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Global Accountants' Liability Update

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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 The Netherlands, Spain, and the United States, which are summarized in the pages that follow.



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Recent court
decisions



The Netherlands

Introduction

On 17 September 2019 the Trade Industry Appeals Tribunal (College van Beroep voor het bedrijfsleven, or CBB) – the highest court for social-economic administrative law in the Netherlands, which is the only tribunal that hears appeals of disciplinary decisions issued by the Accountancy Division – rendered a judgment about the disciplinary liability of an accountant for the acts and/or omissions of a third party. In this case, the third party was the accountant's customer relationship manager (the Crm).

Facts

The accountant, and owner of an accounting firm, signed a 2011 engagement letter agreeing to prepare financial statements and tax returns for the client.

Separately, the Crm provided consulting services to the client. The Crm's consulting work included the preparation of financial forecasts, which turned out to be too favourable and prompted the client to file a complaint with the Accountancy Division. The disciplinary complaint asserted that the accountant should be disciplined for the acts of the Crm. The Accountancy Division agreed because the Crm's consulting work was carried out at the instruction of the accountant and required the knowledge and skills of an accountant.

Judgement

The CBB judgment explains that a prior ruling issued on 22 April 2014 established that disciplinary liability for acts and/or omissions of a third party who carries out independent work under the name of an accounting firm attaches to the accountant only if the

accountant is factually involved in the work at issue or is otherwise "technically responsible" for the acts and omissions at issue.

In the matter at hand, the CBB found the client failed to sufficiently demonstrate the accountant had been factually involved with the work at issue. As a result, the accountant can only be held disciplinary at fault for the work carried out by the Crm if the accountant can be held technically responsible for those acts and omissions. The CBB relied on a number of key facts to conclude that the Accountancy Division was correct to hold the accountant liable for the acts of the Crm. These include:

- (a) the Crm's work at issue resulted from a signed compilation engagement between the accountant and the client;
- (b) in communication to the client, the accounting firm's insurer stated that the accountant was ultimately responsible for the Crm's work; and
- (c) Crm's forecasting work, which related to raising funds to expand the client's business, relied on financial statements prepared by the accountant and therefore required the knowledge and skills of an accountant.

The accountant has acknowledged on appeal that he has disciplinary responsibility for the forecasts the Crm used. As a result of this, the CBB has held the accountant also liable for other activities the Crm carried out in relation to raising funding for the expansion of the client's business, which relied on these forecasts. These consulting activities must therefore be regarded as activities for which the professional competence of an accountant is or can be used, so that they constitute a professional service as referred to in Article 1 of the Regulation on Standards of Professional Conduct and Professional Rules for Accountants (VGBA).

Conclusion

An accountant can be disciplined for the acts and/or omissions of a third party who carries out work at the accountant's instruction and on behalf of the accountant, if the accountant can be held technically responsible. Whether that is the case, depends on the facts and circumstances of the case.

In the matter at hand the CBB ruled that the accountant can be held liable because the Crm carried out work that required an accountants' knowledge and skills, resulting from the signed compilation engagement. The fact that specific knowledge and skills were required followed from the fact that, to carry out the work, the Crm used financial statements prepared by the accountant.

The CBB is of the opinion that, because the accountant has acknowledged that he has disciplinary responsibility for the forecasts used by the Crm, he is also liable for all the work carried out by the Crm relating to these forecasts.

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Spain

Banco Santander: The Supreme Court will decide which jobs threaten the independence of audit firms

The Supreme Court has agreed to hear an appeal filed by Deloitte that will clarify which fees can be considered audit fees and whether a disproportion between the fees for non-audit activities and those received for auditing activities can constitute a conflict of interest that threatens the independence of the audit entity.

This appeal relates to Deloitte's audit of the Banco Santander's annual accounts, which prompted the Spanish Institute of Accounting and Audit of Accounts (ICAC) to sanction Deloitte with a penalty of EUR 1,000,000. By an order dated 15 November 2019, the Administrative Chamber of the Spanish Supreme Court has agreed to hear Deloitte's appeal challenging this penalty, which was originally assessed 8 July 2015.

This penalty was already confirmed by the Administrative Chamber of the Spanish National High Court, which concluded that Deloitte had infringed Article 12.1 of Spanish Law 1/2011 on Account Auditing in two ways. The first alleged infringement, confirmed by the Administrative Chamber of the Spanish National High Court, relates to the disproportionate fees received by Deloitte from the audited companies (Santander Group, S.A

and Banco Santander, S.A.) for non-audit activities compared to the fees received for audit services. The second alleged infringement relates to Deloitte's alleged failure to reflect in the working papers the necessary safeguards to detect and assess threats to independence of audit firms.

