



Accountancy Update

October 2012

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Illegality defence explored further

The illegality defence is based on legal policy designed to prevent a person who has been involved in some form of illegal conduct from enforcing their normal legal rights and from profiting from their own wrongs. The Chancellor of the High Court considered the operation of this defence in the context of breach of duty in respect of a VAT fraud claim brought by an insolvent company and its liquidators against the company's directors and the other parties involved in the fraud. [more>](#)

Round up

Our Round up section includes updates on the most recent FRC report on Audit Quality Inspections, the Sharman Inquiry's report on going concern and liquidity risks, the Treasury consultation on extending the disclosure of tax avoidance schemes and the profession's response to the AADB penalties proposals. [more>](#)

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Any comments or queries?

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Developments in data protection

There are changes coming in the field of data protection. This year, the European Commission published proposals to reform EU data protection law. The new General Data Protection Regulation will bring significant changes, including new obligations for data controllers and data processors, new rights for individuals and increased powers for the data protection authorities.

Robert Johnson from our IP, Technology and Commercial group, looks at the implications for firms. He also considers the increase in the number of organisations obtaining approval of Binding Corporate Rules (BCRs) from the UK Information Commissioner's Office (ICO) and the potential benefits and drawbacks of entering into BCRs.

Get ready for the new Data Protection Rules

The European Commission's proposed reform of EU data protection law, in the General Data Protection Regulation (the Draft Regulation), introduces new obligations for both data controllers and data processors, proposes new rights for individuals and strengthens the powers of the data protection authorities. The Commission clearly intends for tighter regulation but the Draft Regulation is not expected to become law until at least 2015. Given some of the concerns expressed to date, it would be surprising if significant amendments are not made before the Draft Regulation is finalised.

We set out some of the current proposals that could affect both a firm's levels of risk and its compliance burden in the UK.

1. Mandatory breach notification

At present, there is no general requirement for a data security breach to be notified to the ICO. However, the Draft Regulation requires a data controller to notify the ICO not later than 24 hours after becoming aware of a breach.

In principle, this means that every breach is notifiable. Not surprisingly, the ICO has highlighted the danger that it will be swamped with notifications of trivial breaches and that a 24 hour notification period is unlikely to be realistic.

2. Broader definition of personal data

Until now, data protection legislation has only been concerned with personal data in the hands of the data controller. However, the Draft Regulation envisages a broader definition of "personal data" that includes all data that is capable of identifying an individual, even if the person who actually holds the data cannot make the link.

This will put pressure on businesses to ensure that whenever information is collected or processed in a way that might refer to data subjects, there are policies and processes in place that ensure that there is an audit trail around the processing and that the data subject is informed of his or her rights, even when the information processed is very limited.

Any comments or queries

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3. New obligations on data processors

Data security will no longer be the sole responsibility of the data controller. Under existing rules, the obligation of a data processor to comply with security requirements flows solely from its contract with the data controller. Under the Draft Regulation, “data processor only” businesses will fall directly under the data security requirements of the new regime and will face a compliance burden.

4. New rights for individuals

A much touted “right to be forgotten” is proposed, allowing an individual the right to delete their data at any time – of particular significance where an individual wishes to remove data posted online. Fierce lobbying against this by social networks may well see this significantly watered down.

5. Mandatory data protection officers

Data protection officers (DPO) will be mandatory for large private companies (with 250+ employees) and public authorities. The DPO must have “*the necessary level of expert knowledge*” and must not take on any other duties that may result in a conflict of interest with the DPO role.

For many, the role will be broader than many current DPO roles and will include informing the company of its legal obligations, monitoring implementation, training, and notification of breaches. The Draft Regulation appears to see the DPO as an independent watchdog and supervisor, albeit one employed by the company.

6. New sanctions

There will be significant new sanctions for non-compliance. At the upper end, a fine of up to 2% of a company’s worldwide turnover is proposed for breaches of the Draft Regulation. This is much higher than the maximum fine of £500,000 that the ICO may impose.

International data transfers: the rise of Binding Corporate Rules

On 14 June 2012, Citigroup Inc became the latest of 15 international companies to obtain approval of its Binding Corporate Rules (BCRs) from the ICO.

Twenty nine companies across Europe now have approval for BCRs. Whilst the process has certain drawbacks, BCRs offer high profile adopters, such as Citigroup, a new and flexible way to ensure that any transfers of personal data around their global operations meet the strict European rules on international data transfers. Now increased co-operation between European data protection authorities is giving BCRs significant momentum for the first time.

What are BCRs?

BCRs are essentially a set of intra-group governance policies, agreements, declarations and undertakings relating to the transfer of data within a group company structure. They are designed to allow multinational companies to export personal data from the EEA¹ to other group entities in territories located outside the EEA.

