Audit Standards and Fraud Discovery

by Gordon Yale

The issue of fraud and auditor responsibility for its discovery has troubled the accounting profession and its counsel for years. Until 1989, the profession attempted to insulate auditors from liability in this area. These attempts included both lowering client expectations concerning audited financial statements and promulgating standards that explicitly disclaimed audit responsibility for the discovery of fraud.

Despite these efforts, courts and regulators increasingly held auditors accountable for the discovery of fraud in the course of an ordinary audit examination. In many of those instances, regulators or plaintiffs successfully argued that the proper application of existing generally accepted auditing standards ("GAAS") would have uncovered fraudulent transactions or accounting treatments.

With the February 1997 release of Statement on Auditing Standards No. 82, entitled "Consideration of Fraud in a Financial Statement Audit" ("SAS No. 82"), the accounting profession has more formally responded to an auditor's responsibility for the discovery of fraud. The profession has done so not only by acknowledging that the detection of errors and fraud is a primary purpose of audit examinations, but also by providing a highly detailed list of risk factors that may indicate the existence of fraud. These risk factors, coupled with a set of procedures that an auditor must employ to provide "reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud,"[1] provide practical and detailed guidance for auditors and their counsel.

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The Way It Was

Up to 1977, the position of the American Institute of Certified Public Accountants ("AICPA"), the author of statements on auditing standards, was that an "ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations.... Similarly, although the discovery of deliberate misrepresentations by management is usually more closely associated with the objective of an ordinary examination, such examination cannot be relied upon to assure its discovery."[2] Similar cautionary language also was used in letters to clients reporting on the adequacy of client internal controls.

Subsequent to the Equity Funding scandal in 1975, an AICPA committee was formed to evaluate whether failure of auditors to uncover fraud indicated a need to revise existing GAAS. While the committee concluded that no specific changes were needed, the AICPA issued Statement on Auditing Standards No. 16, entitled "The Independent Auditor's Responsibility for the Detection of Errors and Irregularities" ("SAS No. 16"), in 1977

In part, SAS No. 16 stated: "Under generally accepted auditing standards the independent auditor has the responsibility, within the inherent limitations of the auditing process .. to plan his examination to search for errors or irregularities that would have a material effect on the financial statements."[3] Despite this subtle movement toward auditor responsibility, engagement and management letters frequently continued to contain disclaiming language concerning the detection of errors and irregularities.

Despite such disclaimers, plaintiffs continued to successfully assert claims against auditors by alleging that fraud or error would have been discovered but for the auditors' negligence to perform ordinary audit procedures under the due care standard of GAAS. A few early examples of such cases include:

- a Florida case where auditors failed to discover an embezzlement because the auditors failed to compare checks drawn with invoices and other supporting data;[4] and
- a Michigan case where auditors of a city failed to discover defalcations by the city treasurer because of the auditors' failure to investigate delinquent tax accounts, to investigate crude alterations of tax rolls, to reconcile detailed account balances to the control account, or to reconcile or investigate irregularities when discovered.[5]

Despite these early cases, negligence claims against auditors, particularly in connection with securities offerings, were relatively uncommon until the 1960s.[6] At that time, however, actions against auditors brought under the federal securities acts were becoming increasingly popular. Modern disputes involving companies such as BarChris Construction Corporation, The Fund of Funds, Ltd., Mattel Corporation, Four Seasons Nursing Centers of America, U.S. Financial Corporation and Equity Funding of America all demonstrated quite publicly that successful

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claims could be brought against accounting firms, regardless of protective professional standards concerning the discovery of fraud.

Still, change to professional standards has come slowly. Just as the Equity Funding scandal may have precipitated the small changes in SAS No. 16, it was not until the savings and loan crisis, in which a number of major national accounting firms settled government claims for hundreds of millions of dollars, that more profound changes to the professional standards occurred.

SAS No. 53

The first meaningful change came with the release of Statement on Auditing Standards No. 53, entitled "The Auditors' Responsibilities to Detect and Report Errors and Irregularities" ("SAS No. 53"), which became effective as of January 1, 1989. The new standard required that "[t]he auditor should assess the risk that errors and irregularities may cause financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements."[7]

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SAS No. 53 provided that an "audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, needs to be objectively evaluated to determine whether the financial statements are free of material misstatement."[8]

SAS No. 82

SAS No. 82, issued in February 1997, does not depart from SAS No. 53 but expands on it. The new standard dispenses with the euphemism "irregularities" and, for the first time, introduces the term "fraud" into professional accounting standards. Like SAS No. 53, the new standard provides a series of factors, or "red flags," that may indicate intentional misstatements in financial reporting. These risk factors are important because they require the auditor to analyze not only the books and records of a client, but also the economic environment and financial context in which the client operates and the very character of the client's management. In short, the accounting profession now recognizes that motive and means increase the risk of fraudulent behavior.

