PEERING OVER THE SHOULDER OF AN AUDITOR: TIPS TO ATTORNEYS REPRESENTING BUSINESS CLIENTS IN THE AGE OF HEIGHTENED SENSITIVITY TO FRAUD

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I. INTRODUCTION

A recent television commercial depicts a young man sitting in a jail cell. The film moves backwards in time, chronicling his booking, his arrest, his wreck, and, finally, the party and the alcoholic drinks he consumed earlier in the evening that set everything into motion.

The accounting version of this commercial would end with the frequently covered "perp walks," as chief executive and financial officers amble somberly past television cameras after they have been arrested in high-profile cases of corporate corruption. Even more plentiful are editorial cartoons that reflect the declining image of accountants and auditors. Attorneys may be relieved to see public cynicism focused on another group of professionals. Unfortunately, as an accountant and an attorney, it is difficult to dodge catcalls from almost any corner these days. In fact, if the current trend of accountant wrongdoing continues, I may begin emphasizing that I am an attorney rather than one of "those accountants."

I am also an auditor, and, worse yet, depending on your perspective, a government auditor. I have been privileged to serve as the Director of the Division of State Audit for the office of the Comptroller of the Treasury for the State of Tennessee for the past fourteen years. My office is responsible for the annual audit of the State of Tennessee Comprehensive Annual Financial Report (the state's financial statements) as well as the annual audit of federal financial assistance received by the state presented in the annual Single Audit Report of the State of Tennessee. As the chief auditor, I sign the opinion letters included in those reports. In addition, our audit authority extends beyond state agencies to include other

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recipients of state funding, such as non-profit corporations. In other words, we serve as the auditing firm for the State of Tennessee.

Over the years, we have had our share of criminal investigations, and we have also written many audit findings that detail weaknesses in internal controls and instances of non-compliance with pertinent laws, rules, regulations, and policies. As a governmental agency, all of our findings are published. In that sense, we have no secrets, and that is as it should be because we operate with tax dollars. Although all of our findings are of public record, we seldom have stories that are as tantalizing as those emanating from Wall Street; most of our miscreants are relatively low-profile.

The main differences between our financial fraud and those situations currently prominent in the national news are the level of materiality and the direct impact on third parties. Most problems uncovered by state audits are relatively immaterial. In fact, from a purely technical standpoint, Tennessee has never had a misappropriation that was material to the state's financial statements. To rise to the level of materiality, such a number would be staggering. Even though any misuse of public funds is unacceptable, the direct impact of most government fraud on any individual taxpayer is certainly more difficult to perceive than the loss to stockholders and employees of a company that has been gutted by insiders.

Although I do not audit private-sector companies, many similarities exist between the auditing issues presented by both private and public-sector entities. Both have assets and liabilities, administer payroll, collect revenue, and expend resources both in acquiring other assets and producing goods or services for third parties. Financial management of both is dependent upon effective internal controls and compliance with myriad laws, regulations, rules, and policies. The results of their operations and their financial transactions are presented in the form of reports audited by external accountants. And, they both have attorneys.

Auditors are professionals trained to examine the inner-workings of a business to provide assurances about the business to third parties. I often refer to my office as the "Department of What Happened." In this role, we are often the first outsiders to view a financial crime scene. In fact, we are frequently the people who first declare the situation a crime scene. For this reason, our experiences and observations serve to assist others who must deal with the aftermath of fraud. To that end, we work closely with prosecuting attorneys and other investigative agencies, such as the Tennessee Bureau of Investigation and the Federal Bureau of Investigation.

By its nature, auditing usually deals with the past. In fact, the work of our

office is frequently referred to as "post-audit."[2] Internal auditors, who are employees of an entity and who report to top management, are also usually engaged in post-audits of an entity's operations. However, internal auditors may assist management in reviewing proposed procedures or may engage in other concurrent or pre-audit work. Naturally, the internal audit function is an integral part of an entity's internal control system. As such, effective internal audits can help to detect and to deter fraud. Although post-auditors work solely after the fact and are not a part of the entity's internal controls, we hope that our presence also helps to deter fraud. Our recommendations are made to help correct weaknesses and strengthen controls and compliance.

