Monday, October 20
4:30 pm-6:00 pm

301 Answers to Questions You Wish Your Outside Auditor Hadn't Asked

W. Stephen Cannon
Chairman
Constantine Cannon LLP

Maryann Clifford
Corporate Vice President and Compliance Officer
Motorola, Inc.

Catherine Engelbert
AERS Partner
Deloitte & Touche USA LLP

Jonathan Oviatt
General Counsel
Mayo Clinic

Thomas J. Sabatino
Executive Vice President and General Counsel
Schering-Plough Corporation

This material is protected by copyright. Copyright © 2008 various authors and the Association of Corporate Counsel (ACC).
Materials may not be reproduced without the consent of ACC.
Reprint permission requests should be directed to ACC's Legal Resources Department at ACC: 202/293-4103, ext. 338; legalresources@acc.com

Faculty Biographies

W. Stephen Cannon

Steve Cannon is chairman of Constantine Cannon LLP with offices in New York and Washington, DC. Constantine Cannon is a mid-sized firm of 40 lawyers specializing in antitrust and complex commercial litigation, government relations, and regulatory policy.

Prior to joining Constantine Cannon, Mr. Cannon served as senior vice president, general counsel, and secretary of Circuit City Stores, Inc. Before joining Circuit City, Mr. Cannon was a partner in the Washington, DC firm of Wunder, Diefenderfer, Ryan, Cannon & Thelen, where he concentrated his practice in antitrust, trade regulation, and administrative law. Prior to joining Wunder, Diefenderfer, Mr. Cannon spent 10 years in government service. After a clerkship with the South Carolina Supreme Court, Mr. Cannon received an appointment under the US Justice Department's Honors Law Graduate Program. Mr. Cannon was appointed chief antitrust counsel to the US Senate Judiciary Committee and later, Mr. Cannon returned to the antitrust division of the Justice Department as deputy assistant attorney general.

In 2004, Mr. Cannon was appointed to serve on the Antitrust Modernization Commission. The Commission was charged with examining the broad scope of the nation's antitrust laws. Later, Mr. Cannon was appointed to an ABA special task force to examine the status of attorney-client privilege in American jurisprudence. In addition, Mr. Cannon serves on the board of directors of the US Chamber of Commerce National Litigation Center and as counsel to ACC on a range of issues.

Mr. Cannon received both his undergraduate and law degree from the University of South Carolina.

Maryann Clifford

Maryann Clifford is the former corporate vice president and chief ethics and compliance officer for Motorola, Inc. In this role, she had global responsibility for the development and direction of the company's ethics, legal compliance, and global corporate responsibility programs. She is an attorney with an extensive background in corporate compliance, litigation, commercial counseling, and corporate responsibility.

Ms. Clifford served as legal counsel to Motorola for eighteen years. Her roles included managing the global legal team for the mobile handset business for ten years and supporting Motorola's business with the US government in Arizona. She spent her early years in law working as a litigator at the Department of Justice in Washington, DC handling complex civil litigation. She then worked in private practice in Washington, DC; at the firm of Verner, Liipfert, Bernhard, McPherson and Hand (now DLA Piper) also in Washington, DC; and as in-house counsel for Northrop Grumman Corporation in Illinois.

Catherine Engelbert

Catherine Engelbert is a partner with Deloitte & Touche LLP in Parsippany, New Jersey. Ms. Engelbert is currently serving as one of the top technical partners in Deloitte's Northeast Region. She developed a depth of knowledge on a wide variety of accounting and financial reporting matters during her time in Deloitte's national office accounting research group, and has continued to expand on and develop new areas of knowledge in all subsequent leadership positions. Ms. Engelbert's life sciences industry experience currently includes serving as the lead client service partner of large pharmaceutical companies, working on the annual financial statement and internal control audits and related services for large pharmaceutical clients, in addition to providing consultation for several other non-audit clients. Ms. Engelbert also works with large multinational companies around derivatives transactions, hedging strategies, securitization, and other structured financial instrument transactions.

Ms. Engelbert is a member of the American Institute of Certified Public Accountants. She also serves as the treasurer and on the executive committee of a not for profit corporation, and is an advisory board member of the National Multiple Sclerosis Society, Northern New Jersey Chapter. She is also a recipient of the YWCA's Tribute to Women in Industry Award, and of The Women's Fund of New Jersey 25 Most Influential Women in Finance.

Ms. Engelbert earned her BS from Lehigh University.

Jonathan Oviatt

Jonathan J. Oviatt is chief legal officer and corporate secretary of Mayo Clinic. Mayo Clinic is an academic medical center with national and international programs in clinical practice, medical education, and medical research. Mr. Oviatt's responsibilities include the legal department, compliance office, and other administrative functions.

Prior to joining Mayo Clinic, Mr. Oviatt was a shareholder in the Minneapolis office of Moss & Barnett, P.A. He also served on the congressional staff and campaign staff of US Senator Larry Pressler.

Mr. Oviatt is vice chair of the in-house practice group of the American Health Lawyers Association; director of ACC; director and secretary of Integrative Therapies Foundation; past chair of the council of attorneys of the American Medical Group Association; past director and officer of the Minnesota State Bar Association Section on Health Law; past director of Legal Advice Clinics, Ltd.; past president of Olmsted County Legal Assistance; and former chancellor of the United Methodist Church—Minnesota Conference.

Mr. Oviatt received his JD from the University of Minnesota where he was a member of the Law Review and his BA from Augustana College.

Thomas J. Sabatino

Thomas J. Sabatino Jr. is executive vice president and general counsel of Schering-Plough Corporation. He is responsible for overseeing the legal operations of the company, including formulating corporate legal policy and supervising inside and outside counsel and directing corporate activities pertaining to corporate communications, federal legislation, government relations, and corporate security.

Mr. Sabatino most recently served as senior vice president and general counsel for Baxter International, Inc. in Deerfield, Illinois. Mr. Sabatino, who had two tenures at Baxter, first joined that company as corporate counsel, working with Baxter's former systems and medical specialty device divisions and heading Baxter's legal team in the establishment of the IBAX joint venture. He left Baxter to join Secure Medical, Inc., Mundelein, Illinois, as president and chief executive officer. He was named associate general counsel for American Medical International, Inc., Dallas, Texas, then becoming vice president and general counsel. American Medical International later merged with National Medical Enterprises to become Tenet Healthcare Corporation. He left Tenet to rejoin Baxter as associate general counsel. He was then named general counsel and later added the title senior vice president. Mr. Sabatino has also worked for law firms in both Chicago and Boston during his career.

Mr. Sabatino earned a BA, cum laude, from Wesleyan University and a JD from the University of Pennsylvania Law School.

Association of Corporate Counsel
2008 Annual Meeting

301. Answers to Questions You Wish Your Outside Auditor Hadn't Asked

Monday, October 20, 2008
4:30 PM – 6:00 PM

A Panel Discussion

Moderator
W. Stephen Cannon
Chairman, Constantine Cannon LLP

OVERVIEW

The Sarbanes-Oxley Act and the regulations and standards that have arisen since its enactment have expanded the duties of in-house counsel and independent auditors with respect to their client companies' disclosures. Historically, the focus of the auditors has been on financial disclosures and the focus of company counsel has been on non-financial disclosures, but neither can be so limited in the current environment. Sarbanes-Oxley places new requirements on both counsel and auditors in regards to internal investigations, financial statement audits and internal control audits. Disclosure requirements are being promulgated by a variety of entities, including not only the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB"), but also the Public Company Accounting Oversight Board ("PCAOB") and even various state attorneys general. These developments raise new questions and pose new challenges as both auditors and in-house counsel attempt to fulfill their obligations on behalf of their clients and the public. And, all of this discussion is occurring amidst another effort to converge the U.S.'s rules-based Generally Accepted Accounting Principles ("GAAP") with the more principles-based International Financial Reporting Standard ("IFRS").

In this panel, we explore the regulations, rules, standards and organizations that impact the audit process, the relationship between in-house counsel and independent auditors and some of the pending issues that could further change both the process and the relationship.

Part 1. Internal Investigations

The Sarbanes-Oxley Act specifically requires a company to conduct an internal investigation whenever its "independent public accountant 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."

