

FRAUD -- THE AUDITOR'S DILEMMA

An Honors Thesis (HONRS 499)

by

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PREFACE

The submission of this thesis fulfills the final requirements for graduation from the Honors College. This thesis represents the culmination of the honors program at Ball State University.

The primary objective of the honors thesis that follows is to allow the serious accounting student and prospective candidates going into the profession to develop a better understanding of the controversial issues facing the accounting profession, the current and future adversarial environment in which they will be operating, and recommendations for minimizing their susceptibility to litigation through the detection and prevention of irregularities. This thesis places primary emphasis upon the independent auditors' expanding role for the detection and prevention of fraud. Supplementary material has been provided in the "Appendices" for further review and development.

This thesis only provides the reader with a brief overview and analysis of the problems facing the accounting professional and is not meant to be comprehensive or all-inclusive. Therefore, it is recommended that the serious accounting student considering a career in public accounting do further research into the legal implications inherent within the profession itself before beginning their field of work. The purpose of the "discussion" that follows is only to make the reader cognizant, or aware, of the dilemma that has and will continue to challenge the accounting profession.

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INTRODUCTION

The accounting profession is an extremely high-risk practice area vulnerable to the atrocities of litigation. In effect, today's practitioners must be increasingly alert to the inherent risk of accountant's liability and be able to effectively cope with the litigious environment in which they operate. The recent adversarial atmosphere induced by the Savings and Loan Industry and the Chapter 11 Bankruptcy petitions of Laventhol & Horwath and Spicer & Oppenheim serve as painful reminders of the inevitability of the risk of accountant's liability.

Unfortunately, the independent auditor has become the scapegoat for numerous business failures. In modern-day society, the independent auditor has the highest probability of incurring a lawsuit invoked by the creditors and investors of an insolvent business. This condition coincides with the "deep pocket" theory which focuses upon a party's ability to pay rather than who is actually responsible for the financial failure. "[B]ecause the independent auditor is still financially solvent and has good malpractice insurance, he or she is the 'fairest' of all fair game" (Broom and Brown 1991, 31). Nevertheless, deeply embedded beneath this predicament is a far more perplexing problem -- the inability of lawmakers, the legal system, the public, and the profession to reach a consensus as to the independent auditor's role in the detection and reporting of financial management fraud (Swanberg 1988, 7).

The purpose of this paper is to develop a better understanding of the various aspects of fraud, its impact on the

accounting profession, and measures for its detection and prevention. In accomplishing these objectives, it will be necessary to explore the controversy between the auditor's professional responsibility as understood by the profession relative to public opinion, the legal system, and other external forces in regards to the detection of fraud.

THE AUDITOR'S PROFESSIONAL RESPONSIBILITY

The "Expectation Gap"

The real challenge confronting the accounting profession that serves as the primary impetus for the auditor's expanding role in the detection of fraud is the public's perception and expectations of the profession. According to Joseph E. Connor in his article "Close Accounting's Confidence Gap" published on December 3, 1985 in The Wall Street Journal, these expectations are divided into three categories: 1. While the Securities and Exchange Commission (SEC), the courts, the profession, and members of Congress, initially, envisioned the auditor's primary responsibility as one of preventing the fraudulent reporting of financial statements, public opinion extended the scope of this role to include the detection and disclosure of fraudulent financial reporting; 2. Furthermore, the public expected the auditor to forewarn them of any "impending business failure," thus, explaining the frequent association of a business failure with an audit failure; and 3. Finally, public opinion also contended that "the profession's peer-review process [would] prevent substandard audit performance and mete out swift punishment if it occur[red]" (Berton and Schiff 1990, 54-5).

In essence, "[i]ndependent accountants facilitate the efficient operation of the nation's capital markets by developing public confidence in the credibility and reliability of corporate financial information" (Goldstein and Dixon 1989, 439). As a result, public confidence in the accounting profession coincides with its confidence in business, therefore, making them inseparable. Much to the dissatisfaction of the public, however, an audit is only designed to provide "reasonable assurance" as to the reliability of corporate financial statements through the application of generally accepted auditing standards (GAAS) to insure that the statements are "presented fairly in accordance with generally accepted accounting principles (GAAP)" (Goldstein and Dixon 1989, 441).

During the mid-1970s and again in the mid-1980s, in reaction to public discontent and a precipitous "series of large-scale business failures and disclosures of egregious fraud", Congress engaged in critical scrutiny of the accounting profession, threatening to impose a legislative resolution to the problem (Goldstein and Dixon 1989, 440). In an attempt to deter the passage of "remedial legislation," the SEC and the accounting profession adopted more stringent professional standards for the detection and disclosure of fraudulent financial reporting and disciplinary action to enforce the standards.

The adoption of SAS Nos. 16, 17, and 20 in 1977 by the AICPA's Auditing Standards Board ("ASB") was a direct result of an attempt by the profession to mitigate legislative

intervention. While not making fraud detection the primary focus of an audit, SAS 16 (AU 327) required that the independent auditor, "'within the inherent limitations of the auditing process,... plan his examination... to search for errors or irregularities that would have a material effect on the financial statement, and to exercise due skill and care in the conduct of that examination'" (Swanberg 1988, 7). If the auditor, during the process of the audit, had reason to believe that a fraudulent act had been committed, this concern had to be conveyed to management or other proper authorities in charge of the audit. This condition also had to be disclosed within the independent auditor's report. Nevertheless, the duties of the independent auditor fall short of providing absolute guarantees as to the audited financial statements being free of any material misstatements, including financial management fraud. In accordance with SAS 16, "'The auditor is not an insurer or guarantor; if his examination was made in accordance with generally accepted auditing standards, he has fulfilled his professional responsibility'" (Swanberg 1988, 7).

