

# THE AUDITOR'S RESPONSIBILITY TO DETECT FRAUD:

## *RECENTLY ISSUED SAS NO. 82 AND ITS POTENTIAL EFFECT ON FIDELITY CLAIMS*

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### I. INTRODUCTION

In 1993, both the American Institute of Certified Public Accountants (AICPA) Division for CPA firms, the practice section of the Securities Exchange Commission (SEC) and the AICPA Board of Directors recommended the appointment of a task force to review auditors' responsibility to detect fraud.<sup>1</sup> At about the same time, a survey by KPMG Peat Marwick in 1994 indicated that independent auditors were the source of only five percent of frauds detected in various contexts.<sup>2</sup>

The AICPA Auditing Standards Board then reviewed Statement on Auditing Standards (SAS) No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and determined that a new SAS should be developed specifically related to financial statement fraud. Thus, in 1994 the Auditing Standards Board appointed the Fraud Task Force to draft a Statement on Auditing Standards to clarify and define the auditor's responsibility to detect fraud.

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<sup>1</sup> These recommendations supposedly were not a response to efforts by the Securities Exchange Commission under Section 10A(a) of the Securities Exchange Act to establish procedures in accordance with Generally Accepted Auditing Standards regarding required audits of financial statements for companies required to be registered with the SEC.

<sup>2</sup> QUINTON F. SEAMONS, FRAUD FORUM: IMPLEMENTING THE NEW FRAUD AUDITING STANDARD (1996) at 10-12, citing a 1994 Fraud Survey of KPMG Peat Marwick.

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The Fraud Task Force developed SAS No. 82, *Consideration of Fraud in A Financial Statement Audit*. One of the primary objectives of SAS No. 82 is to raise the level of audit performance with regard to detection of fraud during an audit engagement. SAS No. 82 is effective for all audits of financial statements for the period ending on or after December 15, 1997.<sup>3</sup>

The question to be answered, and one of the key purposes of this article, is whether the adoption of SAS No. 82 will impact the fidelity industry. In particular, will the passage of SAS No. 82 affect the way that courts consider the liability of auditors to third parties, such as fidelity insurers? Although the passage of time will undoubtedly answer this question, a review of SAS No. 82 in conjunction with existing law as it relates to the liability of auditors suggests that the passage of SAS No. 82 imposes stricter requirements on auditors and thus might result in a slight tilt in favor of fidelity insurers as they pursue claims against auditors.

## II. COMPARISON OF THE OLD STANDARD WITH THE NEW

### A. *What the Old Standard, SAS No. 53, Required*

In October 1987, the National Commission on Fraudulent Financial Reporting, organized in the 1980s by a number of private accounting organizations, recognized that fraud and its effects are the concern and responsibility of many parties, including management, boards of directors, internal auditors and independent auditors. The Commission acknowledged that independent auditors cannot guarantee the accuracy or reliability of financial statements. However, the Commission recognized the independent auditor's role could be enhanced, particularly with respect to fraudulent financial reporting.

In 1988, the Auditing Standards Board issued SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*. Since the issuance of SAS No. 53, the subject of fraud has continued to draw the interest of ever-growing constituencies. Independent auditors have been the target of litigation and criticism, at least some of which has resulted from misconceptions regarding the auditor's responsibilities with respect to fraud.<sup>4</sup>

Some users of audited financial statements place too much reliance on the auditor's findings, in part, due to misconceptions about the auditor's responsibilities. Three of the more common misconceptions are that the audit will:

1. Detect all material errors and irregularities in the financial statements,

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<sup>3</sup> AICPA, STATEMENT ON AUDITING STANDARDS: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT 82 (1997).

<sup>4</sup> MICHAEL J. RAMOS, CONSIDERING FRAUD IN A FINANCIAL STATEMENT AUDIT: PRACTICAL GUIDANCE FOR APPLYING SAS No. 82, 4 (Anita M. Lyons ed. 1997).

2. Discover all illegal acts committed by the client, and
3. Ensure the financial health of the entity.

The auditor's responsibilities for these items were defined by SAS No. 53.

SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, defines the terms *errors* and *irregularities* as follows. The term *errors* refers to unintentional misstatements or omissions in financial statements. Errors may involve:

1. Mistakes in gathering or processing accounting data from which financial statements are prepared.
2. Incorrect accounting estimates arising from oversight or misinterpretation of facts.
3. Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.

The term *irregularities* refers to intentional misstatements or omissions in financial statements. Irregularities include fraudulent financial reporting undertaken to render financial statements misleading, sometimes called management fraud, and misappropriation of assets, sometimes called defalcations. Irregularities may involve the following:

1. Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared.
2. Misrepresentation or intentional omission of events, transactions (including employee theft), or other significant information.
3. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

The primary factor that distinguishes errors from irregularities is whether the underlying cause of a misstatement of financial statements is intentional or unintentional.

An audit made in accordance with Generally Accepted Auditing Standards (GAAS) should be designed to provide reasonable assurance that errors and irregularities material to the financial statements will be detected. The auditor is expected to exercise due care and a proper degree of professional skepticism in performing the audit and in evaluating the findings. However, AU 316.08 indicated that, since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor's report is not a guarantee. Thus, the failure to detect a material misstatement in the financial statements does not, in and of itself, indicate that the audit was not made in accordance with GAAS.

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When the auditor concludes that the financial statements are materially affected by an irregularity, the financial statements are not prepared in conformity with Generally Accepted Accounting Principles (GAAP). Accordingly, the auditor should insist that the financial statements be revised by management. When this is done, the auditor can issue a standard audit report and express an "unqualified" opinion. However, if the financial statements are not revised, the auditor should express a "qualified" opinion or an "adverse" opinion because of the departure from GAAP and disclose all substantive reasons for his opinion within his audit report. In either case, the auditor is also required to communicate to the audit committee any material irregularities detected during the audit. The auditor ordinarily has no responsibility to disclose material irregularities to parties outside the client.<sup>5</sup>

The primary factor that distinguishes fraud from error is whether intent or lack of intent exists in the underlying act. While the auditor may not be responsible for defining intent, it is the auditor's responsibility to obtain reasonable assurance the financial statements are free of material misstatement. When transactions are considered intentional, they now fall under SAS No. 82. Unintentional material misstatements are addressed under SAS No. 47.

One of the primary purposes of SAS No. 53 was to narrow the expectation gap between the auditor and users of financial statements that arose from the user's misconceptions regarding audits. However, continued criticism and questions regarding the auditor's role and responsibility in the detection of material misstatement in financial statements has led to the development of SAS No. 82.

#### *B. What the New Standard, SAS No. 82, Requires*

Like SAS No. 53, SAS No. 82 was issued to respond to the three common misconceptions and to clarify the auditor's responsibility in the detection of material misstatement in financial statements-whether caused by error or fraud-is central to an audit. The SAS No. 82 supersedes SAS No. 53, and it is effective for audits of financial statements for periods ending on or after December 15, 1997.<sup>6</sup>

While SAS No. 82 may currently be the primary source regarding the auditor's responsibility for detecting material misstatement in financial statements, consideration should be given to the literature preceding SAS No. 82, which is affected and has subsequently been revised. This includes not only SAS No. 53, but also the following:

1. SAS No. 1 and SAS No. 22: address auditor's responsibility to plan and perform the audit to obtain reasonable assurance that the financial state-

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<sup>5</sup> WALTER G. KELL, MODERN AUDITING 47-48 (4th ed. 1989).

<sup>6</sup> See Ramos, *supra* note 7.

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ments are free of material misstatements, whether caused by error or fraud.

2. SAS No. 47: addresses audit risk, materiality and misstatements in financial statements.
3. SAS No. 54: addresses auditor's responsibility for detecting misstatements resulting from illegal acts.
4. Section 301 of the Private Securities Litigation Reform Act of 1995 ("Reform Act"), entitled *Fraud Detection and Disclosure*, amends the Securities Exchange Act of 1934 ("Exchange Act") by adding Section 10A which pertains to *Audit Requirements*.
5. Section 10A(a) of the Exchange Act provides that each required audit of financial statements of Exchange Act registrants shall include certain procedures in accordance with GAAS *as may be modified or supplemented from time to time* by the SEC. The requirement for these audit procedures applies only to companies that are registered, and defined as registrants, under the Exchange Act.

Before discussing SAS No. 82, a few comments are in order about some differences between SAS No. 82 and Section 10A(a) of the Reform Act. It should be noted that the SAS No. 82 statement will apply to every audit, regardless of whether such entity is publicly traded or privately held. Section 10A of the Exchange Act applies only to registrants who must file financial statements with the SEC.