Section 10A of the 1934 Securities Exchange Act requires auditors to notify their corporate client of any potentially illegal act uncovered in the course of an audit and to notify the SEC if the corporation's senior management and board have failed to take timely and appropriate remedial actions. This statutory requirement – and similar requirements in other jurisdictions such as Canada – that auditors engage in a legal analysis of their clients' conduct, creates challenges for both auditors and lawyers.

Section 307 of Sarbanes-Oxley requires lawyers in public companies to investigate and report up the ladder (and potentially "out") any un-remedied allegations of wrongdoing.

Some Questions to Consider

1. Is it realistic, fair, and appropriate for the Securities Exchange Act to task auditors with a responsibility to make an assessment as to the legality of any given transaction or client conduct?

2. Are auditors' findings or reports of potential illegalities and the penalties, fines, or damages that may result ever challenged by corporate clients? If so, what role if any do (or should) corporate legal departments play in that process? What are practical recommendations to improve the resulting report or process?

3. What mechanisms do corporations rely upon to detect fraud and wrongdoing? How do corporations respond to allegations of fraud or wrongdoing? Does the response differ depending upon the source of allegations (auditors, employees, government officials)? Are auditors always informed of allegations of fraud or wrongdoing from employees and government officials?

4. What role do corporate legal departments play in internal investigations? Does the corporate legal department handle all document requests from auditors regarding internal investigations? How common is it to hire outside counsel to conduct internal investigations? Do outside counsel provide documents related to internal investigations to auditors?

5. At what point do corporations typically make disclosures to auditors concerning internal investigations? What types, volume, and scope of documents relating to an internal investigation do auditors typically request? Are different types of requests from auditors handled differently? If so, how?

6. How often are corporations' policies regarding the detection, management, and reporting of these investigations reviewed? By whom?

7. Has the Sarbanes-Oxley Act changed corporate policies with respect to the detection, management, and reporting of internal investigations?

8. To what extent does the Department of Justice's latest revision of its Principles of Federal Prosecution of Business Organizations impact internal investigations? How do the DOJ revisions impact disclosures made to auditors, who are auditing financial statements that are submitted to the SEC and who are under the disciplinary authority of the PCOAB?

Selected Bibliography

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307 (codified at 15 U.S.C. § 7245), "Rules of Professional Responsibility for Attorneys"

News Release, Department of Justice, *Justice Department Revises Charging Guidelines for Prosecuting Corporate Fraud,* August 28, 2008

United States Attorneys' Manual, Department of Justice, Title 9, Chapter 9-28.000 "*Principles of Federal Prosecution of Business Organizations*"(rev. August 28, 2008)

M. Jack Rudnick and John P. Langan, *Managing an Internal Corporate Fraud Investigation and Prosecution,* ACC Docket, April 2007

Part 2. Audits of Financial Statements and Audits of Internal Controls over Financial Reporting

The two main categories of engagement performed by auditors are audits of financial statements and audits of internal controls over financial reporting.

Section 303 of the Sarbanes-Oxley Act provides, *inter alia*, that it shall be unlawful to fraudulently mislead an auditor for the purpose of rendering a corporation's financial statement materially misleading. However, the language of Rule 13b2-2, the SEC rule implementing Section 303, implies that it is unlawful to mislead an auditor even without fraud and by actions that the person should have known could result in rendering the corporation's financial statements materially misleading. This rule puts pressure on corporate legal departments to consent to share privileged information with auditors such as the evaluation of a claim.

Section 307 of the Sarbanes-Oxley Act and the implementing rules adopted by the SEC (17 C.F.R. 205) require attorneys to report "up-the-ladder" evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or its agent. To satisfy their obligations under these provisions, corporate legal departments perform internal investigations that result in privileged communications with the corporation. Auditors often request access to these communications.

Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit, issued by the Auditing Standards Board of the American Institute of Certified Public Accountants ("AICPA") requires an auditor to make inquiries about the existence or suspicion of fraud to appropriate persons within the corporation, including the corporate legal department.

Section 10A of the Securities Exchange Act of 1934 states that auditors should adopt "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." Section 10A provides for civil sanctions for auditors and therefore puts additional pressure on auditors to request access to privileged information and work product that could reveal the existence of illegal acts.

More recently, the New York Attorney General has acted on corporate disclosure policy. On August 27, 2008, Xcel Energy, which is based in Minneapolis, reached an agreement with New York Attorney General Andrew Cuomo that requires "Xcel to provide detailed disclosure of climate change and associated risks" in its "Form 10-K" filings required by the Securities and Exchange Commission. New or expanded disclosures will include an analysis of financial risks associated with present and probable climate change regulation and legislation; climate-change related litigation and the physical impacts of climate change. The agreement resulted from Cuomo's use of the Martin Act as an enforcement tool against energy companies that issue equity securities in his jurisdiction. Cuomo has subpoenaed and, as of early September, remained in negotiations with four other publicly traded energy companies – AES Corporation, Dominion Resources, Dynegy and Peabody Energy.

In a May 2008 letter to Senate Majority Leader Harry Reid and Minority Leader Mitch McConnell calling for a national climate policy, investors led by Ceres and the Investor Network on Climate Risk also specified that the SEC and other regulatory bodies should clarify the climate change information that companies need to disclose in their financial report. A "Request for Interpretive Guidance on Climate Disclosure" was filed with the SEC by a group of investors in October 2007 with a "Supplemental Petition," containing updates on legislative initiatives filed earlier this year. Cuomo and other state attorneys general were signatories to this request.

Some Questions to Consider

1. To what extent should companies and auditors negotiate the terms of the audit engagement letter? What regulatory bodies guide or restrict what may be included in the agreement, particularly auditor/client dispute clauses?

2. Given the role of the audit committee and the financial support staff, what is the appropriate role for the general counsel in negotiating the terms of auditors' requests in advance (e.g. at the time of the engagement)?

3. What types of materials do auditors request from corporate legal departments with respect to each of the following subject matter when performing audits of financial statements or audits of internal controls over financial reporting:
   - Tax opinions or other opinions of outside counsel provided to assure the company of the legality of proposed transactions or other undertakings.
   - Pending or threatened litigation
   - Unasserted claims or assessments
   - Whistleblower allegations
   - Internal investigations
   - Existence or suspicion of fraud
   - Evidence of material violations of securities law, breaches of fiduciary duties or similar violation by the corporation being audited or any agent thereof
   - Other subject matters

4. Are auditors' requests usually in writing? Are they oral? Are written requests in the form of an Inquiry Letter issued by the corporation's management, as provided for in the AICPA's Statement on Auditing Standards No. 12?

5. Are corporate legal departments' responses to auditors' requests always in writing?

6. What has been the impact on corporate legal departments of Statement of Auditing Standards No. 99 (suggesting that auditors question in-house counsel regarding the existence or suspicion of fraud in the audited corporation)?

7. With respect to these issues: What are the various approaches that different corporate legal departments and audit firms have adopted? How common is each of these approaches? What are best practices for corporate legal departments and audit firms? What are the pros and cons of corporate legal departments and audit firms taking an active role? What problems or other issues may arise in the relationship between auditors and in-house counsel? What are practical recommendations to improve the relationship between auditors and in-house counsel?

8. What entities are determining the financial disclosure rules for companies?

9. How do actions by specific state attorneys general, legislatures or other regulatory bodies enter into the audit process?

10. How will Xcel's agreement impact other companies?

Selected Bibliography

ABA-AICPA "Treaty" (AICPA Statement on Accounting Standards No. 12 and ABA Statement of Policy Regarding Lawyers Response to Auditors' Requests for Information), 1975

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303 (codified at 15 U.S.C. § 7242), "Improper Influence of Conduct of Audits"

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307 (codified at 15 U.S.C. § 7245), "Rules of Professional Responsibility for Attorneys"

17 C.F.R. Part 205, Standards of Professional Conduct For Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 2003

Robert J. Kueppers, "*Addressing Auditor/Client Disputes in Engagement Letters: Cause for Concern or Much Ado About Nothing?*" Directors Monthly, October 2006

John K. Villa, *"Audit Letter Responses in the Wake of Sarbanes-Oxley,"* ACC Docket 21, no. 9 October 2003: 164 -169

David M. Brodsky, Pamela S. Palmer & Robert J. Malionek, *"The Auditor's Need For Its Client's Detailed Information vs. The Client's Need to Preserve the Attorney-Client Privilege and Work Product Protection: The Debate, The Problems, and Proposed Solutions,"* White Paper Presented to the General Counsel Working Group convened by the Association of the Bar of the City of New York, 2004

News Release, Office of the Attorney General – State of New York, "*Cuomo Reaches Landmark Agreement with Major Energy Company, Excel Energy, to Require Disclosure of Financial risks of Climate Change to Investors,"* August 27, 2008

News Release, Excel Energy, "*Excel Energy, New York attorney general resolve carbon disclosure issues,"* August 27, 2008

Part 3. Public Company Accounting Oversight Board

The Sarbanes-Oxley Act created the Public Company Accounting Oversight Board, which it entrusted with the task of registering, inspecting, investigating, and disciplining auditors. The PCAOB also is required by Section 103 of the Act to adopt auditing, quality control and independence standards and rules to be followed by auditors.

