Hogan Lovells

Global Accountants' Liability Update

January 2021

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

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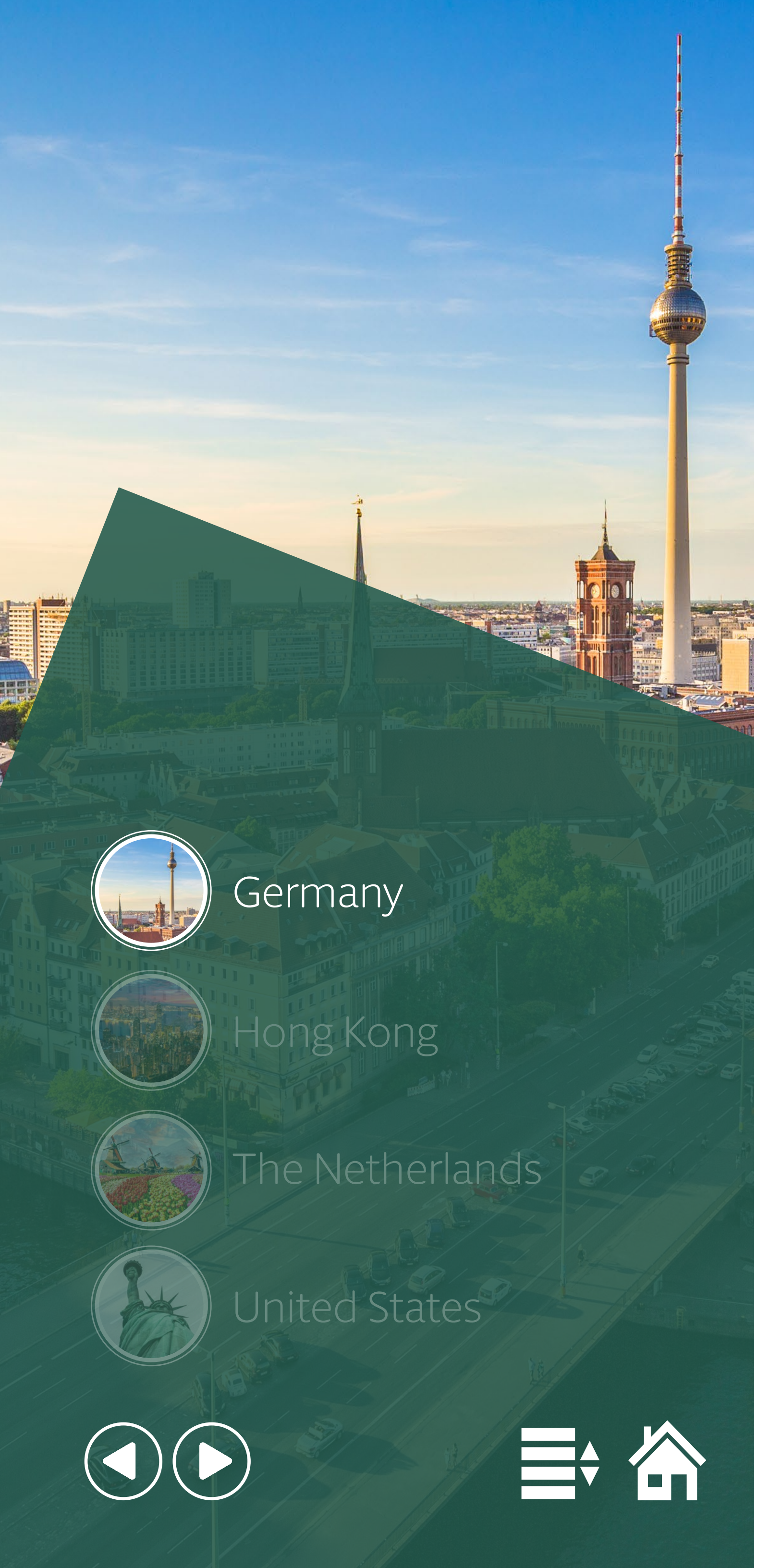
Recent regulatory and enforcement developments



Germany

Accounting reform legislation continues through legislative process

In the November 2020 edition of this newsletter we informed you of a draft bill prepared by the German legislature which proposes several changes to the legal framework for accountants (i.e. "Entwurf eines Gesetzes zur Stärkung der Finanzmarktintegrität – Finanzmarktintegritätsstärkungsgesetz" – which is even for German standards a remarkably long word). In the meantime the draft bill has further processed through the German legislative process. On 1 January 2021 a slightly revised version of the draft bill has been submitted to the Federal Council [Bundesrat]. The Federal Council may submit an opinion on the proposal within six weeks. After that, the draft bill will be submitted to the German parliament [Bundestag].

