

Detecting and Preventing Financial Statement Fraud: The Roles of the Reporting Company and the Independent Auditor

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The bankruptcies or near failures of such organizations as Penn Square Bank, E.S.M. Government Securities, and Continental Illinois Bank have renewed interest in the problem of financial statement fraud—the deliberate issuance of misleading financial reports. During 1985 and 1986, the House Energy and Commerce Subcommittee on Oversight and Investigations conducted 16 hearings¹ in an attempt to uncover the reasons behind this recent wave of so-called audit failures.² These hearings have prompted heated debate about the proper roles of the reporting entity and the independent auditor in detecting and preventing financial statement fraud.

Financial statement fraud directly harms the shareholders and creditors of the issuer of a fraudulent financial report, since they stand to lose all or part of their investments if such fraud results in a bankruptcy or near failure. Fraudulent financial reporting also can have a significant impact on the public's confidence in the integrity of the financial reporting system. Decreased public confidence in the reliability of financial information affects all financial statement issuers, since investors and creditors will demand higher rates of return in the face of greater uncertainty about the accuracy of financial reports.

Before evaluating the proposed solutions to this problem, it is helpful to determine how widespread financial statement fraud has become. Unfortunately, no precise method to measure the inci-

1. 132 Cong. Rec. E2986 (daily ed. Aug. 15, 1986) (statement of Rep. Wyden) [hereinafter Wyden]. In addition, the Oversight and Investigations Subcommittee held hearings on July 10, 22, and 27, 1987.

2. An "audit failure" occurs when a company experiences serious financial difficulties soon after receiving an unqualified opinion by the independent auditor that the company's financial statements are accurate. See Berton, *Self-regulation by Accountants Divides Industry*, Wall St. J., June 20, 1986, at 21, col. 2.

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dence of such fraud has been developed.³ The conventional measurement is the proportion of audits that result in litigation alleging financial statement fraud.⁴ Although 50,000 audits were performed over a recent five-year period, just over 100 lawsuits were filed alleging audit failure.⁵ These figures suggest that about 99.8% of all audits are free of financial statement fraud.

While chairman of the Securities and Exchange Commission (SEC), John S. R. Shad concluded that “[t]he evidence concerning alleged audit failures suggests that the system is working well.”⁶ Shad noted that auditing firms that are members of the SEC Practice Section of the American Institute of Certified Public Accountants (AICPA) must report any allegations of audit failure made in connection with a filing prepared for the SEC.⁷ Since this requirement was initiated in 1979, only 176 such cases have been reported, less than one percent of the audits performed during that period.⁸

The frequency of litigation alleging financial statement fraud, however, provides only an imprecise measurement of the actual occurrence of such fraud. This measurement, by definition, is under-inclusive, because it does not include the *unlitigated* instances of fraudulent financial reporting. It is also over-inclusive, since an *allegation* of financial statement fraud does not mean that such fraud actually occurred. Because the number of alleged frauds has been quite small in relation to the thousands of financial statements issued each year, the actual level of fraud is unlikely to be of crisis proportion, as some insist.⁹

3. See Elliott & Jacobson, *Detecting and Deterring Financial Statement Fraud*, Corp. Acct., Fall 1986, at 34 (“the study of financial statement fraud is plagued by inadequate measurement techniques. . .”); SEC and Corporate Audits (Part 6): Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce on Detecting and Disclosing Financial Fraud, 99th Cong. 2d Sess. 293 (1986) [hereinafter Hearings] (“ . . . the Commission has been unable (and is unaware of any study that has been able) to quantify the nature and impact of such fraud.”) (statement of John S.R. Shad, Chairman, Securities and Exchange Commission).

4. Elliott & Jacobson, *supra* note 3, at 35.

5. Price Waterhouse, *Challenge and Opportunity for the Accounting Profession: Strengthening the Public’s Confidence* (1985).

6. Hearings, *supra* note 3, at 292.

7. *Id.* Such reporting is made to the Professional Oversight Board. See *infra* note 12 for a description of the SEC Practice Section and the Professional Oversight Board.

8. *Id.*

9. See, e.g., Wyden, *supra* note 1, at E2987 (statement by Rep. Wyden characterizing financial statement fraud as a “glaring problem” and noting that “[a]lthough the vast majority of business persons and auditors are honest, responsible citizens, there is no question that a growing minority are trying to skirt or ignore our laws and take improper advantage of our citizens.”)

Nevertheless, even a small amount of such fraud can affect both investors and creditors of the financial statement issuer as well as confidence in the financial reporting process in general. Public confidence depends both on the actual incidence of financial statement fraud and on the public's *perception* of the amount of such fraud taking place. Thus, even if the actual level of financial statement fraud is low, investors may *perceive* that a problem exists, making some action necessary to enhance investor confidence in the reporting system.

This Current Topic considers proposals from three of the most influential actors in the debate on financial statement fraud: Congress, Price Waterhouse, and the National Commission on Fraudulent Financial Reporting. Part I provides a brief summary of the proposed reforms. Parts II and III evaluate aspects of these proposals that concern the responsibilities of the reporting company and the duties of the independent auditor. Part IV analyzes those suggestions in the proposals that relate to the accounting profession's quality control program. Finally, the Current Topic recommends the cost-effective action needed to combat the problem of financial statement fraud.

Because the available data indicate that the actual incidence of such fraud is low, much of the suggested action focuses on promoting public confidence in the financial reporting system rather than making costly structural changes. Primary emphasis is placed on enhancing the competence and independence of the internal audit staff and increasing the severity of sanctions imposed on the perpetrators of fraudulent financial reporting. Because the independent auditor is already subject to effective market constraints and to considerable legal duties, this Current Topic suggests that the public auditor's responsibilities should not be substantially increased.

I. Background

Concern over highly publicized audit failures has prompted several institutions to examine the problem of financial statement fraud. The proposed solutions of Congress, Price Waterhouse, and the National Commission on Fraudulent Financial Reporting, which have received the most attention, are examined below.

