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Discussant's Response No. 2 to "Illegal Acts: What is The Auditor's Responsibility?"

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When I agreed to discuss the paper by Dan Guy, Ray Whittington, and Don Neebes, I did not realize the task would be so difficult. Commenting on a paper about SAS No. 54, written by drafters of the statement, is difficult enough, but then to follow discussions by three of the brightest accounting students at the University of Kansas is really a chore.

Even with the enactment of SAS No. 54, the question of what the auditor is responsible for is still difficult to answer. Does this standard answer the question or does it raise the question, "What is the Auditor Responsible For?" The standard increases the auditor's responsibility for detection of a client's illegal acts and it may be difficult to determine where the responsibility stops.

Some of the work that I have done recently has been in the area of the accountant's liability and responsibility. Consequently, some of my comments concern the potential effect that this new SAS No. 54 could have on the auditor in terms of additional duties and liabilities. I would like to address four areas of concern: (1) the classification of illegal acts as direct or indirect; (2) potential increased liability; (3) interaction with other SASs; and (4) disclosure.

Direct vs. Indirect Illegal Acts

As discussed in the paper by the authors, illegal acts are divided into two categories. The auditor is prescribed different degrees of responsibility based upon the category in which the illegal act falls. The prescribed degree of care is much higher for the first category of acts – those illegal acts that have a *direct* and *material* effect on the financial statement amounts. Since this category of illegal acts would affect the financial statement amounts, the auditor should assess the risk that an illegal act may cause the financial statements to contain a material misstatement. Consequently, the auditor must design audit procedures to provide *reasonable assurance* of detecting the illegal act.

Much recent litigation has been based on the auditor's negligence when there was a failure to discover and report management's errors and irregularities, i.e., management fraud. This same standard of care required for discovery of management's errors and irregularities is now required for the discovery of the client's direct effect illegal acts. This means the auditor will have to understand the legal environment in which the client is operating in order to design procedures that would detect such offenses. This will have

a direct impact on the auditing procedures, especially those designed to test the internal control procedures of the client.

The detection of the indirect effect illegal acts as defined in SAS No. 54 may be much more difficult than the detection of the direct effect illegal acts. These are acts that normally do not have a material effect on the financial statement amounts. The auditor has a responsibility for their discovery, but to a lesser degree than for the discovery of the direct effect illegal acts. As is noted in the paper, except for a few examples given in the statement, differentiating direct effect illegal acts from indirect effect illegal acts is largely a matter of auditor's judgment. There appears to be a very fine line between the two types of illegal acts, and in some cases the distinction may be nonexistent. For example, if a contingent liability is identified as a result of an indirect effect illegal act and a portion of it is required to be accrued, then does it not become a direct effect illegal act with the higher standard of care? After all, this type of act does have a direct effect on the financial statement amounts.

It appears that the distinction between a direct effect illegal act and an indirect effect illegal act may be a source of confusion both to the accountant and to the public. If an illegal act has occurred (regardless of type), and it has a material effect on the financial statements, then it must be reflected in the financial statements. If the illegal act is immaterial, then no disclosure of the act is required to an outside party. However, can there be an illegal act of any consequence not requiring disclosure? Even if the act pertains to the operation of the organization, the commission of the illegal act can cause a legal liability to accrue. The probability of the act being discovered is not relevant; if the act has been committed then the consequences must be considered.

Some acts may not affect a specific line item on the financial statements, but they could affect the continuation of the business. For example, if an act has been committed that might cause an operating license to be revoked, this would affect the ability of the business to continue. If this were the situation, then a going concern assessment must be made and disclosed if the consequences were severe enough. Defining two categories of illegal acts may serve to confuse the auditor and possibly lead to more litigation. It appears that the auditor should look at the effect of the illegal act on the financial statements and whether disclosure could affect an investor's opinion.

Although the standard prescribes a higher standard of care than did SAS No. 17, one of the purposes of identifying two classes of illegal acts was to try to limit the auditor's responsibility. But has this been accomplished? The standard actually makes the auditor more responsible. Even if the illegal act is related to the operating environment, if it can have material effect on the financial statements or on the entity's operation, then is the auditor not responsible for detection? Is the distinction between a direct effect illegal act and an indirect effect illegal act really helpful, or does this provide a false sense of security for the auditor? Could a more useful test be developed?

Legal Liability

How does this increased responsibility fit with potential liability? SAS No. 54 prescribes the same standard of care for direct effect illegal acts as it does for client's errors and irregularities in SAS No. 53. The litigious nature of today's

environment makes the auditor more susceptible if he is careless in his responsibility to detect client's illegal acts. The problem of third party liability is a very real problem, as many accounting firms know.

The more liberal view of auditor responsibility adopted by many of the courts in the 1970s and 1980s proved to be costly to many accounting firms. While the opinions of the courts do vary from state to state, in general, a more liberal view was adopted with respect to third party liability. Many of the courts took the position that clients had a duty to third parties, particularly if the group was identifiable and limited. This standard has the potential for making the auditor liable for the client's injurious illegal acts.

