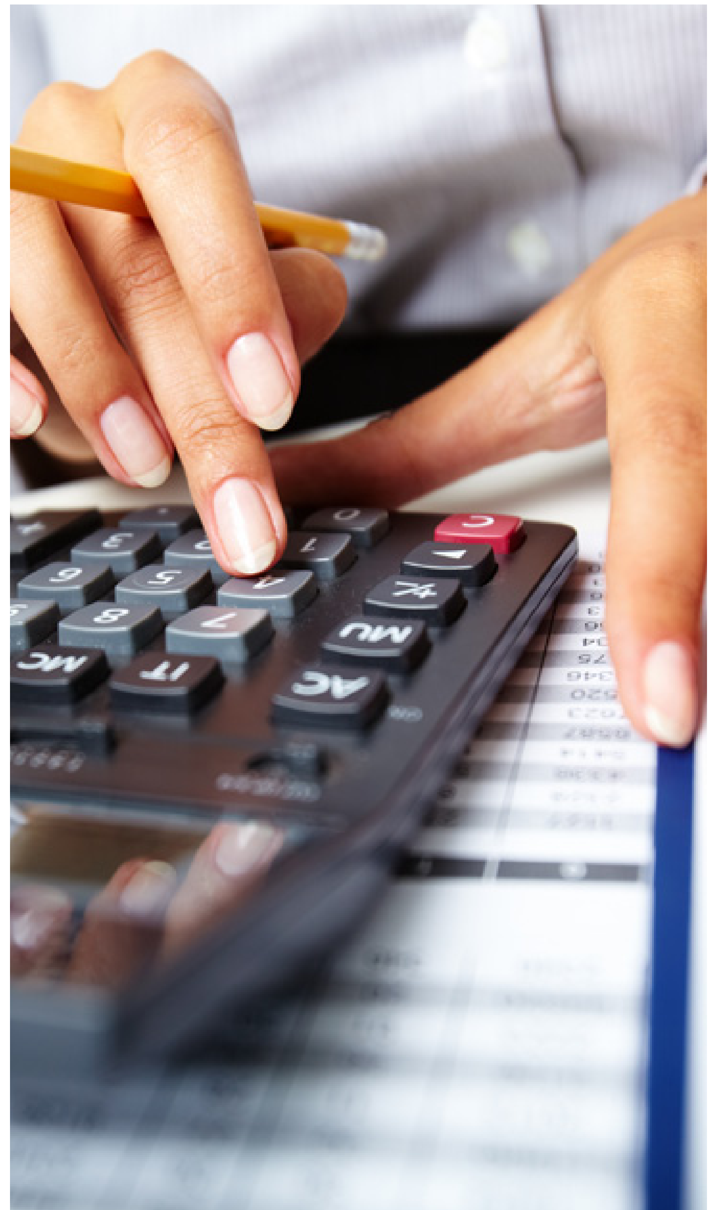

Germany

In a recently published judgment the Higher Regional Court of Schleswig Holstein [*Schleswig-Holsteinisches Oberlandesgericht*], which is a court of appeal in Northern Germany, held that tax consultant firms are not obliged to inform their clients about the existence of possible claims for professional negligence against the client's former tax firms. This obligation arises only if they have been explicitly instructed to analyze such claims.

German courts have historically applied the same standards of liability for law firms, tax consultant firms and accountant firms. Almost 20 years ago, the German Federal Court of Justice [*Bundesgerichtshof*] held that a law firm is obliged to inform his client about possible claims for professional negligence against the client's tax consultant firm (BGH, Apr. 29, 1993, 1993 NJW 2045). Since then, it has been widely accepted that tax consultant firms and accountant firms also breach their duties to their clients if they are aware of possible claims for negligence against other or previous advisors and fail to inform their clients about those claims.

The Higher Regional Court of Schleswig Holstein granted leave to second appeal to the *Bundesgerichtshof* to make a final judgment whether this duty applies to tax consultants or not. If the judgment of the Higher Regional Court of Schleswig Holstein is upheld by the *Bundesgerichtshof* (docket no: IX ZR 186/14), it seems likely that, in the future, German courts will not establish such a duty for accountant firms either.

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Hong Kong

There have been two significant developments in accountant's liability law in Hong Kong recently:

1. New companies law provisions introducing criminal liability for auditors; and

2. Legislative proposals to expand the regulatory regime for auditors.

Criminal liability under the New Companies Ordinance (Cap.622) (New CO)
The New CO took effect on 3 March 2014. This was a complete rewrite of the companies framework in Hong Kong. The new law introduced, inter alia, criminal liability for company auditors:

- for knowingly or recklessly omitting certain required statements from an auditor's report[1]; and

- for failing to give a statement to the company after termination of their appointment as company auditor[2].