A. Congressional Activity

For the second time in ten years, the accounting profession has been the subject of intense congressional scrutiny. In early 1976,

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following disclosures of audit failures and questionable corporate payments to foreign governments, Congress examined the federal government's role in setting accounting standards and criticized the profession's standard-setting procedure as lacking due process and public participation.¹⁰

The profession quickly responded to these congressional concerns. The Financial Accounting Standards Board (FASB) altered its standard-setting procedure in 1977 to provide greater public access.¹¹ In addition, the AICPA reorganized, creating a new Division for CPA Firms, comprised of the SEC Practice Section (SECPS) and the Private Companies Practice Section (PCPS). The AICPA also established an oversight board with public representation to monitor peer reviews of firms that are members of the SEC Practice Section.¹² The profession then convinced Congress to refrain from interfering with this self-regulatory program.¹³

In the early 1980s, however, several large businesses and financial institutions experienced serious difficulties unforeseen by their independent auditors.¹⁴ Many members of the public believed that the auditors should have been aware of the problems and should have provided an appropriate warning to investors.¹⁵ In 1986, Representative Ronald Wyden, a member of the House Energy and Commerce Subcommittee on Oversight and Investigations, re-

10. See Moran & Previts, *The SEC and the Profession, 1934-84: The Realities of Self-Regulation*, J. Acct., July 1984, at 74, 76.

11. *Id.* at 76.

12. In addition to the SEC Practice Section (SECPS), the AICPA also established the Private Companies Practice Section (PCPS). Membership in either section is voluntary. The SECPS is designed for CPA firms that audit SEC registrants, and its membership requirements include: (1) members must report disagreements with management about accounting, auditing, or disclosure matters to the client's audit committee; (2) a member firm must assign a new audit partner to be in charge of an audit if another partner has been in charge for a period of seven consecutive years; (3) each professional in the member firm must have 120 hours of continuing professional education every three years; and (4) each member firm must submit to peer reviews, in which another firm or a team of AICPA officials evaluates the firm's quality control system, at least once every three years. The peer review results must be made available to the public.

The AICPA has set up a special committee, the Professional Oversight Board, made up of respected individuals largely from fields other than accounting, to monitor the activities of the SECPS. For a more detailed description of the SECPS, see A. Arens & J. Loebbecke, *Auditing: An Integrated Approach* 20-23 (3d ed. 1984); Kunitake & Dermish, *The AICPA's Peer Review Program: Implications for Bankers*, J. Com. Bank Lending, July 1985, at 57-61.

13. Price Waterhouse, *supra* note 5, at 5.

14. Among the most notable organizations to experience such difficulties were: Continental Illinois Bank, Penn Square Bank, United American Bank, Frigitemp Corp., E.S.M. Government Securities, Drysdale Government Securities, and O.P.M. Leasing Services, Inc.

15. Price Waterhouse, *supra* note 5, at 6.

sponded to these concerns by introducing H.R. 5439.¹⁶ This bill proposed that the independent auditor be responsible for uncovering only that fraud which has a material effect on the accuracy of the financial statements.¹⁷ H.R. 5439 also would have required the auditor to report a discovered error or irregularity to governmental authorities if the issuer failed to correct and report the problem within 90 days. In addition, the bill mandated that management set up adequate internal administrative controls¹⁸ and periodically evaluate these controls. The bill also proposed that management be required to evaluate the internal accounting controls mandated by the Foreign Corrupt Practices Act of 1977.¹⁹

B. Price Waterhouse Proposal

In response to the renewed congressional interest in the accounting profession, Price Waterhouse, a "Big Eight" public accounting firm, published a comprehensive position paper on financial statement fraud in late 1985.²⁰ The paper recommends attacking financial statement fraud by revising auditing standards and changing the structure and organization of the accounting profession.

Price Waterhouse suggests changing auditing standards to require the independent auditor to perform two new duties: (1) to review and evaluate internal management controls (regardless of

16. H.R. 5439, 99th Cong. 2d Sess., 132 Cong. Rec. E2986 (daily ed. Aug. 15, 1986). H.R. 5439 is a revised version of the Financial Fraud Detection and Disclosure Act (H.R. 4886), which was introduced by Rep. Wyden in May 1986. At the time this article went to press, no legislation relating to financial statement fraud had been introduced in the 100th Congress.

17. H.R. 4886 would have required the independent auditor to ferret out *all* fraud, no matter how material its effect on the financial statements. The SEC and accounting and business leaders criticized H.R. 4886 for its failure to provide a materiality standard. The SEC has estimated that failure to provide such a standard could increase audit fees three to four times present levels, not including the costs associated with increases in auditor liability (such as insurance costs) and the additions to SEC and Justice Department enforcement budgets needed to investigate reported violations. *See* Hearings, *supra* note 3, at 300-01. Auditors simply do not have the training needed to identify all illegal or irregular activities. They have limited legal expertise and would thus have difficulty in identifying violations of regulations in such areas as health and safety and the environment. *Id.* A materiality standard is, therefore, an essential part of any cost-effective solution to the problem of financial statement fraud.

18. Auditing standards distinguish between "administrative controls" and "accounting controls." Administrative controls are defined as including, but not limited to "the plan of organization and the procedures and records that are concerned with the decision processes leading to management's authorization of transactions." Accounting controls are defined as "the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records" Price Waterhouse, *supra* note 5, at 25.

19. 15 U.S.C. § 78m(b)(2)(B) (1982).

20. Price Waterhouse, *supra* note 5.

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whether the auditor relies on such controls in determining the scope of auditing procedures); and (2) to examine the company's business environment for symptoms of potential financial statement fraud. In addition, Price Waterhouse suggests that the accounting profession's quality control system be placed under the auspices of a statutory self-regulatory organization.

C. The National Commission on Fraudulent Financial Reporting

The National Commission on Fraudulent Financial Reporting (NCFRR) was formed in the summer of 1985 in order to gain deeper insight into the problem of financial statement fraud. The six-member Commission and its staff is sponsored and funded by the AICPA, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants.²¹ The NCFRR, commonly known as the Treadway Commission,²² has made a number of proposals designed to combat fraudulent financial reporting. These proposals, summarized in a report released in April 1987, focus on the reporting company, the independent auditor, enforcement objectives, and education.²³

II. Responsibilities of the Reporting Company to Detect and Prevent Financial Statement Fraud

Many proposals have placed primary emphasis on the role of the independent auditor in deterring financial statement fraud. However, a close examination of the problem suggests that real reductions in fraud can best be accomplished by focusing on persons within the reporting entity itself. This Part examines the role of the reporting company in detecting and preventing fraudulent financial reporting.

