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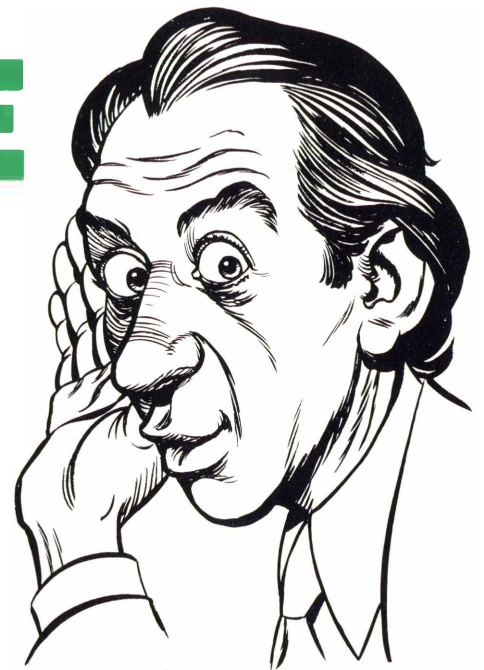
MUM'S THE WORD!



— OR IS IT? —

A Potential Conflict In Auditing And Legal Standards

By Danny L. Kennett and William J. Radig

The independent auditor's duty to disclose management misconduct to third parties is an extremely sensitive area involving both auditing standards and legal standards of conduct. It has been generally argued that the auditor's duty to disclose ended when the auditor notified the client of management misconduct and subsequently withdrew or disassociated himself or herself from the client [Chazen, Miller, and Solomon, pp. 66-70]. Proponents of this argument contend that silent withdrawal is a privilege of the auditor/client relationship and is necessary because of the auditor's unique relationship between a client and the public. Moreover, it has been pointed out that there is no basis in generally accepted auditing standards or legal theory to suggest that anything other than silent withdrawal is appropriate. While, under certain circumstances, the auditor may be legally justified in disclosing misconduct to third parties, the auditor is not legally obligated to blow the whistle.

SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, one of the "expectation gap" pronouncements, generally endorses the silent withdrawal argument. It states, in part [paragraph 29]:

Disclosure of irregularities to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and would be precluded by the auditor's ethical or legal obligation of confidentiality unless the matter affects his opinion on the financial statements. The auditor should

. . . there is no basis in generally accepted auditing standards or legal theory to suggest that anything other than silent withdrawal is appropriate.

recognize, however, that in the following circumstances a duty to disclose outside the client may exist:

a. When the entity reports an auditor change under the appropriate securities law on Form 8-K
b. To a successor audit or when the successor makes inquiries in accordance with SAS No. 7, . . .
c. In response to a subpoena
d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing irregularities with parties outside the client.

The Statement clearly proscribes disclosures to third parties other than those specifically mentioned and cautions the auditor to consult legal counsel prior to notification of such parties. In short, unless otherwise directed by auditing standards, the auditor should remain silent upon withdrawal. Apparently, this policy is required, in part, by the auditor's "legal obligation of confidentiality."

Nevertheless, the auditor may, under certain circumstances, have a legal obligation to disclose management misconduct to third parties other than those specified in SAS No. 53. Causey [1986, p. 1-11] notes that a "relatively new line of court decisions is moving accountants and other professionals to a standard of conduct involving *mandatory disclosure of client misconduct*." Accordingly, he cautions [p. 7-5]: "Where the CPA learns that the client is misleading or attempting to mislead others, the CPA should consult legal counsel as to whether the factual setting permits withdrawal in silence."

Emerging Legal Standard of Conduct

Although SAS No. 53 is authoritative and provides explicit guidance concerning silent withdrawal stemming from management misconduct, its comfort may be more apparent than real. While courts consider a profession's accepted standard of conduct, they clearly are not bound formally or informally by that standard. Moreover, common law is subject to modification, revision, interpretation, and rejection by courts over time. Consequently, auditors should be aware of emerging legal standards of conduct that may conflict with or extend the profession's standards.

Tarasoff v. Regents of University of California and *Fund of Funds, Ltd. v. Arthur Andersen & Co.* are two cases in the "relatively new line of court decisions" Causey notes. In *Tarasoff*, a psychotherapist, during therapy, was informed by a patient of his intent to murder a person whose identity was readily

