Assessing Auditor Liability in Fraud Cases

Session 5D & 7D

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Agenda

■ Will explain 13 areas of an audit that are particularly prone to auditor negligence, based on analysis of cases involving auditors over the past ten years

■ Will use several recent PCAOB Disciplinary Proceedings, as well as some court cases to illustrate audit failures

  □ Some of these involve fraud that impacted the financial statements; others are simply illustrative of common audit failures
Cooley on Torts (1932)

“In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession.”
Cooley on Torts (1932)

“But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.”
Good Faith vs. Negligence?

Today’s session focuses on assessing whether an auditor was negligent in failing to detect a material fraud or whether the auditor made a good faith effort, exercising due professional care, in performing the audit.
Potential Plaintiffs

- Purchasers of stock
- The company that was audited
- Third-party primary beneficiaries
  - Specifically identified to auditor
- Foreseen third parties
  - Not specifically identified to auditors, but known nonetheless
- Foreseeable third parties
  - Those who have reasonable need to rely on the financial statements
Types of Claims

- **Breach of contract**
  - Auditor violated the auditing standards that were agreed to in the engagement letter

- **Tort**
  - Ordinary negligence
    - Lack of reasonable care in performing the audit
  - Gross negligence
    - Reckless departure from auditing standards; lack of even minimum care in performing the audit
Two Points Must be Proven

- The financial statements contained a material departure from the principles that they purport to be prepared in conformity with (e.g., U.S. GAAP, IFRS, etc); For today’s discussion, that material misstatement can result from:
  - Asset misappropriation
  - Financial statement fraud

- The auditor failed to properly follow the auditing standards to which the auditor claims compliance (e.g., U.S. auditing standards, International Standards on Auditing)
Statements Made by Auditors

Most litigation pertains to the statement made by the auditor in the opinion, stating that the financial statements are fairly stated in all material respects.

In *Lattanzio v. Deloite & Touche, LLP*, (2007) it was held that the auditor was not liable for misstatements included in a set of financial statements that the auditor did not issue a report on.
Statements Made by Auditors

- However, some cases have found that auditors can have liability for statements made by their clients, even with no statement explicitly made by the auditor
  - See Global Crossing, Ltd. 2004 case
  - Auditor’s participation was “substantial enough” and investors were “sufficiently aware” of auditor’s participation that investors’ reliance on statements made by management as if they had been made by the auditor
Auditing Standards

In the United States

- PCAOB issues standards for audits of public companies (15 separate standards so far; Follow AICPA standards for everything not specifically addressed in PCAOB standards)
- AICPA issues standards for non-issuers
  - Codified into standardized referencing system

International

- Many countries have their own unique standards
- Many follow International Standards on Auditing (ISAs), issued by the International Federation of Accountants, through the International Auditing and Assurance Standards Board
  - 36 ISAs
The Clean Opinion

- Provides **reasonable** assurance that the financial statements (including the notes) are free of **material** misstatement.
- What is reasonable?
- What is material?
- Remember, auditors do not issue an opinion on whether there was fraud; it is whether the financial statements are free of material misstatement.
Risk Assessments

- Auditors must identify and assess the risks that the FS might be materially misstated, considering:
  1. The client’s industry in which it operates (trends, regulations, etc.)
  2. The nature of the client (operations, ownership, structure, etc.)
  3. Client’s objectives and strategies and the related business risks
  4. The measurement and review of the entity’s financial performance
  5. The client’s internal controls, including how the entity selects and applies accounting policies
Risk Assessments—Auditor Liability

- Industry knowledge is weak
  - Auditor works in too many industries
  - Fails to get industry-specific training or knowledge

- Improper understanding or documentation of internal controls
  - Client-prepared checklist only
  - Limited to copies of policies and procedures
  - No interviews or walk-throughs
  - Follows same audit procedures regardless of internal control considerations