Since 2003, the PCAOB has adopted five Auditing Standards and related rules. AS5 replaced AS2 for fiscal years ending on or after November 15, 2007. The expectation was that AS5 would allow auditors to scale their audits to the complexity of the company and devote less attention to low risk areas and limit requests for privileged documents or attorney work product. The following is a brief summary of the PCAOB Auditing Standards:

- Auditing Standard No. 1 ("AS1"): AS1 addresses technical and non-substantive issues.
- Auditing Standard No. 2 ("AS2"): AS2 requires auditors to evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. In effect, AS2 requires auditors to detect fraud despite the fact that this falls outside their area of expertise.
- Auditing Standard No. 3 ("AS3"): AS3 requires auditors to obtain, review, and retain certain documentation related to the work performed by other auditors (including auditors associated with other offices of the audit firm, affiliated firms, or non affiliated firms) including a list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures.
- Auditing Standard No. 4 ("AS4"): AS4 establishes requirements that apply when an auditor is engaged to report on whether a material weakness identified in a previous annual report continues to exist. It requires auditors to:
  - obtain evidence that the controls identified by management as addressing the material weakness were both designed to satisfy the control objectives and operate effectively to do so;
  - obtain details about management's assertion that the material weakness no longer exists and also obtain updated information on general topics and relevant events occurring after the date of management's decision that the material weakness no longer exists;
  - form a conclusion as to whether the previously reported material weakness continues to exist.
- Auditing Standard No. 5 ("AS5"): Approved by the SEC on July 25, 2007, AS5 contains a set of standards to be applied by an auditor performing an audit of a public company's internal controls over financial reporting. It supersedes AS2, which had been the focus of much of the criticism directed at PCAOB rules.

Some Questions to Consider

1. Does AS5 address some of the issues companies and auditors have been facing in their efforts to comply with AS2? How significant are the following changes:
   - AS5 allows for more proportionality between the degree of risk that a material weakness could exist in a particular area of the company's internal controls and the amount of audit attention that should be devoted to that area (*e.g.* "it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements")
   - AS5 also allows issuers and auditors to scale the audit based upon the size and complexity of the company
   - AS5 directs auditors to use a top-down approach to audits of internal controls
     - First, financial statement level (auditor's understanding of the overall risks to internal controls)
     - Second, entity-level controls
     - Third, significant accounts and disclosures
     - Fourth, company processes
   - AS5 eliminates certain procedures included in AS2:
     - The auditor is relieved of the detailed requirements to evaluate management's own evaluation process
     - The auditor also is relieved of the duty to test a "large portion" of the company's portions or financial position (focus is on risk, not on coverage)
2. Can these changes relieve some of the strain on the relationship between in-house counsel and auditors? If so, in what ways?
3. Are there any unwelcome aspects of AS5 from the auditors' point of view? From the in-house counsel's point of view? From the public's point of view?
4. Does the adoption of AS5 only three years after the adoption of AS2 create legal uncertainty?

Selected Bibliography

Public Company Accounting Oversight Board, http://www.pcaob.org/Enforcement/index.aspx

AS 3 (File No. PCAOB-2004-05, August 25, 2004)

AS 5 (File No. PCAOB-2007-02, July 27, 2007)

Deborah M. House, *Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud,"* ACC Docket , November/December 2006

Part 4. Looking Forward: FASB Statement No.5

The Financial Accounting Standards Board issued for public comment an Exposure Draft of a proposed statement that would "replace and enhance the disclosure requirements in FASB Statement No. 5, *Accounting for Contingencies*." The proposed Statement also would amend FASB Statement No. 141, *Business Combinations*. Comments were due August 8, 2008, and the proposed Statement would be effective for annual financial statements issued for fiscal years ending after December 15, 2008 and for both interim and annual periods in subsequent years.

Among the draft's proposals are:

- A requirement that an entity disclose a loss contingency or loss contingencies, regardless of the likelihood of loss, if both: (a) The contingency or contingencies are expected to be resolved in the near term; and (b) The contingency or contingencies could have a severe impact on the entity's financial position, cash flows, or results of operations. The draft makes clear that "severe impact" is intended to be a "higher threshold than material."
- Quantitative information, including the amount of the claim or assessment or the entity's best estimate of the maximum exposure to loss or range of loss.
- A tabular reconciliation of the total amount of loss contingencies at the beginning and end of each period.

Qualitative information, relevant insurance and indemnification information and information related to events occurring subsequent to the end of the reporting period are also covered by the exposure draft.

The FASB received 236 comment letters on the Exposure Draft. Many recognized the FASB's goal of trying to provide investors with substantive, meaningful information but raised significant issues for the companies and counsel in the FASB's approach.

Some Questions to Consider

1. If approved by FASB, the new Statement would be effective for the fiscal years ending after December 15, 2008. If an auditor, what materials will you look for from clients under this new standard?

2. Under the exposure draft how would the definition of materiality vs. severe impact change? Who within the company makes the decision regarding materiality now and will that change under the new proposed Standard? Is the CLO the right person to make that decision?

3. What impact would the new Standard have on the Treaty between the ABA and the AICPA?

Selected Bibliography

Financial Accounting Standards Board, Exposure Draft, *Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)*, June 5, 2008

Comment Letter, Association of Corporate Counsel, *Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)*, August 8, 2008

Comment Letter, American Bar Association, *Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)*, August 5, 2008

Comment Letter, Accounting Standards Executive Committee of the American Institute of Certified Public Accountants, *Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)*, August 7, 2008

Comment Letter, CFA Institute Centre for Financial Market Integrity, *Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)*, August 7, 2008

Top Ten Reasons Corporate Counsel Should Be On Alert to the FASB's Proposed Amendments to FAS 5, Accounting for Contingencies," Association of Corporate Counsel, 2008

Part 5. Looking Forward: From GAAP to IFRS

On August 27, 2008, the Securities and Exchange Commission voted to publish for public comment a proposed Roadmap that would result in U.S. issuers moving from U.S. Generally Accepted Accounting Principles ("U.S. GAAP") to International Financial Reporting Standards beginning in 2014. Currently, all of Europe and almost 100 countries, not including the U.S., require or permit the use of IFRS. Generally, IFRS is considered to be a more principles-based approach to accounting while U.S. GAAP is more rules based. Because of convergence projects that have taken place between the International Accounting Standards Board ("IASB") and the Financial Accounting Standards Board ("FASB"), the differences have been diminishing but remain significant.

Some Questions to Consider

1. Given the differences in IFRS vs. GAAP, how can CLOs, especially those who do not already work for multinational firms, prepare professionally for the conversion to IFRS?

2. If U.S. issuers moving from U.S. GAAP to IFRS, how could that impact the relationship between in-house counsel and outside auditors?

Selected Bibliography

News Release, U. S. Securities and Exchange Commission, *"SEC Proposes Roadmap Toward Global Accounting Standards to help Investors Compare Financial Information More Easily,"* August 27, 2008

Speech by SEC Chairman Christopher Cox, Proposing a Roadmap Toward IFRS, U.S. Securities and Exchange Commission Open Meeting, Washington, D.C., August 27, 2008

News Release, *AICPA Statement on SEC Roadmap for IFRS,* August 27, 2008

FOR IMMEDIATE RELEASE
Thursday, August 28, 2008
http://www.usdoj.gov/

ODAG
(202) 514-2007
TDD (202) 514-1888

Justice Department Revises Charging Guidelines for Prosecuting Corporate Fraud

NEW YORK – Deputy Attorney General Mark R. Filip announced today that the Department of Justice is revising its corporate charging guidelines for federal prosecutors throughout the country.