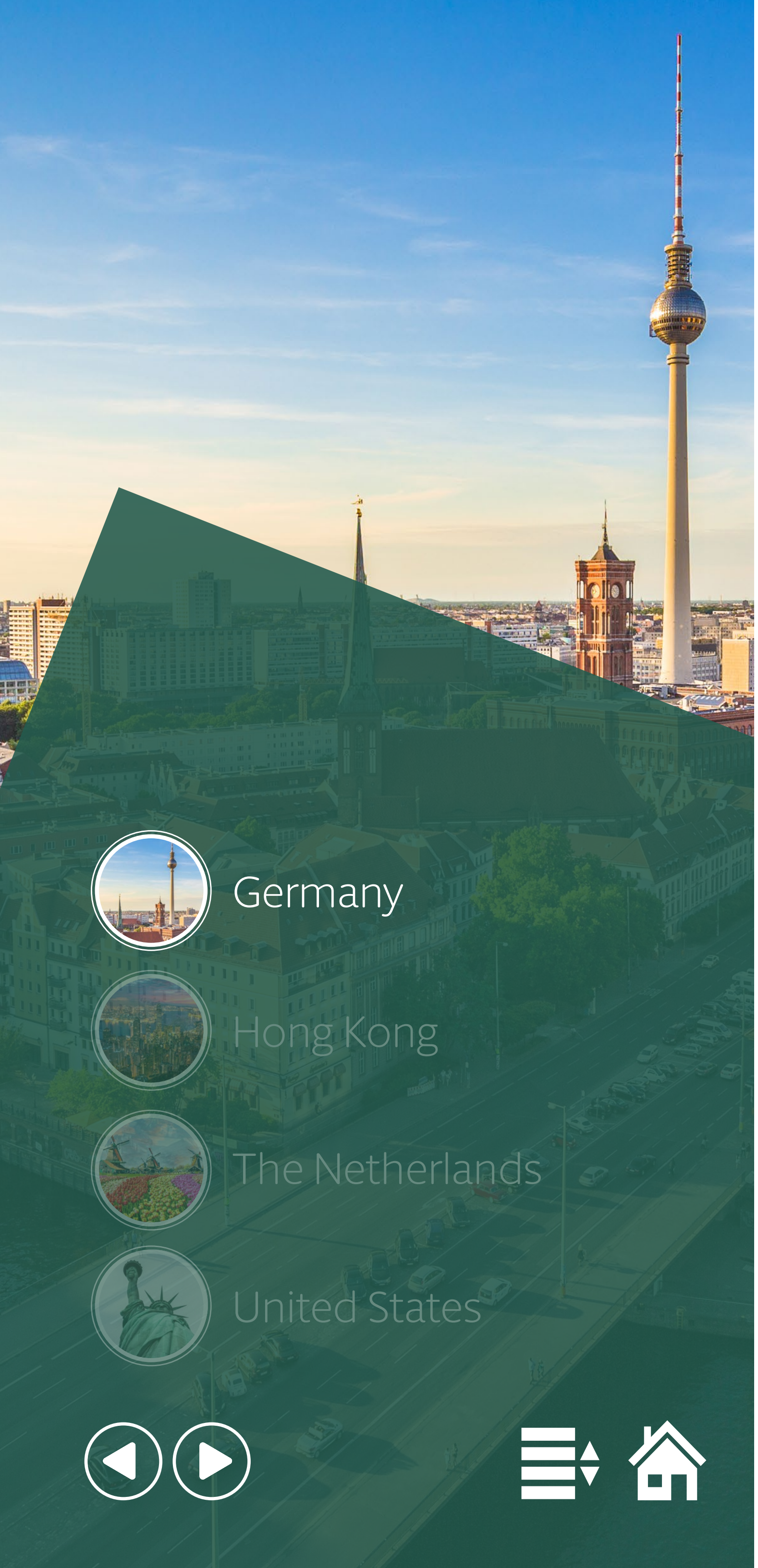
In the November 2020 edition of this newsletter, we reported on three main topics covered by the draft bill: (i) the obligation to replace accountants on a more regular basis, (ii) the ban on non-audit advice, and (iii) a stricter liability regime for accountants. These provisions are included in the current version of the bill that was submitted to the Federal Council. However, the liability caps have been reduced as follows:

- Up to EUR 16 million for capital market-oriented public-interest companies (instead of EUR 20 million)
- Up to EUR 4 million for other public interest companies (instead of EUR 20 million)
- Up to EUR 1.5 million for all other companies (instead of EUR 2 million)

It is likely that interest groups will try to further reduce these liability caps as the legislative process continues.