Section 10A(a) of the Exchange Act requires audit procedures that:

1. Are designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts,
2. Are designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein, and
3. Involve an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

The legislative hearings focused on detecting illegal acts in subparagraph (1) and little attention was focused on subparagraphs (2) and (3) dealing with related party transactions or going concern evaluations. However, authoritative accounting literature already addressed illegal acts as well as related party transactions and going concern evaluations.<sup>7</sup> The Reform Act

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<sup>7</sup> See AICPA Professional Standards(CCH) AU Section 317, *Illegal Acts*, § 334, *Related Parties*, and § 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

did not identify issues not already addressed by the accounting profession. What was new is that the SEC now has express authority to modify or supplement audit standards, at least in these three areas, if not generally.<sup>8</sup>

There may be problems in reconciling the various terms in the accounting literature and the term illegal act in Section 10A(e) of the Reform Act. The terms in accounting literature are: irregularity, error, defalcation, mistake, intentional distortions, etc. SAS No. 82 relies heavily on accounting literature detailed above to impose additional responsibility on auditors to detect fraud. Such literature never imposed an affirmative responsibility on auditors to detect fraud. There has been a general recognition that auditors are not competent to determine whether conduct is illegal. However, Section 10A of the Reform Act imposes a "direct affirmative duty" on the auditor.<sup>9</sup> SAS No. 54 and *Illegal Acts by Clients*, AU Section 317.03 of the AICPA Professional Standards (CCH), currently state:

Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. An auditor, in reporting on financial statements, presents himself as one who is proficient in accounting and auditing. The auditor's training experience and understanding of the client and its industry may provide for recognition that some client acts coming to his attention may be illegal. However, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

SAS No. 82 describes the auditor's responsibilities relating to fraud and provides guidance on what auditors should do to meet those responsibilities. How do auditors' responsibilities differ from those under SAS No. 53? SAS No. 82 clearly states that auditors are responsible for planning and performing audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. It makes no difference whether those misstatements are unintentional or intentional. The auditor is responsible for planning and performing an audit to provide reasonable assurance about whether the financial statements are free of both types of material misstatement.

SAS No. 82 describes two types of fraud: (1) fraudulent financial reporting, and (2) misappropriation of assets. Responsibilities relating to fraud are stated within the context of materiality to the financial statements taken as a whole. Auditors are not responsible for detecting fraud per se, but for detecting material misstatements caused by fraud. Auditors are not responsible for detecting immaterial misstatements caused by fraud. Auditors have always

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<sup>8</sup> See Seamons, *supra* note 4, at 1-11.

<sup>9</sup> See Seamons, *supra* 4, at 11.

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had the responsibility to detect material misstatements caused by fraud. These responsibilities have not changed with the issuance of SAS No. 82.

What has changed under SAS No. 82 is that auditors now are required to perform the following:

1. Consider the presence of fraud risk factors. SAS No. 82 provides examples (detailed below) of risk factors an auditor may consider for fraud related to (a) fraudulent financial reporting, and (b) misappropriation of assets misstatements. An auditor should become familiar with these risk factors and be alert for their presence.
2. Assess the risk of material misstatement of the financial statements due to fraud. SAS No. 82 requires an assessment as to the risk of material misstatement due to fraud. This assessment is separate from but may be performed in conjunction with other risk assessments (for example, control or inherent risk) made during the audit. SAS No. 82 also requires reevaluation of assessments if other conditions are identified during fieldwork.
3. Develop a response. Based on assessments of risk, SAS No. 82 requires development of appropriate audit response. In some circumstances, an auditor's response may be that existing audit procedures are sufficient to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud. In other circumstances, auditors may decide to extend planned audit procedures.
4. Document certain items in the work papers. SAS No. 82 requires auditors to document evidence of the performance of their assessment of risk of material misstatement due to fraud. Documentation should include risk factors identified as being present as well as the auditor's response to these risk factors.
5. Communicate to management. If it is determined that there is evidence that fraud may exist, an auditor should apprise the appropriate level of management, even if the matter may be considered inconsequential. SAS No. 82 also requires an auditor to communicate directly with the audit committee, or equivalent if the matter involves fraud that would materially misstate the financial statements or fraud committed by senior management.

SAS No. 82 provides guidance on auditors' communication about fraud to management, the audit committee, if applicable, and others, including those outside the entity.

How do the auditor's performance requirements under SAS No. 82 differ from those under SAS No. 53? Before the application of SAS No. 82, auditors were required to consider the presence of risk of material misstatements due to errors or irregularities and assess that risk as part of the overall audit risk. Auditors were also required to design and perform audit proce-

dures appropriate for the assessed risk. The difference under SAS No. 82 is that auditors must specifically assess and respond to the risk of material misstatement due to fraud and assess risk from the perspective of the broad categories listed in the SAS. Additionally, under SAS No. 82, auditors must meet new documentation and communication requirements.

SAS No. 82, paragraphs 16 and 18 divide the risk factors that relate to misstatements from fraudulent financial reporting into three categories and misstatements from misappropriation of assets into two categories. In addition, SAS No. 82, paragraphs 17 and 19 give examples of the risk for financial reporting and misappropriation as follows:

16. Risk factors that relate to misstatements arising from fraudulent financial reporting may be grouped in the following three categories:

- a. Management's characteristics and influence over the control environment. These pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
- b. Industry conditions. These involve the economic and regulatory environment in which the entity operates.
- c. Operating characteristics and financial stability. These pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

17. The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting for each of the three categories described above:

a. Risk factors relating to management's characteristics and influence over the control environment. Examples include:

- A motivation for management to engage in fraudulent financial reporting.

Specific indicators might include:

- A significant portion of management's compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.

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- An excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
  - A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.
  - An interest by management in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.
  - A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include:
    - An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics.
    - Domination of management by a single person or small group without compensating controls, such as effective oversight by the board of directors or audit committee.
    - Inadequate monitoring of significant controls.
    - Management failing to correct known reportable conditions on a timely basis.
    - Management setting unduly aggressive financial targets and expectations for operating personnel.
    - Management displaying a significant disregard for regulatory authorities.
    - Management continuing to employ an ineffective accounting information technology, or internal auditing staff.
  - Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
  - High turnover of senior management, counsel, or board members.
  - Strained relationship between management and the current or predecessor auditor. Specific indicators might include:
    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
    - Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's reports.
    - Formal or informal restrictions on the auditor that inappropriately limit his or her access to people or information or his or her

ability to communicate effectively with the board of directors or the audit committee.

- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.

- Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.

b. Risk factors relating to industry conditions. Examples include:

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Declining industry with increasing business failures and significant declines in customer demand.
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

c. Risk factors relating to operating characteristics and financial stability. Examples include:

- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity including need for funds to finance major research and development or capital expenditures.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity, such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions.

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- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
  - Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose.
  - Difficulty in determining the organization or individual(s) that control(s) the entity.
  - Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
  - Especially high vulnerability to changes in interest rates.
  - Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain.
  - Unrealistically aggressive sales or profitability incentive programs.
  - Threat of imminent bankruptcy or foreclosure, or hostile takeover.
  - Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported.
  - Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

18. Risk factors that relate to misstatements arising from misappropriation of assets may be grouped in the two categories below. The extent of the auditor's consideration of the risk factors in category *b* is influenced by the degree to which risk factors in category *a* are present.

- a. Susceptibility of assets to misappropriation. These pertain to the nature of an entity's assets and the degree to which they are subject to theft.
- b. Controls. These involve the lack of controls designed to prevent or detect misappropriation of assets.

19. The following are examples of risk factors relating to misstatements arising from misappropriation of assets for each of the two categories described above:

- a. Risk factors relating to susceptibility of assets to misappropriation
  - Large amounts of cash on hand or processed.
  - Inventory characteristics, such as small size, high value, or high demand.
  - Easily convertible assets, such as bearer bonds, diamonds, or computer chips.

- Fixed asset characteristics, such as small size, marketability, or lack of ownership identification.
- b. Risk factors relating to controls
- Lack of appropriate management oversight (for example, inadequate supervision or monitoring of remote locations).
  - Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation.
  - Inadequate record keeping with respect to assets susceptible to misappropriation.
  - Lack of appropriate segregation of duties or independent checks.
  - Lack of appropriate system of authorization and approval of transactions (for example, in purchasing).
  - Poor physical safeguards over cash, investments, inventory, or fixed assets.
  - Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
  - Lack of mandatory vacations for employees performing key control functions.<sup>10</sup>

After assessing risk factors and developing a response, the auditor is required to document identified risk factors, such as a known history of securities law violation or lack of job application and background checks for employees with access to vulnerable assets.