European data protection law prohibits such transfers unless the relevant territory provides an adequate level of protection for personal data. If such data transfers are governed by approved BCRs, then the transfer will be deemed to comply with this requirement.

Alternatives to BCRs

The other options available to data controllers to ensure adequate protection include: model contract clauses; the consent of the data subject; the Safe Harbor Scheme for EEA/US data transfers; and the data controller's own finding of adequacy.

Uptake

Although the uptake of BCRs began slowly in 2005, there have been 13 successful applications in the UK since April 2009. Four of these have occurred during 2012.

BCRs – the benefits

Once operational, BCRs can provide a framework for intra-group transfers. BCRs are maintained via an ongoing obligation on the data controller to monitor compliance, regularly provide training to employees and conduct regular internal audits.

Key benefits of BCRs include:

1. Awareness: an increase in staff awareness of data protection compliance is an inevitable by-product of increased compliance measures.
2. Flexibility: if drafted widely, BCRs can allow for changes in the company structure and data flows.
3. Ease: BCRs remove the need to rely on complex intra-group contract structures using contracts based on the model clauses.

The application process

1. Selecting a lead authority

The application procedure has been designed to avoid companies having to approach each individual European Data Protection Authority (DPA) separately. The applicant company must select a DPA to be the lead authority, usually based on the location of the European headquarters of the company. Once the lead authority is satisfied with the adequacy of the BCRs, it will refer the application to the other European DPAs for approval.

2. Application documents

Applicants must demonstrate to the lead authority that their BCRs establish adequate safeguards for the protection of personal data throughout their organisation. Key features of the application content are unilateral declarations by a company that its group companies will perform in a certain way in relation to data transfers.

3. Co-operation and Mutual Recognition

Once the lead authority is satisfied with the adequacy of the BCRs, it will refer the application to the other DPAs within the co-operation scheme for approval. Those DPAs will review the application papers (to varying degrees) and provide comments. Any comments or concerns will be fed back to the lead authority and the applicant, and will subsequently be addressed until each DPA is satisfied.

Mutual Recognition is a development which was introduced in April 2011 and which has improved the BCR process. If the lead DPA is satisfied that the BCRs provide adequate safeguards, then other DPAs can accept its findings without further scrutiny. Since its introduction, 19 countries have taken part in Mutual Recognition, including the UK.

BCRs – the drawbacks

BCRs do not always fit comfortably within the national laws of all EEA territories so BCRs are not yet the perfect pan-European solution.

Another disadvantage is that a straightforward application could take 12 months to conclude and there may be delays in the authorisation process within the other DPAs.

Comments

Having seen the recent rise in successful BCRs, it is likely that more companies with international outreach will submit their own applications. Companies who have had their BCRs approved to date include JP Morgan, Chase & Co, British Petroleum plc, Accenture Limited and eBay Inc.

Organisations that may particularly benefit from using BCRs include firms which operate internationally and in global networks, or which have centralised services such as payroll and HR based abroad.

As the application process becomes more streamlined, companies will be able to have increased confidence in the process and we are likely to see more companies benefiting from approved BCR status.

¹ The EU Member States, plus Norway, Iceland and Liechtenstein

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Case notes

Accountants' duty of care to third parties

The High Court recently ruled that accountants did not owe a duty of care to a third party investor¹. Although the case reaffirms the longstanding principle that accountants will not owe a duty of care to a third party investor in these circumstances, it also highlights the danger of contact with third parties and the importance of the terms of the engagement letter which should set out clearly the scope of the duties and to whom they are owed.

KPMG was engaged to provide due diligence services to a company. The issue was whether KPMG owed a duty of care to Arrowhead, a third party investor in the company. KPMG's relationship with its client was governed by the terms of the contract set out in the engagement letter and its terms and conditions. These included specific limitations on the extent of its responsibility and a cap on liability.

The Court held that it was inconceivable that any reasonable businessman would have considered KPMG would voluntarily assume an unlimited responsibility towards potential investors in its client. While Arrowhead did not know of the particular express exclusion in KPMG's general terms of business in relation to third party rights, this was not an unusual term. KPMG did not assume responsibility to Arrowhead, but was only discharging its duty to its client. It would not be fair, just or reasonable to impose such a duty on KPMG. KPMG's relationship was with its client, which was governed by an engagement letter which was likely to contain limitations on the extent of KPMG's liability to its client and very possibly to third parties.

The decision is a welcome confirmation of longstanding existing principles. Whilst third parties may be affected by advice given by accountants, that alone will not give rise to a duty of care on the accountant to the third party. The decision demonstrates that it is important to set out the scope of the retainer at the outset and act within those parameters throughout the business relationship. [Back to contents](#)

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In nearly all disputes involving claims for professional negligence, the parties will instruct an expert witness to provide a report. The High Court has recently considered whether to order disclosure of an undisclosed expert's report prepared at the same time as another report written by the same expert, which had been disclosed². The issues of disclosure and privilege were explored.