These two types of conduct are alleged to infringe article 12.1 of the Law 1/2011 on Account Auditing, which requires that auditors be independent in the performance of their duties and, to ensure this, put in place the necessary safeguards to detect, assess, reduce and, where appropriate, eliminate threats to such independence. The National High Court assessed that Deloitte did not establish the necessary safeguards and consequently was not independent when carrying out the audit in 2011.

It is important to note that Law 1/2011 on Account Auditing has been repealed by Law 22/2015 on Account Auditing. Taking this into account, along with the fact that there is no existing case law directly on point, this case presents an opportunity for the Supreme Court to clarify the law surrounding auditor independence, provide more certainty surrounding auditing companies' activities, and prevent future disputes.

The Supreme Court will decide whether internal audit committees of companies are responsible for inaccurate accounts

The Administrative Chamber of the Spanish Supreme Court issued an Order last November admitting the appeal brought by Codere Group (a Spanish gambling company) and four members of its board of directors who were also members of the company's internal audit committee. As such, all of them were sanctioned for the auditing of the annual accounts of 2012.

Codere Group was fined EUR 100.000 in 2014 by the ICAC and each of the four board members were fined with EUR 10.000 for the submitting consolidated annual accounts of 2012 containing incorrect and false data to the Spanish National Securities Market Commission. The sanctions were confirmed by the Administrative Chamber of the Spanish National

High Court, which also fined PwC as their external auditor.

According to the Spanish Corporate Enterprises Law, all listed companies (including Codere) must establish an audit committee formed by members of the board of directors. Moreover, Law 22/2015 on Account Auditing, in its fourth final provision, states that these committees have the function of supervising the effectiveness of the company's internal control and supervising the process of preparing and presenting the company's financial information. These duties imply an additional obligation to guarantee the veracity of the audited consolidated accounts in

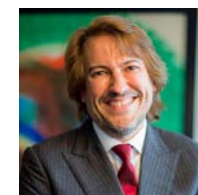


order to provide a true and fair view of the company's situation.

The future Supreme Court ruling on this issue will set an important precedent in case law regarding the extension of liability for inaccuracies or misstatements

in the consolidated financial statements arising from an external audit to directors who are also members of an internal audit committee. This decision may have a significant impact in all listed companies in Spain.

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United States

KPMG prevails against Merrimack College in trial over failure to detect financial aid fraud

On November 19, 2019, following a three-week trial in Massachusetts Superior Court in the case of *Merrimack College v. KPMG LLP*, Case No. 14-cv-2098-BLS2, the jury issued a verdict in favor of KPMG.

Merrimack College filed the action against KPMG, its auditor, in 2014 alleging breach of contract, negligence, negligent misrepresentation, professional malpractice, and violation of Massachusetts' Consumer Protection Law, M.G.L. c. 93A, based on KPMG's failure to detect a decade-long fraud by the College's former Financial Aid Director, Christine Mordach, who in an effort to balance the College's books, fraudulently converted student scholarships into \$4.1 million in federal Perkins loans. The fraud was uncovered in 2011 and Mordach later pleaded guilty to federal mail and wire fraud charges. In its pre-trial memorandum, the College alleged KPMG's negligence caused more than \$9 million in damages.

During the trial, the College attempted to show that the auditors were negligent for failing to perform sufficient audit procedures to detect the fraud and for missing multiple red flags that should have raised

their suspicion. For its part, KPMG's audit partner and managers testified that they adhered to GAAS and that the audit procedures were reasonable under the circumstances; and, KPMG also presented witnesses from the College's management and board to show the College's own negligence in supervising the Financial Aid Office and failing to detect Mordach's fraud.

During the litigation, there were several noteworthy developments impacting accountants' liability law. In May 2017, the trial court granted KPMG summary judgment based on the *in pari delicto* doctrine, which barred the College's claims resulting from its agent Mordach's wrongdoing. However, in September 2018, the Supreme Judicial Court of Massachusetts (SJC) reversed, ruling for the first time that the *in pari delicto* defense was only applicable if the wrongdoing was attributable to "senior management" and that Mordach, as Financial Aid Director, was not a member of the College's senior management. In July 2019, the SJC ruled in *Chelsea Housing Authority v. McLaughlin, et al.* that the *in pari delicto* doctrine was not a defense available to Massachusetts licensed accountants in cases involving fraud because

it had been superseded in 2002 by M.G.L. c. 112, § 87A^{3/4}, which limited the accounting firm's liability to its percentage fault in contributing to the plaintiff's damages after considering the percentage fault of the fraud-doer.