21. See Treadway, Krogstad & Sunderland, *Financial Reporting and Public Confidence, Corp. Acct.*, Fall 1986, at 4-5.

22. The NCFRR is chaired by James C. Treadway, a securities lawyer and former SEC Commissioner.

23. National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting (Exposure Draft) (1987)* [hereinafter *Treadway Commission Report*]. Due to space constraints, I have only selected from the report what I consider to be the most interesting and relevant proposals for analysis in this Current Topic.

The Treadway Commission Report was discussed at the July 10, 1987, hearings of the House Energy and Commerce Subcommittee on Oversight and Investigations. Representative Wyden emerged from these hearings with several criticisms of the Report. See Berg, *House Reception Mixed to Accounting Report*, N.Y. Times, July 13, 1987, at D4, col. 5.

A recent Treadway Commission study of alleged frauds revealed that: (1) 66% of the alleged frauds involved upper-level management; (2) 87% of the frauds studied were perpetrated through the use of misleading financial information (e.g., overstatement of assets or improper revenue recognition) rather than actual theft of corporate assets; and (3) in 45% of the cases examined, the SEC alleged that the fraud resulted from a breakdown in internal controls.²⁴ In light of these findings, many of the Commission's recommendations are aimed at ensuring that internal controls are instituted and monitored. H.R. 5439 also focuses on strengthening the reliability of the reporting entity's internal control system.²⁵

Improving the reliability of the internal control system would yield great benefits by reducing the incidence of internal control breakdowns. A requirement that management maintain an adequate internal control system would thus be an important part of any effort to prevent and detect financial statement fraud.

A. *Expanding the Internal Audit Function*

The internal auditor is an often overlooked actor in the financial reporting process. The NCFRR, however, suggests that the SEC require all public companies to maintain an internal audit function and that this function be given an appropriate degree of organizational independence. Such autonomy is necessary to ensure that the internal audit staff can effectively monitor the preparation of financial statements. In order to achieve this independence, the Treadway Commission would require the chief internal auditor to report to the chief executive officer or to a senior financial officer who is not directly involved in preparing the financial statements.²⁶ Moreover, the Commission would give the chief internal auditor direct access to the audit committee, so that he or she could report any fraudulent reporting uncovered.²⁷

Two studies by the Institute of Internal Auditors indicate that independent auditors are increasingly relying on the work of internal auditors, particularly in the audit of computerized systems. These studies conclude that the effectiveness of internal auditors in

24. Treadway Commission Report, *supra* note 23, at 116. The study examined 119 actions brought by the SEC against public companies and 42 SEC actions brought against independent auditors between July 1, 1981, and August 6, 1986.

25. See *supra* notes 18, 19 and accompanying text.

26. Treadway Commission Report, *supra* note 23, at 34.

27. *Id.*

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preventing and detecting fraud can be improved through “enhanced organizational status and professionalism.”²⁸

Since the internal auditors can directly monitor internal control adequacy and financial statement preparation, the Treadway Commission correctly characterizes their role as helping to provide “the first line of defense against fraudulent financial reporting.”²⁹ Thus, requiring all public companies to maintain an internal audit function should reduce the incidence of such fraud. The NCFRR’s suggestion to have the chief internal auditor report directly both to a top officer not involved with the preparation of the financial statements and to the audit committee would help ensure that the internal audit group will be an effective monitor of the financial statement preparation process, free of coercion from potential perpetrators of fraudulent reporting. In addition to these reforms, professional certification of internal auditors should be required and increased emphasis should be placed on the development of, and adherence to, internal auditing standards.³⁰ This will help to ensure that internal auditors have sufficient technical competence to provide an effective “first line of defense.”

B. Requiring Companies to Maintain Vigilant Audit Committees

A recent Treadway Commission study revealed that 31% of the companies involved in actions brought by the SEC since 1980 did not have an audit committee.³¹ Thus, the absence of such a committee may help to encourage fraudulent financial reporting. Publicly held corporations should be required to have audit committees.³² A vigilant audit committee can effectively monitor the internal control system.³³ A committee that is readily accessible to the internal audit staff should help to detect and prevent breakdowns in this system.

28. Initial Conclusions of the National Commission on Fraudulent Financial Reporting, Fed. Sec. L. Rep. (CCH) ¶ 84,035, at 88,285 (Oct. 29, 1986) [hereinafter cited as Treadway Commission Initial Conclusions].

29. *Id.* at 88,286.

30. The Institute of Internal Auditors (IIA) has granted certification for internal auditors since 1974. Certification, however, has never been required. Adherence to IIA standards is also not required. Elliott & Jacobson, *supra* note 3, at 39.

31. Treadway Commission Report, *supra* note 23, at 116. See *supra* note 24 for a description of the data examined in the study.

32. Treadway Commission Report, *supra* note 23, at 35. The Treadway Commission would require such committees to be made up solely of independent directors.

33. The problem, of course, is assuring that the audit committee will in fact be a vigilant monitor. See Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49, 62 (1982) (“casual evidence suggests that outside directors become friendly peers of their codirectors rather than inquisitive and pressing monitors”). The independent directors who are audit committee members might, how-

The Treadway Commission would require the chairman of the audit committee to include a report of the committee's activities over the past fiscal year in the annual report to shareholders.³⁴ In addition, the NCFRR has authored a set of practice guidelines for audit committees, designed both to advise the committee members and to alleviate the current director liability problem³⁵ by enabling members to assert compliance with the guidelines as a defense in litigation.³⁶

Since most companies already have such committees,³⁷ the costs of this proposal would not be great. In addition, the NCFRR practice guidelines should improve committee diligence and may help combat the problem of attracting quality directors.³⁸

C. *Other Suggested Duties of Management*

Although review and evaluation of internal controls play vital roles in the prevention of financial statement fraud, requiring management to express an opinion on internal control adequacy, as the Treadway Commission recommends,³⁹ would be an inefficient use of corporate resources. Management's crucial responsibility is to implement an effective system of internal controls. Since the independent auditor is already required to review and evaluate internal controls (at least to the extent that such controls are relied on in performing the audit), there is no need for management to duplicate this function. Public reporting by management on internal controls would not reduce the incidence of fraud and would do little to enhance public confidence, since most investors would likely be un-

ever, face reputational losses from mismonitoring which would exceed any direct benefits from such misbehavior. *See id.*

34. Treadway Commission Report, *supra* note 23, at 37.

35. *See* Lewin, Director Insurance Drying Up, N.Y. Times, Mar. 7, 1986, at D1 (Attracting quality directors is becoming more difficult due to the decreased availability of director liability insurance, a consequence of the large damage awards commonly being awarded in litigation against corporate directors.)