Under the guidelines set forth by SAS 17 (AU 328), the audit examination could not "be expected to provide assurance that illegal acts [would] be detected... The determination of whether an act [was] illegal [was] usually beyond the auditor's professional competence" (Goldstein and Dixon 1989, 452). Nonetheless, the auditor was urged to be aware of the existence of illegal acts giving rise to material misstatements on the

financial reports. The auditor, however, was under no obligation to give notice of an illegal act to any party other than the client.

The adoption of SAS 20 (AU 320) introduced guidelines for the consideration of the internal control structure in a financial statement audit. Under this section, "any material weaknesses in the client's internal control system discovered in the course of an audit [was to] be communicated to senior management and the board of directors or the audit committee... [and] precluded reliance upon the system" (Goldstein and Dixon 1989, 453-4).

The SASs, aforementioned, Nos. 16, 17, and 20, however, have since then been superseded by SAS 53 (AU 316), SAS 54 (AU 317), and SAS 55 (AU 319), respectively. These new standards, released in July 1988, became effective as of January 1, 1989. Due to the nature and scope of this analysis, however, this paper will only make reference to SAS 53 (AU 316) on "The Auditor's Responsibility to Detect and Report Errors and Irregularities."

Characteristics of Errors and Irregularities

As defined in SAS 53 (AU 316), errors refer to the "unintentional misstatement or omission of amounts or disclosures in financial statements... [On the other hand,] irregularities refer to intentional misstatements or omissions of amounts or disclosures in financial statements. Irregularities include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called management fraud" (AICPA

1991, 55).

The materiality of the effect on financial statements and level of management or employees involved are two characteristics that may potentially influence the auditor's ability to detect errors or irregularities such as financial management fraud. "Section 312.13 states: 'The auditor generally plans the audit primarily to detect errors that he believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements'" (AICPA 1991, 64). As a result, the independent auditor cannot give any assurance to the detection of immaterial errors or irregularities. In addition, irregularities perpetrated by senior management transcend, or override, the control procedures established to prevent or detect such irregularities. For this reason, auditing procedures and their effectiveness in the prevention and detection of material irregularities bear upon the integrity of management and the control environment.

The extent and skillfulness of any concealment, relationship to established specific control procedures, and the specific financial statements affected also have the potential to affect the auditor's ability to prevent or detect irregularities. "The auditor's ability to detect a concealed irregularity depends on the skillfulness of the perpetrator, the frequency and extent of manipulation, and the relative size of individual amounts manipulated" (AICPA 1991, 65). Furthermore, the collusion, or cooperation between employees and/or management, to commit a

fraudulent act severely hinders the auditor's ability to detect the irregularity. Another factor that could impede the effective application of audit procedures in detecting irregularities is a lack of control procedures, a nonrecurring breakdown of a specific control procedure, or concealment through the circumvention of specific control procedures. Finally, understatements and misstatements in the income statement are less likely to be detected than overstatements and misstatements concealed in the balance sheet.

Auditor's Responsibility to Detect...

As explicitly expressed in the guidelines set forth by SAS 53 (AU 316), the independent auditor's responsibility in regards to the detection of errors and irregularities is to develop an understanding of the characteristics of such errors and irregularities, aforementioned, and to design the audit to provide "reasonable assurance" of the detection of such material misstatements within the financial statements. The auditor is also held accountable for exercising due professional care in the planning, executing, and analyzing of results derived from the audit process, which is to be undertaken with the proper degree of professional skepticism. Nonetheless, analogous with SAS 16 (AU 327) and in accordance with generally accepted auditing standards, the auditor is still "... not an insurer and his report does not constitute a[n] [absolute] guarantee" that financial statements are free of material misstatement (AICPA 1991, 56).

Risk Assessment

During the planning stage of an audit, careful consideration should be given to the assessment of the risk of material misstatements. The auditor's risk assessment will most likely be influenced by the following factors: 1. the auditor's understanding of the internal control, 2. the size, complexity, and ownership characteristics of the entity, and 3. the risk of management misrepresentation. All of these factors and others should be taken into consideration when developing an overall audit strategy and determining the nature, timing, and extent of the audit procedures (AICPA 1991, 57-8).

SAS 53 cautions the auditor to be cognizant of the risk factors in respect to management characteristics, operating and industry characteristics and engagement characteristics. Management characteristics include operating and financing decisions dominated by one single person; unduly aggressive management attitudes toward financial reporting; high management turnover, particularly among senior accounting employees; management placing undue emphasis on meeting earnings projections; and poor management reputation in the business community. If a management group contains some of these characteristics, the auditor must be quite skeptical in accepting and auditing such an engagement.

