AUDITOR MALPRACTICE

FIVE THINGS LITIGATORS SHOULD KNOW ABOUT GENERALLY ACCEPTED AUDITING STANDARDS

By Elizabeth A. Kowalski, CPA, CFE
and
Barry Jay Epstein, Ph.D., CPA, CFF
Russell Novak & Company, LLP
Chicago, Illinois

Independent auditors play a vital role in our capital markets system. A third party opinion on the representations made in a company's financial statements serves as assurance of accuracy and transparency, and builds investor confidence. However, when investors learn of securities fraud or other financial statement misrepresentations, ensuing litigation often focuses highly critical attention on the quality and sufficiency of the information the auditors obtained, and how they processed that information in reaching audit conclusions. On the other hand, in white collar criminal cases, the accused's legal team may find in the audit working papers the basis for a defense against conspiracy claims.
Before advocating for plaintiffs or defendants in audit malpractice, securities fraud or other actions, attorneys should clearly understand five important facts about auditing standards.

1. It's true – it is not the auditor's responsibility to identify all fraudulent activity in the organization. Professional standards require the auditors to opine on their client's compliance with generally accepted accounting principles (GAAP). The auditors are required to plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatements whether those misstatements are due to either error or fraud. While fraud that is material to the financial statements should be uncovered during the performance of typical audit procedures, an audit does not provide absolute assurance that fraud has not occurred at the company.

2. Management is responsible for the financial statements. Auditors are engaged to opine on the financial statements. They are not the authors of the financial statements, and in fact are strictly prohibited from performing certain tasks such as bookkeeping services and making management decisions, lest their independence become impaired. Oftentimes, when auditors are charged with professional malpractice stemming from fraudulent financial reporting by a client, their first line of defense is to remind their accusers that management is responsible for the financial statements. No respected accounting expert would disagree with this statement. However, it is also true that management often relies heavily on the knowledge of their auditors to help resolve technical accounting issues. When this occurs, good auditors will carefully document the fact that the ultimate decisions were made by the company's management, and that their role was limited to technical research done to give management the information needed to select from among two or more options. Management alone makes financial reporting policy decisions, and good auditors will carefully document this in the working papers.

3. Uncorroborated management assertions are not audit evidence. Management is required to submit a "management representation letter" to the auditors which may contain statements regarding the company's accurate, complete disclosure of information to the auditors, as well as various other assertions about contingent obligations, related party transactions, and other matters affecting the company's financial statements. While these representations are important in the conduct of the audit, they cannot substitute for the appropriate application of audit procedures. Commonly, during the course of litigation against accountants, defense attorneys will attempt to cite the management representation letter as evidence that the auditors were victims of management deception, as demonstrated by untruths in the representation letters. However, the correct application of the audit standards would not allow the auditors to have relied solely on these representations and therefore this document is of limited value as part of the defense's strategy.

4. While a formal audit program and appropriate planning are required by the professional standards, rigid adherence to a standard audit program and failure to consider needed modifications to it do not meet professional expectations. The auditors' task is not limited to execution of the audit plan, which often consists of a standard set of procedures dictated by firm policy. Auditors are also required to assess various elements of risk, including inherent risk, control risk, and detection risk, and must furthermore engage in "brainstorming" fraud risk factors, before commencing substantive procedures which have been tailored to reflect these assessments. Perhaps most importantly, auditors are required to exercise professional skepticism in the planning and performance of the audit, which is typically defined as an attitude that includes a questioning mind and a critical assessment of audit evidence.

5. The timing and sequence of audit procedures may reveal whether the work was properly planned and executed. According to professional standards, the auditors' working papers should provide a complete narrative of how they reached their opinion, such that an accountant with similar experience but no previous connection to the engagement can understand the auditors' procedures, judgments, and conclusions. Individual audit working papers should be signed and dated by both preparer and reviewer, and the implied "time line" of the audit engagement may prove crucial in auditor litigation. If, for example, substantive procedures were performed after the audit report date, it may be argued that this work was only performed to "paper the files" and was not timely performed in support of the audit opinion.

While erroneous or even fraudulent financial reporting can occur even with a well conducted audit, the failure to comply with professional standards will typically make the auditors vulnerable. An understanding of auditing standards is thus needed to either defend or prosecute accounting professionals. ■

Elizabeth A. Kowalski, CPA, CFE (EKowalski@rnco.com), is a manager in the Chicago, Illinois firm, Russell Novak & Company, LLP (www.RNCO.com), whose practice areas are forensic accounting and litigation consulting on accountants' liability and financial reporting matters. Barry Jay Epstein, Ph.D., CPA, CFF (BEpstein@rnco.com), is a partner of Russell Novak & Company, LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the co-author of Wiley GAAP 2010, Wiley IFRS 2010, Wiley IFRS Policies and Procedures, the WG&L Handbook of Accounting and Auditing, and other books.

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