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Illegal Acts: What is the Auditor's Responsibility?

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Society has always been concerned with violations of laws and regulations by all types of entities – business enterprises, nonprofit organizations, and governmental units. Highly publicized accounts of management improprieties reported over the last two decades have caused this concern to increase significantly. Several congressional committees, regulatory agencies, and others have suggested that auditors should assume more responsibility for detecting and disclosing violations of laws or regulations, commonly referred to as illegal acts.

Developing standards that articulate the auditor's responsibility for illegal acts has proven to be a very challenging task for several reasons. First, a large diversity of laws and regulations affects most entities, and identifying violations of many of those laws and regulations requires legal expertise. Second, even with this expertise, the complexity of some laws and regulations makes identifying a violation very difficult. Finally, even after an illegal act has been identified, evaluating management's assessment of its potential effects on the entity's financial statements is also very difficult.

This article analyzes the auditing standards that describe the auditor's responsibilities for detecting and reporting illegal acts. It also reviews the historical developments that have brought the profession to where it is today. Finally, we introduce some future issues and research needs in this area.

Historical Developments

The issue of the auditor's responsibility for illegal or questionable acts by clients is not new. It first made front-page news in the mid 1970's as a result of the Watergate scandal. Investigations led to initial disclosures of illegal political contributions by many large corporations. These initial disclosures opened the door to a host of other revelations involving questionable payments by corporations to domestic and foreign government officials. As a result, the profession formally addressed the issue of the auditor's responsibility to detect and report illegal acts by clients. The issue was initially studied by the Commission on Auditors' Responsibilities (the Cohen Commission). Based

on the Cohen Commission's preliminary recommendations, the AICPA Auditing Standards Executive Committee issued SAS No. 17, *Illegal Acts by Clients,* in 1977. This statement was the first professional standard that specifically addressed the auditor's responsibilities to detect and disclose illegal acts.

Many of the concepts in current professional standards were developed by the Cohen Commission. It concluded that the auditor cannot reasonably be expected to assume the responsibility to detect and disclose an entity's violations of laws in general because: (1) auditors do not possess the legal training to recognize all the complex circumstances and processes that give rise to litigation and that suggest its outcome, and (2) many illegal or questionable acts involve small amounts in relation to the financial statements. If society needs assurance on matters that are principally legal, the Cohen Commission concluded that this assurance should be provided by those most capable of doing so, management assisted by its lawyers.

In discussing the auditor's responsibility, the Cohen Commission acknowledged that certain illegal acts, such as tax evasion, have been well defined and are easily recognized by experienced auditors. It also introduced the concept of illegal acts that have a direct and material effect on the amounts in the financial statements, and stated that auditors normally consider the possibility of such acts when planning and conducting their audits.

Consistent with the recommendations of the Cohen Commission, SAS No. 17 [AICPA, 1977] begins by stating that:

> An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that illegal acts will be detected. In reporting on financial statements, an auditor holds himself out as one who is proficient in accounting and auditing. The determination of whether an act is illegal is usually beyond his professional competence [para .03].

The statement goes on to indicate that procedures performed primarily for the purpose of expressing an opinion on the financial statements may bring possible illegal acts to the auditor's attention. But the further removed an illegal act is from the events and transactions specifically reflected in the financial statements, the less likely the auditor is to become aware of the act or recognize its possible illegality.

SAS No. 17 also discusses violations of laws and regulations that have a direct effect on the amounts in the financial statements. It states that the auditor considers such laws and regulations when planning and conducting the audit, and includes as examples tax laws, and laws and regulations affecting the amount of revenue accrued under government contracts. However, SAS No. 17 does not set forth any affirmative detection responsibility.

Finally, SAS No. 17 contains guidance for the auditor when he or she believes that an illegal act has occurred. The auditor is to obtain an understanding of the nature of the potential financial statement effect by inquiry of management, by consultation with legal counsel and, if necessary, perform additional procedures to investigate the act. If an act is determined to be illegal, the auditor is required to report the circumstances to management personnel at a high enough level of authority so that appropriate action can be

taken. In some circumstances, that might be the audit committee of the board of directors.

