

## **COMPLIANCE RELATIONSHIPS WITH AUDITORS IN THE POST ENRON ENVIRONMENT**

The duties of accounting professionals have been dramatically changed by the Sarbanes-Oxley Act (“SOA”) and the attendant Securities Exchange Commission (“SEC”) regulations. As a consequence, the practices and procedures employed by accountants in the conduct of audits have begun to change in the post Enron business environment in response to the prospects of liability under the new rules, as well as a result of emerging theories of accounting and audit malpractice. Auditors have a role in the detection of fraud and in assessing the potential impact of contingent liabilities on the financial condition of the Hospital. The nature of the relationships between auditors, management and legal counsel, which have been settled for thirty years, will face new tensions that were not anticipated when the current rules and procedures were adopted.

It is important to understand the context in which auditors may look to legal counsel and management for information. During a financial audit, members of the audit engagement team collect and review information from numerous sources in order to prepare the Hospital’s financial statements. One of the key components of an audit activity is interaction with client personnel in the process of confirming management representations. This interaction will entail confirmation or authentication by the Hospital’s employee or manager who is responsible for gathering certain data of the accuracy and completeness of information on which auditors intend or rely. Many existing audit procedures are premised on the assumption that the client is telling the truth. Given that auditors will be held to specific legal standards under Sarbanes-Oxley (which the Hospital is not subject to) and its associated regulations, they are becoming—or soon will be—more skeptical of the information they are provided by their clients. The outcome of this trend is likely to be either (1) a development of alternative audit methods that put less reliance on client representations; or (2) a modification of current methods that require the client to assume all risks associated with inaccurate or missing information. More important, the accountant’s role as an audit engagement team member has historically been service-oriented, not enforcement-oriented; that is, the auditor

regards himself/herself as providing a service to the client, not acting to enforce compliance with various laws and regulations.

In the late 1980s, the American Institute of Certified Public Accountants (“AICPA”) proposed a Statement to clarify an auditor’s responsibility for detecting and reporting illegal acts committed by the auditor’s clients. It is important to note that detection of illegal acts is not something an audit performed in accordance with generally accepted auditing standards is designed to do. Instead, the AICPA recommends an auditor “make some ‘illegal act’ inquiries of management” and be cognizant of signals that suggest an illegal act has occurred. Unless the “illegal act” will or does materially affect the Hospital’s financial statements, the auditor is under no obligation to identify or report it. Instead, the AICPA advises auditors to “consult the client’s legal counsel” when he/she discovers evidence of commission by the client of some illegal act. Combined with the representations the Hospital’s legal counsel is asked to make about the organization’s financial stability during a financial audit and the reporting requirements under the SOA and its associated regulations, it is likely that auditors will expand the scope of the representations they obtain from a client to include statements about the Hospital’s compliance with all laws and regulations, not just those that materially impact the financial statements. **Moreover, while not public companies subject to the SOA, the heightened standards of auditor diligence required under the SOA have application to audit clients that operate in industries that are highly regulated or involve public trust issues, such as healthcare.** As a consequence, nonprofit healthcare organizations, such as the Hospital, and their legal counsel must deal with the real possibility that auditors will begin to require of them these same expanded representations of blanket compliance with all federal and state laws and regulations.

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