Attorneys can also positively influence the internal controls of an entity. Their unique position as counselors to management allows attorneys to serve as a conscience to the entity, and they can remind staff and officers of the pitfalls that lax ethics create. Attorneys can often see the warning signs of fraud before auditors. Further, if fraud does occur, they will be heavily involved in sorting out what happened and representing their clients in the aftermath. Attorneys, particularly in-house counsel, can also find themselves caught up in the accusations against their clients.

Attorneys must tread carefully when they have information that their clients may be engaging in continuing improper conduct. The veil of attorney-client privilege may be pierced in such situations, leaving the attorney exposed as a possible participant in the misdeeds of the client. Accordingly, attorneys may claim that they are not accountants and did not understand the technical issues regarding their client's activities. When an attorney is relegated to this type of argument, however, it is certainly not a good sign.

The purpose of this article is to address issues that face attorneys, whether in-house or outside counsel, who represent corporate clients where the possibility of financial wrongdoing exists. More specifically, this article aids attorneys who find themselves standing too close to the flame of their client's wrongdoing to recognize the early signs of trouble and avert disaster for both themselves and their clients.

This article does not focus on the distinctions between criminal and civil actions against clients. Attorneys are well versed in the evidential and procedural differences between these types of actions, and white-collar crime presents no materially unique aspects to those distinctions that impact this overview. In any

[2] "Pre-audit" work, as compared to post-audit work, involves internal controls, which include, for example, reviewing invoices before payment is made.

event, the ethical bar is considerably higher than the test of whether an act is criminal, and in light of the heightened public skepticism regarding corporate integrity, an attorney should advise clients not to relax just because their actions might not be prosecutable. The negative impact on stock prices and reputations can indeed be very costly.

II. EXTERNAL AUDITS CONDUCTED PURSUANT TO GENERALLY ACCEPTED AUDITING STANDARDS

For purposes of this article, entities are divided into two groups: (1) those subject to an external audit based on Generally Accepted Auditing Standards ("GAAS"),[3] which are promulgated by the American Institute of Certified Public Accountants ("AICPA") and (2) those that are not. Although an entity might be subject to an external GAAS audit for many reasons, most entities are ultimately not required to have such a formal external audit. External GAAS audits tend to be required by third parties who have extended credit to the entity or otherwise have a financial interest in the entity. Publicly traded companies are the most common examples.

Banks and other lending institutions may require financial statements from their clients and may even request that an external auditor review the financial statements. A review is, however, much less comprehensive than an audit, and the auditor's letter accompanying a review report materially limits the auditor's exposure to liability for incorrect information contained in the financial statements. Many times these basic financial statements, referred to as "pro forma statements," are not even reviewed by an external auditor. These statements are not as detailed or as comprehensive as the formal financial statements required by Generally Accepted Accounting Principles ("GAAP") as promulgated by the Financial Accounting Standards Board.

Other auditing engagements include, for example, some form of attestation, the technical term for the work involved in forming an opinion about a client's representations. However, attestation engagements serve more limited purposes and involve a more limited scope than a GAAS audit of financial statements. Therefore, engagements such as these, frequently referred to as "agreed-upon procedures," are excluded from this discussion.

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[3] *See generally* CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 95 (American Inst. of Certified Pub. Accountants 2001).

Furthermore, this article does not address in depth auditor liability for negligent audits.[4] The external auditor's responsibility for attesting to the accuracy of the financial statements, for identifying problems that may not directly and materially affect the financial statements, and, ultimately, for detecting fraud is a matter of great debate among the auditing community. A related issue is who has standing to sue an auditor in the event of negligence. Tennessee has adopted the majority position reflected in the Restatement (Second) of Torts,[5] which the Tennessee Supreme Court has interpreted to mean that "an accountant may be liable to a third party with whom the accountant is not in privity, but not every reasonably foreseeable consumer of financial information may recover."[6]

In the public sector, external audit requirements are much more common. Auditing standards for government entities, including non-profit corporations and other organizations that receive government funding, are promulgated by the United States General Accounting Office ("GAO") as the Generally Accepted Government Auditing Standards ("GAGAS"). Government auditing standards mirror the standards promulgated by the AICPA, so a government audit is effectively both a GAAS audit and a GAGAS audit. In addition, government entities are required to prepare their formal financial statements in conformity with GAAP for government entities as promulgated by the Government Accounting Standards Board ("GASB"). The GASB requirements are significantly different from private sector procedural requirements established in GAAP, reflecting both the need for information on a budgetary basis and the restriction on expenditure from government funds.