SAS 53 identifies the following operating and industry characteristics which must be scrutinized in conjunction with an engagement: lower or inconsistent profitability relative to other firms; high sensitivity of operating results to economic factors such as inflation, interest rates, unemployment, etc.; rapid rate of change in industry; decentralized organization with inadequate monitoring; and internal or external factors that raise substantial doubt about the ability of the firm to continue as a going concern. The auditor must use skepticism with regard to these operating and industry characteristics as well (Doost 1990, 39).

The staffing, degree of supervision, the overall strategy

and scope of the audit, and the degree of professional skepticism employed during the engagement are a direct result of the level of risk assessed. A higher risk will result in, all or in part, more experienced personnel engaged in the audit, more extensive supervision, an expansion of the procedures implemented, implementation of procedures closer to if not as of the balance sheet date, modification of the nature of the procedures to obtain more persuasive evidence, and a higher degree of professional skepticism (AICPA 1991, 58-9).

Professional Skepticism

Conducting an audit with an attitude of professional skepticism, or rather a questioning attitude, can be merely stated as the recognition "that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine whether the financial statements are free of material misstatement" (AICPA 1991, 59).

The degree of professional skepticism applied during an audit engagement is significantly influenced by the auditor's consideration of factors which bear upon the integrity of management. Should the auditor have reason to doubt management's integrity, "the auditor would potentially need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations" (AICPA 1991, 60). In addition, if there is doubt that bears upon management's

integrity, management's selection and application of significant accounting policies, primarily those relating to "revenue recognition, asset valuation, and capitalization versus expensing" should be evaluated to consider whether or not they have been improperly applied (AICPA 1991, 60).

Effect of Irregularities on the Audit Report

In the event that it becomes conclusive that the financial statements have become materially misstated due to the existence of an irregularity, the auditor should request the revision of the financial statements; otherwise, he should "express a qualified or an adverse opinion on the financial statements, disclosing all substantive reasons for his opinion" (AICPA 1991, 62). If a circumstance should arise in which the auditor is precluded from the application of essential procedures, or he is unable to discern whether or not potential irregularities may materially alter the financial statements, the standards prescribe that the auditor disclaim or qualify his opinion and communicate his findings to the proper authorities in charge of the audit such as the audit committee or board of directors (AICPA 1991, 62).

In consideration of the situation at hand, the auditor may also be inclined to withdraw from the engagement. This action may be appropriate in the event that the "client refuses to accept the auditor's report as modified" for any of the reasons previously mentioned. Moreover, "if the auditor is precluded by the client from obtaining reasonably available evidential matter,

withdrawal ordinarily would be appropriate" (AICPA 1991, 62). Should the auditor decide to withdraw from the engagement, the reasons for withdrawal should be communicated to the audit committee or board of directors.

Communications Concerning Errors or Irregularities

The audit committee is presumed to be adequately informed of any irregularities unless they happen to be clearly inconsequential, or insignificant. The auditor should, however, report to the audit committee any irregularities involving senior management that he becomes cognizant of during the course of the audit. "Irregularities that are individually immaterial may be reported to the audit committee on an aggregate basis, and the auditor may reach an understanding with the audit committee on the nature and amount of reportable irregularities" (AICPA 1991, 62).

Unless certain circumstances in which "a duty to disclose outside the client" exists or an irregularity influences the opinion expressed on the report, the auditor would be precluded from disclosure of any irregularities to "parties other than the client's senior management and its audit committee or board of directors" as a consequence of an "ethical or legal obligation of confidentiality" to the client (AICPA 1991, 62). Due to the complexity of this situation, however, it may be in the auditor's best interest to consult an attorney prior to any discussion of any irregularities to an outside party.

Responsibilities in Other Circumstances

Depending upon the nature or requirements of the engagement, the auditor may find his responsibilities to detect errors and irregularities more extensive or rather restricted than the "typical" audit engagement. The acceptance of an engagement, such as one with a governmental agency in which the auditor is required to abide by specific standards, may go beyond that prescribed by generally accepted auditing standards. "These standards require the auditor not only to promptly report instances of irregularities to the audited entity's management, but also to report the matter to the funding agency or other specified agency" (AICPA 1991, 63). Conversely, the auditor's responsibility such as the ".. assessment of risk.. and other aspects of the examination.. taken as a whole is necessarily more restricted" in the event that ".. an examination does not encompass a complete set of financial statements.. or when the scope is less extensive than an audit" (AICPA 1991, 63). Therefore, detection of material misstatements by the auditor is considerably reduced.

AUDITOR'S LEGAL LIABILITY FOR FRAUD

Definition of Fraud

The auditor's exposure to liability for fraud may have significant social as well as economic consequences such as damaging effects on the firm's reputation. An essential element for proceeding any further in the investigation of fraud, what it constitutes, and measures for its prevention is to develop a

clear understanding of the type of misconduct which would be alleged as an act of fraud.

In legal terms, an act of fraud may be defined as conduct involving the misrepresentation of "a material fact" with knowledge or "inferable knowledge" of the falsity giving rise to economic injury which was "proximately caused" by "justifiable reliance" upon the false representation. Various elements of this definition need to be clarified. Conduct involving a false representation may include engaging in affirmative action to prevent the discovery of the truth, omitting pertinent disclosures of material fact necessary in assessing the true financial position of the client, and assisting in the fraudulent act of a second party (Miller 1986, 85-6). "A material fact," in this case, constitutes any information that would significantly alter the outcome of the investor or creditor's decision.