36. Treadway Commission Initial Conclusions, *supra* note 28, at 88,285.

37. *See* Acct. Series Release No. 296, [1937-1982 Acct. Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,318, at 62,939 (Aug. 20, 1981) (noting that in a 1980 survey of proxy statement information, 84% of the registrants surveyed had audit committees). *See also* Jenkins & Robinson, The Corporate Audit Committee, Mgmt. Acct., Dec. 1985, at 31-32. New York Stock Exchange rules require listed domestic companies to establish an audit committee made up solely of independent directors. The American Stock Exchange, the AICPA, and the SEC recommend, but do not require publicly owned companies to have audit committees. The SEC does, however, require a corporation to disclose whether or not it has an audit committee. *Id.* at 32.

38. Courts could use these guidelines to define a standard of care that would shield those directors who comply with the guidelines from liability in the event of a fraud, thereby reducing the risk of being a director.

39. Treadway Commission Report, *supra* note 23, at 39.

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able to accurately interpret the information included in such a report.

Moreover, the costs of a public reporting scheme could be quite high. In 1979, the SEC proposed that management report on the adequacy of internal accounting controls (in Form 10-K and in annual reports to shareholders) and that the auditor report on management's assessment.⁴⁰ A survey of 500 companies indicated that a management report on internal accounting controls would cost about \$94,000 per company per year.⁴¹

The NCFRR would also require management to acknowledge in the annual report its responsibilities for the accuracy of the financial statements and the adequacy of internal controls.⁴² Such an acknowledgement might help eliminate the perception that the independent auditor is an insurer of financial statement accuracy.⁴³ Without an accompanying change in the legal rules that define auditor liability, however, this acknowledgement would not deter a defrauded investor from suing the independent auditor. Thus, this proposal would do little to reduce the increasing exposure of auditors to crippling damage awards in litigation.

D. Increasing the Sanctions Imposed on Perpetrators of Financial Statement Fraud

Imposing more severe sanctions on the perpetrators of financial statement fraud might help reduce the incidence of such fraud. In a recent survey of financial executives, corporate secretaries, internal auditors, lawyers, and public accountants, 83% of those surveyed recommended that more severe penalties be assessed against the perpetrators of financial statement fraud.⁴⁴ The Treadway Commis-

40. Securities and Exchange Commission, SEC Roundtable: Financial Reporting and the Role of the Independent Auditor (1986) at 9 [hereinafter SEC Roundtable].

41. Hearings, *supra* note 3, at 304. The Financial Executives Institute conducted the survey. The Treadway Commission does suggest some ways to reduce this cost. The Commission recommends that, unlike the 1979 SEC proposal, management only report on "material matters about which stockholders reasonably should be informed." Treadway Commission Report, *supra* note 23, at 40. The Commission also notes that a report on internal controls would be more informative to investors if it is made part of a larger, comprehensive management report. *Id.*

42. Treadway Commission Report, *supra* note 23, at 39.

43. See Mednick, *The Auditor's Role in Society: A New Approach to Solving the Perception Gap*, J. Acct., Feb. 1986, at 70-72 (discussing the increasing gap between the auditors' stated objectives and users' perceptions of the purpose of the auditors' report.) Mednick points to a growing expectation that the auditor will give an early warning to investors when a client is making poor business decisions or is near financial ruin. *Id.* at 72.

44. Treadway Commission Initial Conclusions, *supra* note 28, at 88,286. The University of Southern California's School of Accounting conducted the survey.

sion recommends that those found to "cause, aid and abet, or participate in fraudulent financial reporting" be barred from corporate office.⁴⁵ While recognizing the severity of this penalty, the NCFRR points out that there is no reason to treat corporate perpetrators differently from independent auditors, who, pursuant to SEC Rule 2(e),⁴⁶ may be barred from practice before the SEC for violations of the securities laws. The Treadway Commission also advocates more criminal prosecutions and longer sentences for those who engage in financial statement fraud.⁴⁷

Barring the perpetrators of financial statement fraud from corporate office should reduce the incidence of financial statement fraud. Fines are usually used to punish the perpetrators of such fraud. Fraudulent financial reporting is, however, difficult to detect. As a result, optimal deterrence requires fines to be set at very high levels.⁴⁸ Since the effectiveness of fines depends in part on the asset levels of wrongdoers,⁴⁹ barring wrongdoers from corporate office can provide greater levels of deterrence than fines alone. One danger of adopting such a severe penalty is the possibility that innocent managers, fearful of being wrongfully suspected of engaging in fraud, may become more risk averse.⁵⁰ This concern, however, may not be well founded. Auditors, for example, are already subject to the threat of being barred from practice, and no one has seriously objected to the ill effects of this possibility on auditor behavior. In addition, if adequate due process protections are adopted to minimize the risk of error, and if the availability of such protections is publicized, innocent corporate officers are not likely to alter their behavior considerably.

III. Responsibilities of the Independent Auditor to Detect and Prevent Financial Statement Fraud

While most proposals have focused primarily on measures aimed at the independent auditor, it is questionable whether any substan-

45. *Id.*

46. 17 C.F.R. § 201.2(e) (1987).

47. Treadway Commission Initial Conclusions, *supra* note 23, at 88,286.

48. See generally A. M. Polinsky, An Introduction to Law and Economics 73-84 (1983).

49. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 57 (1986) [hereinafter Kraakman, Gatekeepers]; See also Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857, 867-68 (1984) [hereinafter Kraakman, Corporate Liability Strategies].

