Illegal Acts: What is the Auditor’s Responsibility?

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Society has always been concerned with violations of laws and regulations by all types of entities – business enterprises, nonprofit organizations, and governmental units. Highly publicized accounts of management improprieties reported over the last two decades have caused this concern to increase significantly. Several congressional committees, regulatory agencies, and others have suggested that auditors should assume more responsibility for detecting and disclosing violations of laws or regulations, commonly referred to as illegal acts.

Developing standards that articulate the auditor's responsibility for illegal acts has proven to be a very challenging task for several reasons. First, a large diversity of laws and regulations affects most entities, and identifying violations of many of those laws and regulations requires legal expertise. Second, even with this expertise, the complexity of some laws and regulations makes identifying a violation very difficult. Finally, even after an illegal act has been identified, evaluating management’s assessment of its potential effects on the entity’s financial statements is also very difficult.

This article analyzes the auditing standards that describe the auditor’s responsibilities for detecting and reporting illegal acts. It also reviews the historical developments that have brought the profession to where it is today. Finally, we introduce some future issues and research needs in this area.

Historical Developments

The issue of the auditor’s responsibility for illegal or questionable acts by clients is not new. It first made front-page news in the mid 1970’s as a result of the Watergate scandal. Investigations led to initial disclosures of illegal political contributions by many large corporations. These initial disclosures opened the door to a host of other revelations involving questionable payments by corporations to domestic and foreign government officials. As a result, the profession formally addressed the issue of the auditor’s responsibility to detect and report illegal acts by clients. The issue was initially studied by the Commission on Auditors’ Responsibilities (the Cohen Commission). Based