In the mid-to-late 1980's, the issue of the auditors' responsibility for illegal acts by clients resurfaced during the development of the "expectation gap" Statements on Auditing Standards (SASs). The public and financial statement users believed that auditors should assume more responsibility for detecting errors and irregularities. This resulted in the Auditing Standards Board's reexamination of the auditor's responsibility for illegal acts, and the issuance of SAS No. 54, *Illegal Acts by Clients,* which superseded the guidance in SAS No. 17.

Detection Responsibility

In defining the auditor's responsibility for detecting illegal acts, SAS No. 54 takes the approach of dividing illegal acts into two broad categories or types. For the first type, illegal acts that have a *direct* and *material* effect on line-item amounts in the financial statements, the auditor has the same responsibility as for errors and irregularities. That is, the auditor should design the audit to provide reasonable assurance that the financial statements amounts are free from material misstatement resulting from these *direct effect illegal acts.* This responsibility is described in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities.* In contrast to SAS No. 17, SAS No. 54 establishes an affirmative detection responsibility for *direct effect* illegal acts that are material.

For the second type, SAS No. 54 states that an audit in accordance with generally accepted auditing standards (GAAS) normally does not include audit procedures specifically designed to detect illegal acts having an *indirect effect* on financial statements. The auditor is responsible for evaluation of such acts only when information comes to his or her attention suggesting the possibility that they have occurred. However, SAS No. 54 does note that the auditor should make inquiries of management about the entity's compliance with laws and regulations. When appropriate, the auditor should also inquire of management about (1) the entity's policies relative to the prevention of indirect effect illegal acts, and (2) the use of directives and periodic representations obtained from management about compliance with laws and regulations. If the auditor becomes aware of information that raises suspicions, the auditor is obligated to apply additional procedures to determine whether an illegal act has, in fact, occurred. SAS No. 54 reaffirms the presumption that an audit made in accordance with GAAS provides no assurance that *indirect effect* illegal acts will be disclosed.

Differentiating the Types of Illegal Acts

Although the concept of direct and material illegal acts was developed in the mid 1970's, auditors are for the first time attempting to operationalize the concept in audit engagements. SAS No. 54 provides examples of both direct effect and indirect effect illegal acts. Apart from these examples, SAS No. 54 leaves the issue of differentiating direct effect illegal acts from indirect effect illegal acts largely to auditor judgment. As the AICPA industry committees

have attempted to develop guidance about illegal acts for industry audit and accounting guides, it has become apparent that distinguishing direct effect from indirect effect illegal acts is a challenging practice problem.

The examples in SAS No. 54 of direct effect illegal acts are the same as those included in SAS No. 17 – violations of tax laws that affect the amount of expense recognized for the period and violations of laws and regulations that affect the amount of revenue accrued under government contracts. Additional examples for entities receiving federal financial assistance are provided in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.* That statement identifies, in broad categories, the types of legal requirements that may have a direct effect on the entity's financial statements. Such laws and regulations generally deal with the following matters:

- The types of services that may or may not be purchased with financial assistance.
- The characteristics of individuals or groups to whom entities may give financial assistance.
- The amounts entities must contribute from their own resources towards projects for which financial assistance is provided.

Indirect effect illegal acts are characterized as being more related to the entity's operating aspects than to its financial and accounting aspects. Examples include violations of laws and regulations related to securities trading, occupational safety and health, food and drug safety, environmental protection, equal employment, and antitrust. The financial statement effect of violations of these acts is normally the contingent liability that may need to be disclosed in the financial statements. For example, securities may be purchased based on insider information. If the purchase is appropriately recorded, there is no direct effect on the financial statements. But the indirect effect – the potential contingent liability in the form of fines or penalties – may not be disclosed. This contingent tail does not make this violation a direct effect illegal act, even if it meets the criteria for accrual under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies.*

