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Global Accountants'
Liability Update

June 2022



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Our global team of securities and professional liability lawyers at Hogan Lovells 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 Hong Kong, The Netherlands, and the United States, which are summarized in the pages that follow.



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Recent Regulatory and Enforcement Decisions

Disciplinary body sanctions auditors for lack of enquiry

The Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants (HKICPA) has sanctioned an accounting firm, its engagement director and its quality control reviewer (the respondents) on 1 April 2022 for breach of section 34(1)(a)(vi) of the Professional Accountants Ordinance (Cap. 50).

The firm expressed an unmodified auditor's opinion on the financial statements of a Hong Kong listed company and its subsidiaries, which covered the acquisition of another PRC company. The purchase consideration for the acquisition involved issuing 350 million shares, 200 million of which were deposited into escrow and would be released to vendors if an agreed profit target was met.

The respondents largely admitted the complaints made against them in terms of their failure or negligence to observe, maintain or otherwise apply professional standards in (i) auditing the consideration payable and intangible assets acquired pertaining to the acquisition, and (ii) carrying out an engagement quality control review during the audit.

The respondents admitted failing to identify the incorrect accounting for the 200 million shares as equity when the shares should have been accounted for as a liability. They also admitted that their audit procedures were insufficient and that they should have made more extensive inquiries and assessments as to the business's prospects.

In making the orders reprimanding each of the respondents and imposing financial penalties of HK\$200,000, HK\$80,000 and HK\$100,000 respectively on the firm, the engagement director and the quality control reviewer, the Committee considered various factors including the "moderately serious" nature of the case, the fact that no dishonesty or professional misconduct was involved, as well as the respondents' admission of the complaints.



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Hong Kong – U.S. mutual qualification recognition agreement lapses

The Hong Kong Institute of Certified Public Accountants (HKICPA) has announced that the current mutual recognition agreement (MRA) first entered into with the U.S. International Qualifications Appraisal Board (IQAB) in 2011 will not be renewed after its expiry on 31 December 2022. The MRA, which was renewed every three years and which was last renewed in 2020, allows Hong Kong and U.S. CPAs to practise in each other’s jurisdictions without having to take additional examinations.

The non-renewal was the result of a dispute over an HKICPA rule requiring overseas applicants for a Hong Kong practising certificate to have at least one year of Hong Kong audit experience. The HKICPA said it was unable to accept audit experience obtained in the U.S. by way of substitute.

The HKICPA recommends that members who are currently eligible to become a member of the U.S. State Boards of Accountancy should take advantage of the abbreviated pathway this year before the agreement lapses.

The HKICPA has similar agreements with accounting bodies in 12 other jurisdictions, including Canada, Australia and New Zealand. For its part, the IQAB has mutual recognition agreements with seven other accountant bodies also including these three countries.

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The Netherlands

Recent Court Decisions

Court of Appeal's decision holds auditor liable to third-party

On 17 May 2022, the Court of Appeal of 's-Hertogenbosch ("Court of Appeal") ruled on the liability of an accountant in connection with the audit of financial statements and the extent to which third-party interests must be taken into account when auditing such financial statements. Referring to the judgment of the Supreme Court of the Netherlands dated 13 October 2006, the Court of Appeal ruled that third parties must be able to rely on the presumption that the image presented with the financial statements is not misleading. Third parties must be able to align their behaviour with information provided in financial statements and rely on this information by making or maintaining (financial) decisions. An accountant must therefore be aware of the interests of third parties.

In this ruling, X alleged that the accountant had made a professional error when issuing an unqualified opinion on the consolidated financial statement of company Y. The error at issue is that the item 'work in progress' (onderhanden projecten) was

valued at a substantially excessive amount (EUR 845,209 more). According to X, he would not have acquired shares in company Z (which is affiliated with company Y) without the error of the accountant.