In addition, the revised bill also includes provisions that will strengthen the supervisory authority of BaFin [Bundesanstalt für Finanzdienstleistungsaufsicht] – the German financial regulator. Specifically, the bill will grant BaFin new authority to investigate companies where there are indications for irregularities. The investigated companies, its employees, as well as its accountants, will be obliged to provide the BaFin with requested documents for such an investigation. In addition, the BaFin will be authorized to summon individuals, including accountants, for questioning. BaFin will also have the power to conduct dawn-raids at the companies or even at third parties' premises. Non-compliance with information requests issued by the BaFin may establish an administrative offense and trigger fines of up to EUR 200,000 for each breach.

These provisions aim to strengthen BaFin's



supervision, which has been strongly criticized for not uncovering the Wirecard incidents earlier. As the Federal Minister of Finance explained, the new bill will equip BaFin with sharper teeth. The draft bill is expected to come into force on 1 July 2021, but the proposals that relate to the enhanced BaFin authorities shall come into force by 1 January 2022. We will keep you updated with further developments.

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Hong Kong

Financial Reporting Council is poised to shape auditor practices

This month's update focuses on three important actions taken by Hong Kong's accounting watchdog, the Financial Reporting Council (FRC) that will significantly impact the way accountants do business and conduct themselves when carrying out audits.

Breakthrough in cross-border cooperation

In December 2020, the FRC for the first time gained access to audit papers of Chinese companies listed in Hong Kong, where the papers are located in the mainland. This development follows execution of an agreement with China's Ministry of Finance in 2019, which paved the way for the move. The papers of seven companies were received, and papers from an additional four companies are expected to follow soon.

Traditionally, the audit papers of companies in mainland China have been considered "state secrets" by Chinese regulators, which has made investigating cross-border auditing irregularities challenging. According to FRC Chairman Kelvin Wong Tin-yau, both Hong Kong and China have successfully established a clear procedure for the FRC to access the audit working papers in compliance with the Chinese state secrets laws.

This development is likely to reassure investors who are interested in Hong Kong-listed mainland Chinese companies and boost the confidence of international investors investing in these companies. It is also expected to serve as a template for cooperation between the financial regulators of the United States and China and raise the possibility that regulators in the United States could oversee accounting practices of U.S.-listed Chinese companies in the future.

Importance of professional scepticism

On 11 December 2020, the FRC issued its first regulatory reports, the Interim Inspection Report and the Report on the FRC's Assessment of the HKICPA's Performance of the Specified Functions (oversight report), since it became the fully-fledged independent regulator for auditors on 1 October 2019.

The FRC's oversight role was established because certain statutory functions continue to be performed by the Hong Kong Institute of Certified Public Accountants (HKICPA) under the amended Financial Reporting Council Ordinance, Cap. 588 (FRCO). These functions relate to the registration of local auditors of listed entities, the setting of standards on professional ethics, auditing and assurance practices, and the setting of continuing professional development requirements for PIE auditors.

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The interim inspection report highlighted that professional scepticism was lacking in at least one area in 90% of the engagements reviewed. The report said that this can undermine the ability of auditors to look hard enough for evidence they need and to critically appraise the evidence obtained. When significant, deficiencies in professional scepticism may result in the auditor not having the evidence necessary to support their conclusion on the financial statements.

The findings noted that auditors should do more to control audit quality by promoting a culture that prioritizes and recognizes quality work and ensuring the ongoing adequacy of resources. Auditors should prioritize the public interest over their own commercial and personal interests.

Many of the findings of the oversight report address the need to strengthen HKICPA's policies and procedures to ensure the consistent, effective discharge of its functions. These include its policies and procedures for the selection of members of committees responsible for the specified functions.

The FRC said it hoped that communicating its findings now should allow auditors to take early action to address the deficiencies identified in advance of the next inspection cycle.

Notification of appointment changes

The FRC has published [a guideline](#) on notification of changes in public interest entity[1] (PIE) auditor appointments in order to accurately determine the frequency of PIE auditors' inspection for the purposes of monitoring and promoting audit quality. Under section 3(1) FRCO, a PIE means a listed company with listed shares or stocks or a listed collective investment scheme in Hong Kong. The Guideline takes effect on 1 February 2021.

The Guideline requires written notification to the Department of Inspection of the FRC no later than seven business days following the appointment of a new auditor and cessation of office of an existing auditor. There is no need to notify any re-appointment in office or any confirmation by shareholders in a general meeting of an appointment to fill a casual vacancy. Failure to comply with the Guideline may cause the FRC to consider whether such failure reflects negatively on the auditors' ability to comply with regulatory obligations.

FRC inspections focus on the effectiveness of the auditor's quality control system and consider whether applicable professional standards, legal and regulatory requirements have been complied with. The list of registered and recognised PIE auditors appears [here](#).