50. Kraakman, Gatekeepers, *supra* note 49, at 57. It is, of course, not in the shareholders' best interests for management to be too risk averse. In fact, shareholders, because they can hold diversified portfolios, prefer reasonable risk-taking by management. See Kraakman, Corporate Liability Strategies, *supra* note 49, at 862-63.

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tial increase in the independent auditor's duties would be cost-effective. The independent auditor is a "reputational intermediary,"⁵¹ subject to powerful market constraints.⁵² There is substantial evidence that concerns with preserving reputation play a key role in the market for auditing services.⁵³

Reputation, however, does have its limits as a constraint on auditor behavior.⁵⁴ Thus, the independent auditor also faces legal liability, which supplements market incentives.⁵⁵ Since accountants have always been subject to legal liability, the real issue is whether it is cost-effective to extend this liability by imposing more stringent legal duties on auditors. Extending these duties too far presents serious risks,⁵⁶ since the profession is already paying out hefty damage

51. A reputational intermediary is someone who is paid to verify the accuracy of another party's information. Gilson, *Value Creation by Business Lawyers*, 94 *Yale L.J.* 239, 289 (1984) [hereinafter *Gilson, Value Creation*], *citing* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 *Va. L. Rev.* 549, 604-07, 618-21 (1984). Lawyers and accountants often serve as reputational intermediaries. *Id.* at 290.

52. Kraakman, *Gatekeepers*, *supra* note 49, at 61-62 (classifying accountants as "market gatekeepers"). A "gatekeeper" is one who prevents misconduct by withholding support (such as certification of financial statements) that is necessary for the wrongdoing to succeed. *Id.* at 54. A "market gatekeeper" is a gatekeeper who faces "powerful private incentives to deter misconduct." *Id.* at 62. Accountants face strong market incentives to maintain their reputations by refusing to support fraudulent financial reporting.

53. Gilson, *Value Creation*, *supra* note 51, at 291 (companies about to go public often switch to a more reputable, Big Eight auditing firm), *citing* Benston, *The Market for Public Accounting Services: Demand, Supply and Regulation*, 2 *Acct. J.* 2 (1979), DeAngelo, *Auditor Size and Audit Quality*, 3 *J. Acct. & Econ.* 183 (1981).

54. Kraakman, *Gatekeepers*, *supra* note 49, at 96-100 (reputation can be a "noisy signal"). Investors do not usually observe the actual quality of the auditor's services; rather, they only observe the subsequent performance of the audited firm. Thus, investors may wrongly discount the reputation of an auditor where the audited firm fails for reasons which were beyond the monitoring responsibilities of the auditor. *See id.* at 97 (making this argument in the context of underwriters' activities).

In addition, if investors evaluate particular auditors in light of the average performance of all auditors and reevaluate all auditors in light of the unexpected performance of individual auditors, there can be serious free-rider problems. *See id.* at 98, *citing* Lynch, Miller, Plott, and Porter, *Product Quality, Informational Efficiency, and Regulations in Experimental Markets* at 60-61, 66-72 (unpublished draft on file with the author) [hereinafter *Lynch et. al.*]. Such free-rider problems limit the effectiveness of reputation as a constraint on auditors.

55. Kraakman, *Gatekeepers*, *supra* note 49 at 99 (gatekeeper liability superimposed on reputational incentives might improve enforcement efficiency). *But see id.* n. 118 ("[I]mperfect legal regulation might also impede the development of effective reputational controls.")

56. If increased legal duties make auditing services too expensive, use of such services might be reduced wherever legally permitted. *Id.* at 77 (tax shelter promoters reluctant to provide investor with tax opinions following increased regulation of such opinions).

Auditors might also refuse to accept engagements with risky firms in response to increased legal duties. *Id.*

awards⁵⁷ and is finding it increasingly difficult to attract quality personnel.⁵⁸ The discussion below outlines the appropriate role of the independent auditor in uncovering fraudulent financial reporting.

A. Examining Internal Controls

Current auditing standards require the independent auditor to test and evaluate internal controls only if he or she wants to rely on such controls to limit the number of substantive tests performed during the audit.⁵⁹ The auditor's review and evaluation of internal controls relate primarily to accounting controls. These controls bear directly on the reliability of the financial reporting system, which, unlike administrative controls, only have an indirect effect on financial statements.⁶⁰

Requiring auditors to review and evaluate all internal controls, as was proposed in H.R. 5439, would likely be cost-effective. While the additional costs that this requirement would impose are not certain, most audits already include a review and evaluation of internal accounting controls.⁶¹ By reviewing and evaluating internal administrative and accounting controls, the auditor would gain valuable insight into the organization and structure of the firm being audited.⁶² Joseph Connor, Chairman of Price Waterhouse, has suggested that the costs of an increased review of internal controls would be low, and he has heard positive feedback from senior financial personnel concerning the benefits of such a review.⁶³

It is not as obvious, however, that requiring auditors to publicly report on the adequacy of internal controls, as proposed in H.R. 5439, would be cost-effective. Some business and regulatory leaders believe that the benefits of such reporting would be significant

57. See, e.g., Yang, *Watching Pinocchio's Nose*, *Forbes*, Nov. 4, 1985, at 73 (Big Eight firms have paid out almost \$180 million in damages since 1980); Weiss, *Auditors Own Up to the Cost of Their Errors*, *Bus. Week*, Apr. 1, 1985, at 34.

58. Indeed, Dean John Burton of the Columbia Graduate School of Business believes that the increasing inability to attract quality personnel is the most serious problem facing the accounting profession today. *Crisis in Accounting: New Controls on the Profession*, *Corp. Acct.*, Fall 1986, at 15-16 [hereinafter *Burton*].

59. A. Arens & J. Loebbecke, *supra* note 12, at 270.

60. Price Waterhouse, *supra* note 5, at 25. Thus, under current auditing standards, the independent auditor need not review administrative controls, except where they are inseparable from accounting controls. *Id.* See *supra* note 18 for a description of accounting controls and administrative controls.