III. ISSUES FOR ENTITIES SUBJECT TO AN EXTERNAL AUDIT[7]

A. The Form and Content of External Audit Reports

An audit report has two main parts: (1) the auditor's report and comments and (2) the auditee's financial statements and comments.[8] The auditor's report

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[4] If an entity is required to have financial statements audited pursuant to GAAP, the external auditor's primary responsibility is to provide reasonable assurance that: (1) the financial statements are in accordance with GAAP; (2) the auditor has conducted the audit in conformity with GAAS; and (3) the financial statements, taken as a whole, are free from material misstatements.

[5] RESTATEMENT (SECOND) OF TORTS § 522 (1977).

[6] Bethlehem Steel Corp. v. Ernst & Whinney, 822 S.W.2d 592, 595 (Tenn. 1991).

[7] For purposes of this discussion, the distinctions that exist between private sector and government entities and the audits of each are ignored, unless otherwise noted.

begins with the auditor's opinion letter, which is usually just a few paragraphs in length. The opinion letter summarizes the auditor's conclusions about whether the financial statements are in conformity with GAAP and whether they are free from material misstatements. Following the opinion letter, there may be findings that detail problems noted during the audit, particularly with regard to internal controls and rule compliance.

Generally, audit opinion letters are of four types. The most favorable, known as an "unqualified opinion," means that the financial statements conform to GAAP and are free of any material misstatements. If an auditor identifies problems with the financial statements but the financial statements generally conform to GAAP, the auditor's opinion will be "qualified." The qualified opinion letter should thus explain the qualification: "Except for …, the financial statements are in conformity with GAAP and are free from material misstatements."

There are, however, circumstances in which an auditor cannot render an opinion on the client's financial statements and, consequently, "disclaims an opinion." For example, if a client limits the scope of the audit by not disclosing requested information, an auditor would be unable to obtain sufficient evidence to form a conclusion about the appropriateness of the information contained in the financial statements. The worst case for the audit client is an adverse opinion. In this type of opinion, the auditor states that the financial statements are actually misleading.

B. The Attorney Representation Letter

Upon initiation of an audit, outside counsel to the subject entity first faces a request from the auditors for information about any pending or potential lawsuits that might be material to the entity's financial statements. Such requests may shock an attorney who is not familiar with audits, and the first reaction usually is to claim attorney-client privilege. This is, however, often quickly resolved when the client instructs the attorney to give the requested information to the auditor because, after all, the information is the client's and not the attorney's.

Auditors request this information to determine whether there are any contingent liabilities that might affect the entity's financial well-being. One purpose of an audit is to provide a snapshot of the entity at a certain date to establish its value, and clearly, anyone interested in investing in or purchasing the entity would

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[8] The auditee's financial statements may include footnotes and other disclosures, and they serve as the audit statement's centerpiece.

want to see the whole picture, including any pending liabilities yet to surface. Stated another way, full disclosure to third parties without the ability to thoroughly investigate representations by management or owners is a fundamental goal of auditing, and the auditor makes such disclosure possible.

C. The Management Representation Letter

The public often confuses the roles of the auditor and the auditee with regard to the primary responsibility for the financial statements. The financial statements are the representations of management and, as such, cannot be prepared by the auditor, although the auditor may assist the client in preparing the financial statements. The most fundamental principle of auditing is auditor independence throughout the engagement, and this independence is essential because the auditor is often in the role of informing third parties about negative aspects of the auditee.

