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AUDITORS' DUTY TO DETECT ILLEGAL ACTS HAVING A MATERIAL EFFECT ON THE FINANCIAL STATEMENTS: A CASE STUDY OF MILLER INVESTMENT TRUST v. KPMG

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Abstract
This is a case study of Miller Investment Trust v. KPMG which notes the court's common law adoptions of Generally Accepted Auditing Standards (GAAS). In this case, the court relied upon GAAS in its decision-making. It covers: (a) elements of securities fraud; (b) Private Securities Litigation Reform Act; (c) assessment of auditors' compliance with GAAS; (d) auditors' professional competence to determine whether a client has committed illegal acts; (e) whether an auditor is required to investigate a client's questionable acts; (f) investigatory procedures required of auditors; (g) what an auditor should do if unable to determine if a client's questionable acts are illegal; (h) what an auditor should do if he finds illegality having a material effect on the financial statements, and it has not been disclosed by the client; (i) minimally acceptable action of an auditor after discovering illegality; (j) disclosure of internal control weaknesses; (k) whether an auditor is required to verify a client's customers' addresses against public records; (l) grounds for denial of an auditor's motion to dismiss in a securities fraud case; (m) whether, in this case, there were sufficient grounds to dismiss the lawsuit; (n) whether an auditor's statement of compliance with GAAS is a statement of fact or an opinion; (o) whether an auditor's statement in an audit report that the client prepared its financial statements in accordance with Generally Accepted Accounting Principles is a statement of fact or an opinion; (p) the elements of Negligent Misrepresentation; and (q) whether an auditor is generally liable to third parties that it has no knowledge of.

Keywords: auditor, duty, detect, illegality, investigate, securities, fraud, standards, negligence

1. General Problem

The problem in this article is to study the legal case of *Miller Investment Trust v. KPMG* and to note the court's common law adoptions of Generally Accepted Auditing Standards (GAAS). This legal case was chosen for study because of the numerous instances of the court's reliance upon GAAS in its decision-making. Whenever courts refer to GAAS in making their decisions, this confers more legitimacy upon GAAS and reinforces its utilization as a source of authority in future audits.

2. Specific Objectives

The objectives of this article are to: (a) explain the elements of a case of securities fraud pursuant to the Securities and Exchange Act of 1934; (b) describe the effect of the Private Securities Litigation Reform Act on a plaintiff's pleading of a securities fraud claim; (c) determine whether the fact-finder in a securities fraud case is allowed to assess if an auditor complied with

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Generally Accepted Auditing Standards during the audit; (d) decide whether an auditor has sufficient professional competence to determine whether a client committed an illegal act; (e) determine whether an auditor is required to investigate whether a client's questionable acts are illegal; (f) describe the specific investigatory procedures that are required to be undertaken by an auditor whenever the auditor becomes aware of the client's acts that appear to be illegal; (g) explain what an auditor should do if he is unable to determine if a client's questionable act is illegal; (h) explain what an auditor should do if he determines a client's act is illegal, the act has a material effect on the financial statements, and the act has not been disclosed by the client; (i) state the minimally acceptable action required by an auditor if he discovers the client has committed an illegal act; (j) state whether an auditor's disclosure of a client's internal control weakness concerning non-routine transactions, also discharges his duty to disclose an internal control weakness concerning related party transactions; (k) determine whether an auditor, in the course of Accounts Receivable confirmations, is required to verify the client's customers' addresses against public records or to make onsite visits to the customers; (l) determine whether, in the pleadings of a securities fraud case, alleged GAAS violations of the auditor coupled with alleged "red flags" ignored by the auditor are generally sufficient grounds for the court to deny the auditor's motion to dismiss the lawsuit; (m) determine whether, in this case, the alleged GAAS violations plus the alleged "red flags" were sufficient grounds to deny the auditor's motion to dismiss; (n) explain whether an auditor's statement in an audit report that it has complied with PCAOB standards or with GAAS is a statement of fact or an opinion; (o) explain whether an auditor's statement in an audit report that the client prepared its financial statements in accordance with Generally Accepted Accounting Principles is a statement of fact or an opinion; (p) list the elements of the common law tort of Negligent Misrepresentation, and to explain whether the auditor in this case had committed that tort; and (q) explain whether an auditor is generally liable to third parties that it has no knowledge of.