61. SEC Roundtable, *supra* note 40, at 8 (comment by J. Michael Cook, Chairman, AICPA).

62. The auditor should, however, only be required to review the internal controls for *material* weaknesses.

63. SEC Roundtable, *supra* note 40, at 9.

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and that the costs would not outweigh these benefits, while others argue that public reporting on the adequacy of internal controls “would be expensive, and of limited value.”⁶⁴ Current standards already require the auditor to report to management and the board of directors any material control weaknesses that he or she uncovers.⁶⁵ Such weaknesses may lead to an increase in the scope of audit tests or to a conclusion that the auditor cannot certify the financial statements.⁶⁶

The review, evaluation, and reporting required under current auditing standards go a long way to reduce the incidence of fraud. The only additional benefit of requiring public reporting would be any increase in investor confidence that such reporting might spur. Given the potential inability of many investors to accurately interpret such a report, however, such increases in confidence are likely to be small.

B. Reviewing the Client's Business Environment

In addition to requiring the independent auditor to review and evaluate internal controls, Price Waterhouse recommends that the independent auditor be required to examine a company's business environment for “symptoms” of financial statement fraud. The AICPA has developed a list of such symptoms, which includes: (1) a highly domineering senior management accompanied by either an ineffective board of directors or by compensation tied to reported performance; (2) deterioration of earnings quality, as evidenced by a decline in sales volume or quality or by excessive interest of senior management in the effect of accounting alternatives on earnings per share; and (3) business conditions that may create unusual pressures, such as inadequate working capital, major investment in a volatile industry, and debt restrictions with little flexibility (e.g., required working capital ratios and limitations on additional borrowings).⁶⁷ The AICPA also includes a list of sample audit procedures that can be used to test for each potential symptom of financial statement fraud.⁶⁸

Requiring the auditor to search for these red flags is an amplification of Statement on Auditing Standards No. 22 (SAS 22), which already requires the auditor to obtain “[a] reasonable understand-

64. *Id.* at 9-10.

65. *Id.* at 10 (comment by Joseph E. Connor).

66. *Id.*

67. Price Waterhouse, *supra* note 5, at 40-41.

68. *Id.* at 40-46.

ing of the client's business and industry"⁶⁹ and to consider "[c]onditions that may require extension or modification of audit tests. . . ."⁷⁰ The Price Waterhouse proposal gives meaning to this vague requirement by providing a checklist of procedures for auditors to consider performing if any symptoms of financial statement fraud are discovered. A comprehensive list of red flags would add specificity to the general language of SAS 22, thereby providing the kind of " 'fundamental guidance' " necessary to determine " 'when an auditor ought to begin suspecting fraud.' "⁷¹

While the costs of this proposal are uncertain, implementation of this recommendation would enable the auditor to acquire a deeper understanding of the risks and uncertainties facing a client. An auditor, however, might rely solely on the procedures included in the checklist and fail to consider the unique risks facing a particular client. Such an auditor might not employ additional tests needed to better evaluate the potential for financial statement fraud.

If the checklist is fairly comprehensive, however, this scenario is less likely. Use of this list of symptoms, coupled with the implementation of procedures to be employed when particular symptoms are present in the company's business environment, would also boost public confidence in the reliability and usefulness of audited financial statements, since investors would have a better idea of the extent to which the auditors had searched for symptoms of fraudulent activities.⁷² This proposal may, in addition, provide the basis for a more manageable standard of care against which to judge auditor performance in the event of litigation following an alleged financial statement fraud. In such litigation, the courts could define a standard of care that would shield from liability those auditors who performed the relevant checklisted procedures.⁷³

69. A. Arens & J. Loebbecke, *supra* note 12, at 151. Statements on Auditing Standards are official AICPA interpretations of the 10 generally accepted auditing standards and are designed to assist auditors in performing their duties. *Id.* at 13-15. All members of the auditing profession are required to adhere to these interpretations. *Id.* at 15.

70. Hearings, *supra* note 3, at 308, quoting SAS No. 22.

71. Yang, *supra* note 57, at 73 (statement by Professor D.R. Carmichael of Baruch College, member of a special AICPA task force set up in the summer of 1985 to examine the independent auditor's role in uncovering fraud.)

72. It appears that investors generally do not believe that audited financial statements provide very useful information. Mednick discusses a 1985 Louis Harris & Associates survey in which two-thirds of the respondents indicated that " 'qualitative information presented outside the financial statements, such as management observations, strategic plans and goals, market growth, etc., often can be more useful than qualitative measures included in the financial statements.' " Mednick, *supra* note 43, at 71.

73. See *supra* note 38 for a similar proposal to help alleviate the current director liability crisis.

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C. *Maintaining the Confidentiality of the Auditor-Client Relationship*

Any proposal that requires the independent auditor to report discovered errors or irregularities to governmental authorities is likely to foster the development of an adversarial relationship between client and auditor.⁷⁴ Such a requirement would encourage even honest clients to provide the auditor with less than complete disclosure out of fear that the auditor will suspect an illegal or irregular act and report his or her suspicions to the enforcement authorities.

Professor Reinier Kraakman has described the ill effects of such a “whistleblower” strategy. He suggests some reasons that such extreme approaches are so rarely employed, noting “our deeply felt aversion to mandatory informing. . .” as well as the incentive of regulatory targets to withhold information from potential whistleblowers that could “transform whistleblowing into a game of anticipatory avoidance or discharge. . . .”⁷⁵ Indeed, even in *United States v. Arthur Young*, an opinion oft-cited for its dicta concerning the overriding duty of the auditor as a “public watchdog,”⁷⁶ the Supreme Court recognized the importance of encouraging full disclosure between auditor and client.⁷⁷ Any acceptable solution to the problem of financial statement fraud must preserve the confidentiality of this relationship.

D. *Increasing Educational Requirements*

Education can play a crucial role in reducing the incidence of fraudulent financial reporting. Accounting faculty at colleges and universities should place increasing emphasis on developing the analytical skills and sense of ethical awareness necessary to detect and prevent financial statement fraud.⁷⁸ As has been frequently suggested, undergraduate accounting curricula should be expanded

74. H.R. 5439 proposed that the auditor be required to report a discovered error or irregularity if, within a reasonable period not to exceed 90 days, the issuer fails to correct the problem and to report it to the appropriate authorities. This was a watered down version of a provision in H.R. 4886, which would have required the auditor to report any known or suspected illegal acts directly to the appropriate governmental authorities.

