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A High Stakes Game of Risk for the Independent Auditor

J. Ralph Byington and Jo Ann Christensen

The recent collapse of Enron Corporation has brought the subjects of white collar crime (WCC) and fraudulent financial reporting (FFR) to the forefront of our national headlines. Among the allegations leveled at Enron Corporation were numerous types of WCC including fraud/conspiracy and FFR. As the independent auditor of Enron Corporation, Arthur Andersen LLP (Andersen) was brought under increased scrutiny by the public, the press, the courts, and various governing bodies. This intense scrutiny ultimately resulted in Andersen suffering a catastrophic loss of business and being found liable for obstruction of justice by the federal government (Thomas, 2002). Additionally, the fallout from Enron has resulted in Andersen being named in lawsuits filed by former employees and shareholders of Enron. The embattled Andersen is also fighting additional lawsuits from such plaintiffs as Andersen retirees, The Baptist Foundation, and the State of Connecticut (Weber, 2002).

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The first purpose of this article is to acquaint readers with how FFR by clients can pose a risk—a high stakes risk—to the independent auditor. Specifically, failure to identify the existence of illegal activity can result in litigation that leads to "empty pockets" for the independent audit firm. Four factors, when combined, comprise this risk to the independent auditor:

1) the extent and magnitude of FFR,

2) auditor responsibility to detect fraud according to the profession's perception,

3) auditor responsibility to detect fraud according to the public's perception, and

4) the current trend in litigation of accounting firms.

The second purpose of this article is to acquaint readers with possible actions the independent auditor can take to reduce the risk of incurring "empty pockets."

In addition to being conscientious about following the requirements of the auditing standards, four possible courses of action include addressing business formation, limiting consulting services, lobbying for industry change, and tweaking the audit process.

Four Factors of Risk

Occupational Fraud and Abuse/ Fraudulent Financial Reporting

White collar crime became an area of concern for business during the last quarter of the 20th century. In 1976, Kelley defined WCC as illegal acts that are

> . . . characterized by deceit, concealment, violation of trust, and not dependent upon the application of threat of physical force or violence (1976, p. 35).

More recently, the Association of Certified Fraud Examiners (ACFE)

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referred to this type of crime as occupational fraud and abuse (OFA) and defined it as the use of one's occupation to personally enrich one's life by the deliberate misuse or misapplication of employer resources or assets. According to the ACFE, at an estimated $600 billion per year, losses to OFA are approximately $4,500 per employee per year (ACFE, 2002). However, this estimated total cost is a conservative amount because the best OFA's are never discovered, some are never reported, some involve incomplete information, and others never make it to civil or criminal courts.

The Federal Bureau of Investigation (FBI) describes OFA as the fastest growing type of crime in the United States (Martin, 1998). Occupational fraud and abuse can encompass everything from employees stealing paper clips to the complex falsification of financial statements. The three categories of OFA are asset misappropriation, corruption, and FFR. Together asset misappropriations and corruption represent 93 percent of OFA, but FFR is by far the most costly. The average asset misappropriation is $80,000, the average corruption scheme is $530,000; however, the average FFR is $4,250,000 (ACFE, 2002). Again, the average for FFR may be a conservative figure considering WorldCom's announcement of a nearly $4 billion overstatement of earnings for the past two years.

Fraudulent financial reporting can be subdivided into the two categories of financial and nonfinancial reporting. The nonfinancial frauds encompass falsifying of employment credentials, internal documents, and external documents. The financial frauds encompass asset/revenue overstatements and understatements, timing differences, fictitious revenues, concealed liabilities and expenses, improper disclosures, and improper asset valuations. While the average OFA scheme spans an 18-month period, the average FFR scheme spans a 25-month period (ACFE, 2002). The magnitude of FFR, the sheer breadth of financial frauds, and the length of time of FFR schemes present a situation in which almost innumerable opportunities for professional risk to the auditor occur. Andersen is a prime illustration of FFR crimes professionally ruining an independent auditor.