1. The Guideline applies to (a) a practice unit registered under Division 2 of Part 3 of the FRCO (registered PIE auditor); and (b) a Mainland auditor recognized under section 20ZT of the FRCO. It does not apply to overseas auditors recognized under Division 3 of Part 3 of the FRCO (other than Mainland auditors recognized under section 20ZT of the FRCO).

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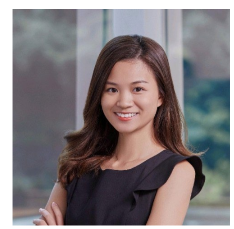

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The Netherlands

Guidelines clarify anti-money laundering rules

Introduction

The anti-money laundering directive (Directive 2015/849 or the Directive) requires Member States to keep a register of the natural persons who are the ultimate beneficial owners (UBO) of a company or legal person. In the Netherlands this is the Ultimate Beneficial Owner register (UBO register). The UBO register was introduced in the Netherlands by the law of 24 June 2020 and the main provisions of the law apply as of 27 September 2020. The UBO register is part of the Commercial Register kept by the Dutch Chamber of Commerce. In the Netherlands, the Directive has been implemented in the Money Laundering and Terrorist Financing (Prevention) Act (Wet ter voorkoming van witwassen en financiering van terrorisme or the "Wwft").

The Wwft and the regulations based upon it leave room for multiple interpretations on some points. On those points, the Guidelines for the interpretation of the Wwft (Richtsnoeren voor de interpretatie van de WWft or the "Guidelines") provide an explanation that does as much justice as possible to the purpose and purport of the Wwft, and that is practically applicable in the Dutch context. The Guidelines are intended for tax advisers and accountants.

Following the entry into force of the UBO register and at the request of several respondents, the Guidelines have been amended to address several subjects. The most important amendments published on 8 December 2020 are discussed below.

The UBO Register

The natural person who ultimately owns or controls a client or the natural person on whose behalf a transaction or activity is carried out is to be classified as UBO. This is the natural person who (ultimately) controls a company's actions. Persons who hold more than 25% of the shares, voting rights or ownership interest in a company should in all cases be recognized as UBOs. This does not mean that natural persons who hold a lower percentage of shares, voting rights or ownership interest in a company cannot also be a UBO. If, after all possible means have been exhausted to identify a "normal" UBO, a pseudo-UBO should be designated. This is a fallback option. Pseudo-UBOs are persons belonging to "senior management." In most cases, this is the statutory director, but different persons are qualified depending on the types of legal entity or company (see the Guidelines for more specific information per category).

Existing Dutch legal entities will have 18 months from 27 September 2020 to register their UBOs with the Chamber of Commerce. For new entities to be incorporated, registration of their UBOs must take place immediately. The following

companies and legal entities incorporated in the Netherlands are obliged to register their UBOs:

1. unlisted private limited companies and public limited companies. (for specific information on UBOs see Section 6.8.2.2 of the Guidelines);

2. churches (for specific information on UBOs see Section 6.8.2.4 of the Guidelines);

3. other legal entities (for specific information on UBOs see Section 6.8.2.5 of the Guidelines); and

4. partnerships (for specific information on UBOs see Section 6.8.2.6 of the Guidelines).

Client due diligence and reporting obligation of the accountant

Before entering into a business relationship with a new client, an institution (including tax advisors and accountants) must determine whether the UBO information is in the UBO register and is obliged to have proof that the client’s UBO in the UBO register. When carrying out customer due diligence, institutions may not rely solely on the information in the UBO register. This means institutions must conduct their own research into who their client’s UBO actually is.

An institution has an “obligation to report back” any discrepancy that it finds between information about a UBO that it has obtained from the Trade Register and information about that UBO that it has obtained in another way. It must report this to the Chamber of Commerce (Article 10c Wwft). Failure to comply with the obligation to report back is subject to sanctions: an administrative fine or an order subject to a penalty for non-compliance may be imposed (Article 29 subparagraph a Wwft and Article 30 subparagraph a Wwft). The obligation to report back shall take account of the transitional period referred to above. If, during that period, an entity has not yet registered data on its UBOs, it is not possible to report back. This is different if data is registered: in the latter case, the obligation to report back also applies within this 18-month transitional period.

It should be noted that as long as there is uncertainty about the UBO(s), an institution may not enter into a business relationship and therefore may not provide services to the entity requesting them.