"Inferable knowledge" includes conduct involving gross negligence, a reckless disregard for the truth or, in this case, for one's professional responsibilities such as complying with generally accepted auditing standards. "Justifiable reliance" means that the reliance was foreseeable or warranted.

"Proximately caused" means that "the economic injury was occasioned by.. reliance on [the] false representation" (Miller 1986, 86).

Fraud: Common Law and Statutory Law

Two types of laws exist that enter into the determination of the liability for fraudulent conduct -- common law and statutory

law. Common law is essentially unrecorded law that has evolved through various court proceedings and judicial interpretations of what society constitutes as "fair" (Meigs 1989, 81). Statutory law is written law established through actions taken by state or federal legislative bodies. The federal securities laws, primarily Rule 10b-5 which facilitates the enforcement of the Securities Exchange Act of 1934, is the principal statutory source promulgating accountant's liability for fraud. The antifraud provision Rule 10b-5 is stated as follows:

Employment of manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce, or of the mails...

- (a) To employ any device, scheme, or artifice to defraud,
 - (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
- in connection with the purchase or sale of any security (Miller 1986, 97-8).

A significant court case pertaining to the application of Rule 10b-5 was decided by a Supreme Court ruling on March 30, 1976, in the case of Ernst & Ernst v. Hochfelder.

This decision seems to place important limitations on the scope of civil liability for damages under Rule 10b-5. The plaintiffs in the Hochfelder case had invested in a securities scheme perpetrated by the president of a brokerage firm... The Supreme Court concluded that the words, "manipulative," "device," and "contrivance" in the statute [Rule 10b-5] clearly show that it was the Congressional intent to proscribe a type of conduct quite different from negligence, and the use of the word "manipulative" particularly

"connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." As a result, the Supreme Court dismissed the action against Ernst and thereby indicated an approach toward limiting the previously expanding bounds of civil liability under the federal securities laws (Skousen 1991, 131).

Actual vs. Constructive Fraud

The act of fraud may be divided into two categories: actual fraud with an intent to deceive and constructive fraud with less than an actual intent to defraud. "Fraud is defined as [the] misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured" (Meigs 1989, 80). In the latter case of constructive fraud, "[t]he conduct that lies between making a false representation solely because of a failure to exercise due care, and making a representation known to be false, consists of making a false representation (1) without belief in its truth or (2) with a reckless or grossly negligent disregard for its truth or falsity" (Miller 1986, 102). Refer to "Glossary" for definitions.

An illustrative case involving constructive fraud is the landmark case of Ultramares v. Touche in 1931. In this court proceeding, the plaintiff alleged that the defendant, during the course of their audit, failed to detect the fraudulent misrepresentation of the accounting records of Fred Stern & Co., Inc., involving the falsification of a material amount of "accounts receivable and other assets which turned out to be

fictitious" (Miller 1986, 5).

In the Ultramares Corp. v. Touche case described above,

Judge Cardozo's various formulations of fraud include:

- (a) "The pretense of knowledge when knowledge there is none";
- (b) "[A]n opinion... may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it;
- (c) A "reckless misstatement";
- (d) "[I]nsincere profession of an opinion"; and
- (e) Closing one's eyes "to the obvious" and "blindly" giving assent.

Of particular importance is Judge Cardozo's statement that negligence may be evidence from which a trier of fact may draw an inference of fraud. Judge Cardozo states that "negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross" (Miller 1986, 106).

Nature of Liability

Under the common law, the accountant's liability may be divided into two parts: (1) liability to the client and (2) liability to third parties. Most of the litigation directed towards the accounting profession are induced by third parties, primarily investors and creditors, in an attempt to recoup their financial losses.

The accountant's liability to the client consists of negligence in the exercise of due professional care and for a breach of confidentiality. In regards to negligence, the client must prove that his financial loss was a result of negligence on the part of the auditor rather than just an error in judgment. The auditor is placed in an awkward position, however, with respect to the confidentiality issue. "Since the accountant is

considered to have a duty to the public, the recent rise in consumerism has imposed tighter limits on what is considered confidential information between the accountant and the client" (Skousen 1991, 126).

"As the fiduciary duty to clients has been limited, liability to third parties and the public has expanded" (Skousen 1991, 126), as presented in the following section.

THREE BASIC APPROACHES TAKEN BY THE JUDICIAL SYSTEM

Unfortunately, there is no uniformity in the application of common law; what presides in one jurisdiction is not necessarily the case in another. Three basic approaches exist in determining the accountant's legal liability. These approaches, in order of increasing accountant's responsibility, consist of the Ultramares approach, the Restatement of Torts approach and the reasonably foreseeable user approach.

Ultramares Approach

The foremost legal case of accountant's liability, the legal precedent for ensuing cases was the landmark decision of Ultramares Corp. v. Touche (1931), which marked the turning point of the law of accountant's legal liability. Pursuant to this case, Ultramares, a factor, extended several loans to Fred Stern & Co. placing justifiable reliance upon the defendant CPAs' unqualified opinion on the company's balance sheet (Meigs 1989, 85). The New York Court of Appeals held that the auditor or accountant was only held liable to third parties who were in privity of contract, or rather an identified third party

beneficiary of the contract. Justice Cardozo was in support of this decision, which was more protective of the accounting profession, as reflected in the following "famous quotation":

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class (Hanson 1991, 29).