All direct effect laws and regulations have one characteristic in common – requirements that dictate the manner in which a financial statement amount should be measured or presented. They have provisions that relate to the *valuation* or *classification* of financial statement revenues or expenses and related assets or liabilities. Such requirements are akin to those in a royalty contract that specify the way in which royalty expenses and liabilities should be measured. According to SAS No. 54, the auditor's concern with compliance with these laws and regulations is derived from their effect on financial statement amounts, not from their legality per se. Thus, the auditor's responsibility runs only to the specific requirements that affect the financial statement amounts. This concept can be illustrated with tax laws and regulations. Certain provisions of the tax code affect the manner in which an entity's tax provision is measured. They have a direct effect on the financial statements. Other provisions relate to the accurate completion and timely filing of tax forms. The effect of violations of these provisions is indirect – the contingent

liability for tax penalties. The auditors' responsibility for this contingency is the same as for other illegal acts that have an indirect effect on the financial statements.

Auditing the Contingent Tail

Certain audit procedures performed for the purpose of forming an opinion on the financial statements may bring possible violations of laws and regulations to the auditor's attention. Examples of such procedures include reading minutes of meetings of stockholders and directors and correspondence from taxing or other governmental agencies, and inspecting documents supporting transactions. In auditing litigation, claims, and assessments, the auditor performs the following procedures that also might disclose illegal acts:

- Making inquiries of and discussing with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtaining from management a description and evaluation of litigation, claims, and assessments, and assurances that all such matters have been disclosed in accordance with Statement of Financial Accounting Standards No. 5 (FASB No 5).
- Examining documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- Obtaining assurance from management that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with FASB No. 5.
- Obtaining a response from the entity's lawyer to a letter of audit inquiry about litigations, claims, and assessments.

These procedures for litigation, claims, and assessments provide limited evidence of compliance with laws and regulations. They rely heavily upon management becoming aware of a violation and making information about the matter known to the entity's lawyer and the auditor. Other evidence might not be available until a governmental agency undertakes an investigation of the violation.

Evaluating the Results of the Procedures

If the auditor's procedures provide an indication that indirect effect illegal acts may have occurred, SAS No. 54 states that the auditor should obtain sufficient information about the nature of the act to evaluate its effect on the financial statements. Obtaining this information begins with inquiries of management at least one level above those involved. If satisfactory information is not obtained from that source, the auditor should consult with the client's legal counsel, and apply any additional procedures necessary to obtain an understanding of the nature of the acts. When the auditor concludes, based on the information, that illegal acts have or are likely to have occurred, he or she should consider their effects on the financial statements as well as the implications for other aspects of the audit.

Indirect effect illegal acts typically result in unasserted claims against the entity. In determining the appropriate financial statement presentation of an unasserted claim, management refers to FASB No. 5. That statement requires management, assisted by legal counsel, to assess the probability of a claim being asserted and the probability of an unfavorable outcome. Based on these assessments, the financial statements may include accrual of an estimated loss, or disclosure of the matter in notes to the financial statements.

The auditor's ability to evaluate the financial statement presentation of the indirect effects of an illegal act is limited. The auditor generally does not have the legal training or experience to second guess the opinion of management and legal counsel. Therefore, to a large extent the auditor acts as a broad control over the information by evaluating management's disclosure of the matter in relation to the lawyer's representations and the criteria in FASB No. 5.

Other Compliance Auditing Requirements

In performing audits of governmental units, not-for-profit organizations, and certain other regulated companies, the auditor may perform additional procedures to test compliance with laws and regulations. These additional procedures are beyond those required to comply with generally accepted auditing standards and are imposed by rule, law, or regulation. An example is the Single Audit Act of 1984 and Circular A-128, *Audits of State and Local Governments,* issued by the Office of Management and Budget (OMB), which requires certain governmental units and non-governmental entities that receive federal financial assistance to engage an auditor to test and report on compliance with certain laws and regulations. Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions,* includes similar requirements for not-for-profit organizations. These additional compliance auditing procedures are similar to agreed-upon procedures under the Statement on Standards for Attestation Engagements [AICPA, 1989]. The regulatory agency or legislative body decides which provisions of laws and regulations need to be tested and the nature and extent of the related procedures. The laws and regulations selected for testing may not even have an indirect effect on the entity's financial statements. Examples of laws and regulations that have no effect on the financial statements are contained in the Employee Retirement Income Security Act of 1974. That act includes provisions, such as bonding requirements, that govern the administration of an employee benefit plan. Violations of such provisions have no direct or contingent effect on the financial condition of the plan. Any penalties are levied against the trustees.