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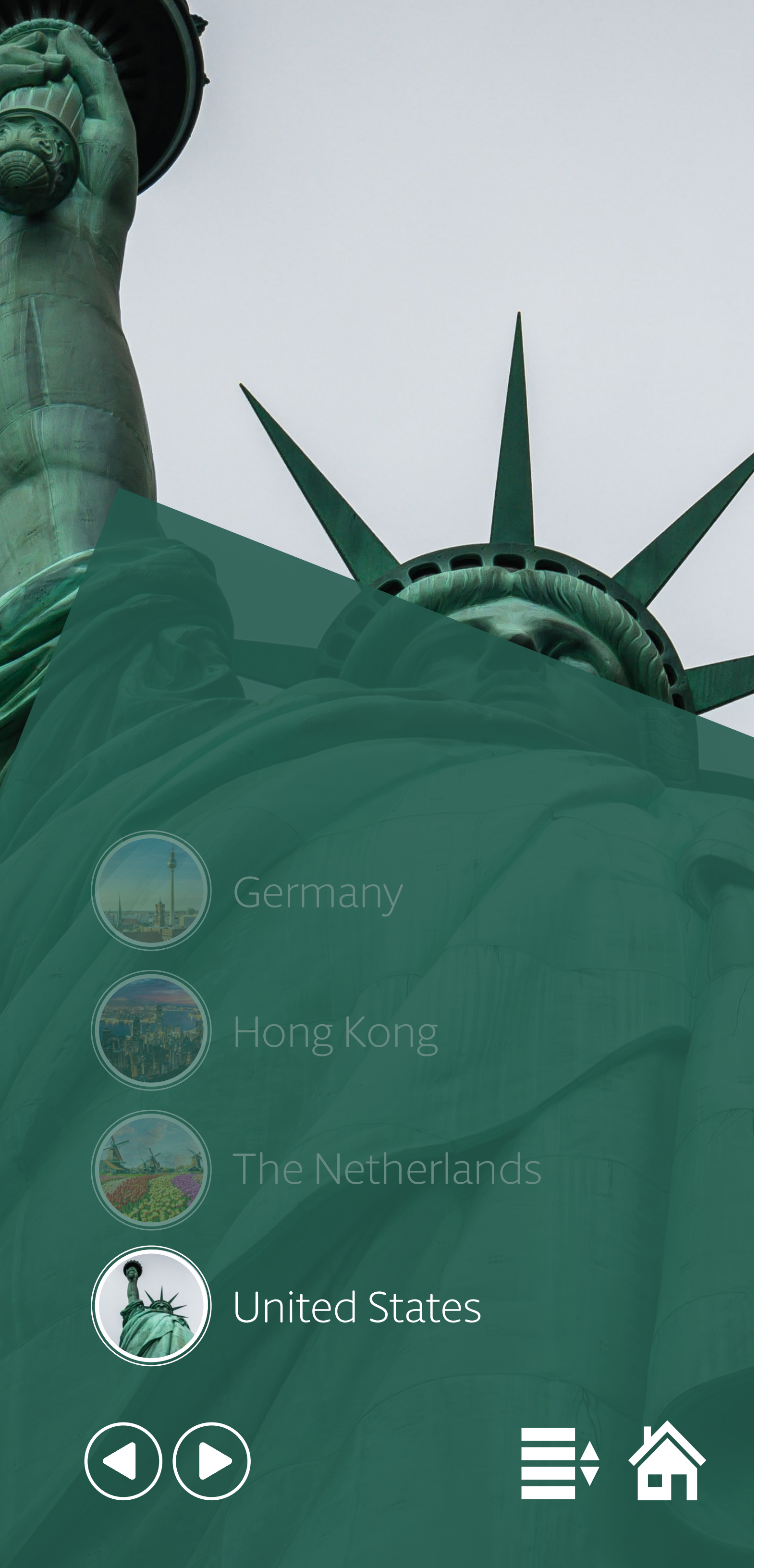
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SEC fines Ernst & Young Global Mexican member firm for improper audits