SAS No. 82, paragraph 37 states:

37. In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud (see paragraphs 12 through 14). Where risk factors are identified as being present, the documentation should include (a) those risk factors identified and (b) the auditor's response to those risk factors, individually or in combination. In addition, if during the performance of the audit, fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required, such risk factors or other conditions, and any further response that the auditor concluded was appropriate, also should be documented.<sup>11</sup>

SAS No. 82, paragraph 38 categorizes the extent of communications based upon:

1. The auditor's determination that there is evidence of fraud, or

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<sup>10</sup> See AICPA, *supra* note 6, at 11-15.

<sup>11</sup> *Id.* at 26.

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2. The auditor's identification of risk factors that have continuing control implications.

In the first case, the matter should be brought to the attention of an appropriate level of management. In the second case, the matter may be reportable to senior management and/or the audit committee.

SAS No. 82, paragraphs 38-40 state:

38. Whenever the auditor has determined that there is evidence that fraud may exist, the matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to the audit committee. In addition, the auditor should reach an understanding with the audit committee regarding the expected nature and extent of communications about misappropriations perpetrated by lower-level employees.

39. When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee. (Alternatively, the auditor may decide to communicate with the audit committee.) (See SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* [AICPA, *Professional Standards*, Vol. 1, AU sec. 325].) The auditor also may wish to communicate other risk factors identified when actions can be reasonably taken by the entity to address the risk.

40. The disclosure of possible fraud to parties other than the client's senior management and its audit committee ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the entity may exist:

- a. To comply with certain legal and regulatory requirements.
- b. To a successor auditor when the successor makes inquiries in accordance with SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315).
- c. In response to a subpoena.

- d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that received governmental financial assistance.

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel before discussing matters covered by paragraphs 38 through 40 with parties outside the client.<sup>12</sup>

A comparison of SAS No. 82 and SAS No. 53 is contained in Appendix A.

### III. POTENTIAL EFFECT ON THE INSURER

#### *A. On Underwriting*

One of the changes brought about by SAS No. 82 is the requirement of the auditor to communicate about fraud to management, the audit committee and others. The requirement to communicate specifically about fraud is a change. The Standard reaffirms the general requirement of the auditor to communicate to appropriate levels of management and to the audit committee.

The underwriter will now be able to request from senior management, the audit committee and the board of directors all documentation and other audit information involving evidence of fraud. Documentation and information can also be requested about whether auditors have identified risk factors that have continuing control implications. It may even be possible to have the insured's auditors "sign off" as to whether any risk factors were identified and discussed with the insured, as part of the underwriting process.

The ability to request all documentation and other audit information involving evidence of fraud and whether auditors have identified risk factors that have continuing control implications will have two significant effects on underwriting. First, if it is a new account, the underwriter may be able to request that the existing insurer be immediately placed on notice of a claim in connection with documentation and other audit information involving evidence of fraud. Alternatively, or in conjunction with a request to place the current insurer on notice, the underwriter may be able to propose a manuscript exclusion dealing with the fraud documented in the audit. Second, with the documentation and other information identifying risk factors, the underwriter may be able to request that the account institute specific loss control measures, to reduce or eliminate the risk factors, as a condition to writing the account.

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<sup>12</sup> See AICPA, *supra* note 6, at 27-28.

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However, underwriters should be aware that some auditors have questioned their responsibility to detect certain defalcations, such as at a retailing company where thefts were reflected in cost of goods sold after book inventories were adjusted to actual quantities on hand. Many believe the auditor should know when inventory shrinkage is not in line with other entities in the same industry. Consequently, some auditors believe the amount contributed to a theft should be shown on a separate line labeled *theft expense*, even though there is no such requirement under GAAP.<sup>13</sup> Thus, even though the audit may address fraud or theft, it may result from the auditor's position that inventory adjustments exceed industry norms, not from specifically documented employee thefts.

Underwriters should also be aware that SAS No. 82 requires the auditor to specifically assess the risk of material misstatement of the financial statements, due to fraud, in every audit. The auditor is not expected to determine the risk of fraud as high or low, but to consider risk factors relating to fraudulent financial reporting and misappropriation of assets in each of the categories shown in paragraphs 16, 17, 18 and 19 of SAS No. 82 (pages 8-11). In the context of this statement, risk assessment is a process rather than a rating or a score. Auditors will consider the presence of fraud risk factors as they relate to (a) fraudulent financial reporting, and (b) misappropriation of assets. The auditors will document certain items in their work papers. Documentation should include risk factors identified as being present as well as the auditors' response to these risk factors.

If the identified risk factors are evidence that fraud may exist, the matter should be brought to the attention of an appropriate level of management. This communication is generally appropriate, even if the matter is deemed inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization.

If the identified risk factors do not appear to be evidence of fraud but have continuing control implications, these risk factors may be considered reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee, or just the audit committee, as required by SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*.<sup>14</sup> The auditor may communicate other risk factors identified when actions can be reasonably taken by the insured to address the risk.

And underwriters should know that with the specific consent of the insured, the insured's auditors may disclose client information, such as a list of risk factors identified during the audit, to third parties or communicated to

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<sup>13</sup> Jane M. Mancino, *The Auditor and Fraud*, J. OF ACCOUNTANCY, at 32-33 (April 1997).

<sup>14</sup> AICPA, PROFESSIONAL STANDARDS 1 AU § 325.

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the insured (Code of Professional Conduct).<sup>15</sup> Undoubtedly, the documentation and communication by auditors to the insured, as required under SAS No. 82, will provide underwriters additional opportunities to obtain greater amounts of information for underwriting purposes. The impact on underwriting will be how the underwriter is able to use that information.

### *B. On Claims*

Just as SAS No. 82 should have two potential major effects on underwriting, it should have two potentially significant effects on claims. The first is likely to be in the number of claims reported. The second is likely to be whether communication about fraud in previous audits will serve as a basis to assert that discovery occurred prior to the policy period and/or whether there has been an automatic termination of coverage.

Historically, external auditors have been infrequent discoverers of fraud. External auditors uncover five percent of the fraud discovered. However, this should increase due to SAS No. 82. Many accounting and insurance practitioners currently believe the new SAS No. 82 will cause auditors to intensify their procedures in such areas as reviewing cash, testing inventory counts, testing vendor authenticity, testing operating expenses, and reviewing internal controls.

Expansion of the audit process, particularly in an attempt by the auditors to evaluate the risk factors relating to misappropriation of assets, will include more cash counts, surprise inventory counts, square footage testing, quantitative analysis, internal comparative analysis, and industry comparisons. It is logical to conclude that with the expanded requirements for auditors relating to testing and detection of fraud the number of fidelity and theft claims will increase throughout the United States.

While it generally takes five years to discover fraud, SAS No. 82 should have an immediate impact on claims for medium and large insureds. However, the claims may not be covered, but rather the result of more stringent accounting methods. Many of the claims would be subject to exclusions, i.e., inventory calculation. It will take three to four years for the full effect of SAS No. 82 to become apparent.

The anticipated increase in the number of claims will warrant the professional scrutiny of the fidelity insurer. Claims will be presented that do not meet certain policy conditions, such as not occurring within policy period, not discovered during period required by policy, lack of timely notice to insurer, and lack of sufficient supporting documentation. However, the increased aggressive accounting and increased communications to management of the aforementioned analytical symptoms

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<sup>15</sup> AICPA, PROFESSIONAL STANDARDS 2 ET § 300.

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will encourage the insured to put the carrier on notice of a potential employee dishonesty loss. Many of these claims may be subject to exclusions, such as defalcation by the insured or the insured's partners, inventory computation or a profit and loss computation.

As indicated earlier, some auditors believe that when analytical procedures or relationships are too unusual or too unrealistic (hereafter, "analytical symptoms"), they should be detailed as such in the financial statements. Common examples of analytical symptoms include: unexplained inventory shortage, excess purchases, too many debit or credit memos, significant increases or decreases in account balances, excess cash shortages, and unreasonable expenses.<sup>16</sup>

Some auditors believe the portion attributed to theft should be separately detailed, even though there is no requirement under GAAP.<sup>17</sup> The separation and detailing of analytical symptoms attributed to employee dishonesty will be increased. This, in turn, will cause an increase in the number of fidelity claims.