In reality, an auditor is unable to examine every transaction that occurred during the period under audit and must therefore rely on sampling and other analytical procedures to gain an understanding of the entity's operations and to focus on areas that suggest the possibility of misstatement or other problems. In recognition of these inherent limitations, an auditor's best response is to require the auditee's management to represent that there is nothing to its knowledge the auditor should know about that has not already been divulged to the auditor. These representations are made in a formal letter, the content of which is dictated by the AICPA, from management to the auditor. In addition, management acknowledges responsibility for auditee financial statements and operations.[9]

The management representation letter must be signed by an individual who has knowledge of the financial and operational activities of the auditee. Moreover, the representation must in good faith and be made by someone in a position to make an honest, accurate representation. Although the chief executive officer ("CEO") may sign the letter, the auditee's chief financial officer ("CFO") or chief business manager generally sign it.

In the aftermath of the recent accounting debacles, the Securities and Exchange Commission ("SEC") now requires the chief operating officers of publicly traded companies to sign an additional statement affirming the accuracy of financial

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[9] Typically, financial statements include notes that make important disclosures as well as the Management Discussion and Analysis ("MD&A"). In the MD&A, management informs the reader of matters that management believes noteworthy, such as new business lines or future plans for growth.

statements.[10] This form does not, however, replace the management representation letter required by auditors. The SEC form seeks to tie the CEO to the financial statements more directly in light of the denials by many prominent CEO's of any knowledge regarding the financial health of their entities just before the entities crashed.

D. Other Representations

There may be other required filings, particularly for publicly traded companies, such as the SEC-required 10-K form. This form must be filed quarterly and contains, for example, descriptions of the business, its properties, legal proceedings, selected financial data, executive compensation, and changes in and disagreements with accountants regarding accounting issues and financial disclosures. Requirements for filing a 10-K and other such forms reinforce the reality that financial statements are the representations of management rather than the auditor.

E. Internal Controls

Internal controls constitute the financial central nervous system of any entity. The AICPA has defined an internal control as "a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations."[11] Further, the AICPA categorizes internal controls into "five interrelated components":

> (1) "control environment," which "sets the tone of an organization" and provides "the foundation for all other components of internal control, providing discipline and structure";
> (2) "risk assessment," the process by which an "entity[] identifi[es] and analy[zes] … relevant risks to achievement of its objectives" and by which it "form[s] a basis for determining how the risks should be managed";

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[10] Securities and Exchange Commission, Order No. 4-460 (June 27, 2002) (requiring the filing of sworn statements pursuant to section 21(a)(1) of the Securities Exchange Act of 1934), *at* http://www.sec.gov/rules/other/4-460.htm (last visited Nov. 22, 2002).

[11] CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 78, § 6 (American Inst. of Certified Pub. Accountants 1995).

(3) "control activities," which are "the policies and procedures that help ensure that management directives are carried out";
(4) "information and communication," defined as "the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities"; and
(5) "monitoring," the "process that assesses the quality of internal control performance over time."[12]

Management is responsible for establishing and maintaining an effective system of internal control within the entity. The controls serve not only as the safeguards to ensure that the entity operates appropriately, but also serve as an early warning system when things go awry. For example, reconciliation of related records is an effective control that can indicate problems with the recording of transactions; when items do not properly reconcile, someone should investigate the discrepancy and determine the cause.

Although management is responsible for implementing effective internal controls that benefit the entity, the internal controls also benefit third parties who deal with the entity. The most obvious third-party beneficiaries of internal controls are stockholders and other stakeholders in the entity who depend on management's effective stewardship. Weak controls that fail to prevent losses to the entity create losses for such parties as well. Similarly, suppliers and lenders rely on sufficient internal controls to prevent insider theft or fraud that prevents the entity from paying its debts.

In addition, internal controls create certain presumptions about the way transactions have been handled. These presumptions can help the auditor or others to pinpoint breakdowns in questionable transactions and to focus their attention on suspect individuals and processes. For example, when there is adequate segregation of duties for cash receipting functions and the evidence indicates that the money was received but not deposited, the problem is probably at the point of deposit.