Audit deficiencies centered around failure to properly plan the audits, specifically:

- Auditor did not test internal controls and (more importantly) did not document how that determination was reached
- Did not document how the assessment of internal controls impacted the planning of the audit to determine the nature, timing, and extent of the tests to be performed
- Audit plan consisted of a disclosure checklist
Risk of Fraud

- Misstatements can be the result of errors or fraud
- Auditors are directed to perform specific procedures associated with the risk of misstatements caused by fraud:
  - Identify specific fraud risks that could lead to a material misstatement
  - Assess each risk (in light of client’s internal controls)
  - Respond to the risk by designing appropriate audit procedures
    - Overall responses (assignment of staff, audit approach, etc.)
    - Specific responses (tests geared toward specific areas)
The Fraud Triangle

- Auditors are instructed to consider Cressey’s fraud triangle in assessing the risk of fraud:
  - Incentive/pressure
  - Opportunity
  - Rationalization
PCAOB Release No. 105-2010-007

- Pertains to Traci Jo Anderson, CPA, and the 2006 audit of HouseRaising, Inc.
- Auditor identified capitalization of software development costs as an area that represented significant risk
  - 92 percent of the company’s assets were in the form of capitalized software
- Audit deficiencies:
  - Failure to obtain adequate evidence that capitalization conformed to GAAP
  - Failure to test stage of development of the software
Pertains to Traci Jo Anderson, CPA, and the 2006 audit of HouseRaising, Inc.

Auditor identified revenue recognition as an area susceptible to fraud
- 88 percent of revenue came from construction contracts

Audit deficiencies:
- Failure to obtain sufficient competent evidence concerning amounts recognized as revenue
- Auditor accepted management’s representation that use of completed-contract method of revenue recognition was appropriate without doing any further work or analysis
  - Percentage of completion method would be preferable under SOP 81-1
Audit Staffing

- Assignment of staff and responsibilities, as well as supervision of staff, are important elements of an audit.
- PCAOB Release No. 105-2009-006 involved Moore and Associates, a CPA firm that went through rapid growth and was found to have assigned untrained and inexperienced staff with no supervision:
  - Casual acquaintances
  - Conveniently located relatives
  - Moore’s ex-wife
  - Moore’s daughter’s then-boyfriend (sent abroad on an inventory observation)
Analytical Procedures

- Consist of the following steps:
  - Identify reliable data
  - Calculate an expected result based on this data
  - Determine whether recorded result differs materially from calculated (expected) result
  - Investigate material differences
    - Determine whether the expectation was flawed, actual recorded results are accurate, or
    - Recorded result is incorrect
Analytical Procedures—Examples

1. Comparing current year recorded amounts with prior year amounts
2. Vertical analysis for current year compared to vertical for prior year
3. Calculating expected revenue by multiplying activity by a price
Analytical Procedures

Used in three phases of an audit:

1. **Planning** – to assist in determining nature, timing, and extent of audit procedures (required)
2. **Fieldwork** – as a substantive audit procedure to audit an account balance or class of transactions (optional)
3. **Final review** – as part of the overall final review of audit evidence gathered during the audit (required)
Audit Deficiencies—Planning Stage

- Failure to identify a risk of material misstatement based on the preliminary analytical procedures
- Identification of a risk of material misstatement, but failing to properly design appropriate additional audit procedures in response to the identified risk
Audit Deficiencies—Substantive Testing

- Audit deficiencies when using analytical procedures to audit an account balance or class of transactions include:
  - Use of unreliable data on which the expectation is based
    - Esp. when data is provided by the same person who is in a position to manipulate the financial results
  - Failing to corroborate management responses
    - Management may provide an initial explanation for why actual results deviate from expected ones
    - Even if the explanation is plausible, auditors must corroborate this explanation
Accounting Estimates