While many claims may be subject to exclusion language, greater emphasis will need to be placed on the *evidence of employee dishonesty* in relation to the *manifest intent to cause a loss and financial benefit received* language. The greatest challenge may be related to the insured's possible statement that "only an employee could have misappropriated" the claimed items. The carriers may have to increase their scrutiny as to reasons for the insured's loss, other than employee dishonesty.

It may be beneficial to carriers to narrow the policy language to differentiate between the external auditors' and the carriers' classification of employee dishonesty. This, in turn, would defer the filing of fidelity claims and the potential possibilities of misinterpretation of the carrier's policy by the insured and the courts.

It seems likely the expanded auditing requirements under SAS No. 82, related to testing, detecting and communicating risk factors and fraud, will consequently lead to the insureds reviewing their employee dishonesty policies. Subsequently, the number of fidelity claims being filed will increase.

#### IV. LIABILITY OF AUDITORS TO FIDELITY INSURER

In the course of investigating a claim, a fidelity insurer may discover that the claim is a direct result of tortious acts committed by someone other than the insured or its employees. A potential target is the accountant who performed

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<sup>16</sup> W. STEVE ALBRECHT, FRAUD BRINGING LIGHT TO THE DARK SIDE OF BUSINESS, at 99 (1995).

<sup>17</sup> See Mancino, *supra* n.8.

the audit of the insured's financial statements that were relied upon to underwrite the bond or who audited the financial statements of the company whose employee has stolen money and for which the fidelity insurer is now expected to pay.

There are two basic means to pursue claims against auditors: (1) claims for negligent misrepresentation or fraud in the audit process or for breach of an implied contract, and (2) subrogation claims--i.e., claims brought by an insurer as a result of payments to the insured or due to an assignment of a claim by an insured. In either case, whether a court will allow an insurer to pursue a claim against an accountant will depend on the jurisdiction in which the claim is brought and the facts of the particular case.

A. *Direct Claims Against Auditors By Fidelity Insurers - An Update of Ultramares and the Privity Requirement*

1. Negligence and Negligent Misrepresentation

Whether a fidelity insurer may bring a direct claim against an auditor for negligence or negligent misrepresentation depends on the relationship between the insurer, its insured and the auditor. An auditor can only be held liable for negligence if the auditor owes a duty of due care to the insurer. Where the insurer is not the auditor's client, that is, where there is no privity between the parties, the auditor's duty to the insurer is limited.

The seminal case regarding accountant liability to third parties is *Ultramares Corp. v. Touche*.<sup>18</sup> In *Ultramares*, the New York Court of Appeals established a privity requirement for claims alleging negligence by an accountant. The plaintiff in *Ultramares* made loans to a company after viewing the company's financial statements, which were audited by the defendant accounting firm.<sup>19</sup> The company thereafter declared bankruptcy, and the plaintiff sued the accounting firm, alleging that the audit was performed fraudulently and negligently and that plaintiff had relied on the audit report in making its loans to the company.<sup>20</sup> The court recognized that the defendant accountant knew its certified financial statements would be shown by the company to banks, creditors, stockholders, purchasers or sellers "and hence the defendants supplied 32 copies of the certified financial statements to the company."<sup>21</sup> However, "the range of transactions in which a certificate of audit might be expected to play a part [was] ... indefinite and wide...."<sup>22</sup> Accordingly, the court expressed concern that "[i]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery

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<sup>18</sup> 174 N.E. 441, 448 (N.Y. 1931).

<sup>19</sup> *Id.* at 442-43.

<sup>20</sup> *Id.* at 443.

<sup>21</sup> *Id.* at 442.

<sup>22</sup> *Id.*

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beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."<sup>23</sup>

Since *Ultramares*, four lines of authority or tests have developed with respect to the scope of an accountant's duty to third parties: (1) privity or near-privity; (2) foreseeability; (3) the RESTATEMENT (Second) OF TORTS § 552; and (4) a balancing test.<sup>24</sup> Jurisdictions vary with respect to which of these four tests is followed. Therefore, prior to bringing any claim for negligence directly against an auditor, a fidelity insurer must determine which test the relevant jurisdiction has adopted.

## 2. Privity/Near-Privity

The privity/near privity test is the most strict and provides the greatest protection to auditors. Absent a direct contract with an accountant, an insurer may recover against an accountant in a jurisdiction that has adopted the "privity/near-privity" test only if the relationship to the accountant is so close as to approach that of privity. In *Credit Alliance Corp. v. Arthur Andersen & Co.*,<sup>25</sup> the court adopted a three-part test for determining when third parties not in privity with accountants may seek recovery from them for reliance on negligently prepared financial reports:

- (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes;
- (2) in the furtherance of which a known party or parties was intended to rely; and
- (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountant's understanding of that party or parties' reliance.<sup>26</sup>

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<sup>23</sup> *Id.* at 444.

<sup>24</sup> See *First Florida Bank, Inc. v. Max Mitchell & Co.*, 558 So. 2d 9, 12 (Fla. 1990).

<sup>25</sup> 483 N.E.2d 110 (N.Y. 1985).

<sup>26</sup> *Id.* at 118.

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Courts in a number of jurisdictions continue to follow this test.<sup>27</sup>

### 3. The Foreseeability Rule

At the opposite end of the spectrum, courts in at least three jurisdictions - New Jersey, Wisconsin and Mississippi - have adopted foreseeability as the only limit on an accountant's liability to third parties for negligently preparing an audit report. In *H. Rosenblum, Inc. v. Adler*,<sup>28</sup> the New Jersey Supreme Court held that an auditor has a duty to "all of those whom that auditor should reasonably foresee as recipients from the company of the [audit report] for its proper business purposes, provided that the recipients rely on the [report] pursuant to those business purposes."<sup>29</sup> Similarly, in *Citizen's State Bank v. Timm, Schmidt & Co.*,<sup>30</sup> the Wisconsin Supreme Court

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<sup>27</sup> In addition to New York, nine other state and federal decisions have approved the privity/near-privity standard for determining an accountant's liability to third parties. See *Ackerman v. Schwartz*, 947 F.2d 841, 846 (7th Cir. 1991)(Indiana law); *McLean v. Alexander*, 599 F.2d 1190, 1202 (3d Cir. 1979)(finding that Delaware courts would apply a privity standard to a fraud claim against an accountant); *Stephens Indus. v. Haskins and Sells*, 438 F.2d 357, 359-60 (10th Cir. 1971)(Colorado law); *Pasternak v. Colonial Equities Corp.*, 854 F. Supp. 64, 102 (D. Conn. 1994)(Conn. law); *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 772 P.2d 720, 722 (Idaho 1989); *Thayer v. Hicks*, 793 P.2d 784, 789 (Mont. 1990)(adopting a modified version of the test set forth in *Credit Alliance*, 483 N.E.2d at 118); *Citizens Nat'l Bank of Wisner v. Kennedy and Coe*, 441 N.W.2d 180, 182 (Neb. 1989); *Landell v. Lybrand*, 107 A. 783, 783 (Pa. 1919); *Ward v. Ernst & Young*, 435 S.E.2d 628, 631 (Va. 1993). Some of the federal cases cited above, while not overruled, have been called into doubt to some extent by state court decisions. See *Wolther v. Schaarschmidt*, 738 P.2d 25, 27-28 (Colo. Ct. App. 1986)(noting that the rationale of section 552 had been adopted by the Colorado Court of Appeals in an earlier case and holding that section 552 does not require privity); *Guardian Constr. Co. v. Tetra Tech Richardson, Inc.*, 583 A.2d 1378, 1386 (Del. Super. Ct. 1990)("conclud[ing] that privity of contract is not an indispensable prerequisite to the recovery of economic damages in negligence cases such as this which fall within the parameters of [section 552]"); *First Commerce Bank & Trust v. Kelley, Hardesty, Smith & Co., Inc.*, 663 N.E.2d 218, 224 (Ind. App. 1996) (emphasizing that "Indiana courts have never adopted the Ultramares standard for accountants"). *Guardian* and *Wolther* did not involve claims against accountants.

<sup>28</sup> 461 A.2d 138, 153 (N.J. 1983).

<sup>29</sup> *Id.* The *Rosenblum* holding has been overruled by statute. See N.J. Stat. Ann. § 2A:53A-25 (West Sup. 1997). In pertinent part, N.J. Ann. § 2A:53A-25 provides:

b. Notwithstanding the provisions of any other law, no accountant shall be liable for damages for negligence arising out of and in the course of rendering any professional accounting service unless: (1) the claimant against the accountant was the accountant's client; or (2) the accountant (a) knew at the time of the engagement by the client, or agreed with the client after the time of engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant; (b) knew that the claimant intended to rely upon the professional accounting service in connection with that specialized transaction; and (c) directly expressed to the claimant, by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service....