New York, Alabama, Colorado, Arkansas, Florida, Idaho, Indiana and Nebraska have all reaffirmed the validity of the Ultramares approach in recent court decisions, three of which were in 1989 (Hanson 1991, 29).

Restatement of Torts Approach

The Second Restatement of the Law of Torts approach offers a "middle ground" position to accountant's liability. Under this approach, the legal system allows for the recovery of damages by a limited class of foreseen parties who justifiably relied upon the independent auditors' report. This approach exposes the accountant to higher potential liability than the application of the Ultramares rule. Pursuant to the application of the Second Restatement of the Law of Torts, "[i]f the accountant is aware that the audit results or financial statements will be forwarded to a particular third party, the accountant can be sued by the third party for negligence even though there is no privity of contract" (Hanson 1991, 29). Alaska, Georgia, Hawaii, Iowa, Kentucky, Michigan, Minnesota, Missouri, New Hampshire, North Carolina, Ohio, Pennsylvania, Rhode Island, Texas, Utah, Virginia and Washington have all adopted the Restatement approach in

determining accountant's legal liability in recent court proceedings.

Reasonably Foreseeable User Approach

Of all the approaches taken into consideration, the Reasonably Foreseeable User approach exposes the accountant to the greatest possibility of incurring liability. This approach takes the Second Restatement of the Law of Torts one step further to include all parties who are reasonably foreseeable recipients of financial statements for business purposes and who justifiably relied upon statements made by the accountant or auditor. The Supreme Court of New Jersey in the court case Rosenblum v. Adler of 1983, which adopted this Reasonably Foreseeable User approach in reaching its decision, is interpreted as follows:

In this case, the defendant CPAs issued an unqualified report on the financial statements of Giant Stores Corporation, which showed the corporation to be profitable. In reliance upon these statements, Rosenblum sold a catalog showroom business to Giant in exchange for shares of Giant's stock. Shortly afterwards, Giant filed for bankruptcy and the stock became worthless. Rosenblum sued Giant's CPAs, alleging ordinary negligence. The case was dismissed by the trial court, on the premise that the CPAs were not liable to third parties for ordinary negligence. However, the state supreme court reversed the lower court, finding that CPAs can be held liable for ordinary negligence to any third party the auditors could "reasonably foresee" as recipients of the statements for routine business purposes (Meig 1989, 85).

"This approach abandons the privity requirement altogether and has been adopted by courts in California, Wisconsin, Mississippi and New Jersey" (Hanson 1991, 30). The jurisdictions adopting this approach seem to feel that the accounting profession has a

duty to act as a "public watchdog" against corporate fraud.

In effect, even though Judge Cardozo set the precedent for accountant's liability to exclude liability for mere negligence while establishing liability to third parties for fraud and gross negligence amounting to fraud, subsequent cases have extended the scope of liability to third parties. Accountants may now be held liable to third parties for fraud, for gross negligence giving rise to fraud, and for ordinary negligence when the accountant knows that the work is being done primarily for the benefit of specified third parties. Refer to "Glossary" for definitions.

COMPUTER CRIME

Computer Fraud

An innovation which has made a significant impact on the accounting profession is the invention of the computer. The integration of computerization into the business enterprise to accommodate the efficient operations of financial institutions and innumerable businesses has increased the inherent risk of computer crime. Today, computer fraud alone accounts for losses amounting to over \$6 billion dollars annually in the United States (Doost 1990, 36).

Fraudulent acts perpetrated through the use of computers are an even greater challenge to the accounting profession. Cases of fraud have been discovered in all areas of an organization, ranging from petty cash to invoicing and accounts receivable to lapping on cash collections and inventory manipulation. The most notable case involving computer fraud was the Equity Funding Case

which resulted in an estimated direct loss of \$200 million and an indirect loss of over \$2 billion (Doost 1990, 37). This case involved the collusion of top management and key employees to defraud a considerable number of investors through a scheme involving the creation of false insurance policies that resulted in an increase in the value of its shares (Doost 1990, 37).

"[L]ess than 25% of all white-collar crimes are ever reported, making it very difficult to study and analyze cases of fraud.. Many fraudulent acts, particularly computer crimes, have been discovered not through regular audits, but by someone reporting them and exposing the perpetrators" (Doost 1990, 36). In light of the proliferation of computer crime and inadequate documentation and data necessary to formulate preventive measures for the detection and prevention of computer fraud, Ernst & Whinney has developed a concept designated as "The Fraud Cube." Underlying this concept is the ideology that there are three-dimensions encompassing computer crime -- relationship, expertise and motivation. In this regard, computer fraud may be perpetrated by agents in direct association with the client company as well as those with no direct contact with the daily operations of the business such as outsiders. Furthermore, a novice is able to penetrate and misappropriate assets or manipulate the files and transactions of a client company just as readily as an agent with a high level of expertise of the functions of the computer system (Doost 1990, 38).

Dealing With Computer Fraud

Ernst & Whinney has devised a three-level line defense system for dealing with computer crime -- prevention, detection, and limitation -- which is briefly presented in the following passages. These guidelines require that the auditor be cognizant of the administrative, physical and technical aspects of the problem in each category.