Specific risk factors enumerated in SAS No. 82 include the following:

- a significant portion of management compensation is contingent on unduly aggressive operating results, financial position, or cash flow;
- an excessive interest by management to maintain or increase the entity's stock price or earnings through aggressive accounting practices;
- a practice by management of committing to unduly aggressive or clearly unrealistic forecasts;
- an interest by management in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons;
- an ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics;
- domination of management by a single person or a small group without compensating controls such as oversight by the board of directors or audit committee;
- inadequate monitoring of significant controls or failure to correct known control weaknesses;
- management disregard for regulatory authorities;
- management employment of an ineffective accounting, information technology, or internal auditing staff;
- nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant accounting estimates;
- high turnover of senior management, board members, or counsel;
- frequent disputes with the current or predecessor auditor;
- unreasonable demands on the auditor, including time constraints;
- formal or informal restrictions on the auditor that limit access to people or information; and
- known history of securities law violations or other claims against the entity or its management.[9]

SAS No. 82 also provided a number of risk factors that related to industry conditions. These risk factors included:

- new accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of an entity;
- high degree of competition or market saturation, accompanied by declining margins;
- declining industry characterized by increasing business failures and significant declines in customer demand; and
- rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.[10]

SAS No. 82 also provided for risk factors that it characterized as related to operational characteristics and financial stability of an entity. Examples of these risk factors are as follows:

- inability to generate cash flows from operations while reporting earnings and earnings growth;
- significant pressure to obtain additional capital necessary to stay competitive;
- assets, liabilities, revenues or expenses based on significant estimates that involved unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity—such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of cost;
- significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm;
- significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions;
- significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification;
- overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose;
- unusually rapid growth or profitability, especially compared with that of other companies in the same industry;
- especially high vulnerability to changes in interest rates;
- unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain;
- threat of imminent bankruptcy or foreclosure, or hostile takeover;
- adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported; and
- poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.[11]

After assessing risk factors, SAS No. 82 requires auditors to consider offsetting strengths, including the entity's internal controls. If the risk factors are not fully ameliorated by the existence of effective controls, the auditor must exercise additional care, including the assignment of more experienced personnel to the engagement, a more comprehensive review of accounting policies, and the collection of more detailed and corroborative evidence to support the firm's audit conclusions.

If the auditor discovers what he or she believes may be fraud, SAS No. 82 requires that the auditor must reevaluate the initial assessment of the entity and broaden the scope of the audit accordingly. In addition, the findings must be discussed with senior management at least one level above where the fraud likely occurred. If the auditor perceives the fraud as pervasive, the auditor should consider withdrawal from the engagement, expressing no professional opinion on the financial statements, and should communicate the reasons for withdrawal to the entity's audit committee or equivalent authority.

In addition, the auditor may be obligated to make some disclosure to outside parties in the event of the following:

- to comply with legal or regulatory requirements;
- to a successor auditor when the successor makes inquiries in accordance with SAS No. 7, "Communications Between Predecessor and Successor Auditors";
- in response to a subpoena; or
- to a funding agency or other specified agency in accordance with requirement for the audits of entities that receive governmental financial assistance.[12]

Conclusion

Clearly, the accounting profession has more fully and precisely embraced the responsibility of designing audit examinations to reasonably assure the discovery of material error or fraud in the course of ordinary audit. Whether these new standards will significantly change the frequency in which auditors are held liable for their failure to discover errors or fraud remains to be seen.

NOTES

1. Section AU 110 of Statement on Auditing Standards No. 1 (1997).
2. Paragraph 5, Auditing Standards and Procedures No. 30, "Responsibilities and Functions of the Independent Auditor" (1960).
3. Paragraph 5, SAS No. 16, "The Independent Auditor's Responsibility for the Detection of Errors and Irregularities" (Jan. 1977).
4. *Dentzler Lumber & Export Co. v. Columbia Casualty Co.*, 156 So. 116 (Fla. 1934).
5. *Maryland Casualty Co. v. Cook*, 35 F.Supp. 160 (D.Mich. 1940).
6. Knapp, *Contemporary Auditing Issues and Cases* (West Pub. 1996) at 272.
7. Paragraph .05 of SAS No. 53, "The Auditor's Responsibility to Detect Errors and Irregularities" (1989).
8. *Id.* at ¶ .16.
9. Paragraph 17 of SAS No. 82.
10. *Id.*
11. *Id.*
12. *Id.* at ¶ 40.

Check out our Calendar of Events on page 126 for CBA, local bar association, and other legal community activities.