Research on the Determination and Judgment Approach of Civil Liability for Misrepresentation by Accounting Firms

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Abstract—In recent years, there have been many cases in the capital market in which accounting firms have assumed civil liability for compensation in cases of misrepresentation. However, different adjudication of similar cases and reversal of judgments in the same case have attracted widespread attention. The reason for this is that on the one hand, it failed to fulfill its duty of diligence and issued false reports. Bearing corresponding responsibilities will help to implement its “gatekeeper” responsibilities. On the other hand, due to the inconsistencies in the current relevant legal regulations, it was given There is room for choosing different adjudicative approaches in judicial practice. This article analyzes the main approaches to domestic adjudication and compares domestic and foreign legislation, clarifying the subject and scope of responsibility, subdividing fault forms, carefully grasping “should have known” and “knowingly”, positively affirming the role of standards, and optimizing the implementation plan of “comparable fault and punishment”. On the other hand, recommendations and analysis are carried out based on the Securities Law and relevant judicial interpretations to balance the promotion of market development and the protection of investors’ interests.

Keywords—accounting firm, civil liability, joint and several liability, gatekeeper, misrepresentation

I. INTRODUCTION

In the development of the securities market, accounting firms have always played the role of “gatekeepers” and “economic policemen” (Reiner and Kraakman, 1984). However, since the Yinguangxi case in 2001, a series of cases involving certified public accountants issuing false reports and making false statements due to their failure to perform their duties of diligence have emerged one after another in the Chinese securities market. At the same time, financial fraud cases of listed companies have exploded from another in the Chinese securities market. At the same time, regulatory commissions and courts have been discussing diligence, industry standards, compensation limits, etc. Too severe penalties will not only be ineffective in improving audit quality, but may even lead to excessive withdrawal of accounting firms (Wang et al., 2011), which has been troubled by the “deep pocket theory” in terms of responsibility, which has had an upward impact on the ecological environment of the capital market.

In practice, Article 42 of the current “CPA Law” stipulates, “If an accounting firm violates the provisions of this law and causes losses to the client or other interested parties, it shall bear liability for compensation in accordance with the law.” This is a highly abstract summary of liability and specific, the type is not specified. On the other hand, in judicial practice, courts refer more to the Securities Law, the Company Law, and several judicial interpretations of the Supreme People’s Court on false statements in the securities market. On January 21, 2022, based on the relevant judicial interpretations issued in 2003 and 2007, the Supreme People’s Court issued the “Several Provisions on the Trial of Civil Compensation Cases for False Statement Infringements in the Securities Market” (Several Provisions, 2022), which further clarifies the scope of responsibilities of each party and improves the provisions on liability for compensation. It is an institutional document of fundamental significance. In this context, this article will analyze whether the demarcation of civil liability of accounting firms is reasonable, how to define the boundary of diligence, and how to implement the principle of “equivalent punishment”. This leads to corresponding thoughts and suggestions.

II. CASE ANALYSIS AND REFLECTIONS ON DOMESTIC IDENTIFICATION APPROACHES

A. Approach 1: Bear Full Liability for Compensation

(1) The Great Wisdom Case-judicial interpretation and the Securities Law complement each other

The China Securities Regulatory Commission’s Administrative Penalty Decision ([2021] No. 11) determined that Genzhong Zhuijiang was suing Kangmei Pharmaceuticals. In July 2016, the China Securities Regulatory Commission’s Administrative Penalty Decision ([2016] No. 89) determined that an accounting firm had Smart Company should have known about its misrepresentation but still issued a standard unqualified opinion report (Fa Interpretation, 2015). The focus of this case is whether the accounting firm “should have known” and thus presumed “intentional”. In the first instance, the Shanghai Intermediate People’s Court focused on passing Article 5, Paragraph 2 of the “2007 Certain Provisions”, which stipulates that any concealment or false report of a listed company’s more serious problems that “should have known” should be deemed as “presumed intentional” and joint and several liability shall be borne. Responsibility. However, Article 109 of the Judicial Interpretation of the Civil Procedure Law clarifies that failure to disclose “knowingly” illegal acts should meet the standard of proof of “beyond reasonable doubt”. Therefore, in the second instance, the Shanghai Intermediate People’s Court, based on the principle of presumption of fault in Article 173 of the 2014 Securities Law, first emphasized that the accounting firm could not prove that it was not wrong, and therefore upheld the original judgment of the first instance.