<sup>30</sup> 335 N.W.2d 361, 366 (Wis. 1983).

ruled that accountants who negligently prepare audit reports will be liable "for the foreseeable injuries resulting from the negligent acts unless, under the facts of [the] particular case, as a matter of policy to be decided by the court, recovery is denied on grounds of public policy."<sup>31</sup> The Wisconsin court adopted the foreseeability standard to protect third parties who rely on the accuracy of a company's audit reports, to deter negligent auditing, and to avoid increases in the costs of credit to the general public which the court believed would result if creditors were forced to absorb the costs of bad loans or perform their own audits.<sup>32</sup> The foreseeability standard has also been adopted by the Mississippi Supreme Court to protect third parties who rely on audited financial statements.<sup>33</sup>

#### 4. Restatement Section 552

The majority of courts have taken a middle ground between the privity and foreseeability standards and have adopted the standard for negligent misrepresentation defined in section 552 of the Restatement (Second) of Torts.<sup>34</sup>

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 365.

<sup>33</sup> *Touche, Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315, 322 (Miss. 1987)(holding, however, that the accountant was not liable because the loss suffered was a result of criminal conduct occurring after the audit was completed).

<sup>34</sup> See *Bowers v. Allied Inv. Corp.*, 822 F. Supp. 835, 839 (D. Me. 1993) (Maine law); *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053, 1061 (5th Cir. 1990)(Louisiana law); *Ingram Indus. v. Nowicki*, 527 F. Supp. 683, 684 (E.D. Ky. 1981)(Kentucky law); *Bunge Corp. v. Eide*, 372 F. Supp. 1058, 1062-63 (D.N.D. 1974)(North Dakota law); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91-92 (D.R.I. 1968)(Rhode Island law); *Boykin v. Arthur Andersen & Co.*, 639 So. 2d 504, 509 (Ala. 1994); *Standard Chartered P.L.C. v. Price Waterhouse*, 945 P.2d 317, 339 (Ariz. App. 1996), *as corrected after reconsideration denied*, (1997); *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992); *First Florida Bank, N.A. v. Max Mitchell & Co.*, 558 So. 2d 9, 14-15 (Fla. 1990); *Badische Corp. v. Caylor*, 356 S.E.2d 198, 199-200 (Ga. 1987); *Kohala Agriculture v. Deloitte & Touche*, 949 P.2d 141 (Haw. 1997); *Eldred v. McGladrey, Hendrickson & Pullen*, 468 N.W.2d 218 (Iowa 1991); *Nycal Corp v. KPMG Peat Marwick*, 688 N.E.2d 1368 (Mass. 1998); *Law Offices of Lawrence J. Stockler, P.C. v. Rose*, 436 N.W.2d 70, 82 (Mich. App. 1989), *leave to appeal denied*, 450 N.W.2d 270 (Mich. 1990); *Bonhiver v. Graff*, 248 N.W.2d 291, 299 (Minn. 1976); *MidAmerican Bank & Trust Co. v. Harrison*, 851 S.W.2d 563, 564-566 (Mo. Ct. App. 1993); *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308, 1312 (N.H. 1982); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609, 617 (N.C. 1988); *Haddon View Inv. Co. v. Coopers & Lybrand*, 436 N.E.2d 212, 214-15 (Ohio 1982); *ML-Lee Acquisition Fund, L.P. v. Deloitte & Touche*, 463 S.E.2d 618, 627 (S.C. Ct. App. 1995), *aff'd in part and rev'd in part on other grounds*, 489 S.E.2d 470 (S.C. 1997); *Bethlehem Steel Corp. v. Ernest & Whinney*, 822 S.W.2d 592, 595 (Tenn. 1991); *Federal Land Bank Ass'n of Tyler v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991); *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032, 1067 (1987), *modified*, 750 P.2d 254 (Wash. 1988); *First Nat'l Bank of Bluefield v. Crawford*, 386 S.E.2d 310, 313 (W.Va. 1989). *But see* *Barrie v. V.P. Exterminators, Inc.*, 625 So. 2d 1007, 1014-16 (La. 1993)(finding that "adopting one of the [three doctrines] as the sole method for determining liability for [the tort of negligent misrepresentation] is not necessary" because Louisiana courts use a "case by case application of the duty/risk analysis").

Section 552(1) establishes liability for negligently supplying information for the guidance of others and for pecuniary loss caused by their justifiable reliance on the information:

One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance on the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Section 552(2) describes the scope of the liability of a person subject to section 552:

Except as stated in Subsection (3)<sup>35</sup> the liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Pursuant to section 552, "the liability of the maker of negligent misrepresentations is limited to the transaction that he intends, or knows that the recipient intends, to influence, or a substantially similar transaction."<sup>36</sup> In a jurisdiction which follows the Restatement test, the auditor's liability is still quite limited. Whether the insurer can satisfy the Restatement's requirements will depend on the facts of the case. The insurer must show that it is within a limited group of persons for whose benefit and guidance the audit was conducted and that the insurer relied on the information contained in the audit in the course of a transaction that the auditor sought to influence.<sup>37</sup>

## 5. Balancing Test

The fourth test was adopted in *Biakanja v. Irving*,<sup>38</sup> in which the court determined that an accountant's liability to third persons shall be determined by the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to

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<sup>35</sup> Subsection (3) of section 552 states that "the liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them."

<sup>36</sup> Section 552, cmt. j., at 137.

<sup>37</sup> The Restatement test is similar to a breach of implied contract theory. Some courts have allowed insurers to proceed against accountants for breach of implied contract where the insurer can show that it was an intended beneficiary of the audit contract. *See, e.g., Seaboard Sur. v. Garrison, Webb & Stanaland*, 823 F.2d 434 (11th Cir. 1987). *See also Bily*, 834 P.2d 745 (In theory, accountant can be liable to express third-party beneficiary of audit engagement contract).

<sup>38</sup> 320 P.2d 16, 19 (Cal. 1958).

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him, the degree of certainty that the plaintiff suffered injury, the closeness the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm.<sup>39</sup>

#### 6. Specific Cases Involving Fidelity Insurers and Sureties

The foregoing discussion dealt with claims by third parties against auditors, in general. Cases involving fidelity insurers or sureties, in particular, are somewhat sparse, but they do exist. A recent California case illustrates the hazards of proceeding against an auditor on such a direct claim.

In *Industrial Indemnity Co. v. Touche Ross & Co.*,<sup>40</sup> the court held that a surety of commercial paper which was sold by a lender to obtain capital to fund a line of credit for the corporation could not, as a matter of law, recover on a theory of general negligence from the auditor which issued an unqualified audit opinion with regard to the corporation's financial statement on which the surety allegedly relied.<sup>41</sup> The court held that an auditor's liability for general negligence in the conduct of an audit of its client's financial statements is limited "to the client[,] i.e., a person who contracts for or engages the audit services."<sup>42</sup> The court went on to hold that an auditor may be held liable to third parties for negligent misrepresentations in an audit opinion only if the auditor intends to supply information, or knows that the client intends to supply it, for the benefit and guidance of a person or limited group of persons in a specific transaction or type of transaction.<sup>43</sup> The court refused to allow the surety to recover under a theory of negligent misrepresentation based on (1) evidence that the auditor had performed annual audits for the corporation for 18 years, (2) lack of evidence that the auditor either consented to or knew about the submission of the opinion to the lender and the surety, and (3) evidence that the use of the opinion by the insurer, to which the auditor consented, in connection with the corporations' preferred

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<sup>39</sup> *Id.* See also *Alumna Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973).

<sup>40</sup> 17 Cal. Rptr. 2d 29 (1993).

<sup>41</sup> 17 Cal. Rptr. 2d at 33.

<sup>42</sup> *Id.*, citing *Bily v. Arthur Young & Co.*, 834 P.2d 745 (Cal. 1992).

<sup>43</sup> *Industrial Indem. Co.*, 17 Cal. Rptr. 2d at 33.