The new provisions apply to auditor's reports or financial statements of a company relating to a financial year beginning on or after 3 March 2014, i.e. the current audit cycle. The provisions relating to accounts and audit are at Part 9 (annexed) of the New CO.

Proposed reform to audit regulation
A three-month public consultation exercise on legislative proposals to expand the regulatory regime for auditors ended in mid-September 2014. The Financial Services and Treasury Bureau is now reviewing the comments and a bill is expected to be tabled in 2015.

Under the proposals, auditors would face stricter disciplinary measures. The existing Financial Reporting Council would become responsible for taking disciplinary action against Hong Kong-listed company auditors, with wide investigative and sanctioning powers, and criminal sanctions for persons failing to comply with the requirements in relation to the FRC's inspections.

1 s.408 new CO
2 s.425 new CO

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Mexico

Background
During the last two years, Mexico has undergone a major restructuring in its legal system. Several constitutional amendments have been passed by Congress in matters related to human rights, antitrust, telecom, finance and commerce, tax, energy, among others. These amendments have influenced almost all legal disciplines and accountants' liability is no exception.

Traditionally, accountants can be held liable for breach of contract in a claim by its client or for wrongful and fraudulent conducts affecting third parties. Liability can be either civil (damages) or criminal (fines and prison). The most important development on accountants' liability in this transformation period was through the so called "Financial Reform" where several financial services and commerce-related statutes were amended and enacted to foster credit issuance and boost commercial dynamics.

One novelty introduced by this reform was the enactment of section 270 Bis of the Reorganization and Bankruptcy Act. This section provides that employees that carry out, instruct, or tolerate conduct harming the bankrupt estate or the creditors' interest during an insolvency proceeding will be personally liable for any damages arising out of such actions or conduct. Thus, besides the traditional criminal penalties accountants are subject to, they may also face civil damages arising from conduct during an insolvency proceeding. Before the inclusion of this section, accountants would seldom be liable for misdeeds affecting a bankrupt estate and liability was typically limited to shareholders or the manager of the bankrupt company. This new amendment puts the spotlight on any employee or service provider that has, or could have, some steering influence over the assets of the company instead of just focusing on managerial liability.

Developments in October 2014
In 2012 the Anti-Money Laundering (AML) Act was passed by Congress. Amongst other provisions, this act requires merchants to submit monthly reports on activities that are often used as cover-up for money laundering (e.g. real-estate brokerage and development, gambling, loans, jewelry trading, used cars trading, etc.). These monthly reports can be submitted either by the merchant itself or an external auditor. The Mexican Securities Commission (Commission) and the Treasury may rely on the information provided in the monthly reports to begin investigating businesses suspected of engaging in illegal activities.

In January 2014, a new set of amendments to several finance-related acts set forth that individuals in charge of ensuring compliance of the duties under the AML Act would have to be certified by the Commission in order to help in investigations conducted by it or to advise the businesses subject to investigation. In other words, external auditors need to be certified to act either as a contractor for the Commission or as an advisor to a business when an investigation takes place.

On 2 October 2014 the Mexican Treasury Department and the Commission issued the regulations for the certification of external auditors. The process is fairly simple:
1. sign up in the Commission's website;
2. file a certification request;
3. submit documents evidencing college education, relevant experience in the field, no conviction history and clean record in any other certifications issued by the Commission;
4. take and pass an exam related to money laundering prevention; and
5. secure the certification.

These regulations will come into force on 1 January 2015.

There is yet no official statement on what the consequences may be of acting as an external auditor without having this certification although but we expect the Commission to issue a complimentary set of rules elaborating on this issue once the rules have come into force. From other sets of regulations in similar matters we deem that these rules will set forth some monetary fines on the external auditor acting as auditor in AML matters without the certification.

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Singapore

Singapore is a member of the Financial Action Task Force (FATF), an intergovernmental body that, among other objectives, establishes standards to address money laundering and the financing of terrorism. In 2012, FATF issued recommendations that Singapore is obliged to comply with. In October 2014, the Institute of Singapore Chartered Accountants (ISCA) published — and Singapore's Accounting and Corporate Regulatory Authority (ACRA) adopted — a document known as Ethics Pronouncement 200 — Anti-Money Laundering and Countering the Financing of Terrorism - Requirements and Guidelines for Professional Accountants in Singapore (Pronouncement).

The Pronouncement is a set of requirements that must be followed by (1) professional accountants and (2) public accountants and accounting entities regulated by ACRA and registered under the Accountants Act. The Pronouncement: (1) requires accounting entities to establish systems and controls that target money laundering and the financing of terrorism; (2) makes it compulsory for public accountants and accounting entities to have customer due diligence and record keeping mechanisms when providing specific services; and (3) contains recommendations vis-à-vis procedures, hiring, compliance, training, and auditing.

