BEFORE YOU SUE:

Understanding Auditors' Defenses for Failures to Detect Erroneous or Fraudulent Financial Statements

By Elizabeth A. Kowalski, MBA, CPA, CFE
Litigation Manager
Russell Novak & Company, LLP

Barry J. Epstein, Ph.D., CPA, CFF
Partner
Russell Novak & Company, LLP

The role of the outside auditors is to opine on a company's financial statements. An unqualified ("clean") opinion will declare without reservation that, "In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in accordance with accounting principles generally accepted in (the country where the report is issued)." If and when it is later revealed that the financial statements contain material misstatements, it's only natural to ask whether the auditors may be liable for losses incurred by creditors or investors that arguably could have been averted if the auditors had detected the errors or irregularities before the financial reports were published.

Even in the face of such seeming audit failures, however, there may be mitigating circumstances – or arguments that could be invoked to defeat assertions of their liability. Before embarking on an accountants' malpractice lawsuit, it is important to consider some of the most common, and often successfully invoked, defenses by the auditors.

"The financial statement departures were not material"

In the standard auditors' opinion quoted above, the auditors state that the financial statements present fairly, *in all material respects*, the financial position and results of operations of the company. An audit does not – and cannot – provide absolute assurance that the financial statements are free from error caused by departures from generally accepted accounting principles (GAAP). An audit is based on various methods of sample testing, and the application of assorted analytical procedures and substantive procedures, designed to provide the auditors with evidence upon which to base their ultimate opinion on the financial statements. However, the auditors do not examine every transaction that impacts upon the financial statements. To do so would be prohibitively time consuming and costly. Therefore, opinions rendered on financial statements are constrained by considerations of materiality; and it could be the case that a GAAP departure or fraud, of an immaterial amount, was not discovered by auditors fully complying with the dictates of generally accepted auditing standards (GAAS).

Auditing standards note that, "information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements." While keeping in mind that materiality has both quantitative as well as qualitative components, it is nonetheless true that two experts could reasonably disagree on whether certain misstated or omitted information is material to a particular set of financial statements.

It should be noted, however, that risk of misstatement has to be controlled at a relatively low level by the auditors. Although this is not defined by professional standards (or legal standards), many professionals acknowledge that a 5% risk of such failure is reasonable under most circumstances.

However, this risk applies to each year's audit. If the same error or fraudulent misrepresentation is made year-upon-year, the risk of missing *all* of these infractions should be much lower. For example, if properly planned and conducted independent audits are performed for six consecutive years, and a risk of 5% of a material GAAP departure is tolerated for a given year's financial reporting, the likelihood of the undetected recurrence of that departure over all the years should be only 0.000002% (= .056). Put another way, the validity of citing allowable risk of misstatements rapidly fades as the error or fraudulent misrepresentation is replicated over the years.

"Even a perfect audit would not have caught this fraud"

Sometimes, the auditors will be targets of litigation because it appears there was accounting malpractice in the performance of the audit. A review of the working papers may reveal what appears to be audit failure. However, an experienced accountant or expert should be consulted to determine whether the apparent failures are true GAAS failures, or simply sug-

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gested due to random (human) error in the conduct of the audit work, or implied by poor documentation of properly performed work.

For example, the auditors may have proposed an adjusting journal entry to the wrong account simply because they wrote down the wrong account number (slipshod work), and not because they fundamentally failed to understand the nature of the business or of the given transaction (which could indeed indicate GAAS failure). Of course, it can sometimes be successfully argued that the accumulation of multiple instances of careless work amounts to GAAS failure, if it can be implied that the auditors had been insufficiently trained, were not proficient in their duties, or had been inappropriately supervised. It is thus important to assess whether the fraud or GAAP departure would have been detected by auditors performing a perfectly GAAS-compliant audit.

"Management lied to us; the auditors were victims, not perpetrators"

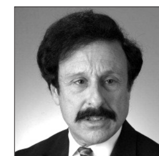
Sam Antar, one of the perpetrators of the massive Crazy Eddie, Inc. fraud in the 1980s, famously discussed all the ways he deceived the auditors. He believed that they were always just one step behind him and would catch him at any time. Given his background as a former CPA and auditor, he knew what types of documents they would request and what questions they would ask. (In this case, they failed to do so.) Whether by altering or creating fictitious documents, by moving inventory between warehouses prior to a visit from the auditors, or by outright lying to the auditors about accounting policies, there are many ways auditors can be deceived by management. In such instances, it may be difficult (*not* impossible) to argue that the auditors are responsible for damages caused by the material misstatement in the financial statements, or that the auditors could have discovered these misstatements, if management been lying to them from the onset of the fraud, particularly if the fraud was collusive in nature.

However, auditors sometimes incorrectly assert that they relied on representations by management, including obtaining the requisite management letter, and therefore are not responsible. This is not generally a valid defense, inasmuch as *unsupported* management assertions are not considered to be meaningful audit evidence. According to GAAS, the auditors must corroborate assertions by management before they may be considered audit evidence.

Whatever the facts of a specific financial statement failure, those contemplating pursuit of the auditors should anticipate the defense arguments commonly invoked, and, to the extent possible, frame counter-arguments early in the dispute. Accounting and auditing experts can thus be important resources to employ when drafting complaints.

Elizabeth A. Kowalski, MBA, CPA, CFE, (ekowalski@RNCO.com) is a Litigation Manager with Russell Novak & Company, LLP, specializing in fraud investigations and litigation consulting.

Barry Jay Epstein, Ph.D., CPA, CFF, (bepstein@RNCO.com) is Partner in the Chicago, Illinois firm, Russell Novak & Company, LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the co-author of Wiley GAAP 2010, Wiley IFRS 2010, Wiley IFRS Policies and Procedures, and other books.



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