3. Background: Facts of the Case

Plaintiffs Miller Investment Trust (Miller) and Jura Limited (Jura) sought to recover investment losses from purchases of $8.7 million of bonds sold by ShengdaTech, Inc. (Shengda) in 2010 and 2011. In 2011, it became known that Shengda had exorbitantly overstated its revenues. Shortly afterward, Shengda defaulted on the bond payments and declared bankruptcy, and Miller lost virtually all of its investment. In their lawsuit filed in 2011, plaintiffs alleged securities fraud pursuant to the Securities Exchange Act of 1934 (Exchange Act) against two defendants: Morgan Stanley, the underwriter of the bond offering, and KPMG-Hong Kong (KPMG), Shengda's auditor. Plaintiffs also sued KPMG for negligent misrepresentation of information pertinent to the bond offering. Plaintiffs alleged that Morgan Stanley and KPMG knew or should have known about misrepresentations of material fact made in the bond offering documents. KPMG filed a motion to dismiss all claims filed against it; the court granted KPMG's motion and all causes of action filed against KPMG were dismissed (KPMG, p. 418).

4. What are the elements of a case of securities fraud pursuant to the Exchange Act?

In the aftermath of the stock market crash of 1929 and the Great Depression which followed, two federal U.S. statutes were enacted pertinent to regulation of the sale of securities (stocks and bonds) on stock exchanges: the Securities Act of 1933 and the Securities and Exchange Act of

1934 (Exchange Act). The 1933 statute regulated initial public offerings of securities. The 1934 statute regulated public offerings of securities following the initial offering, and it also created the Securities and Exchange Commission (SEC), the federal agency charged with enforcement of the 1933 and 1934 statutes. These two statutes are inapplicable to private corporations, i.e., those corporations whose securities are not traded on a public exchange.

Under Section 18a of the Exchange Act, in order to plead a case of securities fraud, a plaintiff is required to state that: defendant made a materially false or misleading statement; the statement was contained in a document filed pursuant to the Exchange Act or any rule or regulation thereunder; plaintiff relied on the false statement; and plaintiff thereby incurred a loss.

In the present case, plaintiffs sued the auditor, alleging that KPMG had committed securities fraud by: (a) making false statements in its audit report; (b) filing the audit report with the SEC; (c) the audit report was read by plaintiffs; (d) plaintiffs relied on the false statements in the audit report by purchasing the bonds; and (e) plaintiffs thereby incurred a financial loss. The false statements allegedly made by KPMG are that it complied with PCAOB standards during the audit, and that its client's financial statements were prepared in accordance with Generally Accepted Accounting Principles (KPMG, p. 421).

5. What is the effect of the Private Securities Litigation Reform Act (PSLRA) on a plaintiff's pleading of a securities fraud claim?

The PSLRA, a federal securities statute enacted in 1995, was designed to prevent unwarranted or frivolous lawsuits from being filed, which can be expensive, time-consuming and can reduce the efficiency of the legal system. The PSLRA requires a plaintiff to state with particularity the circumstances constituting defendant's fraud or mistake. Conclusory allegations are insufficient. Plaintiffs must comply with stringent pleading requirements, *to wit*: they must allege specific fraudulent statements made by defendant, that the statements were made recklessly or intentionally, and that they relied upon the false statements and thereby incurred a financial loss because of the fraud. Before the PSLRA was enacted, plaintiffs could reasonably file a lawsuit simply because the price of a security had changed significantly (Chen, 2020).

In this case, plaintiffs did not comply with the stringent pleading requirements of the PSLRA because plaintiffs did not state with specificity how KPMG had failed to properly perform its audits of Shengda (KPMG, pp. 431, 435).

6. In a lawsuit against an auditor, alleging the auditor violated Generally Accepted Auditing Standards (GAAS), may the fact-finder assess an auditor's compliance using a reasonable person standard?

Yes. The ten general auditing standards have been codified by the Public Company Accounting Oversight Board (PCAOB), the entity created by the Sarbanes-Oxley Act to oversee the accounting and auditing practices of business firms whose stock is publicly-traded. (PCAOB, 2020). The ten general auditing standards have also been codified by the American Institute of Certified Public Accountants (AICPA), the entity responsible for promulgation of accounting and auditing rules for private business firms, i.e., firms whose stock is not publicly-traded (AICPA, 2001).

The KPMG court determined that, although one auditor may apply the standards differently from another, there is sufficient uniformity that a fact-finder may assess compliance using a reasonable person standard, asking whether a reasonable auditor would have taken such steps under the circumstances (KPMG, p. 431).

7. Is determination of whether a client committed an illegal act beyond the auditor's professional competence?
Ordinarily, yes. Auditors purport to have knowledge of accounting and auditing, not the law. An auditor's background, training and understanding of the client may allow an auditor to become aware that acts of a client may be illegal. Nevertheless, a determination as to whether a particular act is illegal would generally be based on the advice of an informed attorney or may have to await final determination in a court of law (PCAOB, AU s 317.03).