The new guidance revises the Department's Principles of Federal Prosecution of Business Organizations, which govern how all federal prosecutors investigate, charge, and prosecute corporate crimes. The new guidelines address issues that have been of great interest to prosecutors and corporations alike, particularly in the area of cooperation credit.

First, the revised guidelines state that credit for cooperation will not depend on the corporation's waiver of attorney-client privilege or work product protection, but rather on the disclosure of relevant facts. Corporations that disclose relevant facts may receive due credit for cooperation, regardless of whether they waive attorney-client privilege or work product protection in the process. Corporations that do not disclose relevant facts typically may not receive such credit, like any other defendant.

While prior guidance had allowed federal prosecutors to request, under special conditions, the disclosure of non-factual attorney-client privileged communications and work product -- which the old guidelines designated "Category II" information -- the new guidance forbids it, with two exceptions well established in existing law.

"The changes that the Department announces today are in keeping with the long-standing tradition of refining the Department's policy guidance in light of lessons learned from our prosecutions, as well as comments from others in the criminal justice system, the judiciary, and the broader legal community," said Deputy Attorney General Filip.

The new Principles introduce changes beyond the question of attorney-client privilege and work product waivers. They instruct prosecutors not to consider a corporation's advancement of attorneys' fees to employees when evaluating cooperativeness. They also make clear that the mere participation in a joint defense agreement will not render a corporation ineligible for cooperation credit. In addition, the new guidance provides that prosecutors may not consider whether a corporation has sanctioned or retained culpable employees in evaluating whether to assign cooperation credit to the corporation.

The revisions and policy changes announced today will be committed for the first time to the United States Attorneys Manual, which is binding on all federal prosecutors within the Department of Justice. The revised Principles will be effective immediately.

The changes announced today were made after careful review within the Department of Justice, and after consultation with several organizations and individuals who expressed an interest in the issues presented. In this regard, Filip noted, "the Department is very grateful for the opportunity to engage in extended and thoughtful dialogue with Senate Judiciary Committee Chairman Patrick Leahy, Sen. Arlen Specter, and other members of Congress, along with representatives of various groups, reflecting a diverse array of voices - including, for example, the criminal defense bar, the civil liberties community, the business community, and former Department of Justice officials."

For more information about the Department's Principles of Federal Prosecution of Business Organizations, please visit http://www.usdoj.gov/.

###

08-757

By M. Jack Rudnick and John P. Langan

Managing an Internal

Corporate FRAUD Investigation and Prosecution

Routine reports of corporate malfeasance, jury verdicts against formerly untouchable senior officers, the emergence of a new cottage industry in corporate compliance—all spawned by the collapse of Enron and fueled by the enactment of Sarbanes-Oxley. The business of corporate fraud and white collar crime has risen to new heights.

Now more than ever, in-house counsel should know how to properly investigate and pursue internal allegations of fraud, theft, and corporate malfeasance. Otherwise, counsel may find themselves on the wrong end of the next audit committee inquiry, an inquiry focused not on the underlying problem, but on how in-house counsel responded to it. In this atmosphere of intense scrutiny, no one is safe from criticism.

The bad news is that lying, cheating, and stealing are as old as mankind, and fraudulent schemes come in many shapes and sizes. They are as creative as the sinister minds that dream them up. The good news is that, from an in-house counsel's perspective, the proper approach to investigating and handling such schemes is consistent and almost formulaic. This is true despite the fact that a surprisingly wide array of legal expertise comes into play when addressing corporate fraud: civil and criminal litigation; corporate governance and compliance; employment law; insurance coverage and recovery; corporate finance and regulation; and tax law, among other areas.

Aided by a hypothetical example,[1] this article spells out the steps in handling a case of theft or corporate malfeasance—from initial detection and internal investigation, to criminal and civil prosecution, through post-prosecution review of better controls and remedial safeguards. A few simple suggestions can help you avoid the common problems that arise in such cases and manage the matter in your position of responsibility.

Typical Fraud Scheme

Mark was doing well in his career. He was a valued and trusted senior officer of the company, having worked his way up the corporate ladder over two decades. He now enjoyed the title of senior vice president of finance of one of the company's most profitable divisions. Sure it was a lot of responsibility, but Mark liked his job.

The problem started when Mark caught up with a college buddy who was the CFO at a similarly sized company in the mid-west. His friend was making triple what Mark was making and with far less responsibility. It was just wrong! Mark made the added mistake of mentioning the discussion to his wife, Ashley. Admittedly, the timing was bad since Mark and Ashley had just agreed to forgo buying that great beach-front property from Ashley's parents, and college tuitions would start soon for his twin daughters. Just an extra $100,000 per year in income could make the difference between a comfortable existence and a stressful life.

It was with this thought that Mark went to work the next day. He started his daily business of overseeing the financial operations of the company. This included such complex projects as reviewing the finances of major merger targets, along with such mundane tasks as approving invoices for endless outside vendors used by the company. Boy, was the company spending a lot of money on outside accounting and law firms! And those rates for the top partners—yet another group of professionals making more money than Mark. That's when he got an idea.

How hard would it be to dummy up a few invoices from an approved, but infrequently used vendor, submit them for approval, intercept the processed check, and deposit it in an account opened using a fictitious corporate name? Who would notice, considering all the money the company spent last year? He would only do it once or twice, more as an experiment than anything else. Who would get hurt?

Ten years and $1.5 million later, Mark was now a highly paid senior officer, even without considering the tax-free nature of his "side" income. Colleges were paid for, he and Ashley owned a great condo in the Bahamas, and they had a nice stock portfolio for retirement. Yes, life was good until an accounts-payable clerk called the outside vendor about one of its recent invoices. It was an innocent inquiry, but the response from the vendor—that it had not performed services for the company in years—was unexpected.

Initial Detection

Detecting Mark's scheme is the first step. The accounts-payable clerk had a few choices when she stumbled upon the suspicious information. She could have ignored it because rules enforcement was not a focus at the company. She could have shared the information with Mark, sensing that he was involved but not wanting to "get him in trouble." She could have been afraid to disclose the information based on the company's historical ambivalence toward corporate ethics or lip service to confidentiality protections surrounding the company's "anonymous" fraud hotline.

This is where written policies and procedures, and an effectively communicated compliance program, are necessary. Gone are the days that a company can rely on the auditors to detect wrongdoing. Companies must now establish a formal Code of Ethics/Conduct which is routinely updated and communicated to employees. The code should be formulated with the aid of outside employment counsel and emphasize the real protections afforded anyone who comes forward with information. An anonymous tip or hot line must be established and routinely published to employees, along with rules governing the confidentiality of the communication.

Also important are employment policies clearly stating that the company owns the communication systems used by the employee, including email and voicemail received and generated by employees. The policy should state that the company has the right in its sole discretion and without prior notice to monitor and review data composed, sent, or received through its computer systems, and that the monitoring activity may limit the level of privacy employees can expect.

A working and effective compliance program is also critical. Adopting systems for routine auditing, establishing mechanisms for reporting suspicious information, and creating a top-down atmosphere of strict ethical behavior so it becomes part of the company's core culture are all at the heart of a good compliance program. Such a program will help detect Mark's theft against the company at an early stage, or deter it all together based on an atmosphere of zero tolerance.

A good compliance program can be particularly important where the wrongdoing is not just a crime against the company, but one against the public at large. Change our

hypothetical from Mark embezzling funds to a small group of employees, led by Mark, illegally removing and disposing of large amounts of asbestos from a portfolio of commercial properties owned by the company. Or perhaps a key financial officer of a public company discovers he or she has been responsible for misstating the company's earnings and then decides to cover the mistake to keep their job.

In either case, laws have been broken and government prosecutors will be interested in whether the crime is an isolated incident of a few, or part of the core culture of the company. The answer may impact the level of criminal liability facing the company, and even whether senior management is drawn into the investigation and criminal charges.