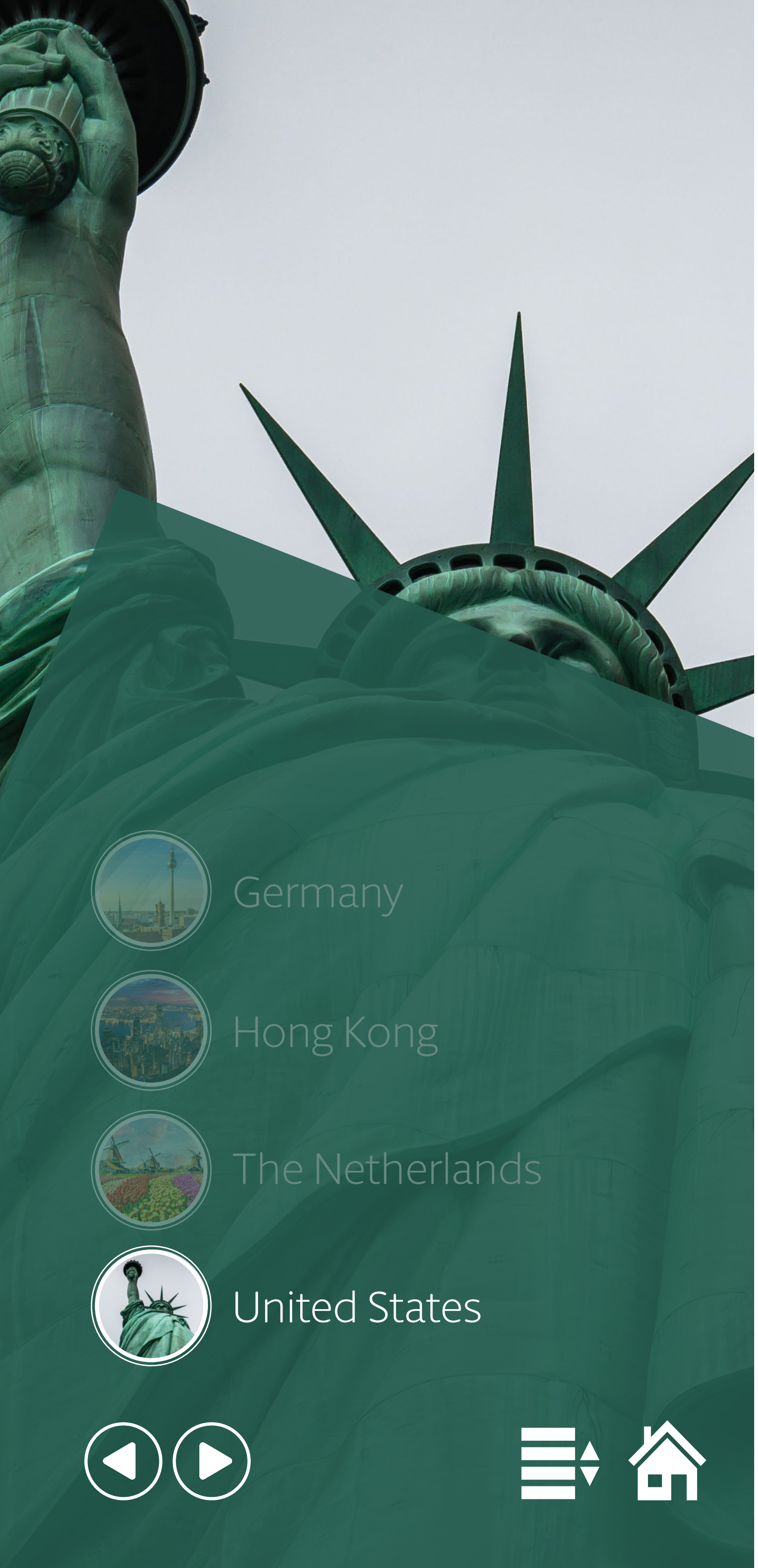
On December 17, 2020, the U.S. Securities and Exchange Commission (SEC) announced that it has reached a settlement agreement with Mancera, S.C. (Mancera), and a partner and senior manager from the firm, in conjunction with claims that Mancera had repeatedly violated U.S. securities laws and Public Company Accounting Oversight Board (PCAOB) standards during audits conducted for their client, Desarrolladora Homex, SAB de CV (Homex). Mancera, a Mexican accounting firm with its headquarters in Mexico City, is registered with the PCAOB, and is a member firm of Ernst & Young Global.

In fiscal years 2010, 2011, and 2012, Mancera conducted audits of the financial statements of Homex, a Mexican homebuilder that bills itself as the largest in the country. The partner and senior manager named in the SEC's order supervised the audits at issue. During the audits, Homex was allegedly the largest client for Mancera's Sinaloa office.

For its part, Homex had been accused of "engag[ing] in a multi-billion dollar financial fraud by overstating both its number of homes sold and its revenues . . . ." During the years at issue, Homex allegedly overstated its revenues by over $3 billion and inflated the number of homes it had sold by over three-hundred percent. Homex achieved these results by recording false revenue and inventory information, as well as falsely accounting for factoring agreements with at least 13 Mexican banks, which Homex was able to repay only by additional bank borrowing, in check-kiting fashion.

The SEC concluded that Mancera did not conduct the audits in compliance with the PCAOB's auditing standards, as it determined that Mancera had failed to, among other things: (1) plan the audit, (2) exercise the required level of professional care when performing the audits, and (3) train and supervise those conducting the audits. In planning the audits, Mancera noted the risk of fraud due to Homex's internal reporting mechanisms and, while planning the 2012 audit, was aware that Homex was under investigation by the SEC for the fraudulent scheme, which caused Mancera to increase its risk rating for Homex to "close monitoring." Nevertheless, Mancera failed to take adequate steps to plan, supervise, and conduct the audits in a manner that comported with its professional obligations.

