Auditor Liability and Litigation: The Management Representation Letter

"But They Told Me So" is Not an Acceptable Defense

By

Barry Jay Epstein, Ph.D., CPA, CFF
Natasha Perssico, MBA
SS&G, Inc.
Chicago, Illinois
bepstein@ssandg.com

An auditor's responsibility is to provide reasonable assurance that a reporting entity's financial statements are free of material misstatements, whether due to error or fraud. An auditor (or audit firm) that fails to detect a material misstatement in a client's financial statements will oftentimes find him or her self in the position of having to defend against accountant's liability for negligence, or worse. Claiming reliance upon fraudulent or misleading information provided by the management of a company in a management representation letter is not a viable defense against auditor liability, even when that assertion (i.e., having been deceived by the client) is actually true.

Professional auditing standards (Statements on Auditing Standards, produced by the AICPA's Auditing Standards Board, for private companies; PCAOB standards for publicly-held companies) address the nature of evidence to be obtained and examined in the conduct of audits. Formal representation letters must be obtained in all such engagements, and the standards (currently AU §333 for audits of private companies, but newly-defined and rewritten as AU-C §580 for audits of periods ending after December 15, 2012; the PCAOB still mandates, as an "interim standard," use of the original AICPA-authored standard, AU §333) provide a laundry list of assertions to which the CEO and CFO are required to represent. An unwillingness to make such assertions, modified and expanded as circumstances warrant, constitutes a limitation on the scope of the audit, normally requiring that the auditor disclaim an opinion on the financial statements. For this reason, clients will never refuse to sign such a letter, although haggling over the wording is commonplace.

Historically, the requirement for a management representation letter is based on the desire to eliminate ambiguities and misunderstandings, particularly about the many representations made verbally by clients during the course of the audit – which, in the absence of a written record signed by the client's top officers, might later arise. Also, the very fact that management knows from the outset that its assorted assertions will have to be reduced to a formal document that it must execute will cause it to be more deliberative and accurate in making such assertions.

Notwithstanding that obtaining a written representation letter is mandatory, its actual value as real audit evidence is minimal. As the professional standards make clear,

> (a)lthough written representations provide necessary audit evidence, they complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, obtaining reliable written representations does not affect the nature or extent of other audit procedures that the auditor applies to obtain audit evidence about the fulfillment of management's responsibilities or about specific assertions.[1]

Thus, an auditor is required to corroborate the assertions provided by management. Specifically, he or she must gather appropriate audit evidence sufficient to opine on the financial statements taken as a whole, and thus implicitly on every material assertion implicit in those financial statements. The accumulation of enough audit evidence to reasonably support the assertions in the financial statements, as well as those provided in the management representation letter, is required; representations from management

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[1] AU-C §580.04. All references in this article are to the newly codified, "clarified" auditing standards issued by the Auditing Standards Board of the American Institute of Certified Public Accountants. Although the substance of AU-C §580 is identical to predecessor standard AU §333 (and thus to the PCAOB's interim auditing standard on this topic), the writing has been streamlined and conformed to what has already been mandated under International Standards on Auditing. It is presumed that PCAOB will eventually also adopt or adapt AU-C §580 for audits of publicly-held companies.

are not appropriate substitutes for performing auditing procedures and gathering audit evidence.[2]

Although this principle is long-established, auditors commonly raise the defense, when accused of certifying materially false and misleading financial statements, that the firm was actually the victim – having been deceived by the client – and thus should not be liable for damages suffered by creditors, investors or others that relied on the financial statements. This argument is almost always destined to fail, however.

Under common law an auditor may be liable to a client for breach of contract, negligence, gross negligence (constructive fraud), and actual fraud, and may be liable to third parties for negligence, gross negligence (constructive fraud), and fraud. In a common law (civil) suit, the plaintiff must prove that the auditor performed with a lack of due care. *Inter alia,* one possibly valid auditor defense in a common law case could include a claim that the client was contributively negligent or fraudulent. This defense, however, does not relieve the auditor of the duty to perform an audit in accordance with generally accepted auditing standards ("GAAS"). Attempting to rely on a deceitful or otherwise inaccurate representation letter from management is a defense that will ring hollow in the courtroom, particularly when plaintiff's expert cites the relevant professional literature, as set forth above.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are the two major federal statutes that provide sources of statutory liability for auditors. The 1933 Act, which applies to the initial offer of shares registered with the Securities and Exchange Commission (SEC), sets forth a plaintiff's burden as the need to prove that (1) the security was part of the shares covered by the registration statement and (2) the