The *United States Sentencing Commission Guidelines Manual*,[2] in conjunction with the *Federal Sentencing Guidelines*,[3] set forth the elements of an effective corporate compliance program. Summarily stated they include:

- prevention and detection procedures;
- high level of oversight;
- due care in delegating substantial discretionary authority;
- company-wide training and communications with periodic updates;
- auditing, monitoring, and reporting including allowing for anonymity and confidentiality mechanisms;
- consistent enforcement; and
- response and prevention.[4]

The 2004 amendments to the *Guidelines* now include a list of modifications synchronizing them with *Sarbanes Oxley* and the emerging number of public and private regulatory requirements.

An effective program under the *Guidelines* will help the company mitigate any potential fine range, in some cases up to 95 percent, if there is also prompt reporting to the authorities and non-involvement of high level personnel in the actual offense.[5] It can also help investigators conclude that the conduct was isolated, and not caused by the company's senior management. At a minimum, suspicious information, such as the call about Mark, will be reported to the appropriate compliance officer and the wrongdoing detected early.

In our hypothetical story, suspicions about Mark have been reported using the anonymous "hotline." Proper controls are in place for in-house counsel to monitor credible reports from the hotline. The information has been reviewed by in-house counsel, a few calls made, and internal financial records reviewed. It appears clear, at least initially and before talking with others within the company, that a stream of payments approved by Mark were never received by the vendor. Now what? The next few moves will be critical in conducting a proper and effective investigation.

The Investigation

The team investigating the situation should be carefully selected, usually a senior auditor at the company, someone from corporate security, in-house counsel, and other trusted individuals. They should have no conflict of interest (such as persons reporting to Mark might have) that could in any way impact their neutrality or judgment. They will gather documents and evidence, interview employees and perhaps outside vendors, and pursue all leads to determine the extent of the wrongdoing.

It is important that the investigatory team starts with an open mind, and not let preconceived notions of what the facts might be dictate the conclusions reached. Memoranda generated should avoid using the term "fraud," "theft," "cover up," "incompetency," or other conclusory terms, and files should be labeled using similarly neutral language. Investigative team members should be reminded that they are "writing for publication" so they should avoid vindictive remarks or other personal commentary and record just the facts. Final conclusions should not be expressed until after the suspected employee's response to the charges has been obtained and evaluated.

The investigating team must keep in mind at all times that civil litigation, and perhaps a criminal referral, will follow almost inevitably from the work they do. Investigative findings, comments and opinions about mistakes made by the company, theories of wrongdoing that do not pan out, and suspicions against employees that are never substantiated—a more sensitive group of documents can hardly be imagined. Therefore, all reasonable steps should be made to maximize the privilege protections of this information.

In that regard, it is imperative that the company document at the outset that the investigation is being launched and overseen at counsel's direction. All subsequent requests for action should come from a lawyer in writing to maximize the protections afforded. In this way, counsel can oversee the investigation while also watching out for the broader interests of the company.

The company should consider directing the investigation through *outside* counsel to avoid any confusion over the multiple roles often played by in-house counsel. Investigative material, including opinions and conclusions reached by the team, must be labeled as privileged, and separate files should be maintained to segregate the privileged material.

Although the initial information from a routine audit or an anonymous tip is not likely afforded privilege or protection under the work-product doctrine (because it was not gathered at the behest of an attorney or because litigation is pending), subsequent information may be protected

If you would not want the nature of your investigative activity disclosed in *The Wall Street Journal,* then you probably do not want to engage in it at all.

from discovery if any future investigation is properly handled.[6] The courts will look to the level of involvement of the attorney in directing the investigation or audit.

How likely is it, really, that the facts of the case and statements can be protected from disclosure in subsequent civil litigation? The work-product doctrine generally protects only mental impressions, conclusions, opinions, or legal theories of an attorney.[7] Thus, purely facts or statements, regardless of whether an attorney collected them, are usually not afforded protection under the work-product doctrine.

The facts, however, may be protected under the attorney-client privilege. To assist in thwarting later legal challenges, counsel overseeing the investigation should make every effort to create a paper trail showing that the reports and/or facts derived from the investigation were created:

- for the purpose of securing legal advice;
- by an employee who was acting at the direction of a supervisor;
- at the direction of a supervisor who sought the information to obtain legal advice for the corporation;
- within the scope of the reporting employee's corporate duties; and
- solely for the eyes of those persons within the corporate structure who need to know the information.[8]

Confronting the Suspected Employee

Confrontation of the employee needs to be carefully planned, witnessed, and documented. It should occur at the end of the investigation when all other available facts are gathered. At the interview, the employee's response or "story," including any admissions or concessions, must be documented. This may involve asking the employee to sign a written statement with the account provided. Depending on how the situation develops, this evidence can prove invaluable in later civil or criminal proceedings. It can also prove useful in defending against later complaints of the employment action taken by the company.

Using investigatory resources to learn background information about the suspected employee prior to the interview is an effective tool that should be used cautiously. If there is a legitimate, non-discriminatory basis for personal background investigation (*i.e.*, asset and real property search, court records, etc.) because the company has a good faith basis to believe the employee has engaged in criminal conduct and the investigation will further help determine whether the suspicions are true, then proceeding with the investigation may be warranted. Watch for particular state privacy laws and provisions of the *Fair Credit Reporting Act*[9] to ensure you do not run afoul of existing law. Use good judgment as to whether investigative tactics (including those of third parties hired by you) are appropriate. If you would not want the nature of your investigative activity disclosed in *The Wall Street Journal,* then you probably do not want to engage in it at all. Make sure to tailor the information sought to a legitimate business purpose in furtherance of the investigation; don't go on a fishing expedition.

If the employee raises new information in the interview that requires further investigation, but the company is concerned about retaining the employee in active status, he or she can be suspended with or without pay pending completion of the investigation. If the employee refuses to cooperate with the investigation, he or she should be reminded that cooperation is an essential function of the job and a failure to cooperate may provide an independent basis for discipline, including termination. Carefully drafted Codes of Conduct or implementing policies will specifically address this issue so the independent basis for action will be clear. Similarly, they will make it clear that retaliation against any other company employee participating in the investigation is strictly prohibited and will serve as an independent basis for action.

When should company counsel advise Mark that he should consult with private counsel? While this is an issue on which in-house counsel may differ, our perspective is not until the confrontational interview has been held. Until that point, it may be argued that the company does not yet have the employee's side of the story, so a final determination of culpability has not yet been reached. Once the employee has answered questions, given his statement responding to the charges, and provided whatever other information that may prove useful to the investigation, it may well be in the company's interest to have the employee engage experienced counsel. Care should be taken, however, to make it clear to the employee that counsel interviewing him/her are counsel to the corporation and not the employee by providing the employee with the "corporate Miranda."[10]

One factor in deciding how to approach the employee will be whether the company needs him or her to address the wrongdoing going forward—such as when a key financial officer is in a unique position to reconstruct the misstated earnings in past financial reports. Will cooperation be forced or voluntary? How badly does the company need the targeted employee's help to further investigate the extent of the fraud or correct the damage? Is the employee at the center of the scheme or a lesser player? These questions must be addressed in formulating your approach.

Action Based on Investigative Findings

Your investigation is complete, you have confronted the employee, obtained whatever helpful information may be gleaned from the employee, and the investigative team has reached the conclusion that fraud has been committed. Once the company has confirmed that wrongful conduct has occurred, action must be taken.

Options for handling the employee include disciplinary action short of termination, suspension with or without pay, or termination. Before communicating the decision to the employee, make sure that an experienced employment lawyer reviews the basis for it. The company must be able to comfortably articulate a non-discriminatory business reason for the decision—preferably something that the average person would understand and accept as reasonable.

The decision and the basis for it should also be communicated to company officers, the board, the audit committee, and any key supervisors. Throughout the investigation, be prepared for an emotional reaction from the company's senior officers or board—anger, frustration, or even an irrational demand for a course of action that is not in the best interests of the company. In-house counsel must manage these issues carefully so that cooler heads prevail.

Until now, things have been handled with great confidentiality. But news of the employee discipline or termination cannot be contained and the company is wise to consider the nature of any response to the natural questions that arise. At this point, the company must decide how to handle the public relations aspect of the situation, at least internally. A consistent message must be formulated and used by management.

