[Maine Law Review](https://digitalcommons.mainelaw.maine.edu/mlr)

Volume 43
Number 1 *A Tribute to Judge Frank M. Coffin*

Article 11

January 1991

The Auditor's Responsibilities for Fraud Detection and Disclosure: Do The Auditing Standards Provide A Safe Harbor?

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Recommended Citation

James L. Costello, *The Auditor's Responsibilities for Fraud Detection and Disclosure: Do The Auditing Standards Provide A Safe Harbor?*, 43 Me. L. Rev. 265 (1991).
Available at: https://digitalcommons.mainelaw.maine.edu/mlr/vol43/iss1/11

THE AUDITOR'S RESPONSIBILITIES FOR FRAUD DETECTION AND DISCLOSURE: DO THE AUDITING STANDARDS PROVIDE A SAFE HARBOR?

INTRODUCTION

Eighty-seven percent of managers recently surveyed were willing to commit financial statement fraud.[1] More than half were willing to overstate assets, forty-eight percent were willing to understate loss reserves and thirty-eight percent would "pad" a government contract.[2] These disturbing results are underscored by the financial miseries still brewing in the savings and loan industry, as well as by other corporate and banking financial debacles of the past decade, including Lincoln Savings & Loan, Wedtech, and the Delorean sports car venture scandal.[3] Amidst these financial ruins we find the

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1. Wall St. J., Mar. 1, 1990, at 1, col. 4. Typically financial statement fraud or misrepresentation comes in the form of management fraud. Management fraud includes the deliberate misapplication of accounting principles (such as recognizing in the current year the full amount of a long-term sales contract to boost current earnings), intentional misstatements (e.g., understating loan loss reserves) or omissions of amounts and disclosures in the financial statements. *See* J. SULLIVAN, R. GNOSPELIUS, P. DEFLIESE & H. JAENICKE, MONTGOMERY'S AUDITING 123 (10th ed. 1985) [hereinafter MONTGOMERY]. Such activity is labeled "management" fraud because it is usually "perpetrated by management . . . [in] furtherance of a management goal, such as higher reported earnings . . . ." *Id.* Management fraud is executed and concealed in a number of ways, including the manipulation, falsification, or alteration of underlying accounting records, management misrepresentations to third parties and company auditors, and other such deceptive practices. *Id.*; J. BURTON, R. PALMER & R. KAY, HANDBOOK OF ACCOUNTING & AUDITING § 9-10 [hereinafter HANDBOOK]. Management fraud is typically on a larger scale than employee embezzlement schemes or defalcations, and because it often involves collusion among top management and overriding of internal accounting controls, it is more apt to go undetected. *See, e.g.*, MONTGOMERY *supra*, at 123.

2. Wall St. J., Mar. 1, 1990, at 2, col. 4.

3. Management of the collapsed Lincoln Savings & Loan Association (losses estimated at $2.5 billion) manipulated accounting principles to misrepresent the value of worthless assets and thereby "foist[ed] more than $250 million in now worthless high-yield bonds on 23,000 investors." Wall St. J., Nov. 21, 1989, at A20, col. 1. This financial statement scam was allegedly facilitated by clean audit opinions from Arthur Young & Company, the thrift's auditors who failed to uncover the fraud. *Id.* Wedtech Corporation collapsed amidst a financial scandal involving political payoffs and management fraud. The fraud purportedly involved falsification of $4.7 million in government defense contract invoices and financial statement misrepresentation, including exaggerating current profits on long-term defense contracts. Despite its magnitude the scam went undetected by Wedtech's auditors. Wall St. J., Feb. 23, 1987, at 21, col. 1. The famed sports car automaker John Delorean diverted huge sums of investors' money, designated for research and development in his sports car venture, to illegitimate uses. Delorean's accountants were later sued for failing to warn investors of this diversion. *See* Rudolph v. Arthur Andersen & Co., 800 F.2d 1040 (11th Cir.

chronic element of management fraud. Unfortunately for investors and depositors a troublesome number of these financial disasters have followed a "clean bill of health" from the company auditors,[4] thus leaving investors, depositors, and creditors looking on in despair. As the investing public labors over its lost investment and nervously contemplates its next move, one question inevitably comes to mind: Who is watching over the financial statements of corporate America? More precisely, where are the auditors?

The investing public has long expected and relied upon the independent audit[5] to uncover and disclose employee embezzlement and fraudulent reporting by management.[6] Certified public accountants

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1986).

4. *See, e.g.*, Wall St. J., Nov. 21, 1989, at A20, col. 1; Wall St. J., Feb. 23, 1987, at 21, col. 1.

5. The independent audit is the professional evaluation of corporate financial statements, designed to provide the financial statement user with reasonable assurances that management has not unfairly biased the economic information in its favor. HANDBOOK, *supra* note 1, at §§ 9-3 to 9-5. The objective of an audit that is performed in compliance with generally accepted auditing standards is to render an opinion on whether an entity's financial statements present fairly the results of operations in accordance with generally accepted accounting principles. *Codification of Accounting Standards*, Statement on Auditing Standards No. 1 § 110.01 (Am. Inst. of Certified Pub. Accountants 1972) [hereinafter all Statement on Auditing Standards will be referred to as SAS]; Rosenblum v. Alder, 93 N.J. 324, 343, 461 A.2d 138, 148 (1983) ("The auditor must make such an examination so as to enable him to express an opinion on the fairness of the financial presentation of the statements.").

6. These expectations were confirmed by the 1978 Commission on Auditors' Responsibilities report which concluded that "significant percentages of those who use and rely on the auditor's work rank the detection of fraud among the most important objectives of an audit." THE COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 31 (1978) [hereinafter COHEN REPORT]. The Cohen Commission, named after Manuel F. Cohen, a former chairman of the Securities and Exchange Commission, was appointed by the American Institute of Certified Public Accountants (AICPA) in 1974 to "analyze the nature and degree of the [expectation] gap in understanding and suggest what should be done to narrow that gap." Olson, *A Look at the Responsibility Gap*, J. ACCT. 52 (Jan. 1975). *See also* HANDBOOK, *supra* note 1, at § 9-10 ("Society clearly expects—in fact demands—auditors to accept an important measure of responsibility for the detection of fraud."); Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 SAN DIEGO L. REV. 233, 258 (1983) ("It must be remembered that one of the specific functions for which the accountant is employed is the detection of corporate fraud."). The viewpoint of financial statement users, the Securities and Exchange Commission, and the courts, regarding the auditor's duty to detect fraud has been summarized as follows: "The first object of an audit is to say that the accounts can be *relied on*, that they are 'all right'; it is absurd to say that they are all right subject of course to the possibility that undetected fraud may have made them all wrong." COHEN REPORT, *supra*, at 32 (quoting A.M.C. Morrison, *The Role of the Reporting Accountant Today*, ACCOUNTANCY (England) March 1971, at 122).

In one sense, the investing public considers the certified public accountant (CPA) to be a "watchdog" of corporate morality and of financial statement integrity. *See* United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (The auditor's function is that of a "watchdog" and the auditor "owes ultimate allegiance to the

(CPAs)[7] who perform these audits, however, have traditionally refused to accept primary responsibility for providing this needed service. Indeed the auditing profession has consistently sought to limit its responsibility and liability in this area by establishing auditing standards that place substantial restrictions on the auditor's duty to detect fraud.[8] CPAs maintain that these self-imposed auditing standards define the contours of their responsibilities, and thus the degree to which the public can rely upon the audit to reveal fraud. According to CPAs, as long as a CPA has performed the audit in compliance with generally accepted auditing standards (GAAS)[9] and

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corporation's creditors and stockholders, as well as to the investing public."); Goldstein & Dixon, *New Teeth for the Public's Watchdog: The Expanded Role of the Independent Accountant in Detecting, Preventing, and Reporting Financial Fraud*, 44 BUS. LAW. 439 (1989); Weiss, *An Introduction to Concepts of Accountants' Liability*, CERTIFIED PUB. ACCT. J., July 1987, at 24.

7. The CPA has legal status as a profession in every state. *See e.g.*, Previts, *Preface* to J. EDWARDS, HISTORY OF PUBLIC ACCOUNTING IN THE UNITED STATES (1978) [hereinafter HISTORY]. Even though CPAs provide a variety of non-auditing services, for purposes of this discussion the terms CPA and independent auditor will be used interchangeably.

8. *See infra* notes 19-51 and accompanying text. The CPA's perception of the audit function contrasts sharply with that of the public. CPAs view the auditor's role in the financial reporting process as limited merely to expressing an "opinion on the fairness with which [the financial statements] present the [company's] financial position in conformity with generally accepted accounting principles." SAS No. 1, *supra* note 5, at § 110.01. Thus CPAs believe that the public misperceives the auditor's role, which according to CPAs is "not to form conclusions about irregularities and illegalities." D. RICCHIUTE, AUDITING CONCEPTS AND STANDARD, 84 (rev. 2d ed. 1989).

Consequently, a disparity, commonly labeled the "expectation gap," exists between the assurances the public expects the audit process to provide and those actually being provided by auditors. *See* Comment, *The Role and Responsibility of Accountants in Today's Society*, 13 J. CORP. LAW 882 (1988). This gap, especially in the area of management fraud, has led to increasing public discontent and has resulted in an overwhelming number of lawsuits demanding retribution from auditors for failing to provide the services the public expects. *See, e.g.*, Guy & Sullivan, *The Expectation Gap Auditing Standards*, J. ACCT., Sept. 1987, at 36.

9. Generally accepted auditing standards (GAAS) constitute the minimum professional standards for conducting an audit. SAS No. 1, *supra* note 5, at § 150.02. Rather than defining particular acts or procedures that must be performed, GAAS provide "measures of quality of performance and [define] the objectives to be obtained by" the audit process. HANDBOOK, *supra* note 1, at § 9-1.

Auditing standards range in specificity from the broadly stated standard that "[d]ue professional care is to be exercised in the performance of the examination and the preparation of the report" to more precise standards that attempt to amplify the general provisions. SAS No. 1, *supra* note 5, at § 230.01. Another auditing standard requires the audit "examination . . . to be performed by a person or persons having adequate technical training and proficiency as an auditor." SAS No. 5, at § 210.01. Compliance with this standard has traditionally been assured through individual state licensing procedures of CPAs. *See generally* MONTGOMERY, *supra* note 1, at 46-48. Some standards speak directly to ethical considerations such as the requirement that the auditor be independent of management. SAS No. 5, *supra*, at § 220.02. The independence requirement is considered paramount in that it provides assurances of the financial statements were presented in accordance with generally accepted accounting principles (GAAP),[10] the CPA's responsibilities have been fulfilled.[11] Thus many in the auditing profession maintain that the professional standards provide a safe harbor for auditors, permitting CPAs who faithfully comply with the professional standards to effectively immunize themselves from liability.[12]

The extent to which CPAs can actually insulate themselves from liability has been the subject of much heated debate, a debate that is likely to resurface with the 1989 promulgation by the American Institute of Certified Public Accountants (AICPA)[13] of Statements On Auditing Standards (SAS) No. 53, *The Auditor's Responsibility*

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fairness and lack of bias in the presentation of financial statements. *See, e.g.*, HANDBOOK, *supra* note 1, at § 9-2.

10. Generally accepted accounting principles (GAAP) "constitute the conventions, rules and procedures of currently accepted accounting practice the sources of which include, but are not limited to, such authoritative bodies as the AICPA's Financial Accounting Standards Board (FASB)." Goldstein & Dixon, *supra* note 6, at 441 n.8. *See* United States v. Arthur Young & Co., 465 U.S. 805, 811 (1984); SAS No. 5, *supra* note 9, §§ 411.05-.08.

11. The auditing standards on management fraud have historically stressed that "auditors [were] not responsible for detecting deliberate financial statement misrepresentations . . . unless the application of generally accepted auditing standards would [otherwise] result in such detection." SAS No. 16, at § 327. *See also* MONTGOMERY, *supra* note 1, at 127. However, this means little in practical terms, since generally accepted auditing standards have never been specifically designed for ferreting out fraud. *See, e.g.*, Levy, *Implementing SAS 53: Detecting Financial Fraud Within a GAAS Audit*, PRACT. ACCT., Dec. 1989, at 52. Levy notes: "An audit under generally accepted auditing standards is not a proper vehicle for fraud detection. There are inherent limitations [such as costs, lack of specialized training, the scope and purpose of a GAAS audit, and fee structures] within . . . the GAAS audit that strongly mitigate against detection of more than routine frauds." *Id.* The GAAS audit, for instance, relies heavily on statistical sampling measures, the concept of "materiality," and the necessity for relying to some degree on the integrity of records supplied by the client. Each of these factors is somewhat foreign to an audit designed to detect fraud. *See, e.g.*, Levy, *Financial Fraud: Schemes and Indicia*, J. ACCT., Aug. 1985, at 78.

12. The auditor's conduct "will be judged by reference to the standards generally applied by the accounting profession for the proper and competent conduct of an audit." *Auditing Practices Committee Members Bulletin, Exposure Draft of an Auditing Guideline: The Auditor's Responsibility For Detecting and Reporting Fraud and Other Illegal Acts*, J. ACCT., Feb. 1988, at 163 [hereinafter *Bulletin*]. *See also infra* notes 80-82 and accompanying text.