In particular, the SEC found that Mancera had failed to obtain sufficient evidence to support its audit opinion. For example, while the Mancera team identified the risk of fraud inherent in the Homex audits, Mancera did not seek corroborating information to ensure consistency and accuracy of information across the audit workpapers. Additionally, while Mancera conducted site visits of selected Homex building projects to confirm the accuracy of counts of homes under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construction and to compare the progress of the on-site work to that recorded in Homex's books, Mancera failed to: (1) properly train and supervise those conducting the site visits, and (2) follow the written instructions during the site visits. Mancera's procedures for confirming home sales through the use of confirmations from notaries public were also flawed, including reliance on incomplete audit evidence. These deficiencies, along with others, led to the SEC's conclusion that Mancera did not exercise the level of professional care needed to perform the audits.

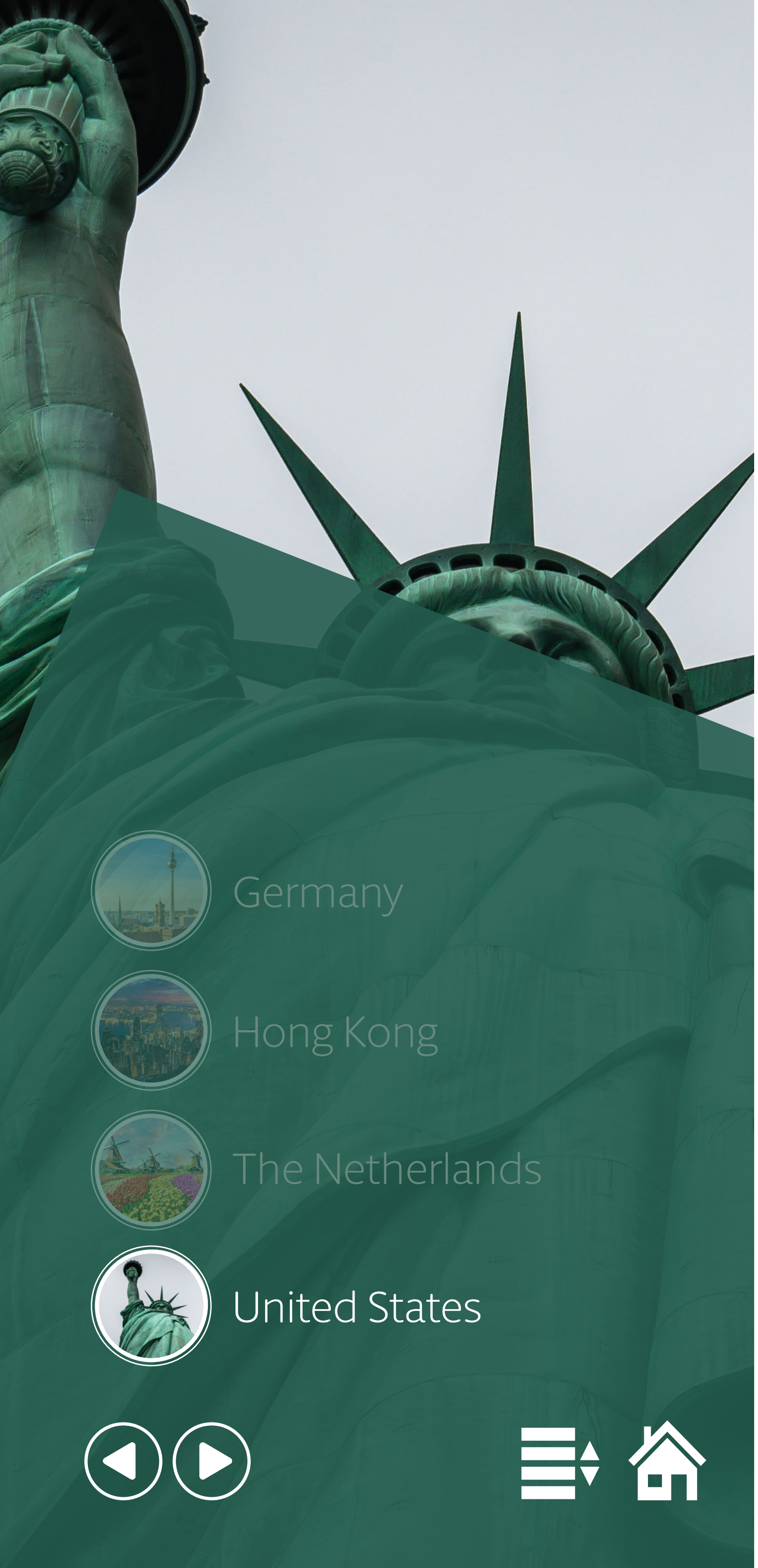
As a result of the described audit failures, the SEC concluded that Mancera violated, and its partner and senior manager caused Mancera to violate, Section 10A(a)(1) of the Exchange Act, which required procedures designed to provide reasonable assurance of detecting illegal acts impacting financial statement amounts. Mancera also caused violations by Homex of Section 13(a) of the Exchange Act and Rule 13a-1 promulgated thereunder, by allowing Homex to file materially false and misleading annual reports with the SEC.