75. Kraakman, *Gatekeepers*, *supra* note 49, at 58-60.

76. *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984).

77. *Id.* at 821 (recognizing the importance of maintaining the confidentiality of the accountant-client relationship in order to encourage full disclosure, but finding interest in preserving confidentiality outweighed by particular interest of IRS in securing accountant's tax accrual workpapers, in light of broad discretion which Congress has granted to IRS to perform its duties of tax collection and assessment).

78. Treadway Commission Report, *supra* note 23, at 76. As the Treadway Commission points out, analytical abilities and ethical awareness are equally important to the development of competent business professionals. *Id.* Thus, these suggestions should

from four to five years.⁷⁹ This additional year would enable students to take a substantial amount of liberal arts coursework in addition to the more technical accounting courses, helping to ensure that future auditors will develop sound reasoning and efficient problem-solving skills. In addition to these changes at the university level, continuing professional education requirements should include courses that will further develop the analytical skills needed to uncover fraudulent reporting.⁸⁰

IV. *The Accounting Profession's Quality Control Program*

There has been considerable debate about the need for the accounting profession to restructure its quality control program in order to boost public confidence in the reliability of the independent audit. This Part examines both sides of the debate.

A. *A Proposed Statutory Self-Regulatory Organization*

The Price Waterhouse position paper recommends changing the organization and structure of the public accounting profession's quality control program. Price Waterhouse generally approves of the current peer review program, but notes that mere "fine tuning" of this system is not enough "to satisfy critics that the public's interest is being adequately served."⁸¹ At the same time, completely abandoning the program in favor of SEC regulation would needlessly waste the profession's investment in a peer review program that is largely effective.⁸² Furthermore, a recent study indicates that legal regulation can exacerbate enforcement inefficiency.⁸³

Price Waterhouse thus proposes a compromise solution in which much of the current quality control system would be placed under the auspices of a statutory SRO. Such an organization would enable governmental oversight within a system that would remain largely self-regulatory.⁸⁴ This proposal would require Congress to create a new membership association under the supervision of the SEC. All accounting firms practicing before the SEC would have to join this

be incorporated into the overall curricula of business schools and not only in the accounting curricula.

79. *Id.* at 80.

80. *Id.* at 81. The AICPA and the American Accounting Association are among the supporters of this proposal. *Id.*

81. Price Waterhouse, *supra* note 5, at 48.

82. *Id.*

83. Lynch et. al., *supra* note 54, at 71 (noting that improperly tailored legal regulation can hinder development of reputations of market participants).

84. Price Waterhouse, *supra* note 5, at 47-48.

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association, and the SEC would appoint a Board of Public Accountancy to govern the SRO and regulate its members.

The new Board of Public Accountancy would retain much of the substance of current SEC Practice Section and Public Oversight Board (POB) procedures. This new Board would have rule-making authority, subject to formal SEC oversight, over such areas as: nomination and election of board members to succeed the initial appointees; quality control, competence, and financial responsibility; disciplinary procedures; and admission to the new SRO. The Board of Public Accountancy would have disciplinary authority over member firms, subject to SEC review, and due process protections would be provided for all membership and disciplinary actions brought by the Board or reviewed by the SEC. Such disciplinary authority would include the power to impose sanctions for violation of Board rules. The sanctions would include expulsion; suspension; limitation of activities, functions and operations; fines; censure; and denial of SRO membership. The proposal would also preserve the confidentiality of information relating to particular audits, thereby creating a "Chinese Wall" between the SEC and the SRO.⁸⁵

This proposal to create a statutory SRO has been the subject of considerable discussion. Although the SEC has not yet reached a general conclusion as to the need for an SRO,⁸⁶ it has already expressed unanimous opposition to Price Waterhouse's specific proposal for a limited SRO that would maintain a veil of confidentiality between it and the Commission.⁸⁷ SEC Commissioner Aulana Peters noted that the SRO proposed by Price Waterhouse would "isolate the SRO from the SEC, contrary to the relationship the Commission has with other self-regulatory bodies."⁸⁸

John Burton, former SEC Chief Accountant and Dean of the Columbia University Graduate School of Business, has long been in favor of establishing a statutory SRO.⁸⁹ Burton disapproves of the current peer review program's wholly remedial focus. He believes that the public would have greater confidence in such a program if punitive actions were taken, punishing firms that have not performed up to par, rather than merely ensuring that necessary improvements in a firm's quality control system are instituted. In

85. *See id.* at 49-57 for a more detailed description of this proposal.

86. *Hearings, supra* note 3, at 312.

87. Grisdela, SEC to Oppose Bill That Forces Auditors to Report Possible Fraud by Their Clients, *Wall St. J.*, June 20, 1986, at 4, col. 3.

88. *Id.*

89. *See* Burton, *supra* note 58, at 19.

Burton's view, a statutory SRO is likely to be more effective in achieving this punitive focus.⁹⁰

The Treadway Commission has also studied the possibility of creating a statutory SRO to govern the profession's quality control efforts. The Commission notes that the functions of an SRO are to establish standards of professional or commercial conduct and to impose meaningful sanctions on members who violate such standards.⁹¹ It concludes that the profession's current peer review program, combined with the additional requirement of SECPS membership for all firms auditing SEC registrants, and a vigorous SEC that doles out appropriate penalties for those firms and individuals that perform at substandard levels, would obviate the need for an SRO.⁹² The Commission's conclusion is compelling; if the SEC is adequately funded and is willing to punish auditors who fail to comply with accepted performance standards, then adoption of an SRO would needlessly duplicate existing quality control functions.⁹³

B. Mandatory SECPS Membership

Public confidence in the financial reporting system can be increased as much, if not more so, by the SEC than by an SRO.⁹⁴ The self-regulatory peer review program, with a largely *remedial* focus, should not be considered in isolation; rather, it must be remembered that SEC enforcement actions and private litigation provide substantial opportunities for *punitive* sanctions to be assessed against wrongdoing auditors and auditing firms.⁹⁵ AICPA Chairman J. Michael Cook and others,⁹⁶ therefore, advocate retaining the current peer review program. They would, however, require that any firm practicing before the SEC be a member of the SEC Practice Section. Such mandatory membership would give the Public Oversight Board (POB), which governs the operation of the peer review program, greater leverage against SECPS member firms, since these firms could no longer opt out of the POB's jurisdiction without losing the opportunity to practice before the SEC. As a re-

90. SEC Roundtable, *supra* note 40, at 18.

91. Treadway Commission Initial Conclusions, *supra* note 28, at 88,288.

92. *Id.*

93. *Id.*

94. The SEC is already more visibly acknowledging such a confidence-building role in the insider-trading context. *See, e.g.,* Nash, Suddenly a Sleepy S.E.C. Is Wide Awake, N.Y. Times, Nov. 23, 1986, at E5.