(2) Kangmei Pharmaceutical Case-the legal status of industry standards is recognized in judicial practice

During the financial audit process from 2016 to 2018, relevant requirements such as the “Audit Standards for...
Chinese Certified Public Accountants” and “Code of Professional Ethics for Chinese Certified Public Accountants No. 1-Basic Principles of Professional Ethics” were violated. Although Genzhong Zhujiang claimed that its rights and obligations were consistent on the grounds that it carried out relevant work procedures in accordance with the auditing standards, it did not assume joint and several liability. The Guangzhou Intermediate People’s Court still determined that the accounting firm failed to pay attention to obviously abnormal or contradictory audit evidence in the administrative penalty decision, failed to conduct internal control tests on cash reconciliations, and failed to adopt alternative procedures to deal with the low response rate. Basic audit procedures were not implemented and there were major deficiencies. According to Article 173 of the 2014 Securities Law, it was ruled jointly and severally liable for compensation.

B. Approach 2: Bear “Proportional Joint and Several Liability”

(1) Wuyang Debt Case—the first case of great significance and clear direction in the bond field

According to the China Securities Regulatory Commission’s Administrative Penalty Decision ([2019] No. 6), the Hangzhou Intermediate People’s Court determined that the accounting firm and securities company involved in the Wuyang Debt Case had major faults and were jointly and severally liable for compensation, and that the credit assessment company and the law firm had separate faults. Bear joint liability for compensation in proportions of 10% and 5%. The focus of the dispute in the first instance was that all parties involved in the case applied Article 173 of the 2014 Securities Law, and the verdict results were quite different. Regarding accounting firms, as well as rating agencies and law firms, the court applied Article 173 of the 2014 Securities Law and Articles 5 and 6 of the 2007 Certain Regulations to the former, and determined that they had committed major faults and were jointly and severally liable for compensation. For the latter two, the court held that the level of general duty of care was not reached, that is, there was fault, and they were given proportional joint and several liability in accordance with Article 173 of the 2014 Securities Law.

(2) Thoughts on issues raised by existing cases

The first is the conditions under which “should know” is equivalent to “intentional” and “knowingly”. In the Great Wisdom Case and the Jinya Technology Case, the court presumed “should have known” as “intentional” or “knowingly”, and the “2007 Certain Provisions” clarified several situations of “intentional” and “knowingly”. If in practice, “should have known” is not “beyond reasonable doubt” or whether the obligation of diligence has been fulfilled, and “should have known” is directly equated with “intentional” and “knowingly”, the civil liability of the accounting firm may be expanded, so it should be treated with caution.

The second is how to view the legal status of auditing standards in judicial practice. In the Kangmei Pharmaceutical case, the court actually used the CSRC’s administrative penalty letter as a reference to determine whether the intermediary was diligent and conscientious, thereby determining whether it had made false statements. Most administrative penalty letters use auditing standards as a standard to measure whether certified public accountants are diligent and conscientious. In the future, whether it is judicial practice or law revision work, whether the legal role of auditing standards should be viewed positively and appropriately reflected, so as to avoid loopholes and space for expanding relevant responsibilities.

The third is how to finely divide the relevant subjects and fault forms to achieve the balance of “equivalent fault and punishment”. The first instance of the Huaze Cobalt Nickel case tried to distinguish the liability of the issuer and the intermediary and impose proportional joint and several liability penalties, but the second instance returned to the judgment of full liability. In the Zhonganke case and the Baoqianli case, there were also disputes and even iterations on whether all parties should bear liability for compensation and what type of fault should be used as the basis for assigning corresponding proportions of liability. If we can distinguish the subject and scope of responsibility, refine the forms of malicious collusion, intentionality, knowingsness and professionalism, and come up with a plan to implement “the punishment is proportionate to the excessive punishment”, it will help to effectively “punish the culprit” and “kill the accomplices” accurately and appropriately. Goal achieved.

III. DOMESTIC PRACTICE AND FOREIGN ORIENTATION OF LEGISLATION ON CIVIL LIABILITY FOR MISREPRESENTATION

A. Domestic Legislative Practice

(1) Determination of the nature of responsibility

The issuer and the securities intermediary must work together to complete information disclosure. From this, it can be judged that the false statement is a joint infringement by several persons. Therefore, according to Article 1168 of the Tort Chapter of the Civil Code, the civil liability for compensation for misrepresentation shall be borne by both parties, and the intermediary shall bear joint liability for compensation. However, the applicable condition for this article should be that the infringement acts are carried out jointly or separately with sufficient cause, otherwise the infringement shall be handled proportionately. This situation also fully demonstrates the legal status of the Civil Code as a general law.