In light of the insight required by Article 2:362 of the Dutch Civil Code and the judgment rendered by the Supreme Court dated 13 October 2006 that third parties must be able to rely on the fact that the picture presented by the financial statements is not misleading, the accountant could be expected to have recalculated the work in progress item. In this respect, the Court of Appeal considers it important that the Trade and Industry Appeals Tribunal (College van Beroep voor het bedrijfsleven (CBb)) ruled in its judgment of 19 April 2017 that the accountant has recognised the risk of fraud as a result of the lack of segregation of duties at company Y. In view of the risk recognised by the accountant, great care could be expected of him, particularly with regard to the item 'work in progress'.



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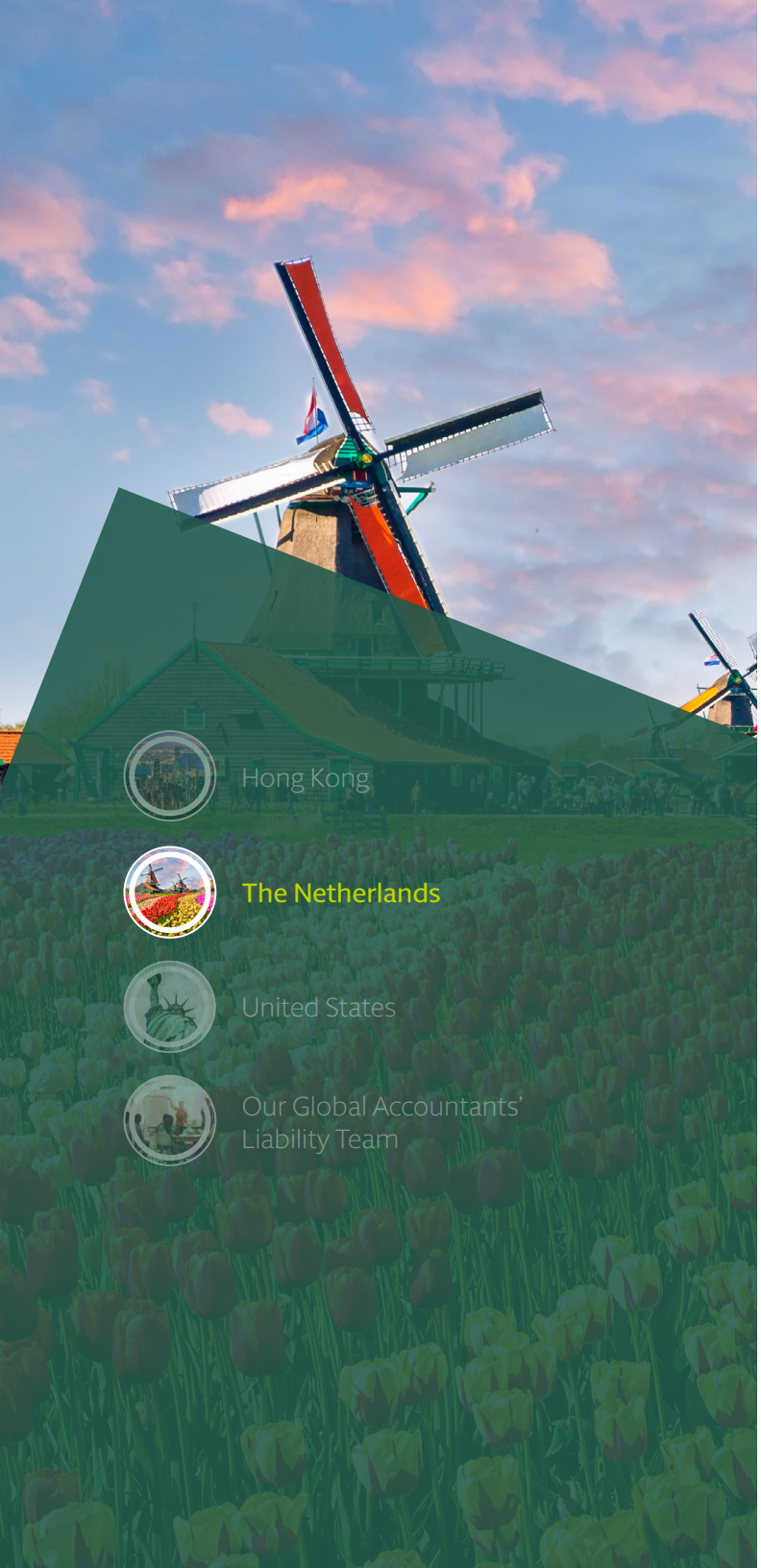


