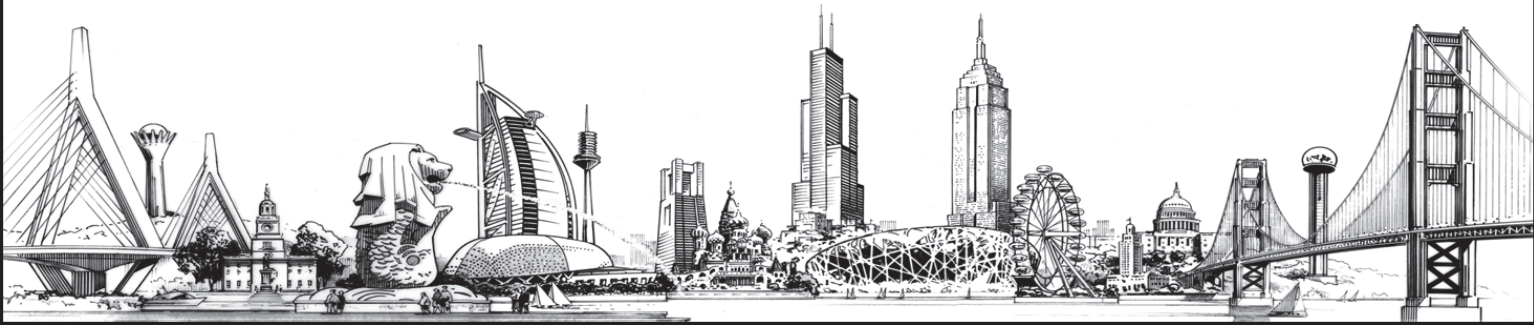


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# **INVESTIGATIONS AND THE INDEPENDENT AUDITOR**

October 1, 2021



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**SECTION I**

## **DUTIES OF THE AUDITOR**

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# Part 1: Overview

## Part 1: Auditor's Duties

- If the auditor becomes aware of a potential illegal act, its duties are:
  1. **Duty to inform:** Auditors generally must inform management regarding all illegal acts, whether or not perceived by the auditor as material.
  2. **Duty to report:** Auditors must report their conclusions to the Board.
  3. **Duty to assess:** Auditors will need to assess the decisions of the audit committee and its counsel regarding the scope, conduct, and conclusion of the investigation.

# Duty to Inform

## Duty 1: Duty to Inform

- "If, in the course of conducting an audit pursuant to this title ... the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (***whether or not perceived to have a material effect on the financial statements of the issuer***) has or may have occurred, the firm shall....
    - (A) (i) determine whether it is likely that an illegal act has occurred; and  
(ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
    - (B) ***as soon as practicable***, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential."
- Securities Exchange Act of 1934 section 10A(b) (emphasis added).

## Duty to Inform Continued

- **Illegal Act Defined**
  - Section 10A casts its net widely. Under Section 10A(f), an “illegal act” includes “an act or omission that violates any law, or any rule or regulation having the force of law.”
  - Section 10A is not limited to illegal acts that involve the company’s business activities.
- **Duty to Investigate**
  - The obligation arises whenever an illegal act “has or may have occurred” and “whether or not perceived to have a material effect on the financial statements of the issuer.”
  - Even the possibility of an immaterial illegal act will trigger the auditor’s obligation to consider and report under Section 10A(b).
- **Reporting Inconsequential Acts**
  - The auditor must report the illegal act to management “unless the illegal act is clearly inconsequential.”
  - Auditor may be unable to determine **without investigation** whether the act is material or inconsequential:
    - “As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of **relatively small amounts that come to the auditor’s attention could have a material effect on the financial statements.**” SAB 99 at 45152 (emphasis added).
    - “[T]he determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law....” PCAOB AU § 317.03.

## Duty to Inform Continued

### **Assessing Materiality**

- A numerical threshold alone may not be an appropriate basis for determining if an act is immaterial.
- Even quantitatively small misrepresentations can be material if done **intentionally**.
  - “While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to ‘manage’ reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant’s financial statements. The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to ‘manage’ earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.” – SAB 99 at 45152.

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