One positive note however, is that a few of the court decisions in the late 1980s and early in 1990 have tended to take a more conservative view of third party liability. The *Credit Alliance* decision is one of the more important decisions in the 1980s.[1] In *Credit Alliance,* the court took a more conservative approach and limited liability to third parties that were identified prior to the engagement. A number of other state courts have adopted this view in 1988 and 1989. Also, early in 1990, in the *Caparo*[2] decision, the English House of Lords adopted a more conservative view similar to that taken in *Credit Alliance.*

Another interesting question that SAS No. 54 raises is the potential involvement of legal counsel in the audit process. Some actions may call for an expert opinion as to whether a law has actually been violated and the implications of the violation. While the accountant is not necessarily concerned with whether a specific act is illegal *per se,* there must be a determination to measure impact on the financial statements. For example, some of the provisions of the Securities Act of 1933 are complex and violations may be very technical.

The auditors' expertise also is at issue here. How familiar with law and regulations must the auditor be in order to make a judgment about violations? If the auditor does not have the degree of competency required, does this mean the employment of counsel may become a regular part of the audit procedure in firms where complex regulations apply? It appears that the potential is there to have legal counsel as a regular member of the audit team.

Interaction with Other SASs

SAS No. 54 is related specifically to a number of the new SASs that were issued in 1988. The auditor's responsibility for the detection of client direct effect illegal acts is the same as is required for the detection of client's errors and irregularities in SAS No. 53. As you know, SAS No. 53 has increased auditor responsibility by requiring the auditor to design audit procedures to provide reasonable assurance of detection.

The duty of the auditor to detect material misstatement as a result of client's illegal acts and the risk assessment (both control and inherent risk) have a direct bearing on the substantive test that are to be performed. If the audi-

[1]Credit Alliance v. Arthur Andersen & Co., 483 N.E. 2d 110, N.Y. App. (1985).

[2]CAPARO Industries v. Dickman, et al. (Touche Ross), English House of Lords (1990).

tor fails to consider the possibility of illegal acts and their impact on the financial statements, then the auditor may be setting himself up for a negligence charge in the event of subsequent problems.

SAS No. 55, *Considerations of the Internal Control Structure in a Financial Statement Audit,* is also impacted by SAS No. 54. The new internal control procedures require a higher degree of understanding of the company's internal control structure. The understanding of the control environment is especially important in relation to detecting illegal acts. The control environment includes such factors as management philosophy, the entity's organizational structure, and various external influences that affect the entity's operations and practices (such as requirements by legislative and regulatory bodies).

As I mentioned earlier, a client illegal act could affect the firms ability to continue business which will cause a going concern evaluation under SAS No. 59. Obviously, a client illegal act will affect audit procedures required by other SAS's, i.e., the design of substantive procedures. These examples illustrate the far reaching effect of SAS No. 54.

Disclosure

Normally the responsibility of notifying parties outside the clients organization of an illegal act not reported in the financial statements is the responsibility of management. However, SAS No. 54, as well as recent court decisions, indicate that the auditor has a higher level of responsibility for reporting certain kinds of misconduct. The new statement seems to fall short in clarifying the auditor's responsibility for disclosure. It notes that in general, the auditor has no responsibility to notify parties outside of the client's organization of the illegal acts. However, it does suggest that circumstances *may* exist that would require disclosure to an outside party. The statement then lists several situations that may require disclosure, but still leaves the decision up to the judgment of the auditor in the specific situation. Some court decisions in the 1980s reinforce and strengthen the disclosure requirement. For example, in the ***Rudolph*** case, the court established its own disclosure standard.[3] The court reasoned that it is not unreasonable to expect an accountant to expose fraud in certain circumstances. In Rudolph, the accountant had knowledge of fraud subsequent to the audit. The court stated "the accountant's information is obviously superior to that of the investors" and the auditor may have a duty to disclose.

Other courts contend that absent some duty to disclose, accountants are not required to tattle on their clients. As the court noted in *Baker,*[4] liability depends on an existing duty to disclose. One question to be answered is does SAS No. 54 create a legal duty to disclose and if so to what circumstances does it apply? Again, it would appear that if the illegal act would impact the financial statement amounts or change an investor's decision, then there

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[3]Rudolph v. Arthur Andersen & Co., 800 F. 2d 1040 (11 Cir. 1986), rehearing denied at 806 F. 2d 1070 (1986), cert. denied, 107 S. Ct. 1604 (1987).

[4]Baker v. Henderson, Franklin, Starnes and Hart, 757 F. 2d 490 (7th Cir. 1986).

already is a duty to disclose. In a 1988 case, allegations that the accounting firm knew of fraud in partnership offering material, but allowed use of its name, led to a claim for aiding and abetting.[5] Could this also apply to illegal acts of clients known by the auditor but not disclosed? Auditors can also subject themselves to RICO suits for merely being "associated with" an organization involved with RICO violations.[6]

Conclusion

In conclusion, the implication of this new SAS does raise some interesting questions. As the authors point out, one way to handle the problem may be to contract separately for compliance procedures. It appears that SAS No. 54 has raised the level of responsibility for the detection *and* disclosure of a client's illegal act. This higher standard of care has the potential of creating an even more litigious environment for the accountant.

[5]Roberts v. Peat, Marwick, Mitchell & Co., 857 F. 2d 646 (9th Cir. 9/19/88).

[6]Schact v. Brown, 711 F. 2d 1343 (7th Cir.), cert denied, 104 S. Ct 508, 509 (1983).