In a significant ruling during the trial, the court determined that the jury's deliberation would first consider the relative comparative fault of plaintiff Merrimack College and defendant KPMG and then, if KPMG was found liable for any of the College's injury, the jury would consider Mordach's responsibility for the College's injury. The court rejected the College's argument that KPMG had to elect to proceed under either comparative negligence or Section 87A^{3/4} but not both.

The jury returned a verdict for KPMG after deliberating for one and one-half days. The special verdict form showed the jury's conclusion that responsibility for the College's injury—determined to be only \$100,000—was due to the College's own negligence; the jury determined that the College was 85% responsible for the injury while the accounting firm was 15% responsible. Accordingly, under Massachusetts' comparative negligence law that bars recovery by plaintiffs whose own negligence is greater than fifty percent, the College was not entitled to collect any damages from KPMG.

The College's claim against KPMG for alleged violation of Massachusetts' Consumer Protection Law, M.G.L. c. 93A, was not presented to the jury. After hearing the evidence at trial, the judge found that KPMG had not violated Chapter 93A and dismissed the College's claim against KPMG.

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Recent regulatory
and enforcement
developments

United States

PCAOB continues to sanction auditors for improper alteration of work papers

The Public Company Accounting Oversight Board (PCAOB or the Board) continues to sanction auditors for improperly adding, deleting, and altering work papers, as highlighted by two recent cases. On October 31, 2019, the PCAOB announced that Deloitte Korea and two of its associated persons, and BDO Mexico and six of its associated persons were each sanctioned by the Board for altering audit documentation in anticipation of PCAOB inspections, as well as for related quality-control violations involving integrity and audit documentation. Both firms failed to design and implement adequate policies and procedures to provide a reasonable assurance that its engagement personnel complied with applicable professional standards and regulatory requirements, including PCAOB documentation requirements. In addition, by misleading PCAOB inspectors, firm personnel violated PCAOB Rule 4006, *Duty to Cooperate With Inspectors*.

In the Deloitte Korea matter, the firm and two of its former partners—Seul Hyang Wee and Hyun Seung Lee—were sanctioned for their role in overseeing the engagement team that backdated work papers and altered hardcopy work papers after anticipating its largest issuer audit would be selected for inspection by the PCAOB in 2014. *In the Matter of Deloitte Anjin LLC*, PCAOB Release No. 105-2019-025 (October 31, 2019), available [here](#). The PCAOB fined Wee and Lee \$10,000 each and barred them from being an associate of a public accounting firm for two years. The firm, for its part, received a fine of \$350,000.

The PCAOB found that the engagement team members backdated their sign-offs on numerous electronic work papers to conceal the fact that they were continuing to perform audit procedures after the Firm had issued its audit report. They also improperly altered a number of hard-copy work papers by adding descriptions of audit procedures. Both Wee and Lee were found to have participated in the backdating and to have been aware of engagement team's efforts to alter hardcopy work papers, but did nothing to stop them, nor did they disclose that information to PCAOB inspections staff.

In the BDO Mexico matter, the firm and six partners of the firm—Ignacio García Pareras, Juan Martín Gudiño Casillas, Luis Raúl Michel Domínguez, Juan Francisco Olvera Díaz, Carlos Rivas Ramos, and Bernardo Soto Peñafiel—were sanctioned for participating in, directing, or contributing to the improper alteration of audit documentation. The PCAOB also found that four of those partners—Gudiño, Michel, Olvera, and Soto—provided misleading information to PCAOB inspectors during its 2017 inspection. *In the Matter of Castillo Miranda y Compañía, S.C., et al.*, PCAOB Release No. 105-2019-028 (October 31, 2019), available [here](#).

The PCAOB determined that beginning in 2015, BDO-Mexico and its personnel routinely violated PCAOB standards, including by failing to timely archive issuer audit documentation, improperly altering numerous work papers in multiple audits after those work papers should have been locked down and archived, and changing the dates on their computer clocks, which concealed when they actually performed and documented work. BDO Mexico was fined \$500,000, and Gudiño, Michel, Olvera, and Soto were each barred from being an associated person of a registered public accounting firm, while García and Rivas received suspensions.

Notably, in both matters, the PCAOB recognized the firms' "extraordinary cooperation," including the conducting of internal investigations and sharing the factual results of those internal investigations with PCAOB staff. For their cooperation, the firms received leniency when the PCAOB imposed the sanctions. Deloitte Korea's fine of \$350,000, for instance, would have been "significantly larger" without its extraordinary cooperation with the PCAOB, according to the Board.



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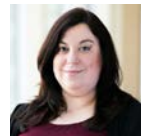
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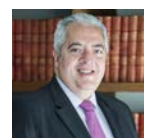
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