F. Two Sides of the Internal Audit Coin

An auditor considers two main points regarding most internal control issues. The first question is whether the entity has established some policy or developed a procedure to deal with the risk represented by the internal control issue. An example

[12] *Id.* § 7.

is the question of potential conflicts of interest. Has the entity developed a process to deal with the potential problem before it becomes a problem? It is always harder to back into a policy in the midst of a dilemma. By that time, judgments are clouded, and there is pressure to act. Also, there are probably already departures from what the new policy provides. Therefore, it looks a little odd when the questionable behavior is grandfathered or otherwise condoned. This is especially true if the auditor has previously addressed the issue, and the entity has ignored suggestions to develop appropriate policies for control.

The auditor's second consideration is whether the policy or procedure effectively controls the risk; indeed, the auditor's real work occurs in testing the control policy to make sure that it is actually in operation. For example, if an entity adopts a policy that requires annual disclosure statements of potential conflicts of interest, the auditor may make a finding, upon review of the disclosure statements, that the entity is not complying with the policy if there is not one statement for each person covered by the policy or if they are not up to date.

One point that we usually make upon encountering such a situation is that management apparently failed to self-monitor for compliance with this particular control policy. Stated differently, not only did staff fail to comply with the requirement, but more importantly, management apparently failed to take the policy seriously. In retrospect, this may call into question the tone set by management. At a minimum, failure to comply provides credence to critics who allege that management is lax in the performance of its duties.

Another frequent problem with internal controls involves management override of controls. The nature of managerial power dictates that internal controls will always lose out when they conflict with managerial desire. For example, if a policy requires that all purchases over a certain amount be bid upon but the boss tells an underling to place an order without obtaining bids, chances are good that the employee will do what the boss says.

In light of this reality, we often audit *all* transactions directly relating to the upper management of an entity. For example, we may examine all of the CEO's and the CFO's travel expenses since one cannot presume the internal controls will be effective over the top officials of the entity. When we discover management override of internal controls, we make note of the arbitrary fashion of management's actions, and if fraud is detected, questions put to management would be framed in a familiar form: "What did you know, and when did you know it?"

An additional internal control issue is management awareness of control

weaknesses. The clearest indicator of a weak internal control is that an external auditor has previously documented formal findings, which are contained in the audit report, that comment on the control weakness. Formal findings typically cite (1) the weakness, (2) the cause of the weakness, (3) the effect of the weakness, and (4) a recommendation to management on how the weakness can be eliminated. An example is a condition of weakness regarding cash receipts. The cause of this weakness could be failure to use pre-numbered receipts and failure to segregate cash receipting functions among employees. The obvious effect of this weakness—inadequate records of individual cash receipts—is that one employee could receive cash, not record it, and fail to deposit it without the entity's knowledge. Accordingly, the auditor's recommendation should be to use pre-numbered receipts and to segregate the various duties related to cash receipting among several staff so that one employee receives the cash, another employee enters the payment in appropriate records, and a third employee makes the deposit.

In addition to the fact that a finding puts management on notice of the problem and its potential consequences, the salient point from a legal liability standpoint is that management is usually asked to formally respond to the finding and recommendation. Management is then left with two basic options: to concur or not to concur.

If management does not concur, the auditor will probably write a rebuttal, and management must explain why they disagree with the auditor, which can be quite telling. Often the reason management does not concur is because it doubts that the benefit of implementing the recommendation justifies its cost. Alternatively, management may protest that the finding is merely theoretical and that they have never had an asset theft or fraud and are therefore justified in trusting their employees. If there is a subsequent problem in this area, however, the entity and management may regret the denial.

In addition to formal findings, auditors may provide management with informal, even unwritten, comments. Although these matters are not contained within the four corners of the audit report, the report may contain language alluding to the fact that such matters were indeed discussed with management. A savvy plaintiff's attorney would follow up on those matters. However, since these matters were not significant enough to warrant a formal finding, the defense could legitimately argue that they were not important and that the entity was not required to change any policies or procedures in response to the oral comment. Furthermore, depending on the amount of time that has elapsed since the audit in question, the auditor may not have retained that information in his or her working papers, so no record of what was said may exist. Even if there is a record in the working papers,

the auditor may attempt to raise privilege and resist disclosure of the information.