8. Notwithstanding the above, is an auditor required to investigate in an attempt to determine a questionable act's legality?
Yes. The Exchange Act and the PCAOB standards require an auditor to determine whether a corrective disclosure is needed and whether the auditor can continue to rely on management's representations on any matter, and generally in furtherance of an auditor's obligation to be professionally skeptical (KPMG, p. 433).

9. With respect to a potential illegal act's effect on the financial statements, what specific investigatory procedures are legally required to be undertaken by an auditor?
PCAOB standards (AU ss 110 and 317) require the auditor to do the following: (a) read the minutes of meetings of Board of Directors; (b) make inquiries to management and client's legal counsel; (c) examine supporting documents; and (d) test the details of transactions and balances with third parties (KPMG, p. 433).

10. What should an auditor do if he is unable to determine is an act is illegal?
If unable to determine illegality, the auditor finds himself in a tenuous situation and may have no choice but to issue a Disclaimer in its audit report. A Disclaimer is essentially a "no comment." The Disclaimer is telling the world that the auditor is unable to gather sufficient credible evidence upon which to base an opinion, and therefore no substantive opinion will be issued (PCAOB, AU s 317.19, .21).

11. What should an auditor do if he determines the act is illegal and has a material effect on the financial statements and the act has not been disclosed by the client?
In this situation, the auditor will issue either a Qualified audit opinion or an Adverse audit opinion. But which one? The key is the degree of pervasiveness that the material effect has on the financial statements as a whole. If the degree of pervasiveness is slight and does not adversely affect the financial statements as a whole, a Qualified opinion should be issued, describing how the financial statements are affected and the financial impact in dollars. On the

other hand, if the degree of pervasiveness is substantial and does adversely affect the financial statements as a whole, an Adverse opinion should be issued, describing how the financial statements are affected and the financial impact in dollars (PCAOB, AU s 317.18).

The auditor is also required to inform the Audit Committee and senior management (Exchange Act, 15 U.S.C.S. s 78j-1(b)(1)(B)).

12. If an illegal act is found by the auditor, what is the minimum acceptable action required by the auditor?

Both the PCAOB standards and the Exchange Act require him to inform the Audit Committee "as soon as practicable" and prior to the issuance of the auditor's report (PCAOB, AU s 317.17; and Exchange Act, 5 U.S.C.S. s 78j-1(b)(1)(B)). In this case, there was no question that auditor KPMG had met this requirement because the Audit Committee was already aware of the illegality, i.e., that Shengda had included a substantial amount of related-party transactions in its sales figure in the income statement. Shengda's CEO held a substantial interest in one of Shengda's customers, and the Audit Committee knew it! The fact that the Audit Committee already knew that information effectively negated KPMG's duty to inform the Audit Committee of the related-party irregularity. (KPMG, p. 434).

13. During an internal control evaluation by an auditor, does the auditor's disclosure of a client's internal control weakness concerning non-routine transactions also discharge the auditor's obligation to disclose an internal control weakness concerning related party transactions?

The Sarbanes-Oxley Act requires auditors of U.S. publicly-traded firms to annually evaluate their clients' internal control systems and to make recommendations for improvement of those systems. The internal control evaluation and the financial statement audit may be done separately, i.e., at different times during the year, or they may be "integrated." An integrated audit is one in which the auditor evaluates the client's control system immediately before conducting the financial statement audit. Integrated audits are commonplace because the information gleaned by the auditor during the internal control evaluation is often useful in planning the financial statement audit, for this reason: any deficiencies in the client's internal controls serve as "red flags" that can be followed up on during the financial statement audit. The internal control deficiencies often highlight the specific parts of the financial statements and the accounting system that are more likely to contain material errors or fraud (Louwers, 2021, p. 176).

PCAOB standards contain a detailed description of what the auditor should do during the internal control evaluation. Those standards describe several types of internal control weaknesses the auditor should look for, including a weakness relating to non-routine transactions and a weakness concerning related party transactions. Those two categories of internal control weaknesses are listed separately; they are not combined (KPMG, pp. 435-436).

The answer to this question is "No." Since the PCAOB lists controls over significant unusual transactions and controls over related party transactions separately, the PCAOB is indicating that these two categories are not synonymous. Therefore, the disclosure of weaknesses in one of these areas does not constitute disclosure of weaknesses in the other. Accordingly, in this case, KPMG's disclosure that Shengda had insufficient internal controls over non-routine transactions did not discharge KPMG's obligation to also disclose any weaknesses in internal control over related party transactions (PCAOB, AS 5.14).