Auditor Responsibility: The Profession's Perception

The profession's perception has always been that the top priority of an independent audit is to express an opinion on the fairness with which the financial statements represent the financial position, results of operations, and changes in financial position of an entity. Illegal acts become a concern of the auditor only when they may cause the financial statements to contain material misstatements. Auditor responsibility for the detection of illegal acts was originally specified in the American Institute of Certified Public Accountants' (AICPA) Statement of Auditing Standards no. 17 (SAS no. 17), *Illegal Acts by Clients*. Ultimately, SAS no. 17 was superseded by SAS no. 54, *Illegal Acts by Clients*, and SAS no. 54 was expanded by SAS no. 82, *Consideration of Fraud in a Financial Statement Audit*. The Auditing Standards Board of the AICPA has issued new guidelines for independent auditors to follow when trying to detect material misstatements that are a result of fraud. These new guidelines further expand SAS no. 54 and SAS no. 82 and will go into effect for audits for periods beginning after December 15, 2002 (New Fraud Standards . . ., 2002).

According to SAS no. 54, illegal acts are defined as violations of laws or governmental regulations. These acts are divided into two categories: 1) those that have a direct and material effect on financial statement amounts and 2) those that have an indirect effect on financial statement amounts. Auditor responsibility for direct and material effect crimes includes assessing the risk that an illegal act may cause the financial statements to contain a material misstatement. *The auditor should design the audit to provide reasonable assurance that illegal acts will be detected.* Because these acts can go undetected, care should be exercised in planning, performing, and evaluating the results of these procedures. Responsibility for indirect acts includes being aware that these acts may exist. If the auditor becomes aware that a crime may have been committed, procedures should be employed to ascertain if the act has indeed been committed.

In general, the auditor should inquire of management about

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compliance with laws and regulations. Information regarding the company's policy for prevention of illegal acts and a representation letter concerning the issue should be obtained. Statement of Auditing Standards no. 54 offers a list of possible information that could indicate the existence of illegal acts. Included in this list are: transactions that are unauthorized and/or not recorded on a timely basis, reports of governmental investigations, reports of regulatory agencies of violations of laws or regulations, and unexplained payments to government employees.

Finally, when evidence of an illegal act exists, the possible effects on the financial statements should be evaluated and management should be informed. Illegal acts should be reported to senior management and to the board of directors or its audit committee.

Auditor responsibility for the detection of illegal activities was expanded under SAS no. 82 as a result of a study conducted by the AICPA's fraud task force. This SAS clarifies auditor responsibility to detect fraud but does not increase the responsibility. Instead, it sets forth standards to support the auditor in executing the audit. In addition to ascertaining from management how management assesses the possibility of fraud risk, the auditor must consider risk factors relating to fraudulent financial reporting and misappropriation of assets within categories. These categories of fraudulent financial reporting are: 1) management's characteristics and influence, 2) industry conditions, and 3) operating characteristics. Two categories to be considered for the misappropriation of assets are susceptibility of assets to misappropriation and controls.

As previously mentioned, auditor responsibilities will be further expanded with the issuance of a new standard. This new standard is an outgrowth of work done by the Public Oversight Board coupled with international standard setters and extensive research. The purpose of the additional standard is to provide auditors guidance in testing for improper revenue recognition. Other critical sections of the statement require the auditor to expand questioning of management and other employees of the entity; ascertain the manner in which the audit committee performs its oversight responsibilities and identify whether the committee has knowledge of or suspects the existence of fraud; determine the extent and manner in which the internal audit personnel has implemented risk safeguards and procedures to combat potential improper revenue recognition; and educate and inform the audit team on where and how the entity's financial statements are most susceptible to material misstatement (New Fraud Standards . . ., 2002).

Auditor Responsibility: The Public's Perception

The public's perception of auditor responsibility differs from that of the profession, a difference referred to as the expectation gap. In the late 1970's, the general public's perception was that the top priority of an audit was to detect fraud (Rachlin, 1977). One survey of shareholders and key professionals found that 66 percent of the investing public believed that an audit is conducted primarily to detect fraud. Analysts, brokers, and the business press tended to agree with this finding (Holdren, 1978). This expectation gap continued into the 1980's with many financial users, senior financial executives, and members of Audit Committees believing that the detection of fraud is a primary responsibility of the auditor (Ludwigsen, 1987). The AICPA issued SAS no. 82 in 1997 because management continued to believe that auditors had a greater responsibility to detect fraud than was being currently met (Ferrell & Franco, 1998). Despite the issuance of SAS nos. 54 and 82, many investors still view an unqualified opinion as the Good Housekeeping Seal of Approval. Because the courts also hold this opinion, the auditor who fails to identify the existence of an illegal act may be held responsible for the act (Foust, 1992). In actuality, blame has been increasingly placed on the independent auditor when fraud is discovered in audited financial statements that have already been issued (Ferrell & Franco, 1998). This situation is exactly what has been hashed out in the courts and the media daily with Andersen.