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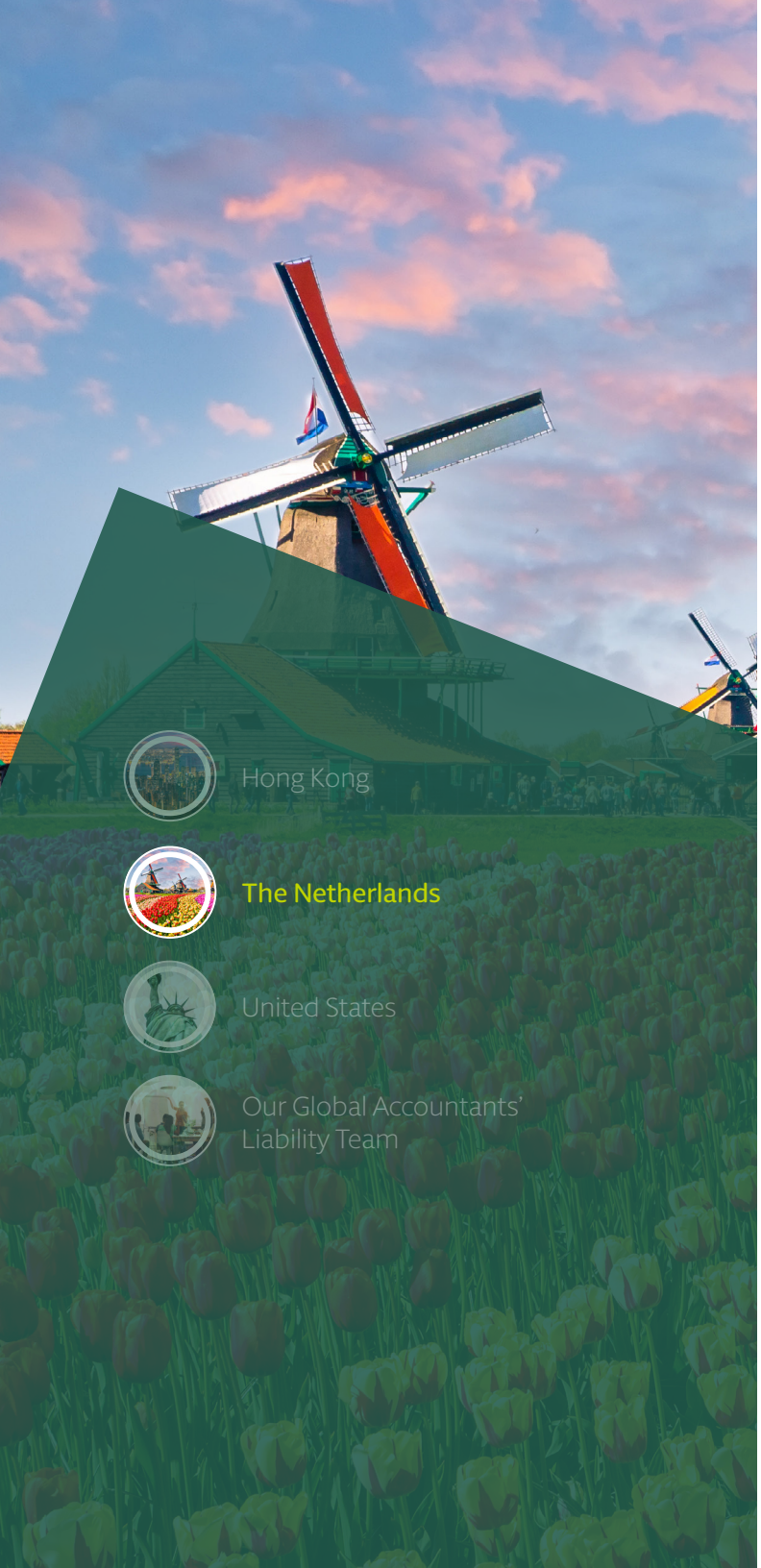
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The fact that the accountant was allegedly deliberately misled by the financial director of company Z does not alter this. Also in view of the risk of fraud, the auditor should have been aware of the potential damage to third parties.