- Must identify and audit all estimates that are material to the financial statements, such as:
  - Collectability of accounts receivable
  - Inventory obsolescence
  - Useful lives of depreciable and amortizable assets
  - Percentage completion on long-term contracts
  - Revenue recognition estimates
  - Probability and amount of contingencies/litigation
  - Actuarial assumptions used in pension liabilities
  - Fair values of certain assets and liabilities
Three Approaches to Auditing Estimates

1. Review and test the process used by management.
2. Develop an independent estimate and compare to the one developed by management.
3. Review subsequent events.
Audit Deficiencies

- First approach
  - Inadequate understanding of management’s process
  - Failure to test the process used by management
  - Improper reliance on third party used by management

- Second approach
  - Use of unreliable data to develop estimate
  - Improper resolution of difference between auditor’s estimate and the one developed by management

- Third approach
  - Failure to properly interpret year-end effect of subsequent event
Fair Value Estimates

- Certain assets and liabilities are to be adjusted to fair value each period:
  - Most investments

- Assets and liabilities acquired in connection with a merger/acquisition are to be recorded at their fair value, not previous book value

- Other assets should be written down from original basis to fair value when an impairment occurs, for example:
  - Intangible assets
  - Property
  - Inventory
  - Investments that are not already carried at fair value
Difficulties in Auditing Fair Values

- Selection of valuation method
- Significant assumptions made by management in applying a method
  - Future cash flows, interest rates, etc.
- Documentation maintained in support of FV
- Segregation of duties in FV determination
- Consistency and reliability of data used in calculations
- Extent to which third-party experts or service organizations are relied upon by management
  - These represent an element of the entity’s internal controls and must be understood by the auditor
Concerning Clancy and Co., PLLC and two of its partners


Among numerous cited audit failures:

- Failed to audit management’s assertion that fair value of assets acquired and liabilities assumed in a 2005 acquisition of another entity approximated book value
Pertains to Traci Jo Anderson, CPA, and the 2006 audit of HouseRaising, Inc.

Auditor identified capitalization of software development costs as an area that represented significant risk

- 92 percent of the company’s assets were in the form of capitalized software

Audit deficiencies:

- Failure to test capitalized software for impairment, even after auditor communicated to management the possibility of impairment and suggested an appraisal
Revenue Recognition

- Audit standards make the assumption that revenue recognition is always a fraud risk—must document why it is NOT a fraud risk
- There can be a blurry line between fraud and an aggressive interpretation of accounting principles
- Revenue recognition schemes:
  - Phony revenue (phony customers or phony sales to legitimate customers)
  - Inflated revenue
  - Timing differences
Financial Statement Disclosures

- Auditor deficiencies:
  - Failure to disclose critical information, for example:
    - Commitments
    - Contingencies
    - Subsequent events
  - Inclusion of inaccurate data in a disclosure
Concerning Clancy and Co., PLLC and two of its partners


Among numerous cited audit failures:

- Failed to disclose that $1 million of a $1,215,000 loan receivable from a related party was past due, despite having knowledge that the loan was past due (they properly disclosed the loan amount, its purpose, and collateral, but omitted the fact that it was past due).
Management Representation Letter

- Standard letter at the end of each audit—drafted by auditor and signed by management, certifying key pieces of information provided to the auditor in connection with the audit

- ISA 580—“Although written representations provide necessary audit evidence, they do not provide sufficient appropriate evidence on their own about any of the matters with which they deal.”

- Auditor deficiency:
  - Placing too much reliance on the representation letter
Subsequent Changes to Work Papers

- When auditors are aware that their work papers may be looked at, is it okay for them to review their work papers one more time?

- Yes—BUT, auditing standards include a “lock down” rule whereby the work papers cannot undergo changes after 45 after report release date:
  - No deletion/discarding of work papers
  - May only add new documentation with disclosure of the date the information was added and why it was necessary to add
  - See PCAOB Release No. 105-2010-008, re: Jacqueline Higgins and E&Y
QUESTIONS ??