Current Trend in Litigation

In general, the accounting profession has been experiencing an increase in litigation and its associated costs over the past 25 years (Chazen, 1986;

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Goldwasser, 1985, 1986; Kaplan, 1987; Mednick, 1987; Tan, 1987a, 1987b; Pacini & Sinason, 1998). According to Minow, more lawsuits have been ". . . filed against accountants in the last decade and a half than in the entire previous history of the profession" (1984, p. 76). During the 1990's, the Big Six alone spent in excess of $400 million each year in legal fees, settlements, and judgements. According to a 1992 AICPA survey, accounting firms other than the Big Six also experienced an increase in claims. Between 1987 and 1991, claims against these firms increased by 67 percent (Kiernan & Lewin, 1994). In addition to these costs, the cost of insurance premiums increased from 5 to 100 percent in conjunction with a doubling of deductibles and a decrease in maximum coverage available (Collins, 1985). These changes are, in part, the result of a judicial expansion of accountants' legal liability. Accountants, like other professionals, are not immune to malpractice suits filed by clients and third parties.

Prior to Andersen's legal wranglings, the trend in litigation and the general public's perceptions regarding the primary function of an audit may have made it difficult for the auditor to assess a practical position with respect to liability and the responsibility for detection of illegal acts. Following the fallout from Andersen's troubles, it should be clear to any independent audit firm that the firm should be on the defensive. It is important for the auditor to be aware that most of the malpractice liability for accountants comes from auditing—with fraud being a major problem (Anonymous, 1999). One-half of the litigation brought against auditors involves fraud detection, and these fraud cases are the types settled with large payments by auditors (Palmrose, 1987). The courts have been more than willing to allow the auditor's "deep pockets" to pay for the losses. The trend has continued. A recent case in California found in favor of the client that sued its auditor. The auditor discovered that the statements had intentionally been misstated and asked the client to correct the FFR. The client refused, the auditor resigned, and the client sued. The decision was a $10 million award, even though the auditor had done everything correctly according to the profession's standards (Kinney, 1998)! In addition, although no final resolution has been made for embattled Andersen, the likelihood is strong that one of the many lawsuits filed against the firm will result in a judgement against Andersen.

In response to the trend in litigation, the AICPA was a strong proponent of legislation passed by Congress that reduced public accounting firms' vulnerability to class action suits involving weak claims. However, this legislation is the same one, the Private Securities Litigation Reform Act of 1995, that calls for auditors to aggressively seek to detect OFA that directly and materially affect a company's statements. Basically, while the law supposedly reduces a firm's vulnerability to frivolous suits, it also requires the auditor to try *much harder* than in the past to detect OFA.

Empty Pockets for the Auditor

Despite the legislation to reduce auditor vulnerability, it is obvious that the independent auditor remains in a high risk situation when auditing for FFR. Considering the frequency with which FFR is being exposed and dissected in the nation's media, it follows that it has become a potentially ruinous concern for every independent auditor. Nevertheless, even the most competent auditor may not detect criminal activity simply because the auditor is not trained to detect criminal activity. Accountants, in general, are not detectives. In actuality, the detection of criminal activity is more the responsibility of the company's management and legal counsel than the independent auditor's. The independent auditor's professional responsibility for illegal acts by clients is limited to the potential impact these acts would have on the financial statements. Most members of the profession believe that the auditor should not have to act as a detective (Ferrell & Franco, 1998). However, the failure to discover illegal acts, including FFR, could still lead to litigation against the auditor. With the public's perception of auditor responsibility and the courts' current attitude, the result of the litigation may continue to lead to "empty pockets" instead of "deep pockets" for the audit firm. According to Jaspan, ". . . there is better than a 50% chance of

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sizable dishonesty within an organization, without any surface evidence, and a 75% chance of costly malpractices" (1988, p. 16). According to Palmrose, if the legal reform is successful in elimination of lawsuits involving weak claims, then ". . . any future litigation against auditors may involve more difficult cases. If so, now more than ever lawsuits are something to protect against" (1997, p. 69). In addition, Goldwasser takes the viewpoint that due to the way the reform litigation reads, the profession can expect to continue to see a large number of lawsuits against auditors for failure to detect OFA (MacDonald,1996).