The prevention line of defense may be divided into administrative, physical and technical aspects. Security checks on personnel, proper segregation of duties and program authorization constitute a partial list of administrative control recommendations for the prevention of fraud. Physical controls entail locating computer facilities in inconspicuous locations and controlling access to the facilities. Finally, technical aspects consist of the encoding of data and the utilization of access control software and passwords, to restrict unauthorized access to terminals (Doost 1990, 38).

Analogous with the prevention line, the detection line of defense may also be separated into administrative, physical and technical aspects of control. In reference to administrative controls, the implementation of access and execution logs will allow for the documentation of users by time and location so that fraudulent activities may be detected. Physical controls might include posting guards and limiting entrance into computer facilities through the use of entry logs, special entry keys and requiring identification badges to be presented. Finally, the

application of transaction logs is one example of a technical aspect of fraud detection (Doost 1990, 38).

The third line of defense against computer crime is limitation. The rotation of duties and transaction limits, pre-printed limits on checks or purchase orders, and various checks that can put limitations on potential errors are examples of administrative, physical, and technical aspects of control, respectively (Doost 1990, 39).

MINIMIZING THE RISK OF LITIGATION

In order to minimize the adverse effects of the impending threat of litigation, the accountant is advised to:

1. place greater emphasis upon compliance with the public accounting profession's generally accepted auditing standards and Code of Professional Conduct;
2. retain legal counsel that is familiar with CPAs' legal liability;
3. maintain adequate liability insurance coverage;
4. implement a thorough investigation of prospective clients before accepting the engagement;
5. obtain a thorough knowledge of the client's business;
6. use engagement letters for all professional services;
7. carefully assess the probability of errors and irregularities in the client's financial statements and exercise special care when the client has material weaknesses in internal control; and
8. exercise extreme care in audits of clients in financial difficulties (Meigs 1989, 97-8).

CONCLUSION

In summary, due to the staggering number of lawsuits filed against auditors arising from cases involving bankruptcies and business failures, it is evident that confusion exists regarding the distinction between a business failure and an audit failure.

Most of the litigation directed towards the accounting profession are induced by third parties, primarily investors and creditors, in an attempt to recoup their financial losses. As supported by the current trend of the legal proceedings, the independent auditor, due to the thorough examination performed in the audit, is perceived as being in the most strategic position to detect any irregularities that could substantially misrepresent the financial position of a firm. Furthermore, it seems that "[b]ecause it is likely that at least some of the litigation directed at auditors is based solely on the deep-pocket theory, the practicing accountant will never be able to entirely remove the risk of litigation from public practice" (Broom and Brown 1991, 33).

In an attempt to minimize the number of lawsuits alleged against the independent auditor, the accounting profession has been and will continue to be forced to devise stricter auditing procedures that enhance the auditor's ability to detect fraud. The auditing standards currently being employed are not designed to detect fraud or provide **absolute** assurance to the detection of material misstatements. If the independent auditor is eventually required to devote greater emphasis on the detection of fraud, however, the exorbitant costs of future audits will be passed on to the client and will, more than likely, be absorbed by the general public.

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GLOSSARY

Breach of contract:

failure of one or both parties to a contract to perform in accordance with the contract's provisions. A CPA firm might be sued for breach of contract, for example, if the firm failed to deliver its audit report to the client by the date specified in the engagement letter. Negligence on the part of the CPAs also constitutes breach of contract.

Common law:

unwritten law that has developed through court decisions; it represents judicial interpretation of a society's concept of fairness. For example, the right to sue a person for fraud is a common law right.

Comparative negligence:

a concept used by certain courts to allocate damages between negligent parties based on the degree to which each party is at fault.

Constructive fraud:

this differs from fraud as defined below in that constructive fraud does not involve a misrepresentation with intent to deceive. Gross negligence on the part of an auditor has been interpreted by the courts as constructive fraud.

Contributory negligence:

negligence on the part of the plaintiff that has contributed to his or her having incurred a loss. Contributory negligence may be used as a defense, because the court may limit or bar recovery by a plaintiff whose own negligence contributed to the loss.

Engagement letter:

the written contract summarizing the contractual relationships between auditor and client. The engagement letter typically specifies the scope of professional services to be rendered, expected completion dates, and the basis for determination of the CPA's fee.

Errors:

unintentional mistakes in financial statements and accounting records, including mistakes in the application of accounting principles.

Fraud:

the misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured.

Gross negligence:

the lack of even slight care, indicative of a **reckless disregard** for one's professional responsibilities. Substantial failures on the part of an auditor to comply with generally accepted auditing standards might be interpreted as gross negligence.

Irregularities:

intentional distortions in financial statements, often accompanied by falsifications in the accounting records.

Negligence:

violation of a legal duty to exercise a degree of care that an ordinarily prudent person would exercise under similar circumstances, with resultant damages to another party.

Ordinary negligence:

violation of a legal duty to exercise a degree of care that an ordinarily prudent person would exercise under similar circumstances with resultant damages to another party. For the CPA, ordinary negligence is failure to perform a duty in accordance with applicable professional standards. For practical purposes, ordinary negligence may be viewed as "failure to exercise due professional care."

Plaintiff:

the party claiming damages and bringing suit against the **defendant**.