While the Pronouncement became effective 1 November 2014, some sections need not be implemented until 1 May 2015. Failure to comply with the new requirements will trigger an investigation by either ISCA or ACRA.

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South Africa

The most recent development in the law relating to the auditing profession is the draft Auditing Profession Amendment Bill, which was tabled in parliament recently and which, in essence, seeks to amend the Auditing Profession Act 26 of 2005 (the Act) in order to introduce a clear definition for "candidate auditors" and to allow for the regulation of such by the Independent Regulatory Board. Further, the draft Bill also seeks to introduce provisions in the Act to align same with the Companies Act 71 of 2008 (the Companies Act).

The Act provides for the regulation of the auditing profession by establishing the Independent Regulatory Board for Auditors (the IRBA). The IRBA is responsible for the registration of individuals and firms as auditors for purposes of practicing the auditing profession.

The process for becoming a registered auditor is due to change with the termination of the Public Practice Examination (the PPE) in November 2014. From 2014, all first time candidates wishing to write the final assessment for a qualification as a Chartered Accountant (CA) will be required to write the Assessment of Professional Competence of the South African Institute of Chartered Accountants. The Assessment of Professional Competence is a general assessment of the competence required of a CA and is not an assessment of audit competence. In order to assess audit competence before registration as an auditor, the IRBA has replaced the Public Practice Examination with the Audit Development Program. The Audit Development Program entails a phase whereby an aspiring auditor becomes a candidate auditor before registration as an auditor.

The Audit Development Program is a period of specialization undertaken by professional accountants who want to become registered auditors. The purpose of this program is to consolidate and refine capabilities that are developed during the training program. This takes place in a more complex learning environment and the aspiring auditors are required to perform roles more senior to those undertaken in the current training contract.

The Act currently does not regulate candidate auditors and this amendment is necessary so that all aspiring registered auditors are under the jurisdiction of the IRBA. In the past, all candidates who successfully completed the PPE and wanted to become a registered auditor would register with the IRBA. The new model provides for a period of specialist training prior to a CA becoming a registered auditor. It is during this period of training that the registered candidate auditor will be subject to the regulation of the IRBA as a candidate auditor.

Further, a new Companies Act was enacted in 2008 to replace the Companies Act, 1973 (Act No. 61 of 1973). The Auditing Profession Act has not been updated to align it to the Companies Act.

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Spain

The Spanish Institute of Accountants and Auditors (ICAC) published the last [Preliminary Draft of the Spanish Audit Act] on the 28 October 2014. At the same time the ICAC opened a 10 day period for comments in which either individual professionals of the sector or companies may pose their queries. Once the 10 day period is over, the ICAC will send the Preliminary Draft to the Ministry of Economy so as to continue with the ordinary parliamentary process for Act adoptions.

The Preliminary Draft envisages the entry into force of the future Act on 17 June 2016. Luis De Guindos, Ministry for Economy, asserted that, independently of the date of entry into force, the adoption of the Act will most likely take place in 2015, once the whole parliamentary process is finished.

The Preliminary Draft makes express reference to the Accountant's liability in Sections 24 and 25. In this regard the Draft text envisages that an Accountant shall be liable for the damages caused because of the breach of his/her obligations. Such liability shall be directly proportional to the damages caused either to the audited company or to a third party. The Draft states that any person or company able to evidence that his/her/it behavior was based in an audit report, may be considered a third party for these purposes.

Moreover, the liability shall be limited to the damages caused to the audited company or the third party and will not include the possible damages caused by the audited company and the third party to further companies or individuals.

When the Audit report is made by an Auditor on behalf of an Audit Company, both will be jointly and severally liable. The statute of limitation period will last for four years from the moment in which the Audit Report is issued.

Every Auditor and Audit Company shall provide a bail or security, which may be a deposit, public debt securities, bank guarantee, or a civil liability policy of the amount and way established by the Ministry of Economy. Such amount shall be proportional to the turnover of the audited company.

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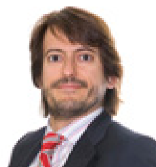

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United States

The Public Accounting Oversight Board (PCAOB) is considering a "compromise" proposal that would require public companies to disclose the name of the audit engagement partner in a new form: "Form 5."

Last year, the PCAOB originally proposed that the name of the engagement partner leading the annual audit be disclosed in the auditor's report itself. After receiving significant objections from the accounting community, however, the Board is now considering a new proposal submitted by PCAOB Chairman James Doty.

Pursuant to the Doty version, the name of the audit engagement partner and other firms participating in the audit would be disclosed in a newly-created Form 5, which would be filed shortly after the company's 10-K annual reports are issued. Use of Form 5 allows for the auditor's name to be contemporaneously available to investors, but also ameliorates a situation where the auditor's name is tied directly to an audit report included in the 10-K. This "compromise" proposal therefore addresses competing concerns of transparency and auditor liability. Still, critics have pushed back on the Form 5 proposal, arguing that naming of the engagement partner on Form 2 of the annual reports filed with the PCAOB is more appropriate; Form 2 filing often does not take place for more than a year after the issuance of the audit report.