What action could the independent auditor then take to reduce the risk of incurring "empty pockets" FFR? In addition to being conscientious about following the requirements of SAS no. 54, SAS no. 82, and the new guidelines, four possible courses of action include addressing business formation, limiting and/or safeguarding consulting services, lobbying for industry change, and tweaking the audit process.

Four Courses of Action

Addressing Business Formation

Historically, accounting firms have been created following the partnership formation model and applicable rules. However, during the past decade, the Big Five and other accounting firms have converted their business entities to the Limited Liability Partnership (LLP). This change has been effective for several key reasons. First and foremost is the liability protection that the name LLP implies. With a straightforward partnership, all partners are liable for the malpractice of each and every partner. However, under the LLP scenario, a partner is limited in liability to only the acts of malpractice attributable to that specific partner. Second, the LLP business entity provides all the tax benefits associated with a partnership.

In recent years, a trend that suggests that the corporation, as the business entity, could actually be preferable to the LLP has evolved. The corporation as a business form for accounting firms has emerged as a viable consideration for several reasons in addition to the traditional limited liability. One, the demand for technology-related stock is increasing. Two, compensation packages are new and diverse. Three, retirement plans and employment taxes have become virtually identical across business entity lines. Fourth, a variety of corporation-based entities, including Limited Liability Companies, S Corporations, and QSubs, are now available to the firm. Fifth, the number of non-accounting professionals has been increasing exponentially over the past several years (Auster, 2000).

Given the recent Andersen troubles and auditor liabilities associated therewith, it follows that in an effort to avoid the "empty pockets" associated with FFR, the independent audit firms should consider the LLP or a corporate form for doing business. These forms of business offer a degree of protection against "empty pockets" because of the limited liability rules.

Limiting Consulting Services

Public accounting firms have found that the business of consulting to existing clients can prove to be extremely profitable. However, it is also the easiest way for a firm to create a perceived conflict of interest and potentially expose itself to lawsuits because it effects the appearance of independence (Bricker, 2002). Thus, the conflict is created. Even though the disclosure of the relationship is mandated by the SEC, many accounting firms received more money for their non-audit services than their audit services from any one client. From this setup, the conclusion can be drawn that the accounting firm that is providing consulting services and audit services to the same company could well be *auditing its own advice!*

Currently, all of the Big Five international firms have voluntarily divested themselves of information technology (IT) consulting services. Consequently, one-stop shopping for audit, tax, risk-management, and consulting has effectively ended (Kahn, 2002). By voluntarily taking this action, the Big Five have managed to stay one step ahead of the government. In response to the Enron/Andersen debacle, Congress has been prompted to take a hard look at accounting reform. Part of this reform revolves around limiting consulting services. It is likely that it will be legislated that accounting firms are prohibited

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from providing auditing services and certain types of consulting services to the same client. The Government Accounting Office (GAO) has also established guidelines prohibiting auditors from auditing their own work and/or providing non-audit services where services involved are material to a part of the subject matter of the audit (Bricker, 2002). To maintain excellent auditing standards and reduce the liability of risk associated with FFR, all accounting firms that offer both audit and consulting services should probably go one step further than the proposed legislation and new guidelines require. All accounting firms should take a hard look at those practices and consider eliminating one of the services or creating two separate houses entirely.

Lobbying for Industry Change

It is clear that under increased scrutiny, the accounting profession has not fared well. Consequently, it is entirely possible that any chance for further self-regulation has evaporated. Thus, it follows that lobbying governmental agencies now administering the regulation of the industry may be the primary way for the profession to have a say in crafting the rules it must follow. Furthermore, this opportunity is excellent for the profession to effect change that can have the potential of reducing auditor risk when auditing for FFR, thus, avoiding "empty pockets."

Tweaking the Audit Process

Another action the auditor can implement to reduce the risk of "empty pockets" is to tweak the actual audit process itself. Tweaking the audit process should include using the engagement letter to specify the responsibility for fraud detection, carefully screening clients while paying close attention to their reputations and integrity and being aware that certain industries are more vulnerable than other industries to FFR, being aware of the areas in which FFR most frequently occurs, and expanding audit procedures for all audits to include a comprehensive search for FFR employing forensic accounting techniques.