The Court of Appeal is of the opinion that the accountant has not exercised the due care that could be expected of him and has therefore acted unlawfully towards X. As a third party, X was entitled to expect the approved financial statements to present a true and fair view and his decision to acquire shares in Z was not based on a misleading picture.



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Recent Regulatory Developments

Netherlands Authority for the Financial Markets issues position paper on fraud

The Netherlands Authority for the Financial Markets (Autoriteit Financiële Markten or AFM) has published a new position paper on fraud.

Identifying and following up on fraud and fraud risks is a vital responsibility of auditors. In a new position paper, the AFM states that audit firms could fulfil this role more effectively. The AFM wishes to see clear indications in the coming years that audit firms are devoting increased and structural attention to the detection and follow-up of fraud risk when performing the statutory audits.

The responsibility for combating fraud rests primarily with the audited entity; however a role is also reserved for auditors. In the position paper, the AFM explains how it sees the role of the auditor in the identification and follow-up of fraud and fraud risks, and their expectations of the sector in this respect.

Fraud will be a permanent item on the AFM's supervisory agenda, and the AFM will carry out a range of related supervisory activities in the years to come. For instance, the AFM wishes to see improvement in the analysis of fraud and fraud risks by auditors and the procedures they perform in this respect.

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Recent Regulatory and Enforcement Decisions

PCAOB censures and fines former vice-chair of audit for failure to supervise

On April 5, 2022, the Public Company Accounting Oversight Board (“PCAOB”) censured and imposed a \$100,000 civil penalty on Scott Marcello, KPMG’s former Vice Chair of Audit. The PCAOB levied this unprecedented fine on Marcello in its first ever disciplinary action for failure to reasonably supervise, according to a statement from PCAOB Chair Erica Y. Williams, in order to demonstrate that it is willing to hold supervisors responsible for firm culture that contributes to misconduct. Section 105(c)(6) of the Sarbanes-Oxley Act authorizes the PCAOB to impose sanctions for a failure reasonably to supervise an associated person who has violated the Board’s professional standards and rules.

In its order, the PCAOB stated that personnel under Marcello’s supervision had obtained confidential lists of the audits that the PCAOB planned to review during its annual inspection and then used that information to enhance the audit documentation for those audits. The conduct of Marcello’s subordinates violated PCAOB rules and securities laws related to the preparation and issuance of audit reports and the obligations of accountants. Marcello did not participate in the scheme, but he failed to take appropriate and immediate steps when he learned of the scheme in March 2016.

Marcello did not report or escalate the information or instruct his team not to use the confidential information obtained from an individual at the PCAOB. Marcello failed again to take appropriate action when he learned that members of his team had once again in February 2017 secured confidential information from the PCAOB, acting only when he noticed other KPMG personnel having negative reactions to learning of the scheme.

The PCAOB additionally found that Marcello’s actions had contributed to a firm culture in which firm personnel, including Marcello’s subordinates, “perceived that improving the Firm’s inspection results took priority over improvements in overall audit quality.” As a result of his actions and omissions, Marcello failed reasonably to supervise his subordinates with a view to preventing their misconduct.

This was the PCAOB’s first disciplinary action for failure to reasonably supervise and the largest money penalty ever imposed on an individual in a settled case. Patrick Bryan of the PCAOB’s Division of Enforcement and Investigations said that it was a “strong message that firm leadership must take their supervisory responsibility seriously.”