(2) Regarding the scope of responsible entities

The 2005 Securities Law not only clarified that the issuer is the primary responsible party in Article 69, but also changed “for the part for which it is responsible” in Article 173 to “jointly and severally liable with the issuer and the listed company for compensation”. And stipulates that the principle of presumption of fault shall apply. Article 163 of the new Securities Law of 2019 continues to apply relevant rules.

(3) Regarding the limits of liability

Article 207 of the 2014 Company Law clearly stipulates that “a company shall be liable for compensation within the amount of the amount assessed or proven to be false.” Article 42 of the “CPA Law” does not provide a detailed explanation of liability for compensation, nor does it differentiate between the CPA’s liability under different fault situations. It
only states that “shall bear liability for compensation in accordance with the law.”

(4) Regarding the classification of fault forms
In determining the fault of misrepresentation, it is mainly from the subjective level to distinguish whether the securities intermediary has fulfilled its obligation of “diligence and due diligence”. “Several Provisions of 2007” carefully distinguish between “malicious collusion”, “knowingly”, “knowledge that should be known” and negligence. For example, Article 5, paragraph 2, clarifies that when a certified public accountant complies with professional standards and rules, he “should know” the act of false statement should be directly recognized as “knowingly”. However, the “2022 Certain Regulations” limits the scope of fault to “intentional” and “serious breach of duty of care”, without directly distinguishing the subjective level. For example, whether “knowingly” in Article 13, paragraph 1, includes “should have known”. There is no significant difference between the definition of serious breach of duty of care (gross negligence) and “presumed intentionality” in paragraph 2 (You and Zhao, 2022).

B. Overseas Legislative Orientation
(1) Legislative practice in the United States based on market development
Article 11 of the 1933 Securities Act regulates many aspects. In terms of filing a lawsuit for false statements, any person who participated in the signing of the Registration Statement or was authorized by a certified public accountant to make a statement can be sued, which significantly increases the risk of professionals being sued. When determining causation, the law makes a comprehensive judgment from both the factual and legal levels. When factual causation is established, the court will determine whether the behavior is the “proximate cause” of the loss from the level of legal causation. In terms of defense and liability, the law adopts the principle of presumption of fault, holding that the CPA’s liability is incidental and shall bear joint and several liability for compensation limited to the price at the time of public issuance of the securities involved. If the individual fulfills his duty of care, he can avoid part of the liability (Mess, 1976).

The Securities Exchange Act of 1934 applies the unforeseen third party to the beneficiary principle, which limits the scope of general negligence liability of certified public accountants. At the same time, Article 10(b) of the Law still holds that if a certified public accountant intentionally makes a false statement, he must bear joint liability, but a “reliance element” is added to the defense, that is, the investor must prove that he relied on it when making a transaction judgment. If the plaintiff has never seen the financial report, that is, he does not know whether the false statement exists. Congress passed the Securities Private Litigation Reform Act in 1995. This law actively introduces the proportional liability design, that is, in the act of misrepresentation, proportional liability will be adopted if the perpetrator is subjectively negligent, and joint and several liability will be assumed if the perpetrator is subjectively intentional.

(2) EU’s implementation principles on the limits of liability

In 2008, the European Union issued the “Recommendation on Limiting the Civil Liability of Auditors” (EU Proposals to Limit Auditors’ Civil Liability, 2022). The EU proposal proposes three feasible measures to end the unrestricted civil liability of auditors: first, unify the maximum amount of compensation or calculate the amount according to a fixed formula; second, determine the audit limit to the actual loss caused to the plaintiff. The civil liability of the auditor or accounting firm shall not be assumed jointly and severally; third, both parties to the audit contract are allowed to agree on the upper limit of the liability. EU member states such as Germany and Belgium have set limits on the liability of audit institutions in the event of negligence in their legislation, and follow the basic principles of the EU Recommendation, which does not apply to cases where accountants are intentional (Zhou et al., 2021).