Precedent:

a legal principle that evolves from a common-law court decision and then serves as a standard for future decisions in similar cases.

Privity:

the relationship between parties to a contract. A CPA firm is in privity with the client it is serving, as well as with any **third-party beneficiary**.

Proximate cause:

this exists when damage to another is directly attributable to a wrongdoer's act. The issue of proximate cause may be raised as a defense in litigation. Even though a CPA firm might have been negligent in rendering services, it will not be liable if its negligence was not the proximate cause of the plaintiff's loss.

Statutory law:

law that has been adopted by a governmental unit, such as the federal government. CPAs must concern themselves particularly with the federal securities acts and state blue-sky laws. These laws regulate the issuance and trading of securities.

Third-party beneficiary:

a person -- not the promisor or promisee -- who is named in a

contract or intended by the contracting parties to have definite rights and benefits under the contract.

(Meigs 1989, 79-81)

APPENDICES

Purpose of the Appendices

The purpose of the "Appendices" is to provide the reader with supplementary information to facilitate his or her understanding of precautionary measures taken by the profession underlying the detection and prevention of fraud. Exhibit 1, designated as "Warning Signals of the Possible Existence of Fraud," offers a detailed listing of possible warning signals that the independent auditor should be aware of and take into consideration in the planning and performing stages of the audit. Exhibit 2, entitled "Checklist of Possible Financial Fraud," and Exhibit 3 on "Warning Signals of Computer-Assisted Fraud" are provided as partial checklists that the auditor may use for the detection of financial and computer-assisted fraud in the course of the audit. Finally, Exhibits 4 and 5, entitled "Causes of Fraudulent Financial Reporting" and "The Treadway Commission's Recommendations for the Independent Public Accountant," respectively, are taken from the Executive Summary of "The Report of the National Commission on Fraudulent Financial Reporting." The purpose of these last two exhibits is to provide a brief summary of the causal factors leading to fraudulent financial reporting and recommendations made by the Treadway Commission in order to limit the frequency of such occurrences.

Exhibit 1 Warning Signals of the Possible Existence of Fraud^a

- 1** Highly domineering senior management and one or more of the following, or similar, conditions are present:
 - An ineffective board of directors and/or audit committee.
 - Indications of management override of significant internal accounting controls.
 - Compensation or significant stock options tied to reported performance or to a specific transaction over which senior management has actual or implied control.
 - Indications of personal financial difficulties of senior management.
 - Proxy contests involving control of the company or senior management's continuance, compensation or status.
- 2** Deterioration of quality of earnings evidenced by:
 - Decline in the volume or quality of sales (e.g., increased credit risk or sales at or below cost).
 - Significant changes in business practices.
 - Excessive interest by senior management in the earnings per share effect of accounting alternatives.
- 3** Business conditions that may create unusual pressures:
 - Inadequate working capital.
 - Little flexibility in debt restrictions such as working capital ratios and limitations on additional borrowings.
 - Rapid expansion of a produce or business line markedly in excess of industry averages.
 - A major investment of the company's resources in an industry noted for rapid change, such as a high technology industry.
- 4** A complex corporate structure where the complexity does not appear to be warranted by the company's operations or size.
- 5** Widely dispersed business locations accompanied by highly decentralized management with inadequate responsibility reporting system.
- 6** Understaffing which appears to require certain employees to work unusual hours, to forgo vacations, and/or to put in substantial overtime.
- 7** High turnover rate in key financial positions such as treasurer or controller.
- 8** Frequent change of auditors or legal counsel.
- 9** Known material weaknesses in internal control which could practically be corrected but remain uncorrected, such as:
 - Access to computer equipment or electronic data entry devices is not adequately controlled.
 - Incompatible duties remain combined.
- 10** Material transactions with related parties exist or there are transactions that may involve conflicts of interest.
- 11** Premature announcements of operating results or future (positive) expectations.

Exhibit 1 *(Continued)*

- 12 Analytical review procedures disclosing significant fluctuations which cannot be reasonably explained, for example:
 - Material account balances.
 - Financial or operational interrelationships.
 - Physical inventory variances.
 - Inventory turnover rates.
 - 13 Large or unusual transactions, particularly at year-end, with material effect on earnings.
 - 14 Unusually large payments in relation to services provided in the ordinary course of business by lawyers, consultants, agents, and others (including employees).
 - 15 Difficulty in obtaining audit evidence with respect to:
 - Unusual or unexplained entries.
 - Incomplete or missing documentation and/or authorization.
 - Alterations in documentation or accounts.
 - 16 In the performance of an examination of financial statements unforeseen problems are encountered, for instance:
 - Client pressures to complete audit in an unusually short time or under difficult conditions.
 - Sudden delay situations.
 - Evasive or unreasonable responses of management to audit inquiries.
-

(Braiotta 1981, 151-2)