It is unclear whether delaying the disclosure of the engagement partner until only shortly after the release of the audit report would assuage the concerns of the Big 4 accounting firms that have weighed in against the proposal. Either way, Doty's persistence after the PCAOB originally broached this topic back in 2011 suggests that the he will ensure that the audit engagement partner's name appears somewhere, even if not in the auditor's report itself.

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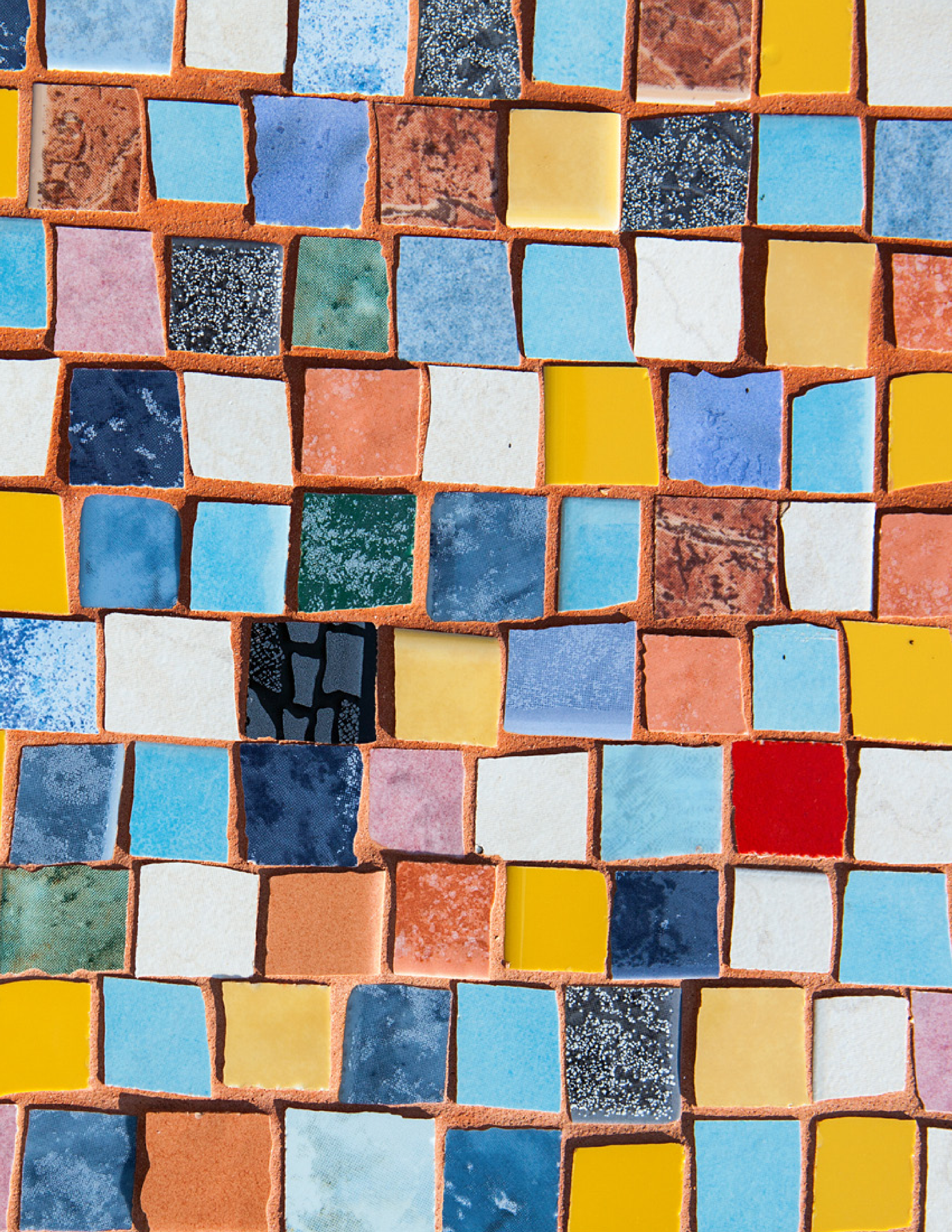

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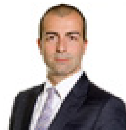

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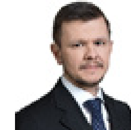

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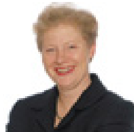

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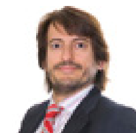

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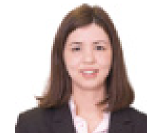

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