This agreed-upon procedures approach appears to represent the most cost-beneficial approach to developing expanded auditing requirements for compliance with laws, and regulations. Regulatory agencies or legislative bodies can contract for the level of assurance that is desired.

Reporting Responsibilities

What impact do illegal acts have on the auditor's reporting responsibilities? The answer to this question is complex and may involve a number of

reporting vehicles. The reporting vehicle typically thought of first is the audit report. Generally, there is no need for the auditor to modify the audit report for illegal acts, provided that the effects of those acts are appropriately presented or disclosed in the financial statements. On the other hand, if the auditor concludes that illegal acts have a material effect on the financial statements, and that effect is not appropriately reflected, the auditor should express a qualified or adverse opinion because of the lack of conformity with GAAP. If management refuses to accept the auditor's modified report, the auditor should withdraw from the engagement and notify the audit committee or the board of directors of the reasons for withdrawal.

One of the objectives of the expectation gap SASs was to improve the communications to boards of directors and audit committees to help them fulfill their financial reporting and oversight responsibilities. Accordingly, SAS No. 54 includes a requirement for the auditor to make sure that the audit committee of the entity is adequately informed of all but inconsequential illegal acts. Management may make the communication unless the act involves senior management in which case the matter should be communicated directly by the auditor. Communication to regulatory agencies or other parties outside the entity is ordinarily not required under U.S. auditing standards, but there are the following exceptions:

- To a funding agency or other specified agency based on audit and reporting requirements of law or regulation.
- When the auditor responds to a Form 8-K filed by the entity to report a change in auditor.
- To a successor auditor who makes inquiries in accordance with SAS No. 7, *Communications Between Predecessor and Successor Auditors.*
- In response to a subpoena.

The first two of these exceptions establish forms of direct reporting of illegal acts to regulatory agencies. The first allows regulatory agencies to directly receive information regarding an entity's compliance with laws and regulations. Regulated entities can be required by law or regulation to engage an auditor to issue compliance reports for filing with the agency. The reports may be based upon specified procedures or procedures performed in the audit of the entity's financial statements. The reporting requirements of an audit in accordance with *Governmental Auditing Standards* (GAAS) is a prominent example of this form of direct reporting. In these types of engagements, the auditor is required to issue an additional report on compliance with laws and regulations based solely on the procedures required by GAAS. The report discloses all instances of noncompliance that are estimated to be material to the entity's financial statements and all indications of illegal acts that could result in criminal prosecution. Since the auditor ordinarily does not possess the expertise to evaluate whether an illegal act could result in criminal prosecution, he or she will normally report all illegal acts or possible illegal acts noted.

The second exception results in a form of direct reporting when the auditor decides to withdraw from the engagement, because management's response to an illegal act is not considered appropriate. If management does

not accurately describe the relationship of the illegal act to the change in auditor in the Form 8-K, the auditor is required to describe the matter in a response to the SEC.

Future Issues

Given the interest of Congress and regulators in others' compliance with laws and regulations, the auditor's responsibilities for illegal acts will no doubt be addressed again. Several issues appear relevant to any future consideration of these responsibilities. These issues and their research implications are presented below.

Can the Auditor's Detection Responsibilities be Expanded Under GAAS?

Current professional standards contain a relatively clear delineation of those illegal acts for which the auditor has detection responsibility. The auditor has a responsibility to design the audit to provide reasonable assurance of detecting violations of laws and regulations having a direct and material effect on financial statement amounts. Expanding the auditor's responsibility under GAAS would likely result in a level of responsibility that is more difficult to interpret.