EXHIBIT 2 / CHECKLIST OF POSSIBLE FINANCIAL FRAUD

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YES	NO	ITEM
<input type="checkbox"/>	<input type="checkbox"/>	High rates of employee turnover
<input type="checkbox"/>	<input type="checkbox"/>	Serially numbered documents missing
<input type="checkbox"/>	<input type="checkbox"/>	Non-serially numbered documents
<input type="checkbox"/>	<input type="checkbox"/>	Excessive or unjustified cash transactions
<input type="checkbox"/>	<input type="checkbox"/>	Excessive or unjustified exchange items
<input type="checkbox"/>	<input type="checkbox"/>	Failure to reconcile checking accounts
<input type="checkbox"/>	<input type="checkbox"/>	Excessive number of checking accounts
<input type="checkbox"/>	<input type="checkbox"/>	Photocopies of invoices in the files
<input type="checkbox"/>	<input type="checkbox"/>	Manager or employee who falls into debt
<input type="checkbox"/>	<input type="checkbox"/>	Excessive number of checks bearing second endorsements
<input type="checkbox"/>	<input type="checkbox"/>	Excessive or material changes in bad-debt write-offs
<input type="checkbox"/>	<input type="checkbox"/>	Inappropriate freight expenses
<input type="checkbox"/>	<input type="checkbox"/>	Inappropriate ratio of inventory components
<input type="checkbox"/>	<input type="checkbox"/>	Business dealings with no apparent economic purpose
<input type="checkbox"/>	<input type="checkbox"/>	Assets sold but possession maintained
<input type="checkbox"/>	<input type="checkbox"/>	Assets sold for less than fair market value
<input type="checkbox"/>	<input type="checkbox"/>	Continuous rollover of loans to management or employees
<input type="checkbox"/>	<input type="checkbox"/>	Questionable changes in financial ratios
<input type="checkbox"/>	<input type="checkbox"/>	Questionable leave practices
<input type="checkbox"/>	<input type="checkbox"/>	Large sales discounts
<input type="checkbox"/>	<input type="checkbox"/>	Physical control of assets and accounting records by same employee

EXHIBIT 3 / WARNING SIGNALS OF COMPUTER-ASSISTED FRAUD

YES

NO

ITEM

Internal auditors have no expertise in computer usage

No restrictions on who has access to computer

Computer has capability of generating negotiable instruments

Employees not properly screened before employment

Reports of computer not properly controlled

Morale of employees low

Computer used to process loans, obtain credit rating and maintain all accounting records

Malfunctions, errors and rejected transactions by the computer are not examined by management

EXHIBIT 4 CAUSES OF FRAUDULENT FINANCIAL REPORTING

Incentives:

- * Desire to obtain higher price from stock or debt offering,
- * Desire to meet the expectations of investors,
- * Desire to postpone dealing with financial difficulties,
- * Personal gain, additional compensation, promotion or escape from penalty for poor performance.

Pressures:

- * Sudden decreases in revenue or market share,
- * Unrealistic budget pressures,
- * Financial pressure from bonus plans based on short-term economic performance.

Opportunities:

- * Absence of board of directors or audit committee that oversees process,
- * Weak or nonexistent internal accounting controls,
- * Unusual or complex transactions,
- * Accounting estimates requiring significant subject judgment by management,
- * Ineffective internal audit staffs.

Exacerbating factor: Weak corporate ethical climate

Perpetrators of Fraudulent Financial Reporting:

- * Sales representatives,
- * Accountants,
- * Executives, and
- * Top management (CEO, president, CFO) in majority of cases studied.

Effect Sought: Smooth earnings or overstate company assets.

EXHIBIT 4 (Cont'd)

Allegations against Independent Public Accountants:

- * Failure to conduct audit in accordance with Generally Accepted Auditing Standards (lack sufficient competent evidential matter);
- * Fail to recognize and respond to "red flags";
- * Most allegations against nonnational firms or sole proprietors.

Classification of Recommendations:

- * For Public Companies,
- * For Independent Public Accountants,
- * For the SEC and Others to Improve Regulatory & Legal Environment, and
- * For Education.

(Sweeney 1989, 17 & 19)

**EXHIBIT 5 THE TREADWAY COMMISSION'S RECOMMENDATIONS FOR THE
INDEPENDENT PUBLIC ACCOUNTANT**

Recognizing Responsibility for Detecting Fraudulent Financial
Reporting

Recommendation: The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to: (1) take affirmative steps in each audit to assess the potential for such reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.

Improving Detection Capabilities

Recommendation: The Auditing Standards Board should establish standards to require independent public accountants to perform analytical review procedures in all audit engagements and should provide improved guidance on the appropriate use of these procedures.

Recommendation: The SEC should require independent public accountants to review quarterly financial data of public companies before release to the public.

Improving Audit Quality

Recommendation: The AICPA's SEC Practice Section should strengthen its peer review program by increasing review of audit engagements involving public company clients new to a firm. For each office selected for peer review, the first audit of all such new clients should be reviewed.

Recommendation: The AICPA's SEC Practice Section requirement for a concurring, or second partner, review of the audit report should be revised as part of an ongoing process of review of this requirement. Standards for the concurring review should, among other things: (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purpose of the review.

EXHIBIT 5 (Cont'd)

Recommendation: Public accounting firms should recognize and control the organizational and individual pressures that potentially reduce audit quality.

Communicating the Auditor's Role

Recommendation: The Auditing Standards Board should revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.

Recommendation: The Auditing Standards board should revise the auditor's standard report to describe the extent of internal accounting control. The Auditing Standards Board also should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessments stated in the proposed management's report.

Reorganization of the Auditing Standards Board

Recommendation: The AICPA should reorganize the Auditing Standards Board to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practice.

(Sweeney 1989, 20)