However, the court held that KPMG had sufficiently complied with its duty to investigate related-party transactions when it consulted with client's legal counsel and the prior auditor (KPMG, p. 433).

14. Is an auditor required to verify Accounts Receivable addresses against public records or by making onsite visits to the client's customers?

Generally Accepted Auditing Standards require the auditor to obtain confirmations from a random sample of the customers owing money to the client, i.e., the customers with Accounts Receivable balances. Accounts Receivable is the only account for which written confirmations are required. Accordingly, the auditor is required to make a random sample of the customers with outstanding balances in their accounts. Written confirmations are mailed to the customers using the addresses that the client has on file. In the confirmation letters, the customers will be asked to verify the amount they currently owe the client (Louwers, 2021, pp. 291-297).

In the present case, plaintiffs suspected that some of Shengda's customers were fictitious.
Plaintiffs contended that the auditor was required to verify the customers' addresses against public records or by making onsite visits to the customers' addresses. This was one of the issues addressed by the court (KPMG, pp. 436-438).

The answer to the question is "no." PCAOB standards do not require this. An auditor is not obligated to check the transactions pertaining to each and every business firm the client does business with. Neither is an auditor required to confirm a client's customers' addresses against public records or to make on-site visits to the customers' premises. Accordingly, KPMG was not required to do this (KPMG, p. 436; PCAOB, AU ss 330.05-.10).

15. At the pleading stage in a securities case, will alleged GAAS violations of an auditor coupled with alleged ignoring of "red flags" by an auditor, be sufficient grounds for the court to deny the auditor's motion to dismiss the lawsuit?

Yes, but only if the "red flags" are significant. If the red flags were indeed significant, then an auditor should act after becoming aware of them by exercising due care, being professionally skeptical, assessing the nature of the client's business adequately, obtaining sufficient competent evidence to afford a reasonable basis for an opinion, and by responding to signals of potential fraud (KPMG, p. 438).

16. In this case, were the alleged "red flags" significant enough to justify the denial of the auditor's motion to dismiss the lawsuit?

No. Plaintiffs alleged that KPMG ignored the following so-called "red flags": (a) the client had frequently been forced to restate—in other words, amend—its financial statements; (b) the confirmation documents received from two banks in which the client allegedly held accounts were of questionable authenticity; (c) the client meddled in the accounts receivable audit by influencing the responses from their customers; (d) the client had been warned by a third party connected with the client that the client might be engaging in fraud; and (e) KPMG's alleged urging of the client not to put certain things in writing (KPMG, pp. 438-442).

However, the court held that: restatement of financial statements is a common occurrence and should not be considered to be a red flag; auditors are not required to authenticate all documents received from third parties; the meddling in the accounts receivable audit was discovered by the auditor at a later point in the audit; the allegations of fraud by third parties were not legally material and significant; and there was a lack of substantiating evidence that KPMG had actually told the client not to put certain things in writing. The court was not impressed with these so-called red flags because they were not tied to any specific applicable PCAOB standards and they only concerned KPMG's subjective knowledge. Proof of subjective knowledge is not required in an audit, and plaintiffs' introduction of it is not relevant to the determination of whether KPMG failed to comply with PCAOB standards during the audit. Therefore, in this case, the so-called red flags were insufficient evidence to support plaintiffs' conclusory allegation that KPMG failed to perform the audit in accordance with GAAS as specified in the PCAOB standards (KPMG, pp. 438-442).

17. Is an auditor's statement in an audit report that it has complied with Public Company Accounting Oversight Board (PCAOB) standards or Generally Accepted Auditing Standards (GAAS) a statement of fact or an opinion?

The court held that statements by auditors certifying their compliance with PCAOB standards or with GAAS are statements of fact. This is because the auditor is the only person or entity that is given the task of complying with those standards. The court stated: "There is no reason that an auditor cannot state with certainty that it followed the PCAOB standards and the GAAS therein as it understood them, including that it exercised the independent judgment that is required by those standards" (KPMG, p. 430).

18. Is an auditor's statement that client's financial statements were prepared in accordance with Generally Accepted Accounting Principles (GAAP) a statement of fact or an opinion?

This is a statement of fact because, unlike the PCAOB standards and GAAS, GAAP are far from being a canonical set of rules and are not compiled in a single-source accounting rulebook. Instead, there are nineteen different GAAP sources, and an accountant must refer to an elaborate hierarchy of those sources to determine which accounting procedure to use. Because GAAP are meant to embody contemporary conventions, GAAP changes and, even at any one point, is often indeterminate. This is in contrast to the PCAOB standards that, although requiring the exercise of discretion, can be identified from one source, and for which a statement of compliance is less a statement of belief than an assertion carrying some certainty (KPMG, p. 442).