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stock offering and subordinated debenture offering, was not sufficiently similar to the surety's guarantee of the line of credit to the corporation.<sup>44</sup>

The lesson to be learned from *Industrial Indemnity Co.* is that, even in jurisdictions that apply the section 552 test, more than simple reliance on the audit itself is necessary. An insurer must show that the auditor had some expectation based on the terms of the engagement or representations made by the insurer to the auditor that the insurer intended to rely upon the auditor's work.<sup>45</sup>

### *B. Subrogation of Fidelity Insurer to Insured's Claim Against the Auditor:*

#### 1. The Superior Equities Doctrine and Other Considerations

The second avenue of recovery against an auditor after payment of claims is based on a theory of subrogation. Subrogation - the substitution of one person in the place of another with reference to a lawful claim, demand or right so that the substituted party succeeds to the rights of the other<sup>46</sup> -- devel-

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<sup>44</sup> *Id.* The court rejected the surety's argument that the auditor's knowledge that its client would use the audited statement to borrow money generally was enough to establish liability. Quoting *Bily*, the court observed, "audits of financial statements and the resulting audit reports are very frequently (if not almost universally) used by businesses to establish the financial credibility of their enterprises in the perceptions of outside persons, e.g., existing and prospective investors, financial institutions, and others who extend credit to an enterprise or make risks-oriented decisions based on its economic viability." *Industrial Indemnity*, 17 Cal. Rptr.2d at 34, citing *Bily v. Arthur Young & Co.*, 834 P.2d 745. An accountant is liable where it intends that its representation "reach an influence either a particular person or persons, known to him, or a group or class of persons, distinct from the much larger class who might responsibly be expected sooner or later to have access to the information and foreseeable to take some action in reliance upon it." *Industrial Indem.*, 13 Cal. App. 4th at 1095, 17 Cal. Rptr. 2d at 34, citing RESTATEMENT (2ND) OF TORTS, § 552, cmt. h. On the other hand, an accountant is not liable if it "merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the information] on the part of anyone to whom it may be repeated,...." *Industrial Indemnity*, 17 Cal. Rptr.2d at 34, citing, *Bily*, P.2d 745 (quoting Section 552, cmt. h); see also *First Nat'l Bank of Commerce v. Monco Agency Inc.*, 911 F.2d 1053, 1061-1063 (5th Cir. 1990)(rejecting argument that "all `potential lenders'" of auditor company "constitutes a `limited group' of information of recipients" under § 552").

<sup>45</sup> Compare *St. Paul Fire & Marine Ins. Co. v. Touche Ross & Co.*, 507 N.W.2d 275 (Neb. 1993)(allegation that firm failed to exercise reasonable and ordinary care in preparing financial statements for its clients and then personally delivered those statements to third party to induce extension of credit to client was sufficient to state cause of action for negligence in favor of surety against accounting firm applying Section 552). In *St. Paul Fire & Marine Ins. Co. v. Touche, Ross & Co.*, the court found particularly significant allegations that, despite its representation to the contrary, Touche did not perform in accordance with generally accepted accounting standards, that Touche met and communicated directly with St. Paul and made Touche's products available to the former for use in dealing with the insured and that Touche intended that St. Paul rely on the documents Touche prepared for the Commonwealth. 507 N.E.2d at 280.

<sup>46</sup> BLACK'S LAW DICTIONARY 1427 (6th Ed. 1990).

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oped as a device of equity "established as a matter of necessity for the purpose of administering essential justice."<sup>47</sup> Where one party has paid the debt of another, justice requires that the payor be able to recover his loss from the one who should have paid it to prevent unjust enrichment.<sup>48</sup>

## 2. The Superior Equities Doctrine

There are two types of subrogation: equitable subrogation and conventional subrogation.<sup>49</sup> "Conventional subrogation" arises from an express or implied agreement between the payor and the debtor or creditor. In contrast, "equitable subrogation" arises as a matter of law from the mere fact of payment by a third party.<sup>50</sup> The determination of whether a fidelity insurer takes its rights against a third party by equitable or conventional subrogation may be important.

Generally speaking, an action based on conventional subrogation is contractually based and is not controlled by principles of equity.<sup>51</sup> In contrast, when a claim is pursued based on equitable subrogation, certain jurisdictions require that the party pursuing the claim demonstrate "superior equities" to those of the party from whom recovery is sought. Stated more succinctly, the superior equities doctrine usually applies to equitable subrogation but not to conventional subrogation. The practitioner must proceed with caution, however, because certain jurisdictions will apply the superior equities doctrine to conventional subrogation. Consequently, it is important for the practitioner to carefully check the law in the relevant jurisdiction.

The familiar "superior equities doctrine" or, as it has also been called, the "compensated surety defense" bars a compensated surety from recovering from a third party who would be liable in a suit directly by the insured, unless the surety can show equities superior to the third party.<sup>52</sup>

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<sup>47</sup> 11 APPLEMAN, INSURANCE LAW & PRACTICE § 6502 (1981).

<sup>48</sup> *Id.* at § 6502; *see* Washington Mechanic's Savings Bank v. District Title Ins. Co., 65 F.2d 827, 829 (D.C. Cir. 1933).

<sup>49</sup> Federal Ins. Co. v. Basabe, No. 88C105041989 WL 134799, \*2 (N.D. Ill., October 13, 1989).

<sup>50</sup> 11 APPLEMAN, *supra* n.52, at § 6501.

<sup>51</sup> John Deere Co. v. Loyd, No. 84-2281-O, 1987 U.S. Dist. Lexis 10049 (D. Kan., October 13, 1987), *citing* 11 APPLEMAN, *supra* note 52, § 6502, at 434-35.

<sup>52</sup> *See, e.g.*, Washington Mechanic's Savings Bank v. District Title Ins. Co., 65 F.2d 827, 829 (D.C. Cir. 1933).

Jurisdictions take three basic approaches to the issue of whether a fidelity insurer can proceed by subrogation without applying the balancing test of the superior equities doctrine. First, a few states simply do not apply the superior equities doctrine. These courts essentially have held that not only has the compensated surety defense "outlived any usefulness that it may once have had," but also in the modern world "the superior equities doctrine is arbitrary in giving to an insured the choice of allocation of ultimate loss, and unjust in increasing the burden of the insured because of his foresightedness in insuring."<sup>53</sup> Moreover, in light of the fact that a vast majority of modern banks are insured against forgery, shifting the loss from one surety to another makes little sense.<sup>54</sup>

Some jurisdictions have taken a second, and opposite, approach and have adopted the superior equities doctrine in *all* cases of equitable or conventional subrogation or assignment. The leading case in this line, *Meyers v. Bank of America National Trust & Savings Ass'n*,<sup>55</sup> reasons that an assignment is just another type of subrogation and hence all rights therefrom depend upon equitable principles rather than an asserted legal right under an assignment. A second theory for applying the superior equities doctrine to assignments and conventional subrogation is that payment by an insurer to its insured destroys any claim its insured would have had against the bank, leaving no claim for the insured to assign.<sup>56</sup> The only remaining possibility for recovery by the insurer then becomes subrogation, which presumes a destruction of the claim.<sup>57</sup>

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<sup>53</sup> Allan Farnsworth, *Insurance Against Check Forgery*, 60 COLUM. L. REV. 284, 324, (1960).

<sup>54</sup> See John D. O'Malley, *Subrogation Against Banks on Forged Checks*, 51 CORNELL L. Q. 441, 444 (1966). See also *Hartford Fire Ins. Co. v. Riefolo Constr. Co., Inc.*, 410 A.2d 658, 662 (N.J. 1980) (rejecting doctrine of superior equities and allowing subrogation as long as insured and insurer have not engaged in behavior which would make such relief unconscionable); *South Carolina Nat'l Bank v. Lake City State Bank*, S.E.2d 103, 106 (S.C. 1968) ("Serious challenges have been levied against the usefulness and practicality of a compensated surety defense under modern banking practices").

<sup>55</sup> 77 P.2d 1084, 1085-86 (Cal. 1938) (*per curiam*).

<sup>56</sup> *Bank of Fort Mill v. Lawyers Title Ins. Corp.*, 268 F.2d 313, 316 (4th Cir. 1959).

<sup>57</sup> *Id.* See also *American Sur. Co. v. Bank of Cal.*, 133 F.2d 160, 164 (9th Cir. 1943) (claim destroyed by payment, so no assignment possible).

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The third approach, as one would expect, takes a middle ground and only applies the doctrine to equitable subrogation claims and does not apply it to conventional subrogation claims or assignments.<sup>58</sup>

### 3. Recent Developments

Ample authority exists that a fidelity insurer may be subrogated to the creditor's right of action against public accountants who, by negligently conducting an audit, fail to discover earlier defalcations, and as a result additional losses to the creditor occur which would have been prevented if the earlier defalcations had been disclosed.<sup>59</sup> The issue is whether an insurer is required to show that, on balance, the equities favor the insurer over the auditor. As noted above, certain jurisdictions require an insurer to surmount the superior equities test even where the insurer has obtained a written assignment from its insured after payment of claims.