IV. ENLIGHTENMENT AND SUGGESTIONS
A. Clarify the Responsible Subjects and Scope of Responsibilities, and Promote Accurate “Fighting of Accomplices”
In the act of misrepresentation, the information disclosure obligor and the accounting firm shall bear no-fault liability and fault liability respectively (Zhou et al., 2022). If the information disclosure obligor has not made a false statement and the relevant content has never been made public, the accounting firm will have no room and possibility to Making false statements. In practice, plaintiffs often ignore this logical relationship and adopt a strategy of inverting the burden of proof to deal with accounting firms.

First of all, the information disclosure obligor is the perpetrator of false statements. Article 2 of the “2022 Certain Provisions” clarifies that the plaintiff needs to submit evidence that the information disclosure obligor made false statements when suing. Logically, after the information disclosure obligor’s liability for misrepresentation is determined, the accounting firm will bear the liability for misrepresentation. In fact, due to the inherent limitations of auditing, CPAs will inevitably make flaws or mistakes during the audit process. However, if the misrepresentation of the information discloser has nothing to do with it, or there is no disclosure at all, there is no causal connection between the two. Secondly, if an accounting firm issues a report involving a false statement and can prove that it has reasonably relied on the professional opinions of a sponsor or other intermediary agency after careful verification or necessary investigation and review to eliminate professional doubts, the court should determine that it has no fault.

B. Breakdown of Fault Forms and Liability Based on the Degree of Duty of Care
Accounting firms’ duties of care often vary depending on the securities product, issuer structure and area of expertise (Ding, 2021). Intention and negligence constitute the subjective elements of general tort liability, and the degree of fault of the former is more serious. Article 13 of the “Several Provisions of 2022” limits fault to “serious breach of duty of care”. If it still remains in the approach of distinguishing between general intentionality and negligence, the scope of fault for false statements will be expanded. If an accounting
firm strictly performs its duty of special care during an audit, even if there are flaws in its ordinary duty of care, it does not run counter to the original intention of the audit system; however, if it violates its duty of special care, no matter how prudently it performs its duty of ordinary care, it will go against its own professional ethics. Positioning and damaging the trust and interests of investors. Moreover, attributing liability based on the degree of fault is a sign of mature fault liability (Wang, 2004). If general negligence and gross negligence are flattened, it will directly increase the civil liability of the accounting firm in this situation.

Article 19 of the “Several Provisions of 2022” clarifies that accounting firms apply the principle of presumption of fault, and based on the design of the information disclosure system, the original intention of the “Securities Law” is to restrict the negligence of accounting firms and the intentionality of their clients. The combination of the two causes of joint infringement (Chen, 2021). Therefore, on the basis of distinguishing intention and negligence, we must first distinguish between intention and negligence of the accounting firm. Secondly, if it is a case of negligence, it is further clarified whether it violates the special duty of care in the professional field. If true, it is “professional negligence”, and vice versa, it is “non-professional negligence”. In terms of liability, according to the subjective state, if it is intentional, the accounting firm shall bear joint and several liability. If the negligence is at a professional level, the investor will bear partial joint and several liability in accordance with the provisions of the Civil Code and Securities Law; if the negligence is at a non-professional level, the investor will need to provide evidence. If there is indeed a fault, the investor will bear proportional liability.

C. Whether “Should Have Known” Is All Included in the Scope of “Intentional or Knowing” Needs to Be Carefully Grasped

“Knowingly” tends to “know” and should be equated with “definitely know” and “probably know” (Zhang and Liu, 2009). Therefore, the often spoken words “may or may not know” are clearly neutral and do not belong to “knowing”, while “impossible to know” and “very likely not to know” do not belong to “knowing”. “Should have known” is equivalent to “presumed to know” (Hu, 2013), embodying the cognitive element of “presumed intentionality”. To put it bluntly, “should know” has two meanings, that is, the specific actor should know something and already knows it, or should know it but does not know it. In other words, if the CPA, in accordance with the duty of diligence in practice, should have known that the audited unit and suppliers colluded inside and outside to provide them with false contracts, but was actually unaware of this situation due to the inherent limitations of auditing, if they are deemed to be “knowingly aware”, Something is indeed wrong. It is recommended that in the interpretation and application of relevant laws and judicial interpretations, on the one hand, as mentioned above, “intentional”, “knowingly” and “professional negligence” should be strictly distinguished. In the form of fault, “should have known” cannot be completely equated with “knowingly”.