Repetitive findings of the same control weakness over several audit periods should be particularly troubling for an entity. This could be viewed as a willful disdain for the merits of the finding or, at least, a continuing insensitivity to the seriousness of the control weakness. Because the findings are usually directed to upper-level management of the entity, the entity may have difficulty brushing off the details as something to which it did not pay much attention. Derivative questions of management that may follow are: "What should you have known and when should you have known it," and "Had the controls been in place and operating effectively, would you have known about the problem?" Others who review the entity's actions may ask the entity's attorneys the same questions.

A by-product of weak controls is that attorneys frequently may find themselves involved in human resource issues. Often the early warning of an employee not playing by the rules is adverse personnel action. It is particularly damning when it appears that management, either through legal counsel or with the participation of legal counsel, fails to take appropriate action. Sometimes fear of an employee instigating litigation against the entity in response to disciplinary action can cause both legal counsel and management to be less than vigorous in their review of allegations of employee misconduct.

For example, several years ago, my office received an anonymous complaint that an inspector in a state department falsified inspection reports. Specifically, the complaint alleged that the inspector, who traveled to various sites to make his inspections, falsified his time records and received reimbursement for travel expenses that he did not incur.

The individual complained to us because the department failed to take appropriate action against the inspector when the matter was first brought to management's attention. A series of hearings were held, and the inspector was placed on administrative leave (with pay, of course) while the matter was investigated. In the pivotal hearing with the staff attorney and the human resources representative, the inspector admitted that he had signed the names of the individuals he was supposed to be inspecting on the inspection reports where the operators were supposed to sign. The inspector's explanation was that the operators were not at the sites when he performed the inspections. Because the inspector found no problems at the site, he signed the operators' names rather than returning later, thereby wasting more time and more money, to get a signature.

Incredibly, rather than confirming the inspector's explanation, the staff

attorney and human resources representative accepted the inspector's explanation and returned him to work. The complainant, who was infuriated by the decision, subsequently contacted us. We quickly contacted the operators and determined that they were on-site the days the inspector claimed that they were not, that they did not seen him, and that they did not authorize him to sign their names on the inspection reports. The inspector was terminated, and the falsified inspections were performed by other staff. The staff attorney and human resource representative were nonetheless resolute that they had acted properly and argued that, after all, they are not auditors.

The strategies employed by a plaintiff's attorney to seek evidence tying an entity and its upper-level management to financial fraud are similar to the ones used by external auditors. Auditors increase their odds of finding problems by combining a detailed examination of transactions with a comprehensive analysis of large-scale activities of the entity. This process also involves looking for key control points that can provide insights into the entity's internal operations. Ultimately, the plaintiff has an advantage in that something obviously went wrong. The key, however, is to determine who was involved, whether it can be attributed to the entity as a whole, and how it was done.

IV. FRAUD

From an audit perspective, fraud is generally divided into two categories: (1) theft of assets, also known as defalcation, and (2) fraudulent financial reporting.[13] Either of these types of fraud can result in material misstatements of an entity's financial statements.[14]

The recent wave of financial scandals has involved both types of fraud. Individuals have been charged with raiding the assets of their entities. In effect, these individuals used their entities as their private "piggy banks," creating losses for investors and employees. Entities have also been accused of inflating their assets and their revenues and of under-stating their liabilities and their expenses to disguise the true financial condition of the entity and to take advantage of third parties. In both cases, the financial statements are misrepresented so that affected parties are unaware of the problems. Charges that insiders who knew the truth unloaded their stock to avoid losses and make fantastic gains while they encouraged others to continue to invest add insult to injury. These acts of deception are essential to fraud.

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13 *See* CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 82, § 3 (American Inst. of Certified Pub. Accountants 1997).

14 *See id.*

Not only does an insider receive an ill-gotten gain but deliberate acts are undertaken to cover up the evidence of what actually occurred.

This cover-up can occur at several levels within the entity. In my experiences in investigating fraud, I have found that perpetrators usually hide their actions by creating a cloud around either the records directly related to the fraud or the transactions related to the fraud. A perpetrator may, for example, keep very sketchy records of certain transactions where one would normally expect rather detailed records. Alternatively, the underlying records may be "misplaced" or otherwise currently unavailable. In more sophisticated frauds, a perpetrator may create a very complex series of transactions that involving some form of churning or dummy transactions that cloak the fraudulent nature of the transaction.

