Auditors’ liability in China

Tips on managing risks of audit-related liabilities in China

By Graeme Johnston and Chris Parker
Many Hong Kong CPAs now audit mainland Chinese businesses. If a problem arises in such audits, the auditor may face serious legal consequences under mainland Chinese law.

Despite increasing harmonization of accounting and auditing standards between Hong Kong and the mainland, the relevant principles of Chinese law still differ significantly from those of Hong Kong.

What standard of due diligence does Chinese law require auditors to observe?

Under Hong Kong law, auditors’ liability to their clients is based on a broad principle: failure to use reasonable care. Compliance or non-compliance with standards is considered in assessing what reasonable care means, but is not the end of the matter. A Hong Kong court may treat relatively minor procedural infringements as legally innocent. If a particular requirement in a standard is clearly inappropriate in a specific context, there is scope for defending a decision made not to comply with it, if the auditor can articulate good reasons.

In contrast, many think that Chinese law imposes civil liability in principle for any breach of an auditing standard, with the defence in such cases amounting mainly to arguments about causation, which are unpredictable for reasons explained below. The so-called “box-ticking” approach for which Chinese auditing often has been criticized is arguably embedded into the structure of the law. Auditors in China therefore need to comply strictly with the standards, even where procedures may seem of questionable value.

What approach does Chinese law take to causation and damages?

The basic Chinese law principles governing damages for breach of contract are similar to those applicable in Hong Kong: Damages are compensatory (not punitive) in nature and so should be equivalent to the loss caused by the breach, provided that the loss was reasonably foreseeable at the time of contracting and could not have been reasonably avoided or mitigated by the claimant. As in Hong Kong, “reasonable foreseeability” includes losses flowing in the ordinary course of events or as a result of special circumstances known to the audit firm at the time the firm agreed to the engagement. But several concepts that have evolved in Hong Kong and elsewhere to limit the potentially stark impact of these principles have so far remained undeveloped in the mainland.

For example, in Hong Kong, an auditor’s breach must clearly have been the “operative” or “practical” cause of the loss before the auditor is held responsible, as opposed to being an event that merely created an opportunity for loss to be suffered, say as a result of the actions of senior management of the audited company. The absence of a clear limiting principle in Chinese law represents a big potential risk.

Interestingly, on the issue of auditors’ role in capital verification – a major source of problems in recent years, there is guidance from the Supreme People’s Court as to how the law should be interpreted. Claimants in such cases must look to the company or the promoters first and can pursue the auditors only if recovery against the company or the promoters is impractical. However, the broader principles still need to be clarified.

Are contractual limitations of liability effective in China?

Under Chinese law, the auditing standards specifically contemplate that audit engagement letters should cover the issue of liability arising in the event of breach. However, the principles of Chinese contract law impose certain restrictions, the most important of which are: Any exemption or limitation clause must comply with the principles of good faith and fairness; a standard clause (that is, a clause prepared for repeated usage that does not result from negotiation with the other party) will be invalid if it exempts the party which provided it from liability; any standard clause must be notified to the other party in a fair and reasonable manner; and it is not possible to exclude liability for gross negligence or willful default.

With these rules in mind, here are several points to look out for when preparing audit engagement letters:

- Seek to limit liability to a particular,
reasonable sum rather than excluding it altogether.

- Ensure that clients are expressly given the opportunity to comment on the terms of an audit engagement letter in draft (e.g. in a covering email providing the draft, which should ideally also draw attention to any limitation clause) before it is finalized in order to reduce the risk of clauses being characterized as “standard” terms.
- Disavow any attempt to exclude liability for wilful default or gross negligence, thereby demonstrating to the court one’s respect for the legal restrictions.
- Ensure that any limitations are drafted with the utmost clarity, using Chinese rather than foreign legal terminology, since courts in China, as in other countries, may well in practice interpret ambiguities or contradictions against the interests of the party that drafted the limitation.

When can auditors be liable to people other than their clients?

In Hong Kong law, scope for auditors to be held liable to people other than their clients is very limited. In short, such liability is restricted to cases where the auditor has “assumed” responsibility to the particular third party. This matter is assessed by reference to issues such as the circumstances surrounding the making and communication of the relevant statement, the relationship among the auditor, its client and the third party, the knowledge of the auditor, the size of class to which the third party belongs (if any) and the reliance placed
on the statement by the third party. In practice, such liability has proved difficult to establish.

Chinese law has not yet had to grapple with the precise limits on liability to third parties. The law says that an auditor is liable to its client and “other interested parties” if, among other things, it fails to comply with the relevant professional standards in producing an audit report, or knowingly or negligently produces an inaccurate audit report. The law also says an auditor has direct liability to investors in listed companies for false or misleading statements or major omissions in an audit report, unless it can prove it was not to blame for the statement or omission. All this presents a legal liability risk to auditors of a sort that client acceptance procedures can only partly control.

**How is liability assessed and can you vary it?**

The ordinary process for determining liability through the Chinese courts is strikingly different from Hong Kong. The emphasis is almost entirely on documentary evidence, with witness evidence counting for little in itself. If you have to defend yourself, having good quality working papers is accordingly even more important in mainland China than in Hong Kong.

It is, however, open to auditors and their clients to agree to resolve their disputes by binding arbitration instead of litigation. The law also says an auditor has direct liability to investors in listed companies for false or misleading statements or major omissions in an audit report, unless it can prove it was not to blame for the statement or omission. All this presents a legal liability risk to auditors of a sort that client acceptance procedures can only partly control.

**Parallel disciplinary and civil proceedings**

In China, as in Hong Kong, an auditor may become embroiled in parallel disciplinary and legal proceedings. In addition to the accountancy regulator, the Chinese Institute of CPAs, the auditor of a listed company in China may come under investigation by the China Securities Regulatory Commission (CSRC). Many audit firms have been investigated and sanctioned by the CSRC for negligent failure to discover a fraud. Such proceedings often run parallel to an investigation into the company itself. The CSRC’s wide powers to conduct interviews and preserve documentary evidence are significant, as is the fact that the concept of a right not to disclose confidential legal advice is not yet fully recognized in China.

Faced with such investigations, be sure to effectively coordinate your response, bearing in mind that whatever is done and said in one context may foreseeably become part of the evidence in another context.

**Practical tips for managing the risks**

Here are a few short but important steps you can take:

- **Do all you can to ensure strict compliance with standards.** The legal risks of not complying with what may seem to be impractical requirements may be severe.
- **Also do all you can to enforce the creation within the firm of very good quality contemporaneous working papers, showing exactly what was done, when and who did it.** This will be the best, and possibly the only significant, evidence of the procedures followed if a problem arises.
- **Pay close attention to the terms of your audit engagement letter and clearly define your responsibilities and the client’s.** Make sure you are clear about issues such as limitation of liability and arbitration. Explain to your staff the legal importance of giving clients a proper, recorded opportunity to comment on the draft terms of engagement.
- **Properly coordinate your dealings with regulatory bodies and courts or arbitration tribunals.** Inconsistencies, however innocent, can cause serious problems.

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