In *Federal Insurance Co. v. Arthur Andersen & Co.*,<sup>60</sup> the New York Court of Appeals considered the rights of a fidelity insurer who sued the insured's auditor for alleged negligence in failing to discover defalcations of the insured's employee. The fidelity insurer paid its insured for a loss caused by the defalcations of an employee and thereafter sued the insured's auditor to recover what it had paid, alleging that the defendant was negligent in failing to discover the defalcations.<sup>61</sup> Simply put, the court of appeals held that

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<sup>58</sup> See, e.g., *American Sur. Co. of N.Y. v. Baker*, 172 F.2d 689, 692 (4th Cir. 1949)(applying North Carolina law; where the choice of action was assignable, the plaintiff had full legal title under the assignment, so court had "no occasion to invoke the doctrine of subrogation," thus not discussing law for equitable subrogation); *First Nat'l. Bank of Atlanta v. American Sur. Co.*, 30 S.E.2d 402, 406-07 (Ga. 1944)(conventional subrogation and assignment are actions at law, not in equity, so no superior equities required to recover, but suggesting equity would require such a balancing); *National Sur. Co. v. Bankers' Trust Co.*, 228 N.W. 635, 637 (Iowa 1930) (allowed a surety company which had paid its insured and received an assignment to sue the bank that had paid on the forged drafts although the surety conceded that it would not have been able to prevail under a subrogation claim); *Aetna Cas. & Sur. Co. v. Lindell Trust Co.*, 348 S.W.2d 558, 570-71 (Mo. Ct. App. 1961)(no showing of superior equities was required on a claim of conventional subrogation because it stands on a contract, not equity); *Grubnau v. Centennial Nat'l Bank*, 124 A. 142, 144 (Pa. 1924) (subrogation was not at issue where insurer had assignment, so superior equities were not involved); see generally Gregory R. Veal, *Subrogation: The Duties and Obligations of the Insured and Rights of the Insurer Revisited*, 28 TORT & INS. L.J. 69, 75-76 (Fall 1992) (discussing states which distinguish equitable subrogation from conventional subrogation and assignment).

<sup>59</sup> See, e.g., *Martin v. Federal Sur. Co.*, 58 F.2d 79 (8th Cir. 1932); *Maryland Cas. Co. v. Cook*, 35 F. Supp. 160 (E.D. Mich. 1940); *Liberty Mot. Ins. Co. v. Harris, Kerr, Forster & Co.*, 89 Cal. Rptr. 437, 10 Cal. App. 3d 1100 (2d Dist. 1970); *Dantzler Lumber & Export Co. v. Columbia Cas. Co.*, 156 So. 116 (Fla. 1934); *Western Sur. Co. v. Loy*, 594 P.2d 257 (Kan. App. 1979); *Hartford Accident and Indem. Co. v. Peat, Marwick, Mitchell, & Co.*, 129 Misc. 2d 990 (N.Y. 1985); *National Sur. Corp. v. Lybrand*, 256 A.D. 226 (N.Y. 1939).

<sup>60</sup>552 N.E.2d 870 (N.Y. 1990).

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there should be no reason why the principle of subrogation should apply any differently when the loss is due to the negligence of accountants than when it has been caused, for example, by the negligence of a bank.<sup>62</sup> The court noted that a fidelity insurer should be permitted to proceed as equitable subrogee when it has been compelled under its policy to pay a loss and when it can establish that the loss was caused by the negligent conduct of its insured's public accountants for which the insured could have recovered.<sup>63</sup>

The defendant auditor contended that it should be insulated from any liability to the plaintiff by the doctrine of superior equities.<sup>64</sup> In declining to apply the doctrine of superior equities to this case, the court noted that the doctrine was designed "to dispense equity and justice among the parties" and should not be permitted where that result will not be achieved.<sup>65</sup> Holding that neither the insured's nor the obligee's rights would any way be diminished by subrogation, nor that subrogation would affect the defendant's position because it could assert whatever rights or defenses it had against the principal's claim and defense of the principal's claim as subrogee, the court upheld the fidelity insurers' right to pursue the auditor.<sup>66</sup>

In contrast, in an unreported decision of the United States District Court for the Northern District of Illinois, *Federal Insurance Co. v. Basabe*,<sup>67</sup> the court held that the doctrine of superior equities applied even though the insurer had received a "release and assignment" of its principal's rights to proceed against an accounting firm that had audited the books of one of the insured's subsidiaries. Federal paid a fidelity claim arising from theft and forgery at its insured's subsidiary and, pursuant to a written assignment, brought a claim against the insured's auditors for failing to detect fraud in the audit. The court held that Federal became equitably subrogated to its insured's rights despite the assignment agreement, which the court held was completely unenforceable as such. The court agreed with those courts which have found that assignment and subrogation are mutually exclusive, i.e., that once a surety has paid on its debt as an insurer, it becomes equitably subrogated to the insured's rights, and that it cannot thereafter proceed under a theory of assignment.<sup>68</sup>

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<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 874.

<sup>65</sup> *Id.* at 875.

<sup>66</sup> *Id.*

<sup>67</sup> No. 88C10504, 1989 WL 134799 (N.D. Ill., October 13, 1989).

<sup>68</sup> *Id.* at \*2. See, e.g., *Bank of Fort Mill v. Lawyer's Title Ins. Corp.*, 268 F.2d 313 (4th Cir. 1959); *United States Fidelity & Guar. Co. v. First Nat'l Bank in Dallas*, 172 F.2d 258 (5th Cir. 1949); *American Sur. Co. v. Bank of Cal.*, 133 F.2d 160 (9th Cir. 1943).

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Turning to the balancing test required by the superior equities doctrine, the court reviewed the various approaches taken by other courts<sup>69</sup> and concluded that, because the case involved the liability of an accountant for failure to detect defalcations and not the liability of a bank for failing to detect forged endorsements, the court was required to look at what factors the insurance company used in calculating its risk in issuing the policy.<sup>70</sup> "In short, when balancing equities, the court must not only consider the negligence of the accountant, it must also determine whether the risk assumed by the surety was modified by a right to be subrogated to the rights of the insured."<sup>71</sup> The court noted that "while it is true that the general accounting principles place a duty on accountants to detect defalcations, an accountants' duties can be limited by agreement."<sup>72</sup> Accordingly, the court denied the auditor's motion for summary judgment because questions of fact remained regarding the auditor's duties under the letter of engagement and whether the risks the insurance company actually assumed were modified by the right to pursue the subrogation claim.<sup>73</sup>

*C. Whether the New Standard Limits or Expands The Possibility for Recovery from Auditors and Practical Advice for Pursuing Such Claims*

Now that we have laid the groundwork regarding how a fidelity insurer can pursue claims against auditors, we turn again to SAS No. 82 to determine whether its requirements assist or hinder insurers pursuing such claims.

There is no question that evidence that an auditor failed to conduct an audit in accordance with generally accepted accounting principles is strong evidence of negligence. In a number of jurisdictions, courts have held that standards established by the accounting industry may constitute evidence of negligence but are not necessarily controlling.<sup>74</sup> One court has affirmatively held that a jury instruction stating that departure from accepted standards of

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<sup>69</sup> Compare *First Nat'l Bank of Columbus v. Hansen*, 267 N.W.2d 367 (Wis. 1978)(paid surety always assumes risk of intervening fraud and can, therefore, rarely if ever have equities superior to innocent third parties) with *John Deere*, 1987 U.S. Dist. Lexis, 10049 (D. Kan. 1987)(considered negligence of bank to be of greater significance than the risks than the surety assumed).

<sup>70</sup> *Basabe*, 1989 WL 134799, at \*3.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at \*4.

<sup>73</sup> *Id.*

<sup>74</sup> *Bily*, 834 P.2d 745 (generally accepted accounting procedures and auditing standards are evidence of standard of care); *Thayer v. Hicks*, 793 P.2d 784 (Mont. 1990); *Maduff Mortgage Corp. v. Deloitte Haskins & Sells*, 779 P.2d 1083 (Or. Ct. App. 1989)(jury may consider standards promulgated by AICPA as evidence of standard of care); *Chevron Chemical Co. v. Deloitte & Touche*, 483 N.W.2d 314 (Wis. Ct. App. 1982).

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accounting practice constituted negligence.<sup>75</sup> Consequently, in any case involving a claim against an auditor, it is important that the practitioner be familiar with the generally accepted accounting principles and their application to the specific facts of the case.