As a result, Mancera will pay more than $1 million: $950,000 in disgorgement, $139,926.43 in prejudgment interest, and $500,000 in civil monetary penalties. As part of the settlement, Mancera agreed to a number of undertakings to improve audit quality, including implementing new policies, and to certify the effectiveness of its improvement plan in the future. Mancera is also required to submit each of its auditors to training to ensure that proper care is exercised in performing audits, particularly of SEC-registered companies. The partner and senior manager are each denied the privilege of appearing or practicing before the SEC as an accountant, and can reapply for admission after five and two years, respectively.

PCAOB fines Grant Thornton $750,000 and sanctions auditors for Erickson audit lapses

On November 5, 2020, the Public Company Accounting Oversight Board (the PCAOB) announced that it had imposed sanctions against Grant Thornton LLP (Grant Thornton) in connection with the audits of Erickson Inc., which provided aviation services, mainly in the logging, firefighting, construction, and defense sectors, and filed for Chapter 11 bankruptcy in November 2016. Among other things, Grant Thornton failed to adequately understand and audit the company's aircraft lease liabilities, and failed to adequately evaluate the company's ability to continue as a going concern.

Grant Thornton agreed to pay a civil money penalty of $750,000. The PCAOB also sanctioned two Grant Thornton audit partners – Gary Homsley, who was the engagement partner, and Larry Dana Leslie, who conducted the engagement quality reviews – for their work related to the Erickson audits. Homsley paid a civil money penalty of $15,000 and was barred from being associated with a registered public accounting firm for at least two years. If his ban is lifted after two years, Homsley will be restricted from participating in certain audit activities for three more years, e.g., he



cannot serve as an engagement partner or engagement quality reviewer. Leslie did not receive a monetary fine, but his activities in connection with any audit will be limited for two years.

According to the PCAOB, Grant Thornton and Homsley "failed to exercise due professional care, including professional skepticism, and failed to obtain sufficient appropriate audit evidence in connection with certain Erickson lease-related liabilities" in connection with audits performed in FY2013 through FY2015. The PCAOB found that neither Homsley nor and his audit team had any prior experience auditing companies that operated aircraft or with accounting rules pertaining to the aviation industry. Despite this, the firm did not provide them with any aviation industry training.

The PCAOB's order also stated that Leslie, who reviewed the firm's Erickson work, failed to perform his role as EQR partner with due professional care by, among other things, "failing to evaluate appropriately the engagement teams' significant judgments with respect to planning, including consideration of the risk of certain Erickson lease-related liabilities and consideration of Erickson's ability to continue functioning as a going concern." As a result of the inadequacy of his engagement quality review, Leslie lacked an appropriate basis for his concurring approval of the issuance of Grant Thornton's unqualified opinion in the FY2014 audit and FY2015 audit.

The PCAOB further faulted Grant Thornton and Homsley for violating the auditing standards on documentation by failing to ensure that portions of each audit's working papers in connection with audit remediation were correctly dated. As a result of this oversight, certain hard copy remediation work papers for the audits, when archived, reflected that those work papers had been completed earlier than they actually had been.

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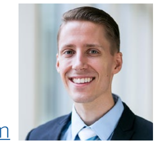

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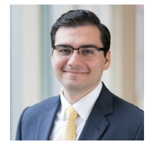

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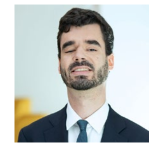

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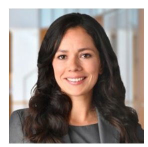

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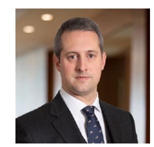

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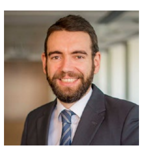

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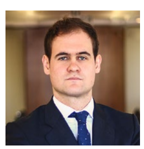

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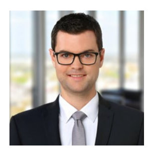

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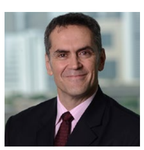

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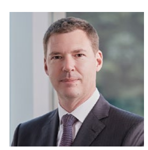

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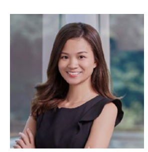

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