The post-mortems of most major financial-statement frauds reveal one common element: the auditors did not understand the underlying transactions. Failing to exercise adequate professional skepticism in their review of the transactions, the auditors accepted management's explanations for transactions that did not make very much business sense.

A. Was the fraud perpetrated on your client or by your client?

When an attorney represents an entity associated with fraud, it is always better to be the victim, which does occasionally occur. For example, an employee or an officer steals from the entity, and the theft might be quite large and might even be material to the financial statements. If the impact on the financial statements is material and third parties are injured as a result, the attorney for the victim-entity should make clear that the perpetrator was a rogue employee, and the entity should seek all available remedies against the perpetrator to make the entity whole again.

B. When your client is the accused

When the entity is accused of fraud, the entity may have some potential exposure for the actions of its employee or its agent. The entity will argue that the perpetrator was acting outside the scope of authority, but the injured parties may be able to demonstrate that the perpetrator had apparent authority to act on behalf of the entity or that the entity ratified those actions.

More importantly, the question always arises whether the entity is partly to blame for the actions of the employee. As a practical matter, this issue may be divided as follows: (1) whether the entity's management knew or had reason to know that the perpetrator was a risk to commit fraud and (2) whether the entity had

sufficient controls over the operations that were affected by the fraud.

With regard to the first sub-issue, several areas may prove embarrassing to the entity. First, the entity may not have performed a thorough background check of the perpetrator upon hiring the perpetrator. More specifically, an individual's past may indicate a risk of fraud in hiring them. For example, an individual who has served time in prison for embezzlement may be an unwise choice to handle the responsibilities for maintaining the entity's bank account.

Second, the entity may have recorded pertinent information in its own personnel records. For example, the perpetrator may have been disciplined for risky behavior that, in retrospect, could have indicated a potential for fraudulent behavior. Such indications are particularly relevant where the entity has notice of certain personal problems that suggest a need for cash, such as garnishment of wages or bankruptcy filings.

C. The Usual Suspects

As plaintiffs try to find a defendant, they tend to cast a fairly broad net, at least initially. As a practical matter, there may be many people at whom to point the finger.[15] The fact that entities of any size exhibit compartmentalization and delegation of authority compounds the defense attorney's task. The degree to which authority is compartmentalized and distributed will vary, of course, not just based on the nature, size, and locations of the entity, but on the personalities of the entity's key parties. For example, in recent accounting scandals, many CEO's have denied any knowledge of their entity's operations, but these denials occasionally are hard to reconcile with a personality that is described as micro-managing.

The plaintiff will try to taint as many people as possible with the alleged fraud and to tie the entity as a whole to the actions and the resulting liabilities. The judgment in any such case will always be very fact-dependent, and the facts will always be complex. Therefore, it is difficult to generalize the possible approaches that an attorney may take in any particular case. There are nonetheless some general features of these cases that can be used to map an overall strategy.

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[15] This is particularly troubling in business settings because of potential conflicts of interest. Corporate attorneys often must balance several parties who may have conflicting interests—the board, the individual board members, the officers and managers, the employees, and the shareholders. Similarly, in a non-corporate setting, conflicts may also arise where there are multiple non-owner managers, officers, and employees.

My office often has found that where top management committed fraud, the board of directors was passive in the operations of the entity. Although directors are beginning to realize that liability can attach to serving as a director, many still simply consider it an honorary position. A lawyer who represents a board member should keep the member aware of the potential for liability for actions of the entity.

These situations frequently occur where the board consists of members who are not involved in the kind of activities that the entity engages in and where the board has found an aggressive, take-charge officer. The board may tend to delegate all matters to that officer. After all, as long as the officer has operations under control, life is relatively easy for the board members, who probably have plenty of other things to worry about. This is especially true where board members are associated with the entity because of their name and reputation.

In some cases, the board members are not just passive. They are ensnarled by the officer in specifically approving, or at least approving in principle, the officer's actions by signing off on what appears to be an innocuous resolution. The board meeting minutes from a year ago may suddenly haunt them when the board members realize that the amorphous comments of the officer at that meeting, in current context, ratify the wrongdoing.