Insurance Coverage

In the midst of handling a fast moving internal investigation, containing the information within the company, and absorbing the emotional body-blow of learning that one of your own is a thief or liar, it may be easy to forget the steps needed to preserve the company's insurance rights. After all, this is not a slip and fall claim which would naturally trigger in-house counsel's focus on insurance. The company's risk manager may not even be part of the investigative team. Failing to take proper action relative to insurance can be a costly mistake, one the second-guessers will seize upon to lay blame when the dust has settled.

ACC Extras on…Employee Law, Embezzlement, and Fraud

- *Internal Fraud: Weeding out the Enemy*
  - Practical Law Article—International Resource
  www.acc.com/resource/v4649
- Indicia of Corporate Fraud
  - This **quick reference** includes a list of pointers to consider when dealing with internal fraud concerns.
  www.acc.com/resource/v3685
- *Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud*
  - This *ACC Docket* article covers 10 red flags you need to be aware of when on the lookout for financial mismanagement and corporate fraud.
  www.acc.com/resource/v7714

So when do you act and what do you do? It depends on the language of your policy and outside coverage counsel should be consulted. Generally speaking, the answer is:

> When you know of circumstances that could form the basis for a company loss, in-house counsel should promptly notify the company's risk manager and all brokers handling the company's insurance and bonding policies.

Counsel must follow up with these brokers or directly with the carriers to insist upon *written confirmation* that the necessary parties have received proper notice.

A typical error is trying to determine which policies might provide coverage and narrowing your list of parties to be notified. With the complexity of insurance coverage these days, this is a mistake. Insurance policies that may be triggered include the company's general liability policy, commercial crime/fidelity policy, commercial property policy, and perhaps even an employee fidelity bond. The usual insurance policy conditions to keep in mind include:

- the requirement that the insured provide timely notice of the incident;

- the insured's obligation to provide a high enough level of cooperation with respect to the insurer's investigation; and
- the requirement that the insured should avoid committing any act which could prejudice the insurer's ability to subrogate the claims against the culpable parties. Exclusions often seen are claims for fines, sanctions, and penalties, and also claims arising out of any dishonest, fraudulent, criminal or malicious act, or omission of an insured.

As discussed later in this article, the company at an early stage will have already engaged its own outside counsel to investigate the fraud and perhaps commence a civil action against the wrongdoers. This may well be at odds with insurance policy language, which gives the carrier input or even control over the selection of counsel to pursue the loss. The problem arises because the normal insurance loss involves a past event impacting a simple monetary claim that can be quantified and assessed.

But allegations of internal malfeasance are different. First, the company does not usually know whether it has suffered a loss, or the extent of the loss, until a thorough investigation has taken place—an investigation that for a wide array of reasons should occur under the watchful eye of the company's hand-picked outside counsel. Second, investigation of the claim is fast-moving and complex, it is not conducive to the delays associated with insurance carrier dealings, nor is it of a nature to be handled by a panel counsel insurance defense lawyer. And lastly, there is more at stake in an internal fraud situation than the actual monetary loss—company exposure to allegations of criminal wrongdoing, government compliance obligations, internal employment and HR issues, public image, and business risk issues, etc.

It is for these reasons that we advise companies to select and move forward with the outside counsel of their choice with respect to conducting the investigation, and address later any complaints of insurance carriers over what attorney was selected. We acknowledge that a dispute over the selection can arise with the carrier but, in our experience, rarely does if counsel is selected with experience in such matters.

Indeed, in cases where an insurance claim has been paid and the loss subrogated, we have never seen a carrier reject the continued retention of the original counsel selected by the company (normally a firm that has been involved for months in developing the complex facts and evidence supporting the claim). So long as the company is providing a sufficient level of cooperation and communication with its insurers, the issue can usually be resolved on an amicable basis.

Civil Litigation

At the core of most employee theft cases are common law claims for fraud, conversion, breach of fiduciary duty, as well as statutory violations such as racketeering. Obviously, maximizing the likelihood of recovering at least some of the stolen property or locating other assets to be seized is at the heart of this strategy. But early litigation also provides a mechanism for obtaining provisional remedies such as temporary restraining notices, orders of attachment, or accelerated motions for other preliminary injunctive relief. Assets can be frozen and important evidence preserved.

Indeed, a number of benefits can drive the company toward litigation as a necessary strategy. For better or worse—in cases of this type—message-sending plays a role in the process. Mark has stolen seven figures from the company and everyone is watching to see how it is handled: Anything less than an aggressive response can be viewed as weakness and an invitation for future trouble.

And then there are the criminal authorities to consider. How significant was the criminal wrongdoing later referred to the government if it was not sufficient to warrant a civil action? The investigators and prosecutors want to know that the company takes these matters seriously. The presence of a timely and aggressive civil action helps to answer any doubt in this regard.

Others are watching, too. The board, audit committee, and shareholders are looking to ensure that the company does everything within its power to recover stolen corporate property or right other wrongs. Among them are the company's insurance carriers which may later seek to pay a claim of loss and subrogate in the civil action. Those involved in that decision and later civil prosecution want to know that their insured was diligent in taking appropriate action. These are among the many considerations in commencing a civil action.

As the case proceeds, the company may well face the question of whether to settle with one individual and "flip" them to secure valuable testimony against another involved in the wrongful conduct. This strategy almost always comes into play. The question of when, with whom, and under what circumstances should the company agree to settle their claims with one wrongdoer is dependent on the circumstances presented.

No doubt, the company has much to offer in terms of avoiding protracted civil litigation, and the cooperator has something of value in return, since proving fraud presents a host of challenges and direct testimony of the scheme can be very helpful. This is where the defendant's selection of experienced criminal or civil counsel will help negotiations and a sensible resolution. Less experienced

Gone are the days that a company can rely on the auditors to detect **wrongdoing.** Companies must now establish a **formal Code of Ethics/Conduct** which is **routinely updated** and communicated to employees.

counsel often cannot see the "end game" and the larger problems facing his or her client.

At some point toward the end of the civil case, the company will be forced to answer the question of what it needs to settle the claims. Interestingly, the answer to this question is almost always the same. The common elements to any settlement involving claims of employee fraud and wrongdoing are:

- admission and contrition;
- confirmation of scope of wrongdoing;
- compensation, symbolic or otherwise;
- cooperation in pursuit of other wrongdoers; and
- conditional release with protections for later default.

Disclosure of Scope

Part of the purpose of the lawsuit is to use discovery to confirm the extent of the wrongdoing. This element of settlement can be among the most important to obtain. If the company is not satisfied they have received it, settlement discussions should break off. The company simply must know the extent of the scheme and that the actions being taken will fully address it: Any suggestion that some of the cancer remains should be unacceptable to the company and its counsel.

Of course, criminal prosecution cannot be threatened as a means to settling a civil claim.[11] If the company has elected not to pursue criminal charges, the parties can proceed right to the interview. But if a criminal investigation is pending, how can the company obtain the type of candid disclosure mentioned above without appearing to be leveraging one action against the other? The answer is timing. The settlement of the civil action can be conditioned on the disclosure and interview needed.

A deal can be struck while the criminal case is pending that an interview will follow once Mark's criminal liability has been addressed. With a criminal case pending, the settlement agreement can provide that a failure to participate fully in the interview will revive the civil claims and trigger large financial penalties. Part of Mark's motive will be to appear cooperative with the company to the criminal authorities.

How can you know if the disclosure is complete and accurate? First, by the time the interview is held, your investigating team should have a very good understanding of what happened. Witnesses should have been interviewed, documents collected, witness statements taken. Whether the story Mark tells "rings true" and is consistent with the other evidence is the first way to check the disclosure. The second is, where legally permissible, by use of a lie detector test, which, by and large, is remarkably effective in confirming the information.

Make sure to select a reputable examiner, preferably someone who the government authorities rely upon. An excellent website is maintained by the American Polygraph Association (APA),[12] which allows for a database search of members by geographical area. According to the APA, "a valid examination requires a combination of a properly trained examiner, a polygraph instrument that records as a minimum cardiovascular, respiratory, and electrodermal activity, and the proper administration of an accepted testing procedure and scoring system." Some states have an official licensing procedure but many do not.[13]

Mark's criminal or civil counsel may wish to weigh in. The better examiners are known and respected by the criminal defense bar, so selecting an expert should not be difficult. Again, timing can address the issue of coordinating the examination with resolution of the criminal case so that Mark is comfortable answering questions. The civil settlement should provide that a failure to properly pass the test unwinds the settlement and leaves the company able to pursue its civil remedies.