From a practitioner's standpoint, the adoption of SAS No. 82 could well have two effects, one legal and one strategic. From a legal perspective, there is little question that SAS No. 82 imposes additional and rather specific requirements on auditors to establish procedures for detecting material misstatements caused by fraud. While it has previously been noted that SAS No. 82 does not require an auditor to actually detect fraud, but only to establish procedures to detect misstatements, it could well be argued that establishment of the procedures, if competently performed, should ultimately detect fraud. It is thus quite possible that a fidelity insurer can argue that the adoption of SAS No. 82 imposes a more strict requirement on auditors and that the violation thereof could be construed as an act of negligence.

From a strategic perspective, SAS No. 82 arguably provides a road map for discovery. As indicated previously, SAS No. 82 provides numerous, specific "risk factors" that an auditor must consider. If a loss has been sustained and if an action against an auditor for failure to detect fraud appears viable, the fidelity insurer can use the risk factors, quite literally, as a checklist to determine if the auditor adequately considered those factors. Assuming that litigation is filed, the items mentioned in the various risk factors can, as appropriate, be converted into interrogatories or production requests and can additionally be utilized as an outline for depositions of the auditors. Naturally, not all risk factors will be relevant in any particular case and thus they must be viewed selectively.

## V. CONCLUSION

The adoption of SAS No. 82 imposes new and stricter requirements on auditors to establish procedures to detect fraud and material misstatements. The imposition of the stricter requirements is likely to result in the detection of fraud and other material misstatements that, in the short term, could well result in an increase in the number of fidelity claims filed. From a longer term perspective, the new requirements provide new opportunities and sources of information for underwriters to more accurately gauge risks they are requested to assume. From a claim and recovery perspective, the new requirements have arguably heightened the standard of care required by

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<sup>75</sup> *Herbert H. Post and Co. v. Sidney Bitterman, Inc.*, 291 A.D.2d 214 (N.Y. App. Div. 1996).

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auditors, thereby rendering a violation of that standard either negligence, or more likely, evidence of negligence. In either instance, the fidelity claim practitioner is provided with additional leverage against an auditor that violates the new standards.

# **APPENDIX A**

*Comparison of SAS No. 82, Consideration of Fraud in a Financial Statement Audit, with SAS No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities*

In the AICPA self-study course, *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities Under New SAS No. 82*, by Michael J. Ramos, Ms. Jane M. Mancino, CPA, of the AICPA, provides a visual comparison between SAS No. 53 and SAS No. 82 as follows:

	<b>SAS No. 82</b> Effective for Audit Periods Ending on 12/15/97 and After	<b>SAS No. 53</b> Before 12/15/97
<b>SCOPE</b>	Deals solely with auditor's consideration of fraud in financial statement audit.	Deals with both errors and irregularities a financial statement audit.
<b>DEFINITIONS</b>	Provides an expanded description of fraud and covers both fraudulent financial reporting and misappropriations. (Paragraphs 3-10)	Defines both errors and irregularities. Notes that irregularities include both fraudulent financial reporting and misappropriations of assets.
<b>DETECTION RESPONSIBILITY</b>	The ASB considers the detection responsibility in SAS No. 82 to be the same as that under SAS No. 53, however, the detection responsibility in SAS No. 82. <ul style="list-style-type: none"> <li>• has been clarified</li> <li>• uses the term <i>fraud</i>, rather than the term <i>irregularities</i></li> <li>• covers both planning and performing the audit.</li> </ul>	

*continued ...*

<b>SAS No. 82</b> <b>Effective for Audit Periods</b> <b>Ending on 12/15/97 and After</b>	<b>SAS No. 53</b> <b>Before 12/15/97</b>
<p><b>Detection Responsibility</b> The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.</p> <p><b>Risk Assessment</b> The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in each of the related categories in Paragraphs 16 and 18 (of SAS No. 82).</p>	<p><b>Risk Assessment and Detection Responsibility</b> The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.</p>

*continued ...*

	<b>SAS No. 82</b> Effective for Audit Periods Ending on 12/15/97 and After	<b>SAS No. 53</b> Before 12/15/97
<b>RISK FACTORS</b>	<p>Provides close to 40 examples of risk factors for both fraudulent financial reporting and misappropriation of assets in the following categories:</p> <p><b>Categories of Risk Factors Relating to Fraudulent Financial Reporting</b></p> <ul style="list-style-type: none"> <li>• Management's characteristics and influence over the control environment</li> <li>• Industry conditions</li> <li>• Operating characteristics and financial stability</li> </ul> <p><b>Categories of Risk Factors Relating to Misappropriation of Assets</b></p> <ul style="list-style-type: none"> <li>• Susceptibility of assets to misappropriation</li> <li>• Controls</li> </ul>	<p>An Assessment of the risk of material misstatements should be made during planning. It identifies 16 factors in the categories listed below that may be considered:</p> <ul style="list-style-type: none"> <li>• Management characteristics</li> <li>• Operating and industry characteristics</li> <li>• Engagement characteristics</li> </ul> <p>It also identifies nine risk factors that may influence the assessment of audit risk at the balance or class level.</p>
<b>OTHER CONDITIONS</b>	<p>Provides 13 examples of other conditions that may be identified during fieldwork that change or support the risk assessment.</p>	None
<b>RESPONSE TO RISK</b>	<p>Both SAS No. 82 and SAS No. 53 note that the auditor's response to risk may affect.</p> <ul style="list-style-type: none"> <li>• Engagement staffing and extent of supervision</li> <li>• Professional skepticism</li> <li>• Nature, timing and extent of procedures performed</li> </ul> <p>SAS No. 82 provides examples of specific responses to</p> <ul style="list-style-type: none"> <li>• Risk at the account balance, class of transactions, and assertion level</li> <li>• Risk of fraudulent financial reporting</li> <li>• Risk of misappropriation of assets.</li> </ul>	

continued ...

	<b>SAS No. 82</b> Effective for Audit Periods Ending on 12/15/97 and After	<b>SAS No. 53</b> Before 12/15/97
<b>PROFESSIONAL SKEPTICISM</b>	An expanded discussion of professional skepticism has been moved to AU Section 230, <i>Due Professional Care in the Performance of Work</i> , to highlight the importance of exercising professional skepticism throughout the audit.	Discusses the concept of professional skepticism and describes professional skepticism in planning and performing the audit.
<b>RESPONSES TO DETECTED MISSTATEMENTS DUE TO FRAUD</b>	<p>For fraud with an immaterial effect on the financial statements, the auditor should:</p> <ul style="list-style-type: none"> <li>• Refer the matter to an appropriate level of management at least one level above those involved</li> <li>• Be satisfied that implications for other aspects of the audit have been adequately considered</li> </ul> <p>For fraud with a material effect on the financial statement or for which the auditor is unable to determine potential materiality, the auditor should:</p> <ul style="list-style-type: none"> <li>• Consider implications for other aspects of the audit.</li> <li>• Discuss the matter and approach to further investigation with an appropriate level of management, at least one level above those involved</li> <li>• Attempt to determine whether material fraud exists and, if so, its effect</li> <li>• If appropriate, suggest that the client consult with legal counsel</li> </ul>	
<b>DOCUMENTATION REQUIREMENTS</b>	<p>The auditor should document:</p> <ul style="list-style-type: none"> <li>• Those risk factors identified as present and the auditor's response to those risk factors.</li> <li>• If other risk factors are identified during the audit that cause the auditor to believe that an additional response is required, the auditor should document those risk factors or conditions and any further response the auditor concluded was appropriate.</li> </ul>	None.

*continued ...*

	<b>SAS No. 82</b> Effective for Audit Periods Ending on 12/15/97 and After	<b>SAS No. 53</b> Before 12/15/97
<b>INQUIRIES</b>	Auditor should inquire of management (1) to obtain their understanding regarding the risk of fraud in the entity and (2) to determine whether they have knowledge of fraud that has been perpetrated on or within the entity. If the entity has established a program to prevent, deter, and detect fraud, the auditor should inquire of those persons overseeing such programs as to whether the program has identified any fraud risk factors.	
<b>COMMUNICATIONS</b>	<ul style="list-style-type: none"> <li>• When the auditor has identified risk factors that have continuing control implications, the auditor should consider whether these risk factors represent reportable conditions that should be communicated to senior management and the audit committee.</li> <li>• Other communications requirements in SAS No. 82 (Paragraphs 35, 38 and 39) are very similar to those in SAS No. 53.</li> <li>• Whenever the auditor determines there is evidence that a fraud may exist, that matter should be brought to the attention of an appropriate level of management.</li> <li>• Fraud involving senior management and fraud that causes a material misstatement of the financial statement should be reported directly to the audit committee.</li> </ul>	