Odedra sought damages for negligence as a result of the escape of heating oil from Mr and Mrs Ball's heating tank to its property. Each party served reports from expert valuers. In correspondence, the claimant's solicitors revealed that they had received another report from the same expert considering separate issues. The claimant's solicitors refused to disclose the second report as Odedra did not intend to rely on it. The defendants applied to the Court for its disclosure.

Any comments or queries

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The High Court stated that there is a requirement for openness in litigation and in certain circumstances that requirement will trump privilege. There may, therefore, be cases in which an expert may have to disclose every report he produces as a condition of being permitted to give evidence at all. However, there may equally be cases where requiring an expert to disclose everything that he produces, regardless of privilege, could give rise to injustice.

There is no general rule that everything is disclosable, regardless of privilege. The disclosure of the second report in this case was refused because both parties' experts had become "slightly confused" and it would be wrong and potentially unjust to require the disclosure of reports based on misunderstood issues.

Although this claim relates to a negligence claim in respect of a property, it is an important reminder of the issues that need to be carefully considered when obtaining expert evidence. Had the judge in this case not considered that both experts had become "slightly confused", the outcome may have been different. The need for openness in litigation and the courts' desire to prevent "expert shopping" mean that a party who changes experts or obtains more than one expert report is at risk of having to disclose previous reports. [Back to contents](#)

Illegality defence explored further

The illegality defence is based on legal policy designed to prevent a person who has been involved in some form of illegal conduct from enforcing their normal legal rights and from profiting from their own wrongs. The Chancellor of the High Court considered the operation of this defence in the context of breach of duty in respect of a VAT fraud claim brought by an insolvent company and its liquidators against the company's directors and the other parties involved in the fraud³.

Bilta, a company incorporated in England and registered for the purposes of VAT, traded in the purchase and sale of carbon credits in 2009. Bilta owed £38 million in unpaid VAT to HMRC and the company was wound up. The liquidators and Bilta commenced proceedings to recover the £38 million from Bilta's two directors (one of whom was also the sole shareholder) and from other companies involved in the fraudulent trades. These were companies that had sold the carbon credits to Bilta and also the companies that had bought them. The design and effect of the fraudulent scheme was to render Bilta insolvent and unable to discharge its VAT liability.

The liquidators and Bilta claimed that the defendants conspired to injure and defraud Bilta and carried on Bilta's business with the intention to defraud Bilta's creditors, and other fraudulent purposes.

The defendants relied on the illegality defence, on the basis that the frauds of Bilta's directors were to be attributed to the company, and that following *Moore Stephens (a firm) v Stone & Rolls Limited*⁴, Bilta could not rely on those frauds to found its claim.

The House of Lords' ruling in *Stone & Rolls* was considered in detail. By way of reminder, *Stone & Rolls* committed credit fraud. The company was owned and controlled by one director (a "one man company"). The liquidator of the company claimed against the company's accountants for failing to detect the fraud. The accountants successfully defended the claim on the basis that the company could not rely on its own illegal acts to found its claim against them.

The High Court in *Bilta* distinguished *Stone & Rolls* on the basis that (a) *Bilta* was the victim of the fraud and not the villain, as the conspiracy denuded *Bilta* of its assets; and (b) it was the directors who owed the relevant duty to *Bilta* (whereas in *Stone & Rolls* the duty was that of the accountants).

In circumstances where a company is, or is likely to become, insolvent, the directors are required to consider and act in the interests of the present and future creditors of the company. In *Stone & Rolls* the accountant's duty was owed only to the company and its members.

Bilta was not a party to, or beneficiary of, the conspiracy. The illegality defence was therefore not available to the directors and so it could also not be available to the other defendants, who were one step removed from the directors and who fraudulently conspired with them to breach their duties. The defendants were liable for conspiracy and fraudulent trading. [Back to contents](#)

1. *Arrowhead Capital Finance v KPMG* [2012] EWHC 1801

2. *Odedra and another v Ball and another* [2012] EWHC 1790 (TCC)

3. *Bilta (UK) Ltd v Nazir* [2012] EWCH 2163 (Ch)

4. [2009] UKHL 39

Round up

FRC Annual Report on Audit Quality Inspections

On 13 June 2012, the FRC's Audit Inspection Unit published its Annual Report on Audit Quality Inspections for 2011/2012, as approved by the Professional Oversight Board.

The report notes that there has been an improvement in overall inspection results, with only 10% of the audits reviewed now requiring significant improvements. The number of audits assessed as good with limited improvements required remained consistent with previous years, at around 50%.

The report states that firms need to ensure that audit quality is not compromised in light of a greater emphasis on audit efficiency. Central safeguards should be established to ensure that total audit hours, the determination of materiality and the extent of work performed are maintained at a level to protect audit quality. It was noted that this is particularly important where significant fee reductions have been agreed.