One final thought regarding lie detector tests: The company should avoid the temptation to rely on them to investigate the charges. Use the test solely for securing compliance with the terms of settlement. This is because *The Employee Polygraph Protection Act* of 1988 (EPPA)[14], forbids adverse employment action against an employee refusing to take the test. Asking the targeted employee to take an exam will restrict the company's ability to terminate him later without opening the door for counter charges that the lie detector results played a role in the decision.[15]

Usually the **resolution of the civil action** occurs in pieces, with one of the wrongdoers **flipping early** and others continuing to litigate.

Compensation

The ultimate sum settling the civil claims is a function of:

- the amount stolen;
- the impact of the theft on the company;
- the level of culpability of the wrongdoer;
- the total financial net worth of the employee and his or her spouse; and
- a cold assessment of what assets are subject to judgment execution in the civil action.

The settlement amount is, to some extent, a symbolic figure designed to punish as much as anything else. Of course, if the loss has been paid by the carrier and the claim subrogated, the carrier will be involved in fixing or at least accepting the settlement sum.

Cooperation

Usually the resolution of the civil action occurs in pieces, with one of the wrongdoers flipping early and others continuing to litigate. Perhaps Mark was working with someone at the outside vendor's accounting group and they were sharing the ill-gotten gains. No matter, an important element in settling claims with the first party who flips is that they will cooperate fully in any existing or future civil litigation.

In order to minimize the bias arguments that will inevitably arise in later litigation, counsel is wise to secure a comprehensive sworn statement of facts which establish and preserve key testimony of the cooperating party as part of the civil settlement. Cooperation means participating in the civil action willingly and honestly, not fabricating testimony just to be helpful to the company.

Conditional Release

The release given in the civil settlement must be conditioned upon the promises and representations by the employee discussed earlier (*i.e.*, passing the lie detector test, honest disclosure of scope, accurate personal financial disclosure, and cooperation with subsequent investigation and post mortem review). Default in meeting any of these obligations should include the right to unwind the settlement even if the claims would otherwise be time barred. They should also carry with them the right to some additional financial penalties to further ensure compliance.

As discussed in this article, a civil settlement has many moving parts and may appear more complicated than it is. Settlements of this type are almost formulaic in that companies always want the same things and the points of leverage are the same against the offending parties. An outside counsel with experience in this area will have the necessary sample documents as you frame your approach.

Government Notification and Referral

There is some debate as to whether a company has an affirmative duty to report internal criminal activity of its employees if the conduct does not violate other laws or regulations governing the company.[16] The comment to ABA Model Rules of Professional Conduct Rule 8.3 suggests that attorneys should "encourage a client to consent to disclosure where the prosecution would not substantially prejudice the client's interests." State laws may demand reporting, and a wide array of regulations governing a company's operations may mandate it as well.

There is, of course, risk whenever the government is contacted about internal company activity. Government investigators and prosecutors are not prone to taking direction from in-house counsel or anyone for that matter. An innocent referral can lead anywhere, including to the prosecution of company employees or vendors not originally considered part of the wrongdoing. And of course, it can lead to the company itself becoming the subject of an investigation. These issues must be carefully addressed before the referral is made and other regulatory agencies are notified.

For these reasons, part of counsel's ongoing assessment is to look at the fraudulent activity from an outsider's perspective—asking whether there are other victims of the criminal activity besides the company and/or whether there are other regulations violated. What if Mark's dummied invoices were from an environmental testing firm that was charged with ensuring that toxic material was properly handled? Years of forged invoices were generated while Mark was supposed to make sure that proper testing and disposal occurred. Now the company has two issues to investigate—how much did Mark steal and was the testing performed?

Even if the company has concluded that the work was performed, the criminal referral will raise this same

question and the government will want it answered to its satisfaction. The company must consider notifying relevant government agencies in a manner that assures regulators that the situation is being handled responsibly. It is a delicate moment because the company cannot control the regulators' reactions. But ignoring the situation should not be among the options considered because it is a sure way to create suspicion and a negative reaction down the road.

On the question of timing, there is built in flexibility which allows the company to investigate the allegations first, before making a determination that criminal wrongdoing or regulatory violations have occurred. The last thing the company wants is to accuse an employee of a crime only to find later that it was wrong or it could not prove the charges (exposing the company to retaliatory claims of defamation, unfair employment action, or malicious prosecution). The investigation period gives the company time to take stock and make some strategic decisions about whether making a referral is warranted or desirable.

There can be a fair amount of strategy in making a successful referral including evaluating whether one is warranted, addressing issues of selecting the prosecuting agency, addressing which regulatory bodies should be notified and in what manner, deciding when to make the referral, determining the key point of communication for the company, and setting the tone for the aggressiveness of the referral as a victim of the crime.

In making a referral, counsel must be prepared for a complete and unrestricted look at evidence gathered from the investigation. This is so because asserting any claim to privilege, while well within the company's rights, will be viewed as uncooperative. The US Sentencing Commission voted in March 2006 to eliminate the language from the Federal Sentencing Guidelines that required corporations to waive the attorney-client privilege if they wanted to earn credit for cooperation. Even with this change, however, companies should be prepared for the government's assumption that the privilege will be waived and the prosecutor's negative reaction if it is not. The last thing the company wants is to raise questions in the government's mind as to its own level of cooperation and involvement in the wrongdoing.

Properly managed, a criminal referral will minimize the chance that the government will blame the company for the acts committed while also establishing a solid working relationship with the investigators and prosecutors. A strong relationship is marked by mutual cooperation and respect, a level of trust that the company is being forthright in disclosing information and addressing the situation, a diligent pursuit of the investigation and prosecution, at least periodic communication, and keeping a balanced perspective in terms of other priorities of the prosecutor's office and the company.

Admission and Contrition

It may sound trite, but after all the time, trouble, expense, and public embarrassment of addressing internal fraud and theft, companies often times insist on obtaining a formal admission of wrongdoing and an "I'm sorry" from the employees. With the amount of leverage involved, this element of settlement normally can be achieved rather easily. People in Mark's position usually have little bargaining position.

In most cases, the criminal authorities can be substantially aided in their investigation by the work already done by the company's existing legal team—particularly when the fraud is complex and document-intensive. Sharing information is an inevitable part of the cooperative relationship. The company must assume that information provided to the government will be later shared with the employee's criminal defense counsel, if it falls under Federal Rule 16 or constitutes *Brady* material.[17]

As discussed before, relevant fact-based records may be the subject of disclosure requests in later civil litigation. But the more sensitive documents to consider are the investigative reports which may be generated by the company's internal team or referral memorandum provided to the government which lays out the company's findings. Both documents are likely to contain opinions and conclusions, along with other potentially sensitive information such as lie detector test results and evidence which is critical of the company in allowing the malfeasance to occur. The company should review and consider the content of these documents before finalizing them for government review.

While the "defensive" thinking discussed above is part of making an appropriate referral, counsel should remember the numerous positive advantages of triggering a prosecution against the offending employee. On the plus side, the presence of a parallel criminal prosecution when pursuing civil claims is obvious. The civil case may be temporarily delayed or even stayed by the criminal case, but the resulting conviction can provide invaluable support in pursuing the civil action.

Many times, the elements of the crime admitted or forming the basis for the conviction are the same as in the civil litigation, giving the civil team irrefutable admissions

or even collateral estoppel/issue preclusion impact on key elements in the civil case. Huge savings in time and money can be achieved in letting the criminal case play out on a parallel course with the civil case.

At minimum, pressing the civil action during the prosecution of a criminal case can give rise to Fifth Amendment testimonial assertions which, in turn, generate valuable negative inferences in the civil action. An unrebutted negative inference can, under appropriate circumstances, provide strong evidence supporting a dispositive motion and an accelerated victory in the civil action.[18]

And of course, a pending criminal prosecution presents the opportunity to avoid the need for any civil litigation at all, when a monetary recovery is secured by way of restitution in the criminal case. The opportunity to avoid protracted and embarrassing civil litigation against the offending employee by obtaining a comprehensive Judgment of Restitution in the criminal case is no doubt appealing.