D. Positively Affirm the Role of Industry Standards in Judging the Obligation to Be Diligent and Conscientious

From the perspective of the accounting profession, audit risk = risk of material misstatement × inspection risk. The inspection risk is borne by the CPA, while the risk of material misstatement must be borne by the CPA and the audited entity. Generally speaking, CPAs can reduce the risk of material misstatements through professional methods and technical means. However, even if the audit process is carried out in strict accordance with the auditing standards, it is inevitable that the audited unit will use sophisticated fraud methods to “conceal the truth.” Therefore, requiring CPAs to perform their duties with due diligence beyond the requirements of the standards will infinitely amplify their legal responsibilities.

From the legal perspective, auditing standards are normative documents. Although courts do not use administrative penalty decisions as a prerequisite for accepting civil cases of false statements, in practice they still often use the decision as a basis for determining whether an accounting firm is diligent and conscientious, and most administrative penalty decisions are based on the relevant requirements of auditing standards.

According to the analysis of audit failure cases in my country in recent years, in 33 cases, the direct reason why accounting firms received penalties from the China Securities Regulatory Commission was that they failed to fulfill their obligations of diligence (Bai, 2021). Article 160 of the 2019 Securities Law clarifies that accounting firms should perform their duties diligently and provide services in accordance with “relevant business rules”. Coincidentally, paragraph 1 of Article 19 of the “Several Provisions for 2022” stipulates that “if no errors are found in the audited accounting data in accordance with the work procedures and verification methods determined by the rules of practice and by maintaining necessary professional prudence,” then the company shall It was determined that the accounting firm was not at fault. It can be seen that whether in the theoretical or practical circles, it has become a trend for the legal status of auditing standards to be recognized and used as a basis for measuring the diligence and responsibility of certified public accountants. It deserves to be treated positively and fully reflected in the revision of laws such as the “CPA Law”.

E. “Two-step” Plan to Achieve “Equivalent Penalty and Punishment” and Avoid Falling into the Trap of “Deep Pocket Theory”

Liability for infringement by several persons includes ultimate liability and risk liability (Peng, 2020). The ultimate liability is the share of each person responsible for compensation based on the damage caused to the third party due to his or her own actions. However, due to the different ways of assuming responsibility for each person responsible for compensation in the actual situation, there is a difference between the actual liability and the liability that should be borne. This is risk liability. If the risk liability is greater than the ultimate liability, then the person responsible for compensation bears a large amount of liability that does not belong to him, and it is not inherently fair to require a defendant who is only 10% at fault to bear 100% of the liability (Hu, 2008). In Minnesota, the United States, a
“depth regulation” is applied to the proportion of liability of the person responsible for compensation, that is, the proportion of joint and several liability that he or she should bear is determined based on the final share of liability (Minn, 2010).

Therefore, it is recommended that when conditions are ripe, the “two-step” plan should be followed to optimize joint and several liability in amending the law. First, determine the type of liability based on the fault form. If an accounting firm maliciously colludes with a listed company and intentionally makes false statements, thus constituting joint infringement, it shall bear unlimited joint and several liability to the third party. If the CPA is not malicious, he or she will be held proportionately jointly and severally liable based on the fault patterns of “intentional,” “knowingly” and “professional negligence”. Second, comprehensively determine the upper limit of liability and scope of compensation. Determine the final liability of the accounting firm in the infringement behavior of several persons who accidentally contacted by the degree of fault and the size of the cause (Yang and Liang, 2006), and then divide the upper limit of multiples of joint and several liability according to the final liability range, taking into account the remuneration collected and the market value of the audited company. Scale and other factors refine the scope of compensation.

V. CONCLUSION

The legal system is the product of rational construction and the product of the balance of interests (Liang, 2012). Since the promulgation of the Securities Law in 1998, China’s laws and regulations on securities misrepresentation have been continuously enriched and improved. The introduction of “Several Provisions in 2022” has further opened up the blocking points in practice. In the future, the “Several Provisions” still need to be improved. The Certified Public Accountants Act and other laws and regulations and auditing standards and other normative documents clarify the classification of fault forms, streamline the adjudication approach, and delineate the scope of compensation, etc., to truly protect the interests of investors and prevent securities intermediaries from falling into the “deep pocket theory”, promote the stable and healthy development of the capital market.

CONFLICT OF INTEREST

The author declares no conflict of interest.

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