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PCAOB sanctions audit firms for relying on unregistered firm's audit work

On April 19, 2022, the Public Company Accounting Oversight Board (“PCAOB”) ordered sanctions against JLKZ CPA LLP (“JLKZ”) and its managing partner, Jimmy P. Lee, (together with JLKZ, “Respondents”) for allowing audit reports for two issuers to be issued by the firm after the underlying audits were conducted by an unregistered public accounting firm. The PCAOB censured Respondents, barred JLKZ from accepting new audit clients that are issuers, brokers, or dealers under the Sarbanes-Oxley Act of 2002, and imposed a \$50,000 fine on Respondents.

In its order, the PCAOB stated that JLKZ entered into an agreement with SBA Stone Forest CPA Co., Ltd. (“Stone Forest”), a public accounting firm in Shanghai that, despite filing an application in 2019, is not registered with the PCAOB. Under the agreement, Stone Forest personnel would serve as the engagement partner, engagement quality review partner, and audit staff, in exchange for the majority of the fee for the 2019 audits of two Cayman Islands corporation issuers. Lee, on behalf of JLKZ, merely reviewed certain workpapers to ensure the documentation was on JLKZ templates and checked the financial statements toward the end of the audit. JLKZ then issued audit reports for both issuers.

The PCAOB found that JLKZ violated PCAOB standard AS 3101, which requires the auditor to conduct an audit before issuing an unqualified opinion on an issuer’s financial statements, because it had not done sufficient work to conclude whether the audit had been conducted with sufficient quality control and thus was insufficient under PCAOB standards to support an unqualified opinion. It further found that Lee was in a position to prevent the firm from violating this standard but failed to do so, and that his failure was knowing.

In a press release announcing this action as well as the PCAOB’s sanctioning of WWC, P.C. for failing to take any steps to ensure that its unregistered Hong Kong affiliate, in ten different issuer audits, did not participate at the level that requires registration, PCAOB Chair Erica Y. Williams emphasized the PCAOB’s commitment to holding firms accountable for failing to comply with the rule on using and supervising unregistered firms.





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PCAOB sanctions a firm and three partners for violating PCAOB standards related to audits and examinations of a broker-dealer

On May 11, 2022 the Public Company Accounting Oversight Board (“PCAOB”) sanctioned accounting firm Citrin Cooperman & Company, LLP (“Citrin Cooperman”) and three of its partners for violation of PCAOB rules and standards in connection with two audits and examinations of a broker-dealer. In particular, the PCAOB imposed a \$200,000 fine on Citrin Cooperman, suspended partner Joseph Puglisi alongside a \$25,000 fine, and censured and limited the activities of two engagement quality review (“EQR”) partners, who were also fined \$15,000 each. The individuals were further required to complete 20 additional hours of professional education or training.

According to its order, the PCAOB found that Puglisi, the engagement partner for the 2016 and 2017 audits and examinations of a certain broker-dealer, failed to do a sufficient evaluation of the brokerdealer’s internal controls over compliance with SEC rules regarding customer protection and reserve requirements. In his audit plans or performances, Puglisi failed to identify specific controls that would support a conclusion that the broker-dealer’s controls were effective in preventing violations of the relevant SEC rules, nor did he do any testing to ensure that any controls in existence were operating effectively. Puglisi also failed to adequately investigate and evaluate FINRA’s repeated findings that the broker-dealer was improperly designating accounts.

The PCAOB sanctioned the two EQR partners in addition to Puglisi because they failed to properly evaluate Puglisi and his teams’ conclusions, in violation of AS 1220. Similarly,

the PCAOB found that Citrin Cooperman violated the PCAOB standards requiring registered firms to have a system of quality control for their accounting and auditing purposes – it was on notice, among other red flags, from a prior PCAOB investigation that Puglisi’s work had major deficiencies but still assigned him to serve as the engagement partner for the broker-dealer without any additional support or resources. Accordingly, the PCAOB ordered Citrin Cooperman, on top of its \$200,000 fine, to engage in significant remedial efforts.

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