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[2] Over recent decades, auditors have been inclined to make client representation letters ever-longer and more detailed, perhaps in the hope of impressing the client's management with the seriousness of its obligations to communicate honestly with the auditors. The general representations regarding management's duty to maintain books and records accurately and to honestly communicate with the auditors are always warranted, but some believe the other, specific representations (e.g., that the allowance for uncollectible receivables is adequate) serve no substantive purpose and may imply a reliance on representations to the exclusion of gathering actual audit evidence, thus lulling the auditor into a sense that an adequate audit has been performed when it has not been.

registration statement was false or misleading or omitted material information that should have been included. Section 11 of the 1933 Act, and Rule 10-b-5 under the 1934 Act provide that defenses available to an auditor under the 1933 Act are limited to (1) claiming that an adequate audit was performed in accordance with GAAS or (2) that all or a portion of the plaintiff's loss was due to factors other than the misleading financial statements.

The 1934 Act applies to securities traded after an initial offering. The burden under the 1934 Act includes proving that (1) the alleged false, misleading, or omitted statement is material in nature (2) the CPA had knowledge of the statement, (3) the plaintiff's reliance on the statements and (4) actual damages sustained as a result of such reliance. Under 10-b-5, defenses against securities fraud include (1) the CPA did not act with intent to deceive, manipulate or defraud, (2) the audit was performed in accordance with GAAS, (3) there was a lack of duty to perform services, or (4) there is no causal relationship between the plaintiff's loss and the CPA's actions.

Over-reliance on management representations has its consequences. Many accountants' negligence disputes have been resolved to their detriment, with critical observations made about unwarranted reliance on management representations in lieu of substantive audit evidence. For example, in the SEC administrative action against accountants Philip S. Present, II, and William J. Scanlon, it was determined that there had been failure to corroborate management's representations regarding conditional purchase orders, concerning write-offs and reversals, and to explain why proposed audit adjustments need not be made.[3]

In another case, an SEC Administrative Law Judge stripped Scott E. Edwards, CPA, of licensing privileges for one year following a decision that the CPA, *inter alia,* inappropriately relied on the management representation letter as audit evidence.[4]

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[3] U.S. SEC, Accounting and Auditing Enforcement Release No. 904 (April 10, 1997).

[4] Initial Decision Release No. 219, Administrative proceeding File No. 3-10220, United States of America before the Securities and Exchange Commission, Washington, D.C.

More significantly, the PCAOB, on February 8, 2012, announced that it had settled a proceeding with Ernst & Young LLP, with the firm being censured and having a $2 million penalty imposed upon it – the largest civil money penalty ever imposed by this agency. In addition, four of its current and former partners were sanctioned for violating PCAOB rules and standards, all in connection with failed audits of Medicis Pharmaceutical Corporation ("Medicis") for the periods ending December, 31, 2005, 2006 and 2007. E&Y allegedly failed to properly evaluate Medicis' sales return reserve, which was a material component of the company's financial statements. According to PCAOB, for all years in question, the firm and its partners failed to comply with PCAOB standards in evaluating: Medicis's accounting practices, which included reserving most of its estimated product returns at the cost of replacing the product, instead of at gross sales price; failing to sufficiently audit key assumptions; and placing undue reliance on management's representation that those assumptions were reasonable.[5]

These, and many other, cases clearly demonstrate that formal management representations – albeit required under auditing standards, and even when highly specific about accounting practices employed by the reporting entity – are not, in and of themselves, adequate evidence to support the auditor's opinion on the financial statements. Representation letters are best thought of as the beginning, and not the ending, of the audit trail.

About the authors: Barry Jay Epstein, Ph.D., CPA, CFF, (BEpstein@SSandG.com) is Partner in the Chicago, Illinois office of SS&G, Inc., where his practice is concentrated on technical consultations on U.S. GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the author of the Warren, Gorham & Lamont *Handbook of Accounting and Auditing*, and was for many years the lead co-author of *Wiley GAAP*, *Wiley IFRS*, and *Wiley IFRS Policies and Procedures*. Natasha Perssico is an Associate in the Business Valuation and Litigation Consulting division at SS&G. In June 2012, she will receive her MBA degree focusing on Forensic Accounting from DePaul University.

[5] http://pcaobus.org/News/Releases/Pages/02082012_DisciplinaryOrderEY.aspx