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PROFESSIONAL LIABILITY BLOG

Auditing Statements: The Critical Distinction Between Fact and Opinion

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Often times, there is a very fine and sometimes even blurred line between fact and opinion. As the Second Circuit recently indicated in the case of In re *Puda Coal Securities Inc.*, an accountant's potential liability for its audit statements can largely come down to the fact that such statements … are nothing more than an opinion.

A "Nightmare" Discovery

As perfectly described at the beginning of the Second Circuit's opinion, this case was rooted in "an accounting firm's worst nightmare." For several years, Moore Stephens Hong Kong ("MSHK") audited Puda Coal Inc. ("Puda"). Based on MSHK's financial statements, until April 2011 Puda's investors were under the impression that Puda still owned 90% of Shanxi Puda Coal Group, Ltd. ("Shanxi").

But nearly two years earlier, in September 2009, Puda's chairman and his brother had transferred Puda's entire interest in Shanxi to the chairman himself, leaving Puda as nothing more than a shell company. Though the transfer was mentioned in Shanxi's shareholder meeting minutes and in documents filed with China's State Administration of Industry and Commerce ("SAIC"), the two brothers essentially pulled off a secret, fraudulent transfer.

But Wait … Not So Fast There Guys

At least, that seemed to be true—until Alfred Litter published a report on April 8, 2011, disclosing the brothers' transfer. Not only were investors first finding out about the transfer through the report, but so was MSHK.

As a result of this revelation, the financial statements MSHK had filed with the SEC on behalf of Puda in 2009 and 2010 were suddenly considered to be materially misstating the facts. Though MSHK resigned as Puda's auditor and announced its 2009 and 2010 audit opinions were no longer reliable, the damage was already done in investors' minds.

Enter the Lawyers

As could be expected, several lawsuits were filed shortly afterward, giving rise to a consolidated securities class action against MSHK and many others. Against MSHK, plaintiffs alleged violations of Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. Before trial, MSHK sought summary judgment on the basis that plaintiffs failed to establish subjective falsity of the alleged statements—an argument that persuaded the Southern District of New York. The Second Circuit also agreed.

In reaching this decision, the appellate court first explained that to succeed on both the Section 10(b) and Section 11 claims, plaintiffs would have to establish that the statements purportedly "matters of opinion" were objectively AND subjectively false at the time they were made.

On that issue, the Court acknowledged that MSHK's failure to obtain Shanxi's SAIC file—as well as its reliance upon unsigned "form" legal opinion letters and two-year old business licenses—was troubling, but the Court ultimately could not find any evidence showing the MSHK auditors knew the brothers had transferred Shanxi to themselves in 2009. According to the Court, the record at best "paint[ed] a narrative of dupes" that MSHK completely failed to identify.

In addition, the Court determined that plaintiffs' auditing expert failed the *Daubert* standard for the admissibility of expert testimony. In particular, the expert acknowledged under oath that her accounting expertise was primarily limited to auditing standards in Hong Kong and China; she also admitted she was not qualified to issue any opinion on Public Company Accounting Oversight Board (PCAOB) standards that are applicable in the United States.

Given the fact that plaintiffs failed to present any convincing evidence showing MSHK knew about the brothers' improper transfer and failed to produce a qualified expert to opine on the applicable auditing standards, the Court was left with no option other than to grant summary judgment in favor of MSHK.

The Takeaway

Overall, this case is very helpful to accountants because it further indicates that auditing opinions really should only amount to an "opinion," and that accountants will be shielded from liability under the federal Securities Exchange Act for such opinions absent a showing that the auditors—even in particularly egregious circumstances—knew of the falsity.

Stated another way, at least under the federal Securities Exchange Act, the presence alone of egregious circumstances does not somehow impute (or mean) the existence of such knowledge. Nevertheless, it is important to note that accountants and accounting firms could still be held liable under some state laws in similar circumstances.

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