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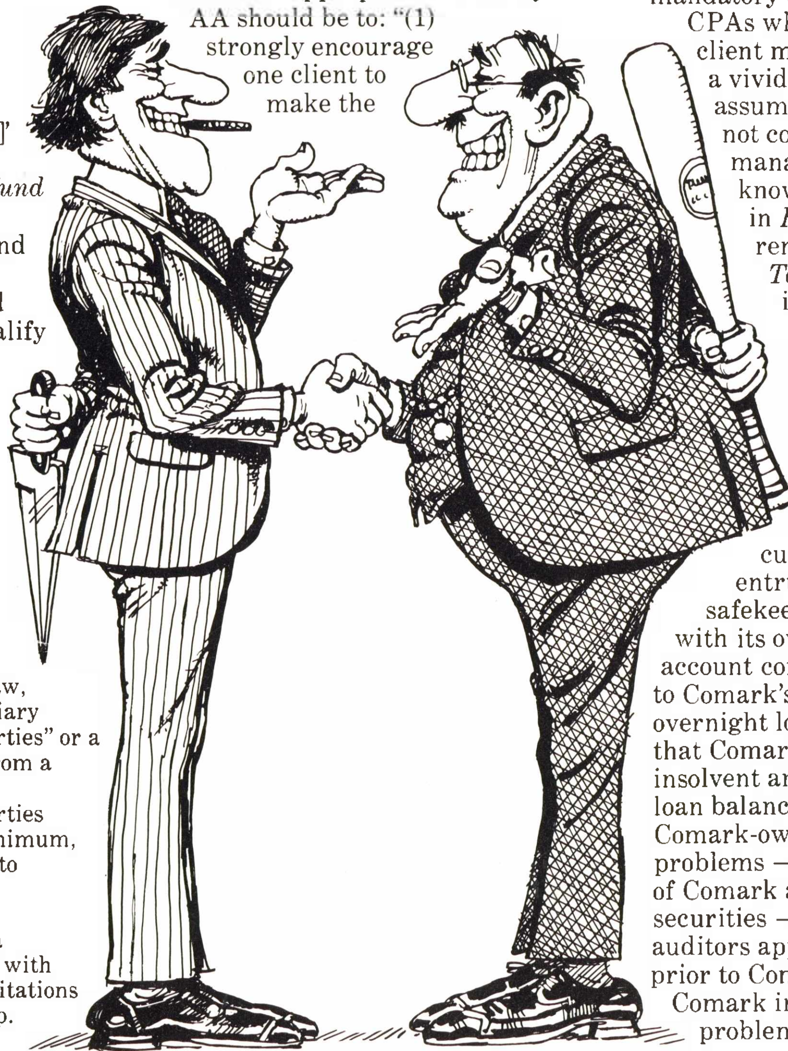
determinable. The victim was not warned, and the threat was carried out by the patient. The victim's parents sued. The court noted the need for, and protection of, the confidential psychotherapist-patient relationship. The court also noted the common law rule that one person does not have a duty to warn those endangered by another's conduct except when the person stands in some special relationship to the perpetrator and/or the intended victim. However, the court held that the psychotherapist owed a higher legal duty to inform the victim of the imminent danger than to maintain the patient's threats in confidence.

Causey also cites *Fund of Funds* in his discussion of recent court decisions, yet the implications of this case remain somewhat ambiguous because there was no

third party and the CPA firm was associated with materially misstated financials. The *Fund of Funds* case involves three parties: the King group of companies (King), Fund of Funds (FOF), and the CPA firm of Arthur Andersen & Co. (AA), who was the external auditor for both King and FOF. Briefly, FOF entered into an agreement with King, whereby King was to advise FOF on the purchase of oil and gas properties and sell such properties to FOF at "arm's length" prices from its own inventory. However, King's relationship was described in the minutes of a Board of Director's meeting as 'essentially a discretionary account managed by [King]' and by AA as a 'quasi fiduciary' duty to FOF." [*Fund of Funds*, p. 1334]. In fact, King frauduently sold oil and gas properties at inflated prices to FOF. AA detected the practice but did not qualify its reports on the financials of King or FOF nor inform FOF of the fraud. The court explained that failure to disclose material information may be a basis for fraud:

> Non-disclosure of material information, or omissions to disclose matter necessary to make other representations not misleading, are also actionable under common law, provided "there was a fiduciary relationship between the parties" or a duty of disclosure arising from a "relationship of trust and confidence" between the parties [citations omitted]. At a minimum, a claim of fraud for failure to disclose may be based on defendant's knowledge that plaintiff was acting under a reasonable, mistaken belief with respect to a material fact [citations omitted] [*Fund of Funds*, pp. 1359 and 60].

The court held that AA failed to disclose King's fraud to FOF "despite a professional duty and an express contractual obligation to do so." [*Fund of Funds*, p. 1360] AA's engagement letter to FOF provided that *"any irregularities coming to our attention would be reported to you immediately"* [*Fund of Funds*, p. 1327]. The court also rejected AA's claim that its knowledge of King's activities was confidential information. Even if the information was confidential, the court, citing expert testimony, noted that appropriate action by AA should be to: "(1) strongly encourage one client to make the necessary disclosure; (2) disclose that it has relevant information not available to the other client; or (3) resign from one account" [*Fund of Funds*, p. 1361]