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19. What are the elements of a common law allegation that an auditor committed Negligent Misrepresentation, and were all of the elements present in this case?

In the course of his business, a defendant must have supplied false information for the guidance of others in their business transactions, causing them to incur financial loss by their justifiable reliance on the information, with defendant's failure to exercise reasonable care or competence in obtaining or communicating the information. Plaintiff must plead that the auditor had actual knowledge of plaintiff's use of the audit report, i.e., the auditor must have believed that plaintiff would rely on the information. In this case, however, plaintiff did not satisfy this element and the Negligent Misrepresentation claim failed (KPMG, pp. 449-453).

20. Generally, is an auditor legally liable to third parties?

No. If the auditor is unaware of any particular purpose for the audit, and the auditor is unaware (on the date the audit report is released) that his work product would be relied on by a plaintiff in making his investment decision, there is no liability to third parties (KPMG, pp. 452-453).

21. Conclusions

a. The elements of a securities fraud case pursuant to the Exchange Act are: a materially false statement of defendant contained in a document filed with the SEC; the false statement was relied upon by plaintiff; and this caused plaintiff's financial loss.

b. The Private Securities Litigation Reform Act requires a plaintiff to comply with stringent pleading requirements and he must allege: specific fraudulent statements made by defendant; the statements were made recklessly or intentionally; and plaintiff justifiably relied upon the statements, thereby incurring a financial loss.

c. In this case, the court ruled that the fact-finder would be allowed to assess whether the auditor complied with Generally Accepted Auditing Standards using a reasonable-person standard.

d. Generally, an accountant or an auditor is not considered to have sufficient professional competence to determine whether a client has committed an illegal act. This is simply because accountants and auditors are not attorneys and do not have legal education or experience.

e. Notwithstanding the above, an auditor is required to investigate whenever he suspects the client to have committed an illegal act. The auditor should investigate in order to determine whether a corrective disclosure is needed and whether the auditor can continue to rely on management's representations on any matter.

f. The Public Company Accounting Oversight Board standards require the auditor to do the following in the course of investigating a client's potential illegal act: read minutes of meetings, make inquiries to management and to the client's legal counsel, examine supporting documents, and test details of transactions and account balances with third parties.

g. If an auditor is unable to determine if the client has committed an illegal act, he should issue a Disclaimer in his audit report.

h. If an auditor determines the client has committed an illegal act, the effect of the act on the financial statements is material and the client did not disclose the act, then the auditor should issue either a Qualified opinion or an Adverse opinion. The choice of Qualified/Adverse depends on whether the impact of the illegal acts adversely affects the financial statements as a whole.

i. If an auditor discovers the client has committed an illegal act, at a bare minimum the auditor is required to inform the Audit Committee as soon as possible and prior to the issuance of the audit report.

j. During an internal control evaluation by an auditor, his disclosure of a client's internal control weakness pertaining to non-routine transactions does not also amount to disclosure of an internal control weakness pertaining to related party transactions; the two categories of internal control weaknesses are not synonymous.

k. Auditors are not required to verify the client's customers' addresses against public records or by making onsite visits to their place of business or their home.

l. In pleading a case of financial securities fraud, a plaintiff's allegations that the auditor violated Generally Accepted Auditing Standards during the audit, coupled with the auditor's ignoring of "red flags" that he should have taken notice of, is sufficient to overcome the auditor's motion to dismiss, but only if the red flags are significant.

m. In this case, the "red flags" were not significant enough to justify the court's denial of the auditor's motion to dismiss. Accordingly, the court dismissed the case.

n. An auditor's contention in an audit report that it has complied with Public Company Accounting Oversight Board standards or with Generally Accepted Audit Standards is a statement of fact; it is not an opinion.

o. An auditor's statement in an audit report that the client's financial statements were prepared in accordance with Generally Accepted Accounting Principles is an opinion; it is not a statement of fact.

p. The elements of common law Negligent Misrepresentation are: defendant supplied false information to plaintiff designed to guide him in his business transactions, defendant failed to exercise reasonable care or competence in obtaining or communicating the information, and plaintiff justifiably relied on the information and thereby incurred financial loss. In the present case, plaintiff's claim failed because plaintiff failed to plead justifiable reliance; the auditor had no knowledge prior to issuing its audit opinions that they would be used for distribution to potential investors.

q. Generally, an auditor is not liable to third parties that it has no knowledge of.

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