95. SEC Roundtable, *supra* note 40, at 18. *See also* Hearings, *supra* note 6, at 311-12.

96. *See* Berton, *supra* note 2 (seven of the Big Eight accounting firms have urged the SEC to mandate SEC Practice Section membership for those firms that audit SEC registrants).

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sult, the public would have greater confidence in the effectiveness of the peer review program.

Mandatory SECPS membership might also lead to real reductions in fraudulent financial reporting. A recent Treadway Commission study of actions brought by the SEC against independent auditors revealed that 64% of the actions involved firms that were not members of the SECPS.⁹⁷ Thus, firms that are not SECPS members appear less likely to detect and prevent financial statement fraud than SECPS member firms.

Several of the approximately 800 (mostly smaller) non-SECPS member firms have severely criticized the peer review program, expressing concern about the cost-effectiveness of peer review.⁹⁸ According to AICPA data, however, the costs of this program are not excessive. Annual dues for SECPS membership are \$15 per professional staff member in the firm, but cannot exceed \$100 if the firm has less than five SEC registrants as clients.⁹⁹ The cost of a triennial peer review for a "small" firm (i.e., a firm with less than twenty professional staff members) averages between \$2,200 and \$6,000.¹⁰⁰ Given the relatively low costs of SECPS membership, along with the benefits of real reductions in the incidence of fraud and greater public confidence due to increased POB credibility, all firms auditing SEC registrants should be required to join the SECPS.

Conclusion

Seven cost-effective recommendations emerge from this analysis of the financial statement fraud debate:

First, companies should be required to institute sufficient internal management controls in addition to the current statutory mandate to implement internal accounting controls.

Second, increased attention should be placed on using the internal audit staff to prevent and detect financial statement fraud. The Treadway Commission has recognized the importance of enhancing the internal auditor's "organizational status and professionalism."¹⁰¹ The internal audit group should be independent of those involved in the financial statement preparation process and should

97. Treadway Commission Report, *supra* note 23, at 117. See *supra* note 24 for an description of the data examined in the study.

98. See Hearings, *supra* note 3, at 311. These firms have also expressed concern about the program's domination by larger firms. *Id.* See also Berton, *supra* note 2.

99. Hearings, *supra* note 3, at 311.

100. *Id.* The average cost of a peer review of a Big Eight firm is about \$800,000. *Id.*

101. Treadway Commission Initial Conclusions, *supra* note 28, at 88,285.

have unlimited, direct access to the audit committee. In addition, professional certification of internal auditors should be required, and increased emphasis should be placed on development of, and adherence to, internal auditing standards. In light of the independent auditor's increasing reliance on the internal auditor's work, it is important to take these steps to ensure that effective monitoring of financial statement preparation can take place.

Third, all publicly held corporations should be required to have audit committees. Such committees can provide effective monitoring of the internal control system as well as an important link to the internal audit staff.

Fourth, the sanctions imposed on perpetrators of financial statement fraud should be increased. Barring from corporate office those responsible for fraudulent financial reporting can provide greater levels of deterrence than fines alone, since the effectiveness of fines is limited by the net assets of wrongdoers. Appropriate due process protections should be instituted to minimize the chance of error and thus to prevent innocent managers from becoming too risk averse.

Fifth, while primary emphasis should be placed on improving the internal audit staff and stiffening the penalties imposed on perpetrators of fraudulent reporting, the independent auditor's duties must also be clarified. The independent auditor is an effective gatekeeper substantially constrained by concerns with maintaining his or her reputation in the market for auditing services. Reputation, however, does have its limits as a constraining force. As a result, the public auditor also faces legal liability for substandard work. If legal duties are made too strong, however, gatekeeping services may become prohibitively expensive or, alternatively, gatekeepers may quit.¹⁰² Because it is becoming increasingly difficult to attract quality people into the auditing profession and auditors are already being crippled by large damage awards in litigation, a clarification of current auditing standards is needed to avert these risks. Requiring the auditor to review and evaluate internal accounting and management controls is a low-cost way to ensure that the auditor has a proper understanding of the client's business environment and internal control system. Such an understanding is vital to the successful prevention and detection of fraudulent financial reporting.

In addition, the independent auditor should be required to monitor the client's business environment for any "red flags" that warn

102. See *supra* note 56.

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of potential fraud, and at least to consider performing relevant procedures designed to uncover such fraud. This requirement should enhance the likelihood of detecting fraudulent reporting. At the same time, it should also encourage courts to engage in a more deferential, procedural review of the independent auditor's performance, making it less likely that an auditor who complies with the requirement will be held liable for failing to uncover fraud.

Sixth, educational requirements should be stiffened to help ensure that the independent auditor has the analytical and ethical training to detect and prevent fraudulent reporting. Accounting programs at colleges and universities should be extended an additional year, and continuing professional educational programs should be designed to further develop the auditor's ability to uncover fraud.

Seventh, all firms auditing SEC registrants should be required to join the SEC Practice Section. This would give the Professional Oversight Board sufficient leverage over auditing firms to make the peer review program a more effective weapon against fraudulent financial reporting.

While financial statement fraud is a problem, it does not warrant wholesale restructuring of the accounting profession. Adoption of these cost-effective measures, combined with a vigilant and adequately funded SEC, will preserve the integrity of our financial reporting system.