Setting aside these home-run impacts, the advantages of the company drafting behind a criminal investigation—with its much larger breadth and jurisdictional reach—is clear. Voluntary witness interviews, grand jury subpoenas, and the full weight of a state or federal prosecutor's office behind an investigation can help gather evidence at a speed and in a manner that cannot compare with the discovery mechanisms available in civil litigation.

Deciding where to refer the criminal complaint in terms of government agency depends on a number of factors including the nature and proof of the wrongdoing. In addition to the cold assessment of what state or federal laws have been broken, other considerations come into play including:

- jurisdictional reach of the prosecuting office;
- resource availability of that office;
- strength and reputation of the office in pursuing complex white collar cases; and
- the relationship the company and its outside counsel enjoy with the offices under consideration.

In making the referral, it is important to establish a clear and single line of communication between the company and the government. The best contact point is the lead company counsel overseeing the internal investigation, since it allows for the regular oversight of questions posed by the government, assurance that complete and accurate information is provided, and the ability to monitor the direction and scope of the investigation from a more objective vantage point.

The last point is one of timing and controlling information. On the theory that some control is lost once a government investigation is triggered, in-house counsel are well served to know as much as they possibly can before making the referral, first completing the entire investigation before referring the matter to those outside the company. Most investigations of this type—involving claims of employee theft or fraud—are conducted as a high priority item that is expeditiously handled by the internal investigative team.

As the investigation proceeds, in-house counsel should assume that the corporate rumor mill will eventually pick up that something is going on. The challenge is to conduct a complete investigation before filing charges of criminal wrongdoing, while not waiting so long that valuable evidence is lost or the company becomes the subject of criticism for not making a timely referral. Daily assessment of these competing goals must occur, with outside counsel assisting the senior decision-making team in terms of when to contact the authorities.

Remedial Steps—Can it Happen Again?

Typically, a company has spent six figures in detecting, investigating, pursuing, and fully addressing the wrongdoing. The matter has gone on for months, if not years, and there is enough embarrassment to go around. It is natural to want to close the case and move on. But counsel is well-advised to conduct a complete post-mortem of the events leading to the fraud.

The company's board and shareholders, the audit committee, corporate security, and the company's outside insurance carriers, among others, have a vested interest in understanding how Mark's scheme was able to be formulated and successfully carried out. What improvements can be made to avoid it ever happening again?

This is where securing Mark's post-resolution cooperation can be particularly helpful. If the criminal case ends in some form of plea deal and a good working relationship has been established with the prosecuting authorities, the company can often secure this type of interview as part of the restitution package. As discussed earlier, such a meeting should certainly be negotiated as part of any civil settlement.

And who better to advise you regarding what controls need adjustment than Mark, the person who found a way around them? This meeting should be held after all other aspects of the case have been resolved so that Mark feels comfortable speaking freely. Often, someone in Mark's position is relieved to talk frankly outside the criminal and civil proceedings.

Take advantage of the opportunity presented for real candor to get the most from the interview. Prepare your outline of questions so that you understand every step of

the scheme, what controls were compromised, and how the fraud was successfully perpetrated.

Once you have a full understanding of what happened, ask Mark what would have stopped him and what suggestions he has for improving controls. There is often a twisted pride in the accomplished theft and a desire of the wrongdoer to tell his secrets. Take advantage of it. Of course, others in accounting, operations, human resources, and elsewhere can be helpful in developing a short list of improvements to the company's internal controls.

Minimizing Risk Through Prudent Corporate Governance

Much can be learned from managing an internal fraud investigation and prosecution, as painful as such an experience can be. New controls and procedures can be identified, adopted, or improved upon. Lessons can be learned that can substantially improve the operations of a business.

In any organization, however, the human factor makes corruption a risk at any level—a risk that can never be fully eliminated. Because the complex machine of corporate decision-making ultimately boils down to people, there are no controls or safeguards that can 100 percent assure protection against greed. The best minds behind formulating new controls and firewalls can always be outsmarted by the criminal imagination.

The best we can do is minimize the risk through prudent corporate governance and operations, and be ready to take appropriate action when wrongdoing is suspected.

Have a comment on this article? Email editorinchief@acc.com.

Notes

1. The "story" described below is a fictional account; however, it is loosely based on the post-conviction explanation of a senior corporate officer for his seven-figure embezzlement scheme carried out over a ten-year period.
2. Available at: *www.ussc.gov/2005guid/gl2005.pdf.*
3. 18 U.S.C. § 3553.
4. *See* United States Sentencing Commission Guidelines Manual, § 8B2.1 *et seq*. (2005), available at: *www.ussc.gov/2005guid/gl2005.pdf.*
5. *See www.ussc.gov/corp/ORGOVERVIEW.pdf.*
6. *See First Chicago Int'l v. United Exchange Co. Ltd.*, 125 F.R.D. 55 (S.D.N.Y. 1989).
7. *See* Fed. R. Civ. P. Rule 26(b)(3) (2006) and your respective state's statute.
8. *Diversified Industries, Inc. v. Meredith,* 572 F.2d 596, 609 (8th Cir. 1977); *see, e.g., First Chicago*, 125 F.R.D. 55; *see, e.g., Harper & Row Publishers, Inc. v. Decker*, 423 F.2d 487 (7th Cir. 1970). Every precaution should be made to adhere to these points, especially the last one because dissemination of the information to a third-party with no need to know the information may constitute a waiver of the privilege.
9. 15 U.S.C. § 1681 et seq.
10. *See* Model Rules of Prof'l Conduct R 1.13(a); see also *www.law.cornell.edu/ethics/comparative/index.htm#1.13*, for a comparison of each state's rule. To prevent ethical violations and/or disqualification from representing the corporation, before interviewing an employee, "Miranda" style warning should be set forth to the employee. The lawyer should ensure that the employee is fully aware of and understands the following vital points: that the lawyer does not represent the employee; that the employee's statements may not be privileged, especially when they relate to the organization's business; and that the employee is advised to obtain independent counsel.
11. *See e.g.*, Model Rules of Prof'l Conduct R. 8.4 (2004); *see also www.law.cornell.edu/ethics/comparative/index.htm#8.4*, for a comparison of each state's rule.
12. Available at: *www.polygraph.org.*
13. For a list of licensing offices, see *www.polygraph.org/statelicensing.htm*.
14. 29 U.S.C. § 2001 *et seq*.
15. For a brief summary outlining the "checklist" for both employers and polygraph administrators *see www.polygraph.org/eppa.htm*.
16. *See, e.g.,* 18 U.S.C. § 4 (Misprision of Felony statute); *Shehorn v. Daiwa Bank, Ltd.,*, No. 96 C 1110, 1996 U.S. Dist. LEXIS 7905 (N.D. Ill. 1996) (applying 18 U.S.C. § 4 to corporations).
17. *See* Fed. R. Civ. P. Rule 16 (governing pretrial conferences, scheduling and case management); *see also Brady v. Maryland*, 373 U.S. 83, 83 S. Ct. 1194 (1963). In a criminal proceeding, evidence in possession of the government material to either guilt or punishment of the accused is deemed "Brady material." Any evidence that can be designated as such must be turned over to the accused in accordance with the Due Process Clause of the U.S. Constitution. While viewed by some as a broad form of additional discovery for the criminal defendant, it is actually just a narrow way in which an accused can obtain information bearing only on his guilt or sentencing.
18. *Securities and Exchange Commission v. Global Telecom Services, L.L.C.*, 325 F. Supp. 2d 94 (D.C. Conn. 2004); *see also, Willingham v. County of Albany*, No. 04-CV-369 (DRH), 2006 U.S. Dist. LEXIS 46941 (N.D.N.Y. July 12, 2006).

Title 9, Chapter 9-28.000

Principles of Federal Prosecution of Business Organizations

9-28.000 Principles of Federal Prosecution of Business Organizations

9-28.100 Duties of Federal Prosecutors and Duties of Corporate Leaders

9-28.200 General Considerations of Corporate Liability

9-28.300 Factors to Be Considered

9-28.400 Special Policy Concerns

9-28.500 Pervasiveness of Wrongdoing Within the Corporation

9-28.600 The Corporation's Past History

9-28.700 The Value of Cooperation
9-28.710 Attorney-Client and Work Product Protections
9-28.720 Cooperation: Disclosing the Relevant Facts