There are concerns that audit teams do not always fully understand the accounting and reporting requirements in relation to the impairment of goodwill and other intangible assets, which were still not being vetted sufficiently. In addition, the FRC remains critical of the extent to which auditors exercise professional scepticism in relation to key judgements and, separately, recommend firms reconsider the adequacy of their procedures to ensure auditor independence. [Back to contents](#)

The Sharman Inquiry's report on going concern and liquidity risks

The Sharman panel, established at the invitation of the FRC, has reported on its inquiry into going concern and liquidity risks, setting out its recommendations in order to improve the management of these risks in future.

Lord Sharman noted that the aim of the directors' assessment and reporting of going concern risks is not primarily to inform outsiders of distress, but to ensure that the company is managed to avoid such distress whilst still taking well-judged risks.

The panel's recommendations to the FRC included:

- Taking a more systematic approach to learning lessons when significant companies fail or suffer significant financial or economic distress (such as by undertaking selective inquiries).
- Working with international bodies to agree a common international understanding of the purpose of the going concern assessment and financial statement disclosure about going concern.
- Reviewing the Guidance for Directors to ensure that the going concern assessment is integrated with the directors' business planning and risk management processes – including a focus on both solvency and liquidity risks.

Any comments or queries

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- Moving away from a model where disclosures about going concern risks are only highlighted when there are significant doubts about the entity's survival, to one which integrates going concern reporting with the Effective Company Stewardship proposals.
- Amending UK auditing standards towards inclusion of an explicit statement in the auditor's report as to whether the auditor has anything to add to or emphasise in relation to the disclosure made by directors about the robustness of the going concern process and its outcome.

The FRC has yet to set out its proposals for implementation of these proposals. It is likely that an impact assessment will be required. [Back to contents>](#)

Tax avoidance: Treasury consults on extending the disclosure of tax avoidance schemes and ICAEW issues guidance

Exchequer Secretary to the Treasury, David Gauke, has announced Government proposals to crack down on the promoters of "contrived and aggressive" tax avoidance schemes.

The proposals include giving HMRC stronger powers, through the Disclosure of Tax Avoidance Schemes (DOTAS) to force promoters to tell them about avoidance schemes and make it easier to impose penalties for failure to provide information to HMRC about a scheme.

Mr Gauke stated that reforms to the DOTAS were required as a result of a changing avoidance landscape. However, the proposed reforms are proving controversial, particularly given that they could result in the requirement to disclose client lists.

The consultation coincides with the publication of ICAEW guidelines which set out the key indicators of tax avoidance schemes. The guidelines reiterate the requirement for members to comply with their professional conduct obligations when advising on such schemes, including the requirement to uphold the reputation of the profession.

The Treasury's consultation closes on 15 October 2012. [Back to contents>](#)

Accountancy Age survey on response to AADB penalties proposals

Accountancy Age has conducted a survey of readers to determine their views on the proposed methods by which AADB penalties are to be assessed in future, as set out in our lead article in the June 2012 Update.

The poll found that 52% of respondents were of the view that the punishments should fit the crime in question, with 42% preferring to see penalties based on the size of the entity in question.

The responses indicate that the midway approach proposed by the AADB, whereby there is a minimum starting point for penalties based on a percentage of the firm's annual turnover, which is then adjusted either upwards or downwards depending in the nature of the misconduct, may prove to be the most popular overall.

Responses to the consultation paper were invited by 11 July 2012 and the AADB has said that it hopes to release the sanction guidance by the end of the year. [Back to contents>](#)

Parliament approves FRC reform and FRC consults on reform to disciplinary schemes

The FRC reforms noted in our June 2012 Update have received parliamentary approval by the House of Commons and House of Lords. From 2 July 2012, strategic decisions have been taken by the FRC Board, supported by the Codes and Standard Committee and the Conduct Committee.

Following this restructuring, the responsibility for operating the disciplinary Schemes will be transferred from the AADB to the FRC through the Conduct Committee. The FRC has launched a consultation on its disciplinary schemes in order to allow for this transition and to enhance the effectiveness and efficiency of the operation of the Schemes. Responses to the consultation were required by 15 September 2012. [Back to contents>](#)

Firm news

The accountancy profession, like many others, is facing increasing regulatory pressure, scrutiny and reform. In our next Breakfast Briefing on 4 October, we will be reviewing some of the key regulatory developments from a claims and complaints perspective affecting accountants.

Simon Goldring will chair the Briefing where Richard Burger will address the ICAEW's approach to disciplinary proceedings and the proactive defence approach; Simon Perkins will talk on the recent AADB reforms; and Rob Morris will address the FSA's intrusive, twin-peak approach. For more information, email seminars@rpc.co.uk [Back to contents>](#)

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