

Southern District of New York: Accounting Firm Did Not Ignore “Red Flags” Where It Disclosed That Its Audit Report Could No Longer Be Relied Upon

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On February 23, 2021, the Southern District of New York granted certain defendants’ motions to dismiss the third amended complaint in a putative securities fraud class action alleging that they made misstatements arising out of a company’s initial public offering materials and subsequent financial statements. [Xu v. Gridsum Holding, 2021 WL 773002 \(S.D.N.Y. 2021\) \(Ramos, J.\)](#). With respect to the company’s former accounting firm, the court held that scienter was not adequately alleged because plaintiffs failed to plead facts suggesting that the firm’s audit was so deficient as to effectively be no audit at all, or that it ignored “red flags” that were so obvious that it must have been aware of fraudulent behavior.

Plaintiffs’ Fraud Allegations

The defendant auditor in this case prepared audit opinions in connection with the company’s 2015 and 2016 financial statements. With respect to the 2016 opinion, plaintiffs alleged that the auditor was “liable for fraud based on its statement that the accompanying financial documents present fairly, in all material respects, the financial position of [the company],” and its statement that it “conducted its audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board.” Plaintiffs further argued that certain audit procedures were not performed.

Applicable Standard for Holding an Auditor Liable for Fraud

The court held that plaintiffs did not adequately allege scienter. The court explained that “Section 10(b) and Rule 10b–5 require plaintiffs to allege a state of mind demonstrating an intent to deceive, manipulate or defraud, also known as scienter.” Further, “[u]nder Rule 9(b) and the PSLRA, a plaintiff must allege facts leading to a ‘strong inference’ of scienter.” The court explained that a plaintiff can “either alleg[e] facts showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness.” Citing Second Circuit precedent, the court explained that “to hold an auditor liable for fraud, such circumstantial allegations [of conscious misbehavior or recklessness] must, in fact, approximate an actual intent to aid in the fraud, such as conducting an audit so deficient as to amount to no audit at all, or disregarding signs of fraud so obvious that the defendant must have been

aware of them.” The court held that plaintiffs failed to meet this standard and further, alleged no facts showing that the auditor had any motive to perpetuate fraud.

Auditor Did Not Ignore Red Flags Where It Identified and Raised Internal Control Issues

On the issue of whether the auditor ignored red flags, the court stated that plaintiffs “allege facts suggesting that [the auditor] eventually did identify and raise several internal control issues relevant to this case.” The court ruled “[i]n light of this, [p]laintiffs do not plead facts supporting a strong inference that [the auditor] must have been aware of, and ignored, red flags.” The court noted that plaintiffs “allege that [the auditor] informed [the company] that its 2016 Audit Report could no longer be relied upon because, over the course of the following year’s audit, [the auditor] identified issues relating to certain revenue recognition, cash flow, cost, expense items, and their underlying documentation that [it] had previously raised with the Company.” The court continued that the company “later revealed that [the auditor] had stated that these issues raised questions related to its ability to rely on the representations of management.”

Countervailing Facts Offset Auditor’s Alleged Failure to Perform an Auditing Procedure

Noting plaintiffs’ argument that “in the course of the 2016 audit [the auditor] still failed to perform a basic audit cutoff procedure to reconcile vendor statements with [c]ompany-recorded invoices, despite knowing of [the company’s] internal control weaknesses” the court determined that “[w]hile this allegation, in a vacuum, might constitute evidence that [the auditor] ignored a ‘red flag,’ it is not enough to offset the countervailing facts in the record that undermine a strong inference of scienter.” The court determined that these countervailing facts distinguished this case from the “red flag” cases cited by plaintiffs. For example, the court described the red flags in *Varghese v. China Shenghuo Pharm.*, 672 F. Supp. 2d 596 (S.D.N.Y. 2009), as “more severe and voluminous, and not undermined by other alleged conduct by the auditor.” The court concluded by stating “[o]n the whole, [p]laintiffs’ allegations support the inferences that [the] 2016 audit opinion was deficient, even negligent, and that [the auditor] likely did not perform procedures that it should have. But they do not support the inference that these errors were done fraudulently.”

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