The engagement letter states the terms of the audit engagement and defines the auditor-client understanding. Basically, it is a contract specifying what the auditor is going to do. Its intended purpose is to differentiate between auditor and client responsibility so that both the auditor and the client have a clear understanding as to the scope of the audit. It is also a means of avoiding misunderstandings with the client and avoiding legal liability for claims that the independent auditor did not perform the work as promised. It should be prepared for every audit, whether for a new client or a continuing client. Considering the fact that the best defense is often a good offense, the auditor should state very clearly in this letter that the auditor is not responsible for the detection of fraud. By making it clear from the very beginning of the auditor/client relationship that the purpose of an independent audit does not include the detection of fraud, the auditor may be able to avoid liability problems that would occur if fraud were discovered subsequent to the audit. In several instances, the courts have ruled against the audit firms because they did not have an engagement letter—even when they did everything else correctly. In one instance, a firm was held responsible for thefts by a client's bookkeeper even though the firm was only performing a review (Goldwasser, 1999)!

Before accepting a new client, the auditor should assess the possibility of risk associated with auditing the client. When interviewing prospective clients, the auditor should be concerned about the potential client's reputation and integrity while being aware that certain types of businesses are more vulnerable to FFR than others. The interview process should include a phase in which the auditor can look beyond the client for sources of additional information. Examples of these sources include court records and dockets, credit agencies, business groups the client may be associated with, and even the client's banker and attorney. Any source with whom the client has a relationship could provide vital information to the accounting firm. The auditor should be skeptical, should look beyond the paper, and should not assume honesty.

Two types of businesses that have been found to be particularly vulnerable to intentional FFR are manufacturing and transportation/ communications (Beasley et al., 2000; Byington & Christensen, 1995-1996). Another type that has shown a dramatic increase in fraud in recent years has been

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the software industry. Because of the fierce competition for quickly-obtained capital and the short life of the products, pressure to book sales rapidly occurs. This type of approach is likely to result in bad accounting (Anonymous, 1999).

While planning and performing the audit, the auditor should be aware of the areas in which FFR most commonly occurs. As mentioned previously, financial frauds encompass asset/revenue overstatements, asset/revenue understatements, timing differences, fictitious revenues, concealed liabilities, concealed expenses, improper disclosures, and improper asset valuations. Extra care and attention should be exercised when addressing these areas.

The independent auditor may further reduce the risk of "empty pockets" by expanding the audit procedures for all audits to include a comprehensive search for FFR. This comprehensive search should be performed by a forensic accountant or at least employ forensic accounting techniques. Forensic accounting first appeared during the 1970's and 1980's in response to insider stock-trading fraud cases and then later in response to the savings and loan business scandals (Martin, 1998). For example, forensic accountants were needed to reconstruct the books and establish what went wrong with failed institutions. These accountants are trained in standard accounting practices but also receive special training in how to detect and report fraudulent records. The difference between their approach and the traditional approach is that all figures are treated as suspect until proven otherwise. Unlike conventional accouting techniques, honesty is not assumed (Martin, 1998). Thus, by treating all numbers as suspect, the forensic accountant will conduct a thorough investigation of how the figures actually got to the statements—basically, where did the funds come from and where did they go? This type of search is more likely to uncover illegal acts than the conventional methods and cannot help but reduce the independent auditor's risk of incurring "empty pockets."

Conclusion

The magnitude and extent of FFR is staggering. Each and every day the public is inundated with yet another example of FFR. As a result, the independent auditor is a participant in a high stakes game of risk because failure to discover FFR can lead to litigation that can result in "empty pockets" for the auditor.

What action could the independent auditor then take to reduce the risk of incurring "empty pockets" FFR? Common business sense alone dictates that the auditor should be conscientious about following the requirements of SAS no. 54, SAS no. 82, and the new guidelines. In addition, at least four other possible courses of action exist: addressing business formation, limiting consulting services, lobbying for industry change, and tweaking the audit process. Finally, every audit program should be designed to include a comprehensive search for FFR, not just an assessment of risk factors. The search should employ the use of a forensic accountant or forensic accounting techniques. In conclusion, while the primary purpose of an independent audit is not the detection of FFR, as long as the public's perception and the courts' perceptions remain the way they are, the auditor's best protection against "empty pockets" is to look for FFR with *each and every* independent audit regardless of whether it will have a material effect on the statements.

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