13. The AICPA is a professional organization of CPAs with more than 200,000 members throughout the United States. *See* MONTGOMERY, *supra* note 1, at 43. Through its Auditing Standards Board, the AICPA is the recognized rulemaking body of the auditing profession. *Id.* at 45. The Securities and Exchange Commission has traditionally deferred to the AICPA the promulgation of auditing standards for audits of publicly traded companies under the Securities and Exchange Acts, thus giving this private-sector body broad authoritative powers over CPAs and corporate audits. *See, e.g.*, Goldstein & Dixon, *supra* note 6, at 441 n.7; McKesson & Robbins, Inc., Exchange Act Release No. 19, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020 (Dec. 5, 1940).

to Detect and Report Errors and Irregularities.[14] SAS No. 53 is the latest in a series of auditing standards that attempt to define the CPA's responsibility for detecting fraud,[15] and represents the culmination of an intense effort by the AICPA to stem a growing tide of public criticism and suits against auditors.[16] SAS No. 53 differs from prior auditing standards on management fraud by acknowledging for the first time that an auditor has an affirmative obligation to detect fraud. Under SAS No. 53 the CPA must now design the audit to provide reasonable assurances of fraud detection.[17]

The AICPA undoubtedly hopes that courts will, in time, apply SAS No. 53 as the measure of liability for CPAs when they are sued for failing to detect or disclose management fraud, thereby providing auditors with a safe harbor and some certainty in this volatile area of auditor liability.[18] Lawyers who represent CPAs will soon be asked to advise their clients on whether CPAs can fortify themselves against liability by complying with this new standard. This Com-

14. SAS No. 53 § 316 supersedes SAS No. 16 § 327, and is effective for audits of financial statements for periods beginning on or after Jan. 1, 1990. Consequently, court decisions on this new standard are currently unavailable. This Comment attempts to gauge, from cases decided under previous standards, how courts will react to SAS No. 53 and the effect that compliance with SAS No. 53 is likely to have on the auditor's liability. For further discussion regarding the provisions of SAS No. 53, see *infra* notes 56-69 and accompanying text.

15. *See infra* notes 19-51 and accompanying text.

16. *See, e.g.*, Bertholdt, *Public Expectations—Meeting the Challenge*, CERTIFIED PUB. ACCT. J., Aug. 1986, at 10; Guy & Sullivan, *supra* note 8, at 36; Kolins, *Flood of Auditing Standards Adopted to Help Close Expectation Gap*, THE PRACT. ACCT., May 1988, at 76. These articles discuss public criticism of the profession and the debate over the proper role of the accountant in the context of the so-called "expectation gap."

Over the last two decades the auditing profession has been inundated with lawsuits against auditors, most involving charges that the auditor failed to detect or disclose management fraud. *See, e.g.*, Collins, *Professional Liability: The Situation Worsens*, J. ACCT., Nov. 1985, at 57; Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797 (1959); Mednick, *Accountants' Liability: Coping With the Stampede to the Courtroom*, J. ACCT., Sept. 1987, at 118; Minow, *Accountant's Liability and the Litigation Explosion*, J. ACCT., Sept. 1984, at 70; Tan, *Legal Liability and Professional Responsibility, A Precarious Balance*, 55 OUTLOOK, Summer 1987, at 9.

For a thoughtful discussion concerning the various categories of auditor liability, including liability for fraud under common law principles and statutory standards, see RICCHIUTE, *supra* note 8, at 116.

17. *See, e.g.*, D. Carmichael, *Fraud and Illegal Acts—A New Look*, CERTIFIED PUB. ACCT. J., Feb. 1987, at 94; Guy & Sullivan, *supra* note 8, at 37-38.

18. In public accounting, a profession where lawsuits seem inevitable and where large settlements appear the norm, the prospects for this standard creating a safe harbor for auditors should be of premiere importance. This is especially true today when recessive economic conditions raise both the possibility that corporations will indulge in fraudulent reporting practices and the potential for increased malpractice suits against auditors. *See, e.g.*, D. GOLDWASSER, ACCOUNTANTS' LIABILITY 1989, 24 (Practising Law Inst. 1989).

ment endeavors to provide guidance by ascertaining the evidentiary role SAS No. 53 is likely to play in future malpractice suits.

Part I of this Comment provides an historical analysis of auditing standards on fraud detection. Part II examines the extent to which courts are actually applying GAAS as the measure of liability, and thereby permitting the auditing standards to define and dictate the responsibilities of auditors. Finally, in Part III, SAS No. 53 is evaluated to determine whether its provisions sufficiently parallel the types of responsibilities for detecting and reporting fraud previously imposed on auditors by the courts.

For those CPAs who are optimistic that compliance with SAS No. 53 will protect them from liability, this Comment reaches a rather sobering conclusion. CPAs should be advised that, contrary to the views expressed by some writers and auditors, courts do not consider compliance with GAAS as conclusive evidence that the auditor exercised due care. Instead, courts merely resort to GAAS for guidance concerning the minimum degree of care required of auditors, leaving the trier of fact to determine the outer contours of the auditor's duties and responsibilities. In the arena of management fraud, SAS No. 53 creates at best a narrowly paved one-way street for auditors. While a CPA's failure to comply with SAS No. 53 will almost certainly result in liability, it is doubtful that compliance with this new standard will automatically excuse the auditor from liability. Further, the degree of an auditor's responsibility for detecting and disclosing fraud under SAS No. 53 falls short of that traditionally imposed by the courts. The new standard limits the CPA's duty to detect collusive management fraud and qualifies the auditor's duty to design the audit to detect fraud where there are no "suspicious circumstances" present. In addition, significant restrictions exist on the CPA's obligation to make third-party disclosures of detected fraud. It will be shown that such limitations on the auditor's responsibilities are unhappily at odds with court decisions which fail to acknowledge similar limitations.

I. An Historical Overview of the Auditing Standards Relating to the Auditor's Duty To Detect and Disclose Fraud

A. *The Early History and SAP No. 30*

The perplexing and often controversial debate over whether a CPA is obligated to detect and report fraud has long haunted the auditing profession. While CPAs have consistently welcomed responsibility for detecting unintentional errors and omissions in the financial statements, the same cannot be said for intentional misstatements or other fraudulent client conduct.[19] The authoritative auditing standards have routinely allowed auditors to meet their

19. *See, e.g.*, Ricchiute, *supra* note 8, at 98.

professional responsibilities without significant obligations to detect and disclose management fraud.[20] These standards, however, diverge sharply from historical practices of independent auditors.[21] In fact, during the early part of this century there was a universal understanding, even among auditors, that the detection of fraud was among the most important objectives of an audit of financial statements. This common understanding is confirmed by early audit textbooks, which consistently included fraud detection among the three primary objectives of the audit.[22]

However, a revolutionary change in the auditing profession's position on fraud detection was visible by the late 1930s.[23] As auditors began vocalizing their concern that the profession had assumed a seemingly impossible undertaking, pressure mounted to change the profession's position and essentially re-educate the public on the auditor's role in detecting fraud. These efforts culminated in the rewriting of authoritative auditing literature and in the 1939 promulgation of Statements on Auditing Procedure (SAP) No. 1, *Extensions of Auditing Procedure.*[24]

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20. MONTGOMERY, *supra* note 1, at 120.

21. For a detailed discussion concerning the historical evolution of the auditing function, see HISTORY, *supra* note 7. *See generally* D. CARMICHAEL & J. WILLINGHAM, PERSPECTIVES IN AUDITING: READINGS AND ANALYSIS SITUATIONS 2-36 (1971) [hereinafter PERSPECTIVES]. Carmichael and Willingham noted that the function of detecting fraud is deeply rooted in the historical role of auditors, dating back to the early 1500s. *Id.* at 2-3. As late as the 1930s many auditors and writers were emphasizing the importance of fraud detection as a primary function of auditing. *Id.* at 8-9. *See also* MONTGOMERY, *supra* note 1, at 9-15; R. MAUTZ & H. SHARAF, THE PHILOSOPHY OF AUDITING, 129 (1961) [hereinafter PHILOSOPHY]. Writing in 1961, Mautz and Sharaf stated: "Until recently there was substantial acceptance of the idea that an independent audit had as one of its principal purposes the detection and prevention of fraud and other irregularities." *Id.* at 129. However, the authors noted: "Currently we find considerable emphasis on elimination or at least minimization of this responsibility through . . . statements in the professional literature." *Id.*

22. An early edition of MONTGOMERY listed the threefold objectives of the audit as: (1) "The detection of fraud"; (2) "The detection of technical errors"; and (3) "The detection of errors of principle." PERSPECTIVES, *supra* note 21, at 7 (citing R. H. MONTGOMERY, AUDITING THEORY AND PRACTICE 13 (1912). This provision also appeared in Montgomery's second (1923) and third (1927) editions. PERSPECTIVES, *supra* note 21, at 7 n.10.

23. PERSPECTIVES, *supra* note 21, at 8-10. "By the end of [the 1930s] there was a fair degree of agreement [among auditors] that the auditor could not, and should not, be primarily concerned with the detection of fraud." *Id.* at 9.

24. SAP No. 1 reads as follows:

> The ordinary examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant is not designed to discover all defalcations, because that is not its primary objective, although discovery of defalcation frequently results. . . . To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation

Many auditors interpreted the revised auditing literature as a formal repudiation by the profession of any substantive responsibility for detecting fraud. They regarded that task as overly burdensome, prohibitively costly, and beyond the average auditor's capabilities.[25] SAP No. 1 and other authoritative auditing literature at the time thus endeavored to extinguish previously held notions that the auditor was engaged primarily to uncover fraud.[26]

Since the enactment of SAP No. 1, auditors have continually struggled, without substantial success, to refine their position on client fraud and to establish auditing standards on fraud capable of convincing the public that only a limited role in detecting client fraud is justified. During the 1960s SAP No. 1 came under widespread public attack, and pressure mounted for CPAs to reconsider their official position and acknowledge a greater degree of responsibility for detecting fraud.[27] The AICPA responded to these outcries by redrafting the auditing standards through the promulgation of Statement On Auditing Practice (SAP) No. 30.[28]

This standard, however, was viewed by many as unresponsive to the public's concerns because it did little more than reiterate and amplify the position taken in SAP No. 1.[29] While the standard in-

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of benefit or safeguard therefrom, and place an undue burden on industry. Reprinted in MONTGOMERY, *supra* note 1, at 121-22.

25. *See, e.g.*, NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING, REPORT, at 50 (1987) [hereinafter TREADWAY REPORT].

26. The fact that this standard, in 1939, cut across the grain of common understanding concerning the role of auditors has had a troublesome significance for the profession. The public's expectations today are still deeply rooted in the profession's earlier undertakings to detect fraud. Under the circumstances, attempts by the profession to renounce or amend those undertakings may ultimately prove futile. At a minimum, more will be required than the promulgation of new and often esoteric standards which fail to reach the public consciousness.

27. *See* TREADWAY REPORT, *supra* note 25 at 50.

28. *See* SAP No. 30, RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR IN THE EXAMINATION OF FINANCIAL STATEMENTS ¶ 5 (1960) (first published in the *Official Releases*, J. ACCT. 74-75 (Jan. 1961) [hereinafter SAP No. 30].

29. MONTGOMERY, *supra* note 1, at 123. *See also* PERSPECTIVES, *supra* note 21, at 11. SAP No. 30 stated that in "making the ordinary examination, the independent auditor [should be] aware of the possibility that fraud may exist . . . ." SAP No. 30, *supra* note 28, ¶ 5. However, the statement went on to note:

> [T]he ordinary examination incident to the expression of an opinion on financial statements is not primarily or specifically designed, and *cannot be relied upon,* to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination *cannot be relied upon to assure its discovery.*

Id. (emphasis added).

In analyzing the effectiveness of SAP No. 30 one commentator observed: "It is somewhat questionable whether this statement has provided the proper solution." PERSPECTIVES, *supra* note 21, at 11. This commentator also made the following creased the auditors' obligations slightly, by stressing that auditors had an obligation to "be aware of the possibility that fraud may exist,"[30] the standard also made it clear that an auditor was under no affirmative duty to go beyond that bare consideration and to specifically design tests to detect such fraud.[31] Indeed, the language contained in SAP No. 30 was so negatively stated that it justifiably led auditors to conclude they had little or no obligation to structure their audits to detect fraud.

The only suggestion in SAP No. 30 that auditors should be held accountable for failing to detect fraud was a provision stating that the auditor could be responsible where the "failure [to detect fraud] clearly result[ed] from noncompliance with generally accepted auditing standards."[32] However, this provision fell far short of obligating an auditor to detect and disclose fraud. The provision could be interpreted to mean that if in the course of a normal GAAS audit fraudulent circumstances became apparent, then the CPA should take some sort of action. As noted earlier, however, a GAAS audit is fundamentally ill-suited for ferreting out fraud.[33] The goal of a GAAS audit, according to auditors, is primarily to determine if the financial statements conform with GAAP. Consequently, even strict adherence to generally accepted auditing standards would have provided little meaningful assurance that fraud would be detected during the audit.[34]

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suggestion:

> In order to be in a position to form a professional opinion regarding the financial statements, the auditor must do sufficient work so as to be reasonably assured that there are no errors of commission or omission . . . . This is necessary regardless of the source of those errors. To deny responsibility for testing to determine if material fraud may exist because of any consideration of time or cost involved or because of the difficulties of detection is to reduce the value of the professional opinion.

Id.

30. TREADWAY REPORT, *supra* note 25, at 50; SAP No. 30, *supra* note 28, at ¶ 5.

31. *See, e.g.*, PERSPECTIVES, *supra* note 21, at 10-12. Beyond the statement in SAP No. 30, ¶ 5 that the audit could not be relied upon to discover or disclose management fraud, SAP No. 30 ¶ 8 stated: "The subsequent discovery that fraud existed during the period covered by the independent auditor's examination does not of itself indicate negligence on his part." SAP No. 30, *supra* note 28, at 75.