If an entity-client is not subject to external audits, an attorney will not be faced with the formal processes described above. The lack of formal audit process does not mean, however, that the entity is free from accountability for its actions. In some regards, the exposure of the entity and its principals for financial misdealing may be even greater without an audit.

When an audited entity is accused of financial improprieties, allegedly aggrieved parties usually cast suspicion on several parties. This chosen several includes not only management, owners, and the board members, but also their external auditors. From the auditor's perspective, it sometimes seems that the auditors are held to an even higher standard than their clients, those who actually committed the wrongdoing.

However, if the entity-client is not audited, then an attorney cannot question why someone outside the entity failed to inform the entity-client of the subject wrongdoing. This sounds a little absurd, but that is exactly what many entities argue when fraud is detected, even when it is perpetrated at the highest levels of the entity. These arguments usually do not exonerate the insiders from liability, but they do tend to muddy the waters a bit—something that can serve the entity-client under the right circumstances.

A typical argument made by management when accounting irregularities are uncovered is that they were either advised by their external auditors that, for example, their treatment of revenue recognition was permissible under GAAP or that their auditor did not question the irregularities. I suppose that an attorney for an entity without external audits could argue that their client, not having had the advice of an external auditor, did not know what they were doing. Whatever the particular circumstances of your client, remember that if the entity is not audited it will be standing alone when questionable accounting practices arise.

The following issues are pertinent to entities accused of accounting irregularities whether or not they are subject to external audits. Measures the entity has taken to identify conflicts of interest by officers, employees, and board members is another area that auditors consider risky. Many times there is an aversion to developing formal policies in this area because management feels that this is an affront to their integrity. Why should they have to disclose anything? These types of defensive arguments are especially common when the auditor cannot point to any particular requirement for such a policy, other than good business practices. Again, your client's refusal to adopt such a policy may be embarrassing in the future if a problem develops.

V. ILLEGAL ACTS AND CONTINGENT LIABILITIES

Auditing standards differentiate between fraud and illegal acts. As referenced above, fraud involves either asset theft or financial report misstatement. Illegal acts by clients are "violations of laws or governmental regulations."[16] They are "acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity."[17] They do not include, however, "personal misconduct by the entity's personnel unrelated to their business activities."[18]

Examples of illegal acts by clients include, for example, violation of Environmental Protection Act restrictions or state or local laws regarding emissions of contaminants. The impact of such acts could be civil or criminal and could involve fines, penalties, or interruption of business activities, all of which could have significant financial statement implications.

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[16] CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 54, § 2 (American Inst. of Certified Pub. Accountants 1988).

[17] *Id.*

[18] *Id.*

Interestingly, an illegal act that in itself is clearly quantitatively immaterial may still have a material impact on the entity. An example is the payment of a relatively modest bribe to a regulator. If discovered, however, the impact could be debarment from programs, as well as substantial fines and penalties.

VI. CONCLUSION

Although auditors are often cast as neurotic individuals who roam around with a "gotcha" mentality, auditors and entity managers should in reality be on the same side. Differences of opinion may exist about the degree to which controls are needed in particular situations, and auditors tend to be more risk-averse than managers, who must balance the need for controls with the need to watch costs and the need to strip processes of unnecessary hurdles. However, when it comes to questions of honesty in representations to third parties, we should all be on the same side.

That also goes for legal counsel. Attorneys can have a tremendous impact on their clients as they advise them of the consequences of taking the wrong path in the quest for profit or funding. In the present climate, it is especially important that legal counsel be a proactive part of management's conscience as management faces the temptation either to meet earnings expectations or to avoid taking strong action against staff who have betrayed the entity's trust. Too much is at stake to go about business as usual. The path to material fraud does not start on the day the entity misrepresents its results of operations. Rather, it begins when management first starts cutting corners, usually with an excuse, such as "If we don't do it, too, we will be buried by our competition," or "We will just do it for a while until we can get back on our feet." If these rationalizations are accepted, the day may come when all the parties, including the attorney, wish that they could rewind the tape to do it over again. Just like the commercial.