First Fed. Sav. & Loan v. Oppenheim, Appel. Dixon

Does the auditor have a duty to warn the victims if there is imminent danger of financial loss to known third parties? Although *First Federal* does not establish precedent, it clearly reveals the court's predisposition to enforce a mandatory disclosure standard for CPAs who become aware of client misconduct. It is also a vivid example of the risks assumed by a CPA who does not consult legal counsel when management misconduct is known. The factual setting in *First Federal* is remarkably similar to *Tarasoff*. Both cases involve defendents having professional confidentiality relationships and third party victims. In *First Federal*, the auditors were informed by their audit client, Comark, that its customer-owned securities, entrusted to Comark for safekeeping, were comingled with its own securities in an account controlled by and pledged to Comark's bank/clearing agent for overnight loans. The auditors knew that Comark was technically insolvent and that the overnight loan balance exceeded the value of Comark-owned securities. Both problems — the financial difficulties of Comark and the comingling of securities — were known by the auditors approximately a year prior to Comark's collapse. When Comark informed its bank of both problems, the bank immediately

It is obvious that CPAs should consult their own legal counsel to determine if the factual setting permits withdrawal in silence.

foreclosed on the loan and liquidated all securities held in the pledged account. This event occurred approximately five months after Comark's year-end. However, financial statements, at least statements with which the auditors were associated, were never issued.

Plaintiffs — customers who lost their securities entrusted to Comark for safekeeping — alleged two negligent misrepresentations by the auditors. First, with knowledge to the contrary the partner-in-charge verbally assured a Comark salesperson that there should be no problem with the year-end financials.

Second, customer-owned securities held in "safekeeping" by Comark were confirmed directly with the customers in two separate mailings as part of the year-end audit procedures. Customers were requested to "please confirm directly to our auditors . . that the attached statements are a complete and accurate record of . . . all securities we are holding for you in safekeeping," which the courts viewed as "impliedly, but effectively representing that the writer or sender believes the securitiese are indeed being held in safekeeping" [*First Federal* p. 436]. Plaintiffs argued the confirmations were "*affirmative* negligent misstatements of fact" by the auditors rather than a failure to disclose certain facts.

The oral misrepresentation had little, if any, effect on the court's decision. The second alleged misrepresentation formed the crux of the case. The court held: "Certainly, once [the CPA firm] communicated with the plaintiffs, it owed them a duty to speak truthfully" [*First Federal*, p. 435]. In addition, the *First Federal* court [p. 434] held that the confirmations were "financial reports" in applying the *Credit Alliance* criteria. Under a complex web of legal theories, the auditors were successfully sued for violations of RICO, common law negligence, and common law fraud.

Could liability have been avoided if the auditors had withdrawn from the engagement in silence before direct confirmations were mailed to the customers? The court did not have to address this question, nor did it have to address the auditor's defense that they owed a "higher legal duty" not to disclose detrimental information obtained in the confidential auditor-client relationship. Nevertheless, the court chose to comment on the confidentiality issue. Its comment makes it clear that in the court's view, it was the auditor's duty to disclose at some point in time prior to the direct confirmations.

> It should be noted moreover that given the allegations of [the auditor's] awareness of Comark's insolvency, Comark's fraudulent hypothecation of its customers' securities, and the immediate danger of devastating financial losses plaintiffs risked by continued association with Comark, [the auditors] may well have had a duty to disclose. It is an accepted proposition in the area of common law fraud that a claim for deceit based on a failure to disclose may be based on a defendant's knowledge that a plaintiff was acting under a reasonable, mistaken belief with respect to a material fact (citations omitted) [*First Federal*, p. 435, note 7].

Does the auditor have a duty to warn the victims if there is imminent danger of financial loss to known third parties?

Immediate danger and imminent danger, like other legal and auditing concepts, defy precise definition. In *First Federal*, Comark's severe financial difficulties, unless corrected, assured third party losses: either the customers would lose their securities or Comark would default on its loan.

There is one final aspect of this case that merits mention. The CPA firm was clearly aware of a legal hazard. However,instead of consulting their legal counsel, they consulted and apparently relied upon the advice of Comark's counsel. Subsequently,the CPA firm brought suit against Comark's legal counsel [*First Fed. Sav. & Loan v. Oppenheim, Appel, Dixon*, 634 F. Supp. 1341 (S.D.N.Y. 1986)]. This action is still unresolved.

Summary and Conclusions

New auditing standards and emerging legal standards of conduct may be on a collision course regarding withdrawal in silence when management misconduct is involved. SAS No. 53 categorically states that disclosure to outside parties "would be

precluded by the auditor's ethical or legal obligations of confidentiality" unless the auditor is associated with financial statements and other specific circumstances. In contrast, a relatively new line of court decisions suggests that auditors may have an affirmative duty to disclose client misconduct when identifiable third parties are in imminent or immediate danger of devastating financial loss.

It is obvious that CPAs should consult their own legal counsel to determine if the factual setting permits withdrawal in silence. *First Federal* also demonstrates that CPAs should consult their own legal counsel before communicating either directly or indirectly with third parties who are or may be affected by management misconduct.

SAS No. 53 may have little impact on the profession, other than to raise a flag of caution. Auditors who find themselves pondering their duty to disclose management misconduct will be influenced more by the advice of their attorneys than by advice offered in the professional standards. Perhaps this is the way it should be in the matters of errors and irregularities, since litigation is both probable and prevalent in such matters.

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