32. *Id.*

33. *See supra* note 11. There exist no auditing standards that "set forth specific procedures that are required [for detecting fraud], nor do [any] mandate that procedures be specifically designed for this purpose." MONTGOMERY, *supra* note 1, at 124. This statement was made prior to the adoption of SAS No. 53, which appears to require that some procedures be designed by the auditor for detecting fraud.

34. The normal GAAS audit differs from an audit designed to detect fraud both in its ultimate objectives and in its execution. While a normal GAAS audit involves selective testing of account balances and transactions to determine their propriety in relation to GAAP, with primary concern for items material to the financial statements, an audit to detect fraud is "concerned with what lies behind transactions, without regard to materiality . . . [or concern] about the application of generally ac-

SAP No. 30 ultimately failed as the controlling standard for auditors in the area of client fraud. The standard was regarded by many auditors as an inadequate vehicle to avoid liability.[35] In many cases, courts appeared to simply ignore the standard, allowing actions to be brought against auditors for failing to follow adequate procedures to detect and disclose fraud.[36]

B. SAS No. 16

Prior to the mid-1970s, even though courts were holding auditors liable for failing to detect fraud, no formal attempt was undertaken by the profession to consider imposing a higher obligation on auditors.[37] But following the well-publicized Equity Funding debacle[38] and the ensuing public scrutiny of professional standards, an AICPA committee was established in 1975 to re-examine the auditor's responsibility for detecting management fraud.[39]

This committee, however, reached the conclusion that "no substantive change in the degree of responsibility was necessary."[40] Instead the committee determined that any shortcomings in the professional standards could be addressed simply by providing auditors with more guidance in their role.[41] Apparently the AICPA consid-

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cepted accounting principles unless misapplication has led to fraudulent statements." LEVY, *supra* note 11, at 79.

35. *See, e.g.*, Carmichael, *supra* note 17.

36. Courts have permitted actions against auditors either for failing to discover or failing to disclose fraud in the following instances: Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983); Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982); United States v. Simon, 425 F.2d 796, 806 (2d Cir. 1969); United States v. White, 124 F.2d 181 (2d Cir. 1941); Fischer v. Kletz, 266 F. Supp. 180 (S.D. N.Y. 1967) ("Yale Express"); Owyhee County v. Rife, 100 Idaho 91, 593 P.2d 995 (1979); Western Surety Co. v. Loy, 3 Kan. App. 2d 310, 594 P.2d 257 (1979); Bonhiver v. Graff, 311 Minn. 111, 248 N.W.2d 291 (1976); City of East Grand Forks v. Steele, 121 Minn. 296, 141 N.W. 181 (1939); Lincoln Grain, Inc. v. Coopers & Lybrand, 216 Neb. 433, 345 N.W.2d 300 (1984); Rosenblum v. Adler, 93 N.J. 324, 461 A.2d 138 (1983); National Surety Corp. v. Lybrand, 256 A. 226, 235-36, 9 N.Y.S.2d 554, 562-63 (1939); Maduff Mortg. v. Deloitte Haskins & Sells, 779 P.2d 1083 (Or. Ct. App. 1989). *See generally*, Annotation, *Accountant's Malpractice Liability to Client*, 92 A.L.R.3d 396, 411-15 (1979).

37. *See* TREADWAY REPORT, *supra* note 25, at 50-51; MONTGOMERY, *supra* note 1, at 122.

38. The Equity Funding case involved a complex massive fraud perpetrated by Equity Funding Corporation of America, an insurance company. Equity Funding was accused by the government of "overstating its income and claiming nonexistent assets in order to increase the market value of its stock." United States v. Weiner, 578 F.2d 757, 763 (1978). The insurance company's auditors were found guilty of securities fraud for their involvement in the audits of Equity Funding and release of the misleading financial statements. *Id.* at 764.

39. MONTGOMERY, *supra* note 1, at 122.

40. TREADWAY REPORT, *supra* note 25, at 50; MONTGOMERY, *supra* note 1, at 122.

41. *See* Goldstein & Dixon, *supra* note 6, at 451. *See also* MONTGOMERY, *supra* note 1, at 122.

ered cases involving an auditor's negligent failure to detect fraud to be isolated incidents of a failure to understand his or her responsibilities.[42] The AICPA eventually tailored the committee recommendations and in 1977 enacted SAS No. 16[43] as a successor to SAP No. 30.[44]

Although SAS No. 16 admitted an obligation to at least "search for" fraud, it still was criticized for not going far enough in addressing the deficiencies found under its predecessors. Much of this criticism focused on the reality that under the new standard there remained no reliable assurances that the audit process would uncover fraud. While the auditor was required under SAS No. 16 to plan the audit to "search for" fraud, this requirement did not mean the auditor had any duty to "detect" fraud.[45] In practical terms, auditors remained unwilling to acknowledge any substantial responsibility beyond assuring that the financial statements complied with GAAP. SAS No.16, in fact, repeated the position that liability for detecting fraud could arise only where there was clear evidence of an auditor's

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42. During this period, the Cohen Commission was also deliberating about the role of auditors in detecting fraud. *See supra* note 6. Interestingly, the Cohen Commission, which was largely composed of non-AICPA members, reached a different conclusion. Rather than emphasizing the inherent limitations of the audit process, as was the tendency under previous standards on fraud, the Cohen Commission "proposed a much higher level of responsibility." RICCHIUTE, *supra* note 8, at 101. According to the Cohen Commission, the auditor "has a duty to search for fraud, and should be expected to detect those frauds that the exercise of professional skill and care would normally uncover." COHEN REPORT, *supra* note 6, at 36. The Cohen Commission prefaced this conclusion on a finding that "[u]sers of financial statements should have a right to assume that audited financial information is not unreliable because of fraud . . . . An audit should be designed to provide reasonable assurance that the financial statements are not affected by material fraud. . . ." *Id.* at 36. This language was eventually adopted in large part by SAS No. 53. *See infra* note 62 and accompanying text. While these findings may have been a factor leading to a change in the professional standards, the Commission's stance was viewed as "aggressive" by many accountants and writers. *See, e.g.*, RICCHIUTE, *supra* note 8, at 101.

43. SAS No. 16 at §§ 327.01 and 327.05. This standard stated in pertinent parts:

> .01 This section provides guidance on the independent auditor's responsibility for detecting errors or irregularities [e.g., management fraud] when making an examination of financial statements in accordance with generally accepted auditing standards.
>
> . . . .
>
> .05 The independent auditor's objective in making an examination of financial statements in accordance with [GAAS] is to form an opinion on whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with [GAAP] . . . . Consequently, under [GAAS] the independent auditor has the responsibility, *within the inherent limitations of the auditing process*, . . . to plan his examination to *search for* [material] errors and irregularities.

Id. (emphasis added).

44. *See* Goldstein & Dixon, *supra* note 6, at 451-54 for a detailed discussion of SAS No. 16, as successor to SAP No. 30.

45. *See* Goldstein & Dixon, *supra* note 6, at 451-52.

departure from GAAS.[46]

In addition, SAS No. 16 gingerly followed in the footsteps of its predecessors, SAP No. 1 and SAP No. 30, by incorporating much of the same negative and defensive language, qualifying the limited duties for fraud detection it did impose. For instance, the standard broadly restricted the duty to "search for" fraud by noting that this obligation was subject to the "inherent limitations of the auditing process."[47] This "inherent limitation" language implicitly limited auditors' responsibility to search for collusive management fraud or forgery.[48]

This collusive fraud limitation was accompanied by an even more striking limitation which implicitly relieved the auditor of any measurable duty to be skeptical and inquisitive of management. SAS No. 16 stated that "unless the auditor's examination reveals evidentiary matter to the contrary, his reliance on the truthfulness of certain representations [including those dealing with intent, knowledge, and completeness of records] and on the genuineness of records and documents obtained during [the] examination is reasonable."[49] This qualifying provision undermined the integrity of SAS No. 16 and rendered any requirement that an auditor was obligated to search for management fraud virtually meaningless. In other words, if an auditor could comply with the duty to search for fraud under the presumption that management was "honest"[50] and the supporting documentation genuine, the audit was bound to be fraught with shortcomings, at least from the perspective of the public's expectations. Any examination conducted under the presumption of management honesty was certainly far less comprehensive or inquisitive than it would have been had an opposite, or at the very least, a neutral presumption existed regarding management's honesty and integrity. Consequently, under SAS No. 16, substantial reliance on the audit by users of the financial statement to detect management fraud would have been unwarranted.[51]

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46. SAS No. 16 at § 327.13. "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." *Id.*

47. *Id.* at § 327.05. *See also*, Comment, *The Role and Responsibility of Accountants in Today's Society*, *supra* note 8, at 881 n.187 (1988).

48. Though the standard did not expressly state that an auditor lacked responsibility to detect such fraudulent activity, the implication was apparent: "Certain acts, such as collusion between client personnel and third parties or among management . . . may result in misrepresentations being made to the auditor or in the presentation to the auditor of falsified records or documents that appear truthful and genuine." SAS No. 16 at § 327.12.

49. *Id.*

50. *See* Carmichael, *supra* note 17, at 94.

51. *Id. See also* MONTGOMERY, *supra* note 1, at 124-25.

C. *SAS No. 53: An Attempt to Solve the Management Fraud Expectation Gap*

By the mid-1980s, it was apparent that CPAs' unwillingness to accept more responsibility for detecting management fraud was frustrating the profession's efforts to maintain credibility. Corporate and banking debacles once labeled "business failures" were increasingly dubbed "audit failures,"[52] a situation shamefully underscored by an epidemic of lawsuits leveled against auditors for, among other things, failing to uncover and disclose management fraud.[53] The public, the courts,[54] and Congress[55] all demanded that auditors accept more responsibility in detecting and reporting fraud.

Apparently acknowledging the inability of SAS No. 16 to portray the auditor's responsibilities in a manner capable of overcoming public scrutiny, the auditing profession bowed to public pressure and again refined the existing standards on fraud. The auditing profession's bedrock—its legitimacy and credibility—was threatened. Also at stake was the continued viability of the CPA's right to self-regulation.

Among the more influential institutions affecting a modification in the AICPA standards on management fraud was the National Com-

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52. *See, e.g.*, Comment, *The Role and Responsibility of Accountants in Today's Society*, *supra* note 8, at 882.

53. *See supra* notes 16 and 36.

54. *See, e.g.*, *supra* notes 16 and 36.

55. The threat of government intervention has long troubled the auditing profession. *See, e.g.*, Goldstein & Dixon, *supra* note 6, at 443-46, 457-61. Congress has expressed the view that auditors should have a significant responsibility for detecting and preventing fraudulent financial reporting. *Id.* at 441. *See also* TREADWAY REPORT, *supra* note 25, at 51. During the 1980s, pressure escalated for Congress to statutorily impose obligations on auditors to detect such fraud. *See, e.g.*, Goldstein & Dixon, *supra* note 6, at 457. Paramount to this effort was the Congressional Subcommittee on Oversight and Investigations, then headed by Rep. John Dingell (D-Mich.). *See* BDO SEIDMAN, CLOSING THE EXPECTATION GAP: A PRACTICAL ANALYSIS OF THE NEW AICPA AUDITING STANDARDS, at 6 (1988) [hereinafter BDO SEIDMAN].

In 1985, the Dingell Committee began studying ways of reducing fraudulent financial reporting, with particular emphasis placed on the public's expectation regarding the auditor's role in detecting and reporting fraud. *Id.* Rep. Dingell expressed the findings of that committee by noting: "The public expects that the independent auditors will make reasonable efforts to assure that fraudulent corporate activity will not go undetected or unreported." Carmichael, *supra* note 17, at 94 (quoting Rep. J. Dingell). The Dingell Committee subsequently initiated a bill that would have required auditors to perform "specific and substantial procedures to reasonably ensure the detection . . . of any material [fraud]. . . ." *Id. See also* BDO SEIDMAN, *supra*, at 6; Goldstein & Dixon, *supra* note 6, at 493-98. In addition to these detection obligations, the auditor, under another proposed bill, would have had significant "whistle blowing" responsibilities, including an obligation to disclose all fraudulent reporting to the SEC. BDO SEIDMAN, *supra*, at 6. Although these bills were not passed, they strongly influenced a modification in the auditing standards. Perhaps more importantly, they could reappear in the future, "raising again the spectre of government intervention in the accounting profession." *Id.*

mission on Fraudulent Financial Reporting (the "Treadway Commission," named after its chairman, James Treadway, a former SEC commissioner).[56] The Treadway Commission was charged in 1985 with investigating the causes of fraudulent reporting and, among other things, ascertaining the appropriate responsibilities of independent auditors in the detection of fraud.[57]

Arguing against the need for congressional intervention in the regulation of the profession, the Commission concluded that the gap in expectations over management fraud could be alleviated in large part by auditors acknowledging greater responsibility for detecting fraud.[58] To that end, the Treadway Commission recommended replacing SAS No. 16 with a more stringent standard, one that imposed upon auditors the kinds of duties and obligations that were already being imposed by the courts.[59] As the Treadway Commission concluded: "The restated responsibility for detecting fraudulent financial reporting and the additional guidance described would recognize a responsibility that many in Congress and the courts already say exists."[60]

In 1989 the AICPA implemented many of the Treadway Commission's recommendations by promulgating SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities.*[61] The highlight of SAS No. 53 is the long sought affirmative duty imposed on the auditor to detect fraud, which raises the auditor's threshold responsibility by imposing an obligation not merely to "search for" fraud but to "design the audit to provide reasonable assurance of detecting errors and irregularities."[62] This design is to be formulated based upon an initial audit assessment of the risk that such irregularities may be present, and could cause *material*

56. *See* TREADWAY REPORT, *supra* note 25; Goldstein & Dixon, *supra* note 6, at 468-74; BDO SEIDMAN, *supra* note 55, at 6.