Any approach to expanding the auditor's responsibility must involve increasing the auditor's responsibility for the contingent tail. But this runs headlong into the auditor's limited legal expertise. It's clear that the auditor could design procedures to obtain reasonable assurance of detecting violations of certain laws and regulations that might have an indirect effect on an entity's financial statements. For example, the auditor of a financial institution could design effective procedures for testing compliance with the requirement to submit currency transaction reports for all large cash deposits. Designing effective tests of compliance for indirect effect laws and regulations that have no reasonably objective criteria for identifying violations, simply would not be feasible. Therefore, any expanded responsibility would vary from industry to industry and perhaps, even from client to client in the same industry, depending on nature of the laws and regulations that affect the entity. Using this approach, a clear-cut definition of the auditor's responsibility under GAAS could be achieved only by developing professional standards or laws and regulations that set forth specifically those laws and regulations that the auditor would be required to test for compliance.

Another way to define this expanded responsibility would be to include in professional standards factors that affect the likelihood that the auditor will detect particular indirect effect illegal act. Such factors would probably include the following:

- The auditor's assessment of the materiality of the contingent effect of the act on the entity's financial statements (i.e., the materiality of the potential fine or penalty).
- The auditor's assessments of the joint probability that the entity committed the act and a claim will be successfully asserted.

- The auditor's ability to recognize the act (i.e., the extent of the auditor's knowledge of the subject matter of the law or regulation, and the complexity of the law or regulation).
- The extent of the evidence that is available that would provide an indication that the act has occurred.

This approach would leave the laws and regulations selected for testing, as well as the nature and extent of the procedures performed, largely to the judgment of the auditor. Therefore, a "fuzzy" definition of the auditor's detection responsibility would result.

Both of these approaches to expanding the auditor's responsibility under GAAS suffer from another limitation. The degree of assurance about the disclosure of the effects of a violation of a law or regulation would vary depending on the nature of the law or regulation. More assurance would be provided for those laws and regulations for which the auditor could design effective compliance procedures. It's questionable whether these varying levels of assurance could be effectively communicated to users of the audit report. One might also question whether it is cost-beneficial to provide additional assurance for only certain types of contingencies. However, research addressing these questions would be useful. From a broad research perspective, it would also be useful to have information regarding the expectations of users about the auditors responsibility to detect illegal acts. What assurances about compliance with laws and regulations do investors and regulators expect from the audit in accordance with GAAS?

Can the Auditor's Detection Responsibility be Expanded Outside of GAAS?

Expanding the responsibility of the auditor outside of GAAS is the approach that some regulatory agencies are currently taking or considering. As described above, laws and regulations are being developed that establish requirements for reports by auditors on the application of agreed-upon compliance procedures. This approach to expanding the auditor's responsibility would appear to be more effective and efficient than expanding the auditor's responsibility under GAAS. Regulators can contract for the level of auditing desired regardless of the effects of the laws or regulations on the entity's financial statements. Also, all expansions of audit requirements would go through normal legislative or administrative due process.

This regulatory market for compliance auditing would also appear to be a fruitful subject for research. The use of agreed-upon procedures as a method to contract for these services creates a unique market in which the user can contract for a specific level of auditing. It provides a new setting for examination of agency relationships.

Is There a Need to Expand the Auditor's Responsibility for Direct Reporting of Illegal Acts?

As indicated above, the auditor already has a limited responsibility to report illegal acts directly to regulators. Still, some regulatory agencies are re-

questing that auditors assume more direct reporting responsibility. As a part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the Secretary of the Treasury was instructed to study the feasibility of adopting regulations similar to those of England's Banking Act 1987. That act charges the U.K. accounting profession with the task of developing standards that define when the auditor should report management improprieties directly to the Bank of England. If auditors in the U.S. are required to communicate certain matters directly to regulators, how would this affect their relationship with management? Would it affect the level of communication between the two parties? These would also appear to be interesting research questions.

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