57. TREADWAY REPORT, *supra* note 25, at 2.

58. *Id.* at 49-52; Goldstein & Dixon, *supra* note 6, at 472 (In lieu of legislation, the Treadway Commission urged that "the profession be given an opportunity to improve auditing standards in cooperation with the public.").

59. *See* TREADWAY REPORT, *supra* note 25, at 51.

60. To accomplish this task, and improve the auditor's ability to detect fraudulent financial reporting, the Treadway Commission recommended a number of modifications to SAS No. 16, including an acknowledgement that the auditor should "be responsible for actively considering the potential for fraudulent financial reporting . . . and for designing specific audit tests to recognize these risks". In addition, the Commission recommended requiring auditors to assess the client's internal control environment; and finally, auditors "should not assume management integrity but should [instead] apply professional skepticism to this determination." *Id.* In short, the Treadway Commission recommended that audit procedures be designed to "provide reasonable assurance of detecting [fraudulent financial] reporting." *Id.* at 49.

61. SAS No. 53 § 316.

62. *Id.* at § 316.05.

misstatements in the financial statements.[63]

The new standard also includes a provision requiring auditors to "exercise . . . the proper degree of professional skepticism to achieve reasonable assurance that errors and irregularities will be detected."[64] This professional skepticism requires the auditor to assume management is neither honest nor dishonest,[65] thereby eliminating the controversial presumption, found in prior auditing standards as fraud, that management is honest.

In addition, SAS No. 53 evidences a newfound willingness by the AICPA to speak in less defensive language;[66] it presents the auditor's duties in more affirmative terms without overemphasizing the "inherent limitations" of the auditing process.[67] Instead, SAS No. 53 focuses more precisely on defining the obligations the profession believes an auditor has, rather than those an auditor does not have.

One might justifiably conclude from the foregoing that through SAS No. 53, and particularly the formal recognition of an affirmative duty to detect fraud, the auditing profession has made significant strides towards narrowing the so-called expectation gap.[68] Whether the new standard will actually restore public confidence in auditors remains to be seen; the outcome necessarily depends upon whether SAS No. 53 will effectively change the manner in which auditors conduct their business.[69] For the everyday auditor, however, a pressing question remains: Can CPAs be assured that compliance with SAS No. 53, the most recent GAAS defining their obligations for fraud detection, will be enough to insulate them from liability?

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63. *Id.*

64. *Id.* at § 316.08.

65. *Id.* at § 316.16-17; TREADWAY REPORT, *supra* note 25, at 51. "SAS No. 53 throws [the] comfortable notion [that auditors can presume management is honest] on the heap of discarded audit folklore. Auditors can't assume management is honest or dishonest." Carmichael, *The Auditor's Guide to Errors, Irregularities and Illegal Acts*, J. ACCT., Sept. 1988, at 42.

66. *See* Carmichael, *supra* note 65, at 42.

67. *Id.* Carmichael noted, however, that SAS No. 53 retains the qualification that "forgery or collusion may result in failure to detect material irregularity." *Id.* For a detailed analysis regarding this restriction, see *infra* notes 138-157 and accompanying text.

68. Many observers remain skeptical and maintain that, in a pragmatic sense, the auditor's duties to detect fraud are virtually unchanged by SAS No. 53. As one commentator concluded:

> It is difficult to see what the [AICPA] has achieved. The actual standards, while employing new terminology, require essentially the same as what most practitioners would agree the old standards required.
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> . . . .
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> . . . Although the final draft of this statement [SAS No. 53] employs language which is quite different from that of [SAS No. 16], the meaning of the new statement seems to change little.

D. GOLDWASSER, ACCOUNTANT'S LIABILITY 1988, 34-35 (Practising Law Inst. 1988).

69. *See, e.g.*, Carmichael, *supra* note 65, at 48.

The answer to that question, as previously noted, depends largely on whether courts apply GAAS as the measure of a CPA's liability; that is, are GAAS really a safe harbor for auditors? If GAAS are given a conclusive evidentiary role, then CPAs may gain a great deal of comfort by complying with SAS No. 53. On the other hand, if the trier of fact is not so constrained and plaintiffs are free to introduce evidence that the auditor should have done more than SAS No. 53 required, the possibility of liability will remain even for those CPAs who faithfully comply with the standard.

II. THE ROLE OF AUDITING STANDARDS: ARE THEY THE STANDARD OF CARE FOR AUDITORS?

A. *Historical Significance of Compliance With Professional Standards*

The predominant view dictates that while evidence of professional standards may be highly probative, such evidence will seldom if ever be dispositive in deciding whether a defendant exercised due care.[70] The only apparent exception to this rule is found in the medical profession, where medical standards are generally considered the controlling measure of liability in medical malpractice cases.[71] Of course, professional standards may be helpful, particularly in complex malpractice cases, by providing information on what the defendant's professional community considers proper behavior.[72] At the same time, care must be taken to avoid exaggerating the utility and function of these standards. Professional standards should not

70. *See* 57A AM. JUR. 2D *Negligence* §§ 173, 174 (1989). *See also* Fabian v. E.W. Bliss Co., 582 F.2d 1257 (10th Cir. 1978) (industry standards are not conclusive as to ordinary care and design, but are admissible evidence); Seaboard Coast Line R.R. Co. v. Clark, 491 So.2d 1196 (Fla. Dist. Ct. App. 1986) (violation of industry standards is evidence of negligence).

71. *See* W. PROSSER, J. WADE AND V. SCHWARTZ, TORTS: CASES AND MATERIALS 185 n.2 (8th ed. 1982). Indeed, as a general rule in medical malpractice cases, the plaintiff is not permitted to proceed without introducing evidence on the medical standards. *Id.* at 177 n.4. *See also* Morris, *Custom and Negligence*, 42 COLUM. L. REV. 1147, 1163 (1942). Morris observed that as a rule in typical professional negligence cases "[a] plaintiff who produces no evidence to show that the defendant departed from the customs [or if applicable, formal standards] of his craft may, nevertheless, win his case. . . . But in medical malpractice cases failure to establish non-conformity is fatal to the plaintiff, and the defendant who establishes conformity is entitled to a directed verdict." *Id.* The same apparently cannot be said for auditors. The author has been unable to locate a single court decision directing a verdict for the auditor merely upon a showing of compliance with the auditing standards.

For a discussion concerning the evidentiary role of standards for other professions, see, e.g., Wade, *The Attorney's Liability for Negligence*, 12 VAND. L. REV. 755 (1959) (attorneys); Peck & Hoch, *Liability of Engineers for Structural Design Errors: State of the Art Considerations in Defining the Standard of Care*, 30 VILL. L. REV. 403 (1985) (architects and engineers).

72. *See, e.g.*, W. PROSSER, J. WADE AND V. SCHWARTZ, *supra* note 71, at 177 n.4.

and do not replace the role of the jury in determining either what constitutes due care or whether, under the particular circumstances, the defendant exercised that due care.[73] Consequently, where a malpractice defendant establishes compliance with industry standards he does not thereby establish as a matter of law that due care was exercised.[74]

The rationale for this view is clear. If evidence that the defendant complied with industry standards were permitted a conclusive evidentiary role, the function of the jury would be reduced to the mechanical process of applying the self-imposed standards of the defendant's profession. While this would obviously provide substantial legal certainty to professionals, the result would run counter to society's decision to entrust the jury with determining the constructs of due care. Further, allowing professional standards to control would likely have many adverse effects, not the least of which are the problems inherently associated with a self-policing profession.[75] Finally, to permit professionals, such as auditors, the advantage of having their esoteric standards define the measure of liability for the profession's members is to create a two-tier system of adjudication between the haves (of a professional status) and the have-nots. While the propriety of an ordinary layman's conduct would necessarily be judged by a jury, once an individual is admitted to a profession, the issues would be labeled complex and the defendant's professional standards would rule. The unfairness of such a system cannot be overstated, and raises an important question: Why should professionals, including CPAs, be allowed to decide their own legal fate by setting their own standards, while other nonprofessionals must accept the uncertainties associated with a jury

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73. 57A Am. Jur. 2d *Negligence* §§ 173-175 (1989). "[B]ecause the standard of care exacted by the law is an external and objective one, the law does not permit the defendant to make the determination of what is and what is not due care under the circumstances." *Id.* at § 75. *See also* Morris, *supra* note 71, at 1147-51. This idea was long ago summarized by Judge Learned Hand in *The T.J. Hooper*, wherein he stated:

> [I]n most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission.

The T.J. Hooper, 60 F.2d 737, 740 (2d Cir. 1932).

74. *See* 57A Am. Jur. 2d *Negligence*, § 178. Note that if the opposite were true, defendants would prevail on motions for directed verdicts upon proof of compliance with professional standards or upon a plaintiff's failure to prove noncompliance.

75. As one commentator noted: "We can ill-afford to let those whose interest may run counter to paying the bill for sufficient, and sometimes expensive, safeguards escape liability because all of them are guilty of the same short-comings." Morris, *supra* note 71, at 1155.

determination?[76]

Accordingly, unless the accounting profession has successfully differentiated itself from other professions, such that the auditing standards *do* form the measure of liability for CPAs, it would be both unwise and unrealistic to expect GAAS to play a greater evidentiary role than the prevailing view dictates for standards of other professions. However, some commentators appear to see something unique in the auditing standards, something apparently akin to the evidentiary role played by the medical standards.[77] These commentators have concluded, and appear to be advising CPAs, that the auditing standards are the measure of liability for auditors; therefore, because of the authoritative weight attached to GAAS, conformity to these standards can effectively insulate the auditor from liability.[78] The following section argues, however, that such advice is unfounded, and places those auditors so advised in jeopardy by instilling in them an unwarranted degree of confidence in using the auditing standards as an adequate vehicle for avoiding liability.

B. Analysis Of The Fallacy That Compliance With GAAS Creates A Safe Harbor For Auditors

Although many commentators and auditors concede that evidence of compliance with GAAS is probative but, nonetheless, inconclusive,[79] an important and vocal dissent exists which concludes that the auditing profession is similar to the medical profession in that

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76. The answer to this question cannot simply rest on the assertion that malpractice cases are inherently complex and thus require the governance of professional standards to direct the jury. Juries are constantly being called upon to decide equally complex issues involving nonprofessionals. *Contra*, Henderson, *Judicial Review of Manufacturers' Conscious Design Choices: The Limits Of Adjudication*, 73 COLUM. L. REV. 1531 (1973). Henderson argued that "[c]ourts are inherently unsuited" for determining certain kinds of complex polycentric cases. *Id.* at 1531. In the area of product safety standards he stated that courts must "regularly and routinely delegate responsibility for such standards to extra-judicial decision-making processes." *Id.* Henderson further argued that when courts attempt to ascertain proper standards of conduct in such complex cases they are "badgered into trying to deliver more than the process of adjudication is capable of delivering . . . ." *Id.* at 1578. *See also* Kirst, *The Jury's Historic Domain In Complex Cases*, 58 WASH. L. REV. 1 (1982).

77. *See infra* notes 80-82 and accompanying text. For a discussion on the inept analogy between the standards of the medical profession and the standards of the auditing profession, see generally, Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 65-86 (1975).

78. *See infra* notes 80-82 and accompanying text.

79. *See, e.g.*, Fiflis, *supra* note 77, at 62-86. Fiflis argued that "it will not do to excuse an accountant from liability if he merely complies with the model [e.g., auditing standards] unless society determines that the accounting model should be the legal standard." *Id.*, at 66. Fiflis concluded that society and courts have not permitted the auditing standards to become the legal standard. *Id.* at 80-83. *See also*, Note, *Thor Power Tool Co. v. C.I.R. Further Erodes C.P.A.'s Defense Of Observing Professional Standards*, 19 AMER. BUS. L.J. 87 (1981).

its professional standards are viewed as the measure of an auditor's liability.[80] As one commentator stated: "[A]s long as a CPA objectively complies with GAAP or GAAS and faithfully adheres to any pertinent AICPA Professional Standards, he will satisfy his duty of care."[81]

The view that GAAS constitute the yardstick by which courts measure a CPA's liability, however, is a fallacy, vulnerable to considerable criticism. Initially, this position can be criticized for failing to provide any meaningful justification for permitting these often esoteric and self-imposed standards a greater evidentiary role than that accorded to the standards of other professions.

In addition, supporters of this position may be criticized for their misplaced reliance upon selective court dicta and court decisions

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80. *See, e.g.*, Gruenbaum & Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 Loy. L.A.L. Rev. 247, 257 (1980); Hagen, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. Cont. L. 65 (1987); Hawkins, *Professional Negligence Liability of Public Accountants*, 12 Vand. L. Rev. 797, 802 (1959) ("Unless we concede that the negligence formula serves no purpose but to call forth the ad hoc reaction of a jury, we need to seek out some more specific standards to incorporate into the negligence formula for the guidance of the jury."); Notes and Comment, *Accountants' Liability*, 13 St. John's L. Rev. 310, 313 (1939) ("Accountants who have adhered to accepted standards of audit procedure will not be held liable, as a general rule, for misrepresentation.").

Both the AICPA and some audit textbook authors also appear to hold out some hope that the auditing standards will be construed as the controlling measure of a CPA's liability. Indeed, the AICPA has made a practice of submitting amicus curiae briefs on behalf of auditor-defendants, arguing for a defense based upon adherence to GAAS. *See, e.g.*, Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); United States v. Simon, 425 F.2d 796 (2d Cir. 1969).

One commentator has noted that "[t]he AICPA [consistently] has stated that compliance with GAAP and GAAS . . . should constitute an effective defense." Montgomery, *supra* note 1, at 157. The editors of Montgomery note the success of the AICPA, stating that "courts have only on rare occasions rejected adherence to GAAP and GAAS . . . as an effective defense." *Id.* The editors, however, provide no authority for this proposition or any cases where compliance with these standards *alone* was expressly stated by the courts to constitute an effective defense. While courts have found in some cases that compliance with the auditing standards constituted sufficient due care under the circumstances, this is not the same as holding that compliance with GAAS constitutes an effective defense. Another textbook author is less certain of the evidentiary role of GAAS. The author wrote that GAAS are the "model" for audit engagements and that while courts have sometimes "ruled that auditors should reach for a higher standard of care . . . it is not clear whether courts will in the future require a higher standard." Richiutte, *supra* note 8, at 140.

81. Hagen, *supra* note 8, at 87-88. *See also*, Earle, *The Fairness Myth*, 28 Vand. L. Rev. 147 (1975). "[C]ourts have generally encouraged the auditor to adhere to these professional standards by shielding him from liability when he does," and any views contrary to the position that a CPA meets the due care obligation upon compliance with GAAS and GAAP "must be read against the entire body of case law adjudicating accountants' liability: that an auditor may not be held liable for damages when in good faith he has acted in accordance with the relevant auditing standards and accounting principles generally accepted by his profession." *Id.* at 147-48.

that have held CPAs liable for failing to comply with GAAS in order to conclude that the converse, compliance with GAAS would exonerate the defendant. Their argument has been summarized as follows: "To the degree that [courts] render auditors legally liable for failing to detect a fraud that would be detected by the application of professional auditing standards, auditors' legal responsibilities for fraud detection and their professional obligations for fraud detection are the same."[82] Such a conclusion, however, is misguided. The mere decision to hold auditors liable for failing to comply with GAAS does not conversely imply that CPAs are let off the hook upon proof of compliance with GAAS. This is not a matter of having to take the bitter with the sweet. Absent a clear directive by the courts, the most that can be taken from decisions holding CPAs liable for failing to comply with GAAS is that GAAS constitute the *minimum* degree of care required by courts.

Proponents of the view that GAAS constitute the measure of an auditor's liability, however, believe they do have a clear directive from the courts and to this end rely upon *Escott v. BarChris Construction Corp.*[83] and *Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs.*[84] A detailed consideration of these two cases demonstrates such reliance as both tenuous and unwarranted.

1. *Escott v. BarChris Construction Corp.*

BarChris is probably the case most often cited for the proposition that GAAS constitute the measure of due care for auditors.[85] The case involved a class action suit brought by investors in BarChris debentures against the company, Peat Marwick, the independent auditors hired to perform a year-end audit and follow-up S-1 review, and others.[86] The plaintiffs charged Peat Marwick with failing to discover or disclose various material errors and omissions contained in the company prospectus.[87] With respect to the S-1 review, Peat

82. D. CARMICHAEL & J. WILLINGHAM, PERSPECTIVES IN AUDITING 232 (4th ed. 1985) [hereinafter PERSPECTIVES 4TH ED.].

83. 283 F. Supp. 643 (S.D.N.Y. 1968).

84. 455 F.2d 847 (4th Cir. 1972).

85. *See* Fiflis, *supra* note 77, at 81. Some commentators argue that *BarChris* affirms the conclusion that, because courts find auditors liable when they fail to follow GAAS, auditors are relieved of liability by proving compliance with GAAS. *See, e.g.*, PERSPECTIVES 4TH ED., *supra* note 82, at 232.

86. Escott v. BarChris Constr. Co., 283 F. Supp. at 652, 655. An S-1 review is a review performed after the date of an audited balance sheet. *Id.* at 701. The purpose is to review subsequent events in order to ascertain whether any material changes have occurred that should be disclosed prior to issuing the financial statements. The scope of such a review is more limited than a full audit. *Id.*

87. Plaintiffs alleged that the registration statement overstated contract sales figures by $2,525,350 by including fictitious sales. *Id.* at 655-60. Plaintiffs also alleged that the auditors failed to adequately disclose that, of the $285,482 cash on hand,

Marwick defended by raising the statutorily provided "due diligence defense"[88] and the issue thereby became whether "despite [Peat Marwick's] failure to find out anything [its] investigation was reasonable within the meaning of the [due diligence defense]."[89]

The *BarChris* court ultimately found the Peat Marwick S-1 review to be deficient and determined Peat Marwick had failed to meet its burden of showing due diligence.[90] In reaching its decision, the court stated in dictum that "[a]ccountants should not be held to a standard higher than that recognized in their profession . . . . [Peat Marwick's review] did not come up to that standard."[91]

This language was seen by many observers as a boon for the auditing profession; commentators grasped at these words to affirm that GAAS provide a safe harbor for auditors. One commentator deduced from this decision: "Presumably then, proof of compliance with GAAS is sufficient to establish a due diligence defense."[92]

Ignoring for the moment the obvious rebuttal that the court never explicitly stated that compliance with GAAS would have been sufficient, this conclusion is flawed in several other respects. First, by stating that an accountant should not be held to a higher standard than that recognized in his profession, *BarChris* merely restates the general principle applicable to all professions. That is, reasonable care for professionals means "that they will render their services with that degree of skill, care, knowledge, and judgment usually possessed and exercised by members of that profession in the particular locality, in accordance with accepted professional standards . . . ."[93] However, this black letter statement of the law is rarely, if ever, interpreted to mean that professional standards are the deciding factor in a malpractice case.[94] Therefore, the suggestion that *BarChris* supports the broader proposition that GAAS are the measure of liability for auditors would appear on its face to constitute an im-

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$147,467 should have been reclassified as a long term investment in a nonconsolidated subsidiary. *Id.* at 660-61. It was alleged that $125,000 of the accounts receivable should have been labeled uncollectible, and that accounts receivable were otherwise overstated by $150,000. *Id.* at 661-62. Finally, plaintiffs alleged that current assets should not have included $264,689 of notes due beyond a year's time. *Id.*

88. *Id.* at 697-702. In a section 11 action against auditors, the auditors are permitted to raise as a defense that they exercised due diligence. Securities Act of 1933, § 11(b), 15 U.S.C. § 77k(b) (1988).

89. Escott v. BarChris Constr. Corp., 283 F. Supp. at 702.

90. *Id.* at 703.

91. *Id.*

92. Gruenbaum & Steinberg, *supra* note 80, at 257.

93. Annotation, *supra* note 36, at 400. *See also* Franklin Supply Co. v. Tolman, 454 F.2d 1059, 1065 (9th Cir. 1972); Gammel v. Ernst & Ernst, 245 Minn. 249, 253, 72 N.W.2d 364, 367 (1955); Kemmerlin v. Wingate, 274 S.C. 62, 65, 261 S.E.2d 50, 51 (1979); Greenstein, Logan and Co. v. Burgess Marketing, 744 S.W.2d 170, 185 (Tex. Ct. App. 1987).

94. *See supra* notes 70-75 and accompanying text.

proper interpretation of the court's dictum.

Those who rely upon *BarChris* for the proposition that GAAS constitute the standard by which auditors will be judged also fail to deal honestly with the court's findings. Some commentators, for instance, attach significance to a determination by the court that the Peat Marwick work program complied with GAAS but that the auditor assigned failed to follow the program. This finding is stretched to argue that because the Peat Marwick "written work program utilized for the review conformed to [GAAS], . . . [it] would have provided the accountants with the due diligence defense had it been complied with."[95]

The court, however, never stated that compliance with the audit program would have sufficed to prove the auditor's due diligence. A review of the actual deficiencies found in Peat Marwick's work indeed proves that even had the auditor faithfully adhered to the program he would not have reached the level of conduct and care envisioned by the *BarChris* court.

Among the inadequacies found in the auditor's investigation, the court emphasized the auditor's failure to: (1) discover the existence of an executive committee meeting and minutes to that meeting, which would have revealed that a bowling alley, purportedly sold by *BarChris*, in fact never existed;[96] (2) learn about significant undisclosed "intercompany sales";[97] (3) discover that a list of contracts provided by BarChris included several fictitious entries for nonexistent job contracts;[98] (4) learn that "BarChris was holding up checks in substantial amounts because there was no money in the bank to cover them";[99] and (5) make "any inquires" of several officers.[100] Most importantly, the court determined that the auditor should have independently verified management responses to inquiries. According to the court, the auditor merely "asked questions, . . . got answers which he considered satisfactory, and . . . did nothing to *verify* them."[101]

A close inspection of the Peat Marwick work program[102] leads to the conclusion that strict compliance with the program would not have addressed the above-noted shortcomings. The Peat Marwick work program, for instance, required only that the auditor review the corporate minutes but gave no indication that the auditor

95. Gruenbaum & Steinberg, *supra* note 80, at 256.
96. Escott v. BarChris Constr. Corp., 283 F. Supp. at 702.
97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.* (emphasis added).
102. *Id.* at 701. The court quoted portions of the Peat Marwick work program in its discussion. These portions presumably reflected the critical provisions of the audit work program as they related to the due diligence defense.

should perform tests or follow other procedures to detect the existence of all notes of executive meetings, as the court implied was necessary.

The work program further only guided the auditor to perform various analytical procedures including comparing of financial numbers (between corresponding periods) and inquiring as to any material variations in those figures. The auditor was also instructed to "[r]eview the more important financial records and inquire regarding material transactions . . . and any other significant items"; and make various other inquiries regarding "changes in material contracts."[103] Unless the amounts in question represented significant variations from prior periods, application of these analytic procedures would not necessarily have led the auditor to design detailed tests to detect the withholding of checks[104] or to ascertain the propriety and genuineness of the contract list. Detailed tests of account balances and amounts listed on the "contract list," beyond mere analytical review procedures and inquiries, arguably would have been necessary to detect fictitious entries, non-existent contracts or undisclosed intercompany transactions.[105]

The Peat Marwick work program further lacked any suggested obligation for the auditor to make inquiries with each BarChris officer as the court suggested should have been done.[106] Finally, and most importantly, the work program, and thus GAAS, did not require the auditor to independently "verify" responses to inquiries as the court suggested the auditor should have done.[107] The applicable auditing

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103. *Id.* at 701-702.

104. To ensure such a discovery the auditor probably would have had to perform cash reconciliation procedures or detail-tests of transactions on the cash account. *See generally* MONTGOMERY, *supra* note 1, at 644-49. As noted, however, the Peat Marwick S-1 Review program did not require that such procedures be performed.

105. Essentially, analytical procedures, such as those required by the Peat Marwick work program, merely put the auditor on notice to inquire further if there are sufficient variations over prior periods. *See generally*, MONTGOMERY, *supra* note 1, at 355-62. A work program that met the court's expectations under these circumstances, however, would have required the auditor to do at least some detailed tests designed to insure the integrity of the amounts included in the contract list. That is, beyond mere analytic procedures that the program required, the auditor may have needed to perform such tests as confirming contract amounts or tracing amounts included in the contract list to supporting written contracts to verify their existence. *See generally id.* at 526-39 (discussing normal audit procedures to ascertain the existence and propriety of receivable account balances).

106. Escott v. BarChris Constr. Corp., 283 F. Supp. at 702.

107. Gruenbaum and Steinberg merely refer to the court's statement that the auditor should have independently verified responses to questions directed at BarChris officers as a gloss placed by the court over the GAAS review procedures. Gruenbaum & Steinberg, *supra* note 80, at 256. However, the author suggests that this was far from a mere "gloss," since requiring auditors to independently verify answers obtained by client personnel during an S-1 review would add a significant layer to the review. Indeed, requiring independent verification would have made the examination

standards, as reflected in the Peat Marwick work program, quite simply failed to meet the court's expectations. Even in *BarChris*, therefore, it was unlikely that compliance with GAAS alone would have sufficed to relieve the auditor of liability.

One final note on *BarChris*: it should be remembered that *BarChris* involved circumstances under which the auditor failed to meet even the minimum standard of conduct imposed by the profession. As one commentator said: "*BarChris* is itself only a dictum that custom is the standard since in that case the defendant failed to reach even the level of custom. The court did not hold that he had reached that level and hence would be excused."[108]

2. *Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs*

A more recent case cited for the proposition that compliance with GAAS creates a safe harbor for CPAs is *Rhode Island Hospital*.[109] In that case, one of the bank's borrowers submitted fraudulent financial statements listing $212,000 in fictitious leasehold improvements.[110] The bank sued the borrower's auditors for failing to detect the fraud, or even if they had detected it, for failing to adequately inform the bank of the fraud.[111]

Although the auditors' report disclaimed an opinion on the financial statements,[112] the court found that this disclaimer did not go far enough in informing the bank of the inherent inaccuracies contained in the financial statements.[113] According to the court, the audit opinion merely indicated that the auditors were not expressing an opinion on the "fairness" of the financial statements. The auditors' opinion, however, "expressed no reservation" concerning the existence of the improvements and indeed raised no specific questions regarding the values which, the court observed, were indicated by the accountants' opinion and cover letter to be "more or less than $212,000."[114] Beyond finding that the auditors failed to make adequate disclosures in the disclaimer opinion, the court also concluded that the auditors were negligent in "failing to look or, having looked,

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appear less like a review and more like a full scale audit.

108. Fiflis, *supra* note 77, at 82.

109. 455 F.2d 847 (4th Cir. 1972).

110. *Id.* at 848.

111. *Id.* at 851.

112. CPAs use disclaimer opinions in an effort to disavow responsibility for the financial statements. In essence, disclaimers alert the financial statement reader that the auditor does not express an opinion on the financial statements. *See, e.g.*, Hagen, *supra* note 80, at 71.

113. Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d at 851-52.

114. *Id.*

fail[ing] to find" the fictitious improvements.[115]

The importance of this opinion, however, lies less in its specific holding than in the credence it appeared to give GAAS. The court provided a detailed analysis of the AICPA auditing standards regarding disclaimer opinions,[116] and noted that such standards required the auditors to disclose more than they did in this instance (e.g., "state that they either did not look for or could not find evidence of material costs for the purported leasehold improvements").[117]

Relying upon this reference to GAAS, one commentator surmised: "[T]he case illustrates the authoritative weight a court will give to the official pronouncements of the AICPA. By arduously measuring the CPA firm's conduct against the [auditing standards], *Rhode Island Hospital* shows that the AICPA Professional Standards *will be applied as the reasonable man standard in a negligence case.*"[118] This conclusion, however, fecklessly inflates the meaning to be attached to the court's reference to GAAS. A careful reading of the opinion reveals that prior to mentioning the auditing standards the court analyzed the defendant's behavior in light of what the court itself deemed appropriate under the circumstances, concluding that the auditor failed to meet that standard. Only then did the court look to the auditing standards, doing so not for *authority* as to what constituted negligent conduct, but rather for guidance. The court noted "[o]ur *conclusions* with respect to the report and disclosure are *reinforced* by reference to industry standards."[119]

The same commentator also failed to point out that the *Rhode Island Hospital* court prefaced its reference to industry standards by stating that "[w]hile industry standards may not always be the maximum test of liability, certainly they should be deemed the minimum . . . ."[120] In other words, failure to comply with GAAS, the minimum test of a CPA's liability, will result in liability. Like *BarChris,* this case involved a situation where the auditor failed to meet the level of care required by GAAS. It was not a situation where the auditor met GAAS and was found not negligent. Thus, the same logical shortcomings exist for using this case to support the proposition that compliance with GAAS will exonerate the CPA.

Rhode Island Hospital and *BarChris* cannot provide support for any general proposition that GAAS are safe harbor for auditors. At

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115. *Id.* at 852 (the court noted, however, that actionable negligence would lie only if the bank had made further loans in reliance on the financial statements).

116. *Id.*

117. *Id.*

118. *See* Hagen, *supra* note 80, at 83 (emphasis added).

119. Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d at 852 (emphasis added).

120. *Id.*

best, these cases offer some insight into the relevance and utility of the auditing standards in litigation. While these decisions may underscore the probative worth of GAAS and may illuminate GAAS as one possible means by which courts or juries may ascertain the constructs of ordinary care for auditors, they do so without ever taking the generous leap towards hailing GAAS as the end in itself.

C. *Maduff Mortgage Corporation v. Deloitte Haskins & Sells: An End To The Myth*

In 1989, the Oregon Court of Appeals, in *Maduff Mortgage Corporation v. Deloitte Haskins & Sells*,[121] was asked to determine whether a jury is confined to the professional auditing standards in determining a CPA's liability. The decision reached by that court should help to dispel any glimmering vestiges of hope that GAAS comprise the legal standard of care for auditors.

The case originated as an action by United States National Bank of Oregon against Maduff Mortgage Corporation (MMC) to collect on a defaulted note.[122] MMC joined its auditors, Deloitte Haskins & Sells, charging them with failing to discover and disclose fraud in certain MMC loan transactions.[123]

MMC provided construction loans to builders of residential housing.[124] MMC had a policy of limiting loans to eighty percent of the expected value of a completed residence and in most cases demanded that the contractor obtain a presale agreement from buyers promising to purchase the residence on completion of construction.[125] In 1981 MMC began lending to Macal Development. By September 30, 1982, the date of MMC's audited financial statements, several loans to Macal were "over-disbursed" and there was evidence that, with the complicity of MMC's president and other employees, these funds were improperly diverted by Macal for uses not permitted by the loan agreements or required by the presale agreements.[126] In addition, the court found that the required presale agreements were either not obtained or had been "forged."[127] MMC

121. 98 Or. App. 497, 779 P.2d 1083 (1989).

122. *Id.* at 499, 799 P.2d at 1084.

123. *Id.* However, the claims between the bank and MMC were settled and the case proceeded to trial with MMC as plaintiff and Deloitte Haskins as the only defendant. *Id.*

124. *Id.* at 499-500, 799 P.2d at 1085.

125. *Id.* The funds for this loan program came from a line of credit at the bank. "When construction was completed, MMC would provide permanent mortgage financing for the purchaser, and the proceeds of the mortgage loan would be used to pay off the construction loan. MMC would then sell the mortgage loans." *Id.*

126. *Id.* The court did not elaborate on the specific uses to which the funds were improperly diverted. When it stated that loans were "over-disbursed," the court was apparently referring to loaning money in excess of the 80% limitation noted earlier.

127. *Id.*

claimed that because its auditors, Deloitte Haskins, failed to detect and disclose the fraudulent scheme, MMC was unable to minimize its losses.[128]

A critical issue at trial centered on the auditor's duty to detect fraud.[129] Over the objections of Deloitte Haskins, the jury was instructed that while an auditor was not a guarantor of the accuracy of the financial statements, the law required that the accountant exercise the "care, skill and diligence that is generally practiced by careful accountants."[130] The instruction requested by Deloitte Haskins, on the other hand, "in effect stat[ed] that an auditor is not liable for failing to detect fraud unless it has failed to comply with generally accepted auditing standards. . . ."[131] The jury ultimately found Deloitte Haskins negligent and awarded MMC $1.02 million in damages.[132] On appeal, Deloitte Haskins argued that the court erred in failing to properly instruct the jury on the role of the auditing standards.[133] Deloitte Haskins predicated its argument on the contention that "the standards promulgated by the . . . [AICPA were] the generally accepted auditing standards against which an auditor's examination must be evaluated. . . ."[134]

The Oregon Court of Appeals, however, flatly rejected this argument regarding the role of GAAS and held:

> [T]he AICPA standards are *only evidentiary* . . . . They are principles and procedures developed by the accounting profession itself, not by the courts or the legislature. They may be useful to a jury in determining the standard of care for an auditor, but they are not controlling. The amount of care, skill and diligence required to be used by defendant[s] in conducting an audit is a question of fact for the jury, just *as it is in other fields for other professionals.*[135]

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128. *Id.* MMC and its affiliates claimed more than $12 million in damages were caused by Deloitte Haskins' negligent audit. Appellant's Opening Brief at 14-15, Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. 497, 779 P.2d 1083 (1989) (No. A45241) [hereinafter Appellant's Brief].

129. Respondent's Brief at 12-14, Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. 497, 779 P.2d 1083 (1989) (No. A45241) [hereinafter Respondent's Brief].

130. Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. at 501, 779 P.2d at 1085.

131. *Id.* at 501, 779 P.2d at 1086. Deloitte Haskins' instruction paralleled the language of SAS No. 16. *See supra* note 11.

132. Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. at 499, 779 P.2d at 1084-85.

133. Appellant's Brief, *supra* note 128, at 15-19.

134. Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. at 502, 779 P.2d at 1086. Deloitte Haskins' defense depended on getting this requested instruction, and had it succeeded it would have been able to argue that a GAAS audit is not designed to detect fraud, "particularly management fraud." Appellant's Brief, *supra* note 128, at 16-19.

135. Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. at 502, 779

Maduff Mortgage serves a direct hit against proponents of the idea that GAAS constitute the legal standard, leaving little doubt that an auditor's obligations to the investing public are not necessarily discharged by complying with GAAS.[136] In the final analysis, while proof of compliance may be a useful tool in ascertaining the propriety of the auditor's conduct, giving the jury both guidance and direction, it does not in and of itself resolve the question of liability. Thus, the auditing profession has followed the path of most professions by failing to convince the courts to adopt the professional standards as the legal standard for auditors.

Because GAAS are not the controlling legal standard, auditors must accept the sobering reality that SAS No. 53 will not comprise

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P.2d at 1086 (emphasis added).

136. The Oregon court is not alone in its decision. Federal courts have long hinted at this result in the context of SEC violations. *See, e.g.*, United States v. Simon, 425 F.2d 796 (2d Cir. 1969). In that case, accountants were convicted of aiding in the issuance of materially misleading financial statements. The defendants, accompanied by the AICPA as amicus curiae, sought the same insulation provided doctors by medical standards and argued on appeal that, in determining whether the financial statements were misleading or "fair," the jury should be confined to GAAP: "[A] defendant [can] be found guilty only if, according to generally accepted accounting principles, the financial statements . . . [do] not fairly present the financial condition of the company." *Id.* at 805. Judge Friendly, in a landmark decision, disagreed with this assessment of the accounting standards and stated: "Proof of compliance with generally accepted standards was 'evidence which may be very persuasive but not necessarily conclusive . . . .' " *Id.*

Accord Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 122 (S.D.N.Y. 1974)

> Much has been said by the parties about generally accepted accounting [standards] . . . . We think this misses the point. Our inquiry is properly focused not on whether Laventhol's report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position of [the audited company] to the untutored eye of the ordinary investor . . . .

Id. at 121. Further, the duty of full disclosure "cannot be fulfilled merely by following generally accepted accounting principles." *Id.* at 122.

Up to now many commentators have been reluctant to apply such cases as proof that GAAS are not the legal standard for auditor liability. They argued that these cases must be confined to SEC actions in which no directly applicable *accounting* standard was available or that these cases dealt solely with GAAP and not GAAS. *See, e.g.*, Comment, *Judges As Accountants*, 13 Am. Bus. L.J. 108, 109 (1975). *See also*, Fiflis, *supra* note 77, at 72-73, 81. For example, Fiflis raised the possibility that "court[s] [have] looked to the standards of the profession for an auditing question but to [their] own judgment for an accounting question." *Id.* at 81. The rationale for this distinction, Fiflis argued, could be that

> communication of financial data to lay readers, based on accounting principles and reporting requirements, should be tested by the standard of meaningfulness to the layman, while those processes of auditing, consisting of data collection, testing, and drawing of inferences, are a matter for the expertise of an auditor, to be regulated by those who know something about the processes.

Id. Maduff Mortgage, however, would appear to dispense with these distinctions.

the full legal obligation an auditor has for detecting and disclosing management fraud. The significance of this conclusion cannot be overstated. As public concern over the savings and loan crisis widens and a recession appears imminent, society is very likely to continue its call for auditors to provide meaningful services in fraud detection and disclosure. Moreover, if courts find that in strictly following SAS No. 53 the profession as a whole has been lax, the courts are more apt to ignore this standard altogether. The following section considers this possibility.

III. SAS No. 53: A Failed Attempt at Matching the Court's Expectations

Even though SAS No. 53 may not constitute the controlling measure of an auditor's legal obligations, the standard might still provide useful guidance to auditors on what should be accomplished during an audit in order to avoid liability. This result could occur, for instance, if the auditor's responsibilities defined in SAS No. 53 adequately paralleled those previously imposed by courts. Indeed, the Treadway Commission recognized the need to match the courts' expectations and concluded that the revised standard on detecting fraudulent financial reporting should reflect the level of responsibility that the "courts already say exists."[137] The following discussion suggests strongly that, through SAS No. 53, the AICPA has failed in this endeavor. While the AICPA has finally officially acknowledged an affirmative duty to detect and disclose fraud, the degree of that duty imposed under SAS No. 53 falls short of that previously imposed on CPAs by the courts.

SAS No. 53, for instance, qualifies the auditor's duty to detect fraud where the fraud is concealed by management collusion and forgery. The standard also appears to limit the CPA's duty to design the audit to detect fraud where there are no suspicious circumstances suggesting that fraud might be present. Finally, substantial limitations exist on the auditor's obligation to disclose fraud to the investing public once fraud has been detected. An analysis of these three limitations on the auditor's responsibilities under SAS No. 53 follows and demonstrates the standard's shortcomings.

A. *The CPA's Obligation to Detect Fraud Concealed by Management Collusion or Forgery*

Throughout the history of the auditing standards the profession has attempted to limit the CPA's responsibility for detecting fraud involving collusion or forgery.[138] SAS No. 53, unfortunately, appears to do little more than reaffirm this restriction on the auditor's re-

137. Treadway Report, *supra* note 25, at 51.

138. *See, e.g., supra* note 48 and accompanying text.

sponsibilities by stating: "Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity."[139]

There is a rather potent implication here that CPAs need not design their audits to detect forgery or collusive fraud, on the ground that a normal GAAS audit cannot be expected to detect such fraud. However, should auditors actually interpret this provision to limit their responsibility for detecting fraud in this manner, they will find themselves at odds with substantial court precedent.[140] Courts appear unwilling to recognize the distinction made by auditors between the duty to detect fraud involving collusion or forgery and the duty to detect other forms of fraud, such as individual employee embezzlement schemes or fraudulent reporting by a department

139. SAS No. 53 § 316.07. This is a significant restriction given that most efforts by management to falsify financial statements would normally be expected to involve some form of collusion or forgery, such as management overriding of internal controls, and falsifying or forging underlying accounting records, misapplication of accounting principles, and recordation of fictitious transactions. *See* COHEN REPORT, *supra* note 6, at 32-33. Indeed, it is hard to imagine how a material misrepresentation in the financial statements could be hidden from auditors without some form of collusion or forgery among management, employees or third parties. Thus, to the degree that SAS No. 53 is read to restrict a CPA's obligations for detecting collusive fraud, it would seem that an auditor's obligation for fraud detection under the standards remains limited.

Interestingly, early AICPA exposure drafts issued for public comment did not contain this reservation. These drafts simply called for the auditor to design the audit to provide assurances of uncovering *all* types of material fraud, regardless of their cause. *See* D. GOLDWASSER, ACCOUNTANT'S LIABILITY 1988, 35 (Practising Law Inst. 1988).

140. There is good reason for believing that auditors might interpret SAS No. 53 as limiting the CPA's obligation to detect fraud. At least one textbook author has said the Treadway Commission "appreciated that an auditor cannot be held responsible for detecting all material irregularities, particularly those involving a carefully concealed forgery or collusion . . . ." RICCHIUTE, *supra* note 8, at 98-99. *See also* Guy & Sullivan, *supra* note 8, at 38 (while SAS No. 53 increases an auditor's responsibility to detect fraud the standard "[o]f course . . . recognizes that some irregularities—particularly forgery and collusion—may preclude even a properly designed and executed audit from detecting" the irregularity). More importantly, a widely used CPA admissions examination review guide informs its readers that they should "know that an audit should be designed to provide *reasonable assurance* of detecting material errors and irregularities . . . . [But also they should know that] a properly designed and executed audit may miss a material irregularity, particularly one involving forgery or collusion." I. Gleim and P. Delaney, CPA EXAMINATION REVIEW VOLUME I OUTLINES & STUDY GUIDES 121 (17th ed. 1990). There is a strong implication in each of these writings that while an auditor must provide assurances of fraud detection, this does not mean the CPA will be held responsible for failing to detect collusive fraud or forgery. Some auditors may be inclined to rely on the inherent limitations of a GAAS audit, including time constraints, the need for auditors to rely upon representations made by management and third parties, and limitations posed by sampling techniques as justification for making little or no effort to design the audit to uncover collusive frauds or forgeries.

head.[141] Instead, courts have held auditors to a duty to uncover fraud without regard to whether the fraud was perpetrated through the individual acts of employees or the collusive efforts of management, employees or third parties.[142]

In *Cenco Inc. v. Seidman & Seidman*,[143] for example, auditors were charged with failing to detect or disclose a "massive fraud" involving top Cenco management, including the chairman and president.[144] The fraud involved inflating inventory values in order to exaggerate the worth of Cenco stock, thereby enabling the company to obtain financing.[145] The fraud managed to remain undetected and unreported despite several annual audits, and it was only through the efforts of a new Cenco employee that the fraud was uncovered. After the discovery the value of Cenco's stock plummeted by seventy-five percent. Subsequently Cenco's shareholders brought a class action suit against Cenco's auditors, Seidman & Seidman.[146] Although the shareholders' suit was settled before trial, the court's willingness to entertain this action, despite allegations of massive collusion, should be discomforting to auditors who expect to be relieved of responsibility when the fraud involves collusion.

Maduff Mortgage Corporation provides further support for the proposition that auditors may be liable for failing to detect collusive fraud.[147] As previously mentioned, *Maduff Mortgage Corporation* involved a fraudulent scheme to divert construction loan proceeds to improper uses.[148] The fraud was accomplished and concealed from the auditors through the collusive efforts of MMC's employees and top management.[149] These individuals, for instance, supplied the auditors with an array of misinformation, misstatements and forged supporting documentation.

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141. A fraud perpetrated by collusive management efforts might entail forging invoices, manipulating accounting data and making misrepresentations to auditors in an effort to exaggerate corporate earnings or assets. While a noncollusive fraud might simply involve the individual acts of a department or division head misreporting divisional profits to boost the department head's year-end bonus. The former is arguably more difficult to discover, and thus entails more thorough and costlier audit procedures.

142. *See generally* Bonhiver v. Graff, 311 Minn. 111, 248 N.W. 2d 291 (1976) (suit by receiver against bankrupt company's auditors for failing to uncover collusive embezzlement scheme in which company officers embezzled more than $2 million from failing company); Robert Wooler Co. v. Fidelity Bank, 479 A.2d 1027 (Pa. Super. 1984) (accounting firm found liable for failing to uncover employee defalcation scheme involving forgery); Annotation, *supra* note 36, at 418-24 (1979).

143. 686 F.2d 449 (7th Cir. 1982).

144. *Id.* at 451.

145. *Id.*

146. *Id.*

147. 98 Or. App. 497, 779 P.2d 1083 (1989).

148. *See supra* notes 124-128 and accompanying text.

149. *Id.*

The auditors argued on appeal that they were prejudiced by the court's failure to instruct the jury on SAS No. 16, the auditing standard defining the CPA's duty to detect fraud applicable at the time.[150] According to the defendants, the court's failure to instruct the jury on SAS No. 16 meant that the "jury could not know that there [were] severe limitations on an auditor's responsibility to detect fraud."[151] The defendants further contended that this was "particularly prejudicial because there was substantial evidence that MMC's officers and employees engaged in fraud and made knowing misrepresentations to [Deloitte Haskins]."[152] The auditor's defense was thus predicated on showing that under GAAS the auditor's duty to detect fraud is limited, especially where there is evidence of collusion among management. The court, however, concluded that the auditing standards were not the controlling measure of the auditor's duty to detect fraud and upheld the jury's verdict against Deloitte Haskins.[153] By doing so, the court was implicitly holding that the auditor's responsibilities for detecting fraud were not truncated merely because the fraud involved forgery or collusion.[154]

The Securities and Exchange Commission (SEC) also appears reluctant to differentiate between the auditor's responsibilities to detect fraud perpetuated through collusion and forgery and the auditor's duty to detect other fraudulent schemes. In the now famous 1940 *McKesson & Robbins, Inc. v. Price Waterhouse & Co.*[155] decision, the SEC held that "[public] accountants can be expected to detect gross overstatements of assets and profits whether resulting from collusive fraud or otherwise."[156]

The courts and the SEC thus demonstrate a willingness to relieve auditors of responsibility for detecting fraud merely on the basis that the fraud involved collusion, forgery or management misrepresentations to the auditors. Auditors should therefore hesitate in reading SAS No. 53 to limit the auditor's duty to detect fraud under such circumstances. To stay in line with the courts' expectations, CPAs should instead plan their audits to detect *all* forms of fraud, regardless of the cause. Where auditors fail to uncover collusive fraud even after designing tests to detect such fraud, perhaps their

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150. Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. at 501-502, 779 P.2d at 1086.

151. Appellant's Brief, *supra* note 128, at 5.

152. *Id.*

153. Maduff Mortgage Corp. v. Deloitte Haskins & Sells, 98 Or. App. at 502, 779 P.2d at 1086.

154. It is perhaps worth noting that this author has been unable to locate any court decisions holding as a matter of law that auditors are not obligated to detect collusive fraud.

155. Exchange Act Release No. 2,707 [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,020 (Dec. 5, 1940).

156. *Id.*

best defense is not that they lacked an obligation under SAS No. 53 to detect the fraud, but rather that they acknowledged the responsibility and exercised reasonable care under the circumstances.[157] This means, of course, recognizing that under certain circumstances auditors must design audit procedures and tests beyond that which a normal GAAS audit requires, such as testing for forgery, independently verifying management representations, and other acts particularly aimed at uncovering collusive fraud.

B. *The CPA's Responsibility to Design the Audit to Detect Fraud Absent Suspicious Circumstances*

Under SAS No. 16, the predecessor to SAS No. 53, an auditor had a duty to search for fraud;[158] however, absent suspicious circumstances, some commentators and auditors believed the auditor was relieved of this obligation under the auditing standards.[159] A close reading of SAS No. 53 suggests very little has changed in this regard. SAS No. 53 states, for instance, that the auditor at the outset of each audit engagement should "design the audit to provide reasonable assurance of detecting errors and irregularities [e.g. fraud] that are material to the financial statements."[160] However, according to the standard, the audit "design," including the scope of the audit and the specific tests and procedures to be followed during a particular audit, should be formulated based upon an assessment of the "risk that [fraud may exist and] may cause the financial statements to contain material misstatement."[161]

The question that arises is: what occurs when the risk assessment for a particular client provides no indication that fraud may be present? A reasonable interpretation would be that the auditor is relieved of responsibility to design the audit to detect fraud in such cases. Simply stated, SAS No. 53 could lead auditors to conclude that where the risk of fraud is low, or where there are no suspicious circumstances giving rise to such risks, CPAs may afford fraud little

157. This is essentially the same argument made by Mautz and Sharaf in 1961. *See* PHILOSOPHY, *supra* note 21, at 139-140. For a thoughtful discussion on how auditors can design their audits to detect various forms of fraud, see Levy, *Financial Fraud: Schemes and Indicia*, J. ACCT., Aug. 1985, at 78; Levy, *supra* note 11, at 52; C. Woelfel & W. Woelfel, *Fraud: The Inside Criminal*, CERTIFIED PUB. ACCT. J., Mar. 1987, at 41.

158. *See supra* notes 43-45 and accompanying text.

159. SAS No. 16 § 327.06 implied this by stating, for instance, that the "scope of the auditor's examination would be affected by . . . results of his substantive tests, and by circumstances that raise questions concerning the integrity of management." Moreover, the provision stated that the auditor's plan to search for fraud was influenced by the "possibility of material . . . irregularities" which may be indicated by application of his audit procedures. *Id.* In short, the implication was that the discovery or awareness of suspicious circumstances triggered the obligation to detect fraud.

160. SAS No. 53 § 316.05.

161. *Id.*

or no attention when designing their audit procedures for a particular audit.

On the surface then, one could conceivably argue that SAS No. 53 has merely reshuffled the deck regarding the auditor's responsibilities absent "suspicious circumstances," without actually adding any new cards. Similar to its predecessors, SAS No. 53 implies the lack of responsibility to detect fraud absent the existence of suspicious circumstances, or other indicia raising the risk of fraud. Courts, however, are not apt to be as forgiving of auditors. Many courts and commentators have concluded that merely by virtue of the auditor's implicit undertaking the auditor has a duty to detect fraud without regard to whether there are suspicious circumstances.

Prior to the enactment of SAS No. 53 one commentator observed that the auditor's duty will not permit him to "wait for an alarm bell to arouse him to investigation. He has a duty in the first instance to focus a skeptical eye on the accounts. That is the purpose of an audit."[162] This point is confirmed by several court decisions holding auditors liable for failing to detect fraud even where suspicious circumstances were lacking.

In *Hochfelder v. Ernst & Ernst*,[163] auditors failed to uncover weaknesses in the client's internal control structure.[164] These weaknesses allegedly permitted the company president, Leston Nay, to embezzle funds invested by customers.[165] Nay induced customers to invest funds in a special account which he represented would yield interest at a high rate of return. Nay was able to accomplish this task through his so-called "mail rule," under which all employees had been instructed by Nay not to open any mail specifically addressed to his attention.[166]

Despite any overt evidence raising suspicion that fraud may have been afoot, the *Hochfelder* court found that by undertaking the examination auditors implicitly assume some responsibility for uncovering those weaknesses in the internal control structure that may permit defalcations.[167] By uncovering weaknesses in the internal controls, this in turn might have led the auditors to suspect and detect Nay's fraud.[168] In effect, then, the court said auditors have in the first instance some obligation to search for fraud, notwithstanding the absence of circumstances leading an auditor to suspect fraudulent activity.

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162. Fiflis, *supra* note 77, at 97.

163. 503 F.2d 1100 (7th Cir. 1974).

164. Internal controls are essentially the "means of monitoring compliance with established [company] policies and procedures [designed to safeguard assets]." MONTGOMERY, *supra* note 1, at 243.

165. Hochfelder v. Ernst & Ernst, 503 F.2d at 1103-04.

166. *Id.* at 1112.

167. *Id.* at 1109-11.

168. *Id.* at 1110-11.

More recently, in *Rosenblum v. Alder*,[169] the New Jersey Supreme Court expressly stated that the presence or absence of suspicious circumstances is not a determining factor in deciding whether auditors have a duty to search for fraud. In *Rosenblum* the plaintiff relied upon the audited financial statements of Giant Stores Corporation in deciding to merge his company with Giant.[170] After the merger, it was discovered that Giant had manipulated its assets and omitted disclosing substantial liabilities in an effort to conceal enormous company losses.[171] Because of this discovery, trading of Giant stock on the New York Stock Exchange was terminated and plaintiff's newly acquired 360,000 shares became worthless.[172] Rosenblum sued the Giant Stores auditors for failing to discover these fraudulent activities.

After acknowledging the inherent limitations of an audit and providing a detailed discussion of the auditor's role, the court concluded:

> Nonetheless, the independent auditor should be expected to detect [management fraud] that would be uncovered in the exercise of normal professional skill and care. . . . The accountant must determine whether there are suspicious circumstances and, even in the absence of suspicious circumstances, make a reasonable sampling or apply some testing technique.[173]

Clearly then, as these cases demonstrate, the courts are willing to hold auditors responsible for failing to detect fraud, even where there are no circumstances leading the auditor to suspect, at the outset of the audit or at some point during the audit, that fraud may be present. Inasmuch as SAS No. 53 is read by auditors to provide otherwise, another substantial gap will exist between the nature and degree of a CPA's responsibilities imposed by the courts and the responsibilities defined under the auditing standards.[174]

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169. 93 N.J. 324, 461 A.2d 138 (1983).

170. *Id.* at 330-31, 461 A.2d at 141.

171. *Id.* at 331, 461 A.2d at 141.

172. *Id.*

173. *Id.* at 344, 461 A.2d at 148-49.

174. To the degree SAS No. 53 is designed or interpreted to limit the auditor's *duty* to fraud, in a manner illustrated by this Comment or otherwise, CPAs will likely find SAS No. 53 falling victim to the same public scrutiny imposed on predecessor auditing standards on fraud. Attempts to limit or disavow responsibility for a service the public desires and expects auditors to perform may prove futile and inevitably will lead to a continuation of the litigation explosion involving auditors. Auditors may thus wish to consider the observations regarding fraud detection made by Mautz and Sharaf in 1961:

> [H]ere is an important social service that the profession could render the economic community if it would [acknowledge meaningful responsibility for the detection of fraud]. . . . Why should independent auditors as a group abdicate this opportunity and this responsibility? Our claim to professional status carries with it the responsibility of service; independent certified

C. The Auditor's Whistle-Blowing Obligations

Another potential problem for auditors under SAS No. 53 arises out of the standard's disclosure provisions. Suppose a CPA does discover fraudulent activities of management: what are the auditor's obligations in disclosing the fraud? Of particular concern here is the extent to which an auditor must blow the whistle and disclose the fraud to third parties—investors, creditors and the general public. This is a perplexing and troubling problem for auditors and one that inherently involves dueling ethical obligations. For example, because a CPA's ethical obligations mandate strict client confidentiality,[175] a CPA would necessarily be presented with a Catch-22 situation if the auditing standards imposed a liberal disclosure obligation for discoveries of fraud.[176] The AICPA apparently recognized this potential predicament and drafted the SAS No. 53 third-party disclosure requirements in a guarded manner. The effect was to almost entirely relieve CPAs of reporting management fraud to outsiders.

For example, the standard provides that "[d]isclosure of irregularities [including management fraud] to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility. . . ."[177] Further, the standard says any such disclosure "would be precluded by the auditor's ethical or legal obligations of confidentiality."[178]

This provision would, therefore, appear to rule out the possibility for any significant routine public disclosure of client fraud. In fact, there are essentially only three limited means by which the public may be alerted to management fraud under SAS No. 53. First, the standard tangentially notes that an auditor *may* need to disclose irregularities to the SEC and a successor auditor where there is a

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> public accountants, if they are truly professional men, are not in business solely for their own profit. Not only do they have responsibilities to their clients and to those who rely on their opinions, it seems reasonable to charge them as a profession with responsibilities to the business community. No other profession . . . meets this need . . . . There are many who may feel that auditing has failed in its trust if it refuses to be of service here.

PHILOSOPHY, *supra* note 21, at 129 (footnote omitted).

Mautz and Sharaf disagreed with auditors' attempts to disavow responsibility for detecting fraud, advocating instead the recognition of an affirmative duty to detect fraud to be governed and understood within the provinces of the "reasonably prudent person" concept. *Id.* at 131-40.

175. AICPA Ethics Rule 301 states: "A [member] shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client." 2 AICPA PROFESSIONAL STANDARDS § 301.01 (CCH 1977).

176. For a thoughtful discussion of the dilemma auditors face in attempting to reconcile their ethical obligations with potential whistle-blowing obligations, see Causey, *The CPA's Guide to Whistle Blowing*, CERTIFIED PUB. ACCT. J., Aug. 1988, at 26.

177. SAS No. 53 § 316.29.

178. *Id.*

change in auditors.[179] Second, the auditor may need to make certain disclosures in response to a subpoena. Third, certain disclosures may be required to a governmental agency when the audit is conducted "in accordance with requirements for the audits of entities that receive from a government agency financial assistance."[180] The number of cases that could potentially fall within these categories, however, is likely to be limited.

Moreover, the standard states that if the auditor becomes aware of material irregularities the auditor "should insist that the financial statements be revised and, if they are not, express a qualified or an adverse opinion . . . disclosing all substantive reasons for his opinion."[181] One might be tempted to conclude that this requirement is sufficient to inform the public of corporate fraud and meet the public's disclosure expectations. However, one must ask whether correcting the financial statements really addresses the heart of the problem. Suppose, for instance, that an auditor caught a client's top management, including the board of directors, in a scheme to misstate revenues or overstate assets. Suppose further that this fraudulent scheme involved massive efforts by management to falsify underlying records and conceal large losses. Under SAS No. 53, if auditors could convince the company's management to correct the financial statements, the auditors apparently would have fulfilled their responsibilities. The problem with this scenario, however, is that investors and creditors would still be left in the dark, and perhaps might even be deceived, about the integrity and reliability of the company's management—never knowing that, save the auditor's efforts in detecting the fraud, they may have been swindled. Meanwhile, the management team that attempted the fraudulent reporting scheme remains in power and could conceivably attempt fraudulent activity at a future date. To the degree that some investors and creditors take into account aspects of management's moral conduct when making investment decisions these investors would clearly be ill-informed in their buying decisions.[182]

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179. *Id.*

180. *Id.*

181. *Id.* § 316.26.

182. One commentary observed that even immaterial fraudulent activities could affect an investor's decision:

> Some people hold that information about various aspects of management's moral conduct can influence investors' decisions. By this reasoning, bribes, kickbacks, [and] other improper payments in relatively small amounts . . . can be considered material. . . . Such events may also be considered pertinent to an investor's evaluation of management's ability to fulfill its stewardship responsibilities . . . . These arguments . . . support the position that financial statements are misleading to investors if they do not disclose improper and illegal activities.

PERSPECTIVES 4TH ED., *supra* note 82, at 235.

The foregoing illustrate some of the inherent inadequacies of SAS No. 53 in providing investors and creditors with information concerning management's fraudulent activities. Although the AICPA, faced with the need to balance its self-imposed ethical obligations of confidentiality against the public's right to know, may have had legitimate reasons for limiting the auditor's disclosure responsibilities, CPAs should still question whether courts will be as forgiving. Unfortunately, the question is a difficult one to answer since the courts have not presented a clear view of the degree to which auditors are held responsible for making public disclosures of client fraud.

To be sure, courts are not reluctant to hold auditors liable in either criminal or civil actions for fraudulent misrepresentation where the auditor has actual knowledge that the financial statements are fraudulent and still participates in issuing the statements.[183] Beyond this, however, it is unclear whether auditors have a broader duty to blow the whistle, such as in the hypothetical above, where the company's financial statements are not materially misstated.

One recent decision that should give auditors some comfort is *DiLeo v. Ernst & Young*.[184] In that case the court refused to permit an action against CPAs for failing to sufficiently disclose loan loss reserves. The case arose out of the Continental Illinois Bank failure in which investors and depositors lost millions of dollars. The plaintiffs, shareholders in the failed institution, charged the bank's auditors, Ernst & Young, with securities fraud for their certification of allegedly fraudulent financial statements.[185] To support their charge the plaintiffs alleged that the bank was too slow in increasing its loan loss reserves for uncollectible loans. As a result, the bank's reported loan loss reserves were understated by as much as $600 million dollars, and net credit losses were underreported by approximately $4 billion.[186]

The appellate court upheld a lower court's refusal to allow the action against the auditors, finding, among other things, that the plaintiffs had failed to sufficiently allege either scienter or any duty to disclose.[187] With respect to the duty to disclose the appellate

183. *See, e.g.*, United States v. Weiner, 578 F.2d 757 (9th Cir. 1978); United States v. Natelli, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); (auditors criminally liable for willfully and knowingly making materially false and misleading statements); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112 (S.D.N.Y. 1974) (auditors found liable for making insufficient disclosure despite apparent compliance with GAAP); Fischer v. Keltz, 266 F. Supp. 180 (S.D.N.Y. 1967)(auditors have a duty to anyone still relying on a prior audit report to disclose subsequently discovered errors).

184. 901 F.2d 624 (7th Cir. 1990).

185. *Id.* at 625-26. Action brought under Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

186. DiLeo v. Ernst & Young, 901 F.2d at 626-27.

187. *Id.* at 628.

court stated:

> Although accountants must exercise care in giving opinions on the accuracy and adequacy of firms' financial statements, they owe no broader duty to search and sing. Such a duty would prevent the client from reposing in the accountant the trust that is essential to an accurate audit. Firms would withhold documents, allow auditors to see but not copy, and otherwise emulate the CIA, if they feared that access might lead to destructive disclosure.[188]

While this strong language is certainly favorable to CPAs and offers hope that the AICPA hit the mark with SAS No. 53 disclosure requirements, auditors should avoid relying too heavily on this decision. The case merely involved the plaintiffs' failure to provide sufficient allegations in the complaint. The case does not answer the question of whether an auditor may be found liable for common law fraud or negligence in failing to detect or disclose inadequate loan loss reserves.[189] It is unlikely the court would have been as forgiving of the auditors had the complaint alleged actual knowledge by the auditor of intentional underestimations of the loan loss reserves.

Moreover, the decision should be weighed against the holding in *Fund of Funds, Ltd. v. Arthur Anderson & Co.*[190] In that case plaintiffs alleged that one of Arthur Anderson's clients was defrauding another, and charged the auditors with, among other things, failing to warn the defrauded client. The auditors' defense—that the defrauded client had no right to the information and that the auditors' duty of confidentiality prevented such disclosure—did not prevent the jury from returning an $80.7 million verdict against the CPA firm.[191]

The *DiLeo* decision, as well as the disclosure provisions of SAS No. 53, should also be read against the United States Supreme Court decision in *United States v. Arthur Young & Co.*,[192] which involved an accounting firm's attempt to claim work-product immunity under section 7602 of the Internal Revenue Code. The account-

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188. *Id.* at 629 (citation omitted). The author suggests the court's rather bleak assessment of what might happen is not entirely accurate. If auditors did have a broader duty to disclose fraud the great majority of clients would continue to furnish auditors with the same information currently being provided to CPAs, since failure to cooperate would necessitate that the auditor disclaim an opinion or withdraw from the engagement. Either possibility would result in some form of disclosure (withdrawal requires disclosure of reasons to the SEC) and raise speculation that the client had something to hide. Said another way, the majority of clients who have nothing to hide in terms of fraudulent activity, would not fear possible disclosure of fraud and thus would likely continue to provide auditors with the same access to information currently enjoyed by auditors.

189. *Id.* at 628-29.

190. 545 F. Supp. 1314 (S.D.N.Y. 1982).

191. *Id.* at 1325. The case was eventually settled on appeal for $45 million. Causey, *supra* note 176, at 30 n.3.

192. 465 U.S. 805 (1984).

ing firm of Arthur Young refused to turn over to the IRS certain tax accrual work papers that pertained to a client's audit examination. The auditors argued that the same work-product privileges afforded to attorneys under the *Hickman* doctrine[193] should apply to accountants. The Court disagreed with this analogy, however, and stated:

> The *Hickman* work-product doctrine was founded upon the private attorney's role as the client's confidential adviser and advocate . . . . An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant . . . *owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.* This "public watchdog" function . . . requires complete fidelity to the public trust.[194]

The Court presented the issue in a different context by asking to whom the auditor owes his allegiance. The Court appeared to suggest that the CPA's obligations to the public could override the profession's self-imposed ethical obligations of client confidentiality. The Court's decision, at the very least, provides reinforcement for the public's perception of the accountant as a watchdog over corporate morality.[195]

Although the decision narrowly focused on determining whether the statutory immunity privilege applied to auditors, CPAs should nonetheless feel great discomfort in the *Arthur Young* Court's willingness to view auditors as public watchdogs. The decision is still relatively new and its full ramifications have yet to be felt by auditors. In the final analysis, auditors should anticipate significant opposition to their refusal, under SAS No. 53, to disclose known frauds on the mere pretense that such disclosures would represent a violation of their ethical obligations.[196]

CONCLUSION

Lawyers representing CPAs inevitably will be asked to advise their clients on whether compliance with SAS No. 53 will be an effective tool for avoiding liability in the area of management fraud.

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193. *See* Hickman v. Taylor, 329 U.S. 495 (1947).

194. United States v. Arthur Young & Co., 465 U.S. at 817-18 (emphasis added).

195. *See* Weiss, *An Introduction to Concepts of Accountants' Liability*, CERTIFIED PUB. ACCT. J., July 1987 at 24.

196. *See, e.g.*, Causey, *supra* note 176, at 37 ("The courts are moving accountants . . . to a standard of conduct requiring disclosure of client confidential information whenever necessary to protect prospective victims. This movement can be expected to increase in scope and result in changes in rules of ethics . . . ."). *Arthur Young* would appear to reinforce this conclusion and widen the pool of "prospective victims" that the auditor may need to inform.

Their advice should be simple. Neither GAAS nor SAS No. 53 constitute the controlling measures of an auditor's liability. The door remains open in auditor malpractice suits for plaintiffs to introduce evidence indicating that the auditor should have done more than the profession's self-imposed standards dictated.

Complicating the situation is that the auditor's obligations for detecting and disclosing fraud under SAS No. 53 fall short of those previously imposed on auditors by the courts. Perhaps the best advice for auditors is to design their audits to detect *all* forms of fraud, regardless of the cause and regardless of whether suspicious circumstances are present. Further, to the degree that courts perceive CPAs as owing their allegiance to the investing public and view the public's right to know as outweighing the auditor's ethical obligations of confidentiality, CPAs may, under certain circumstances, find compliance with the fraud disclosure provisions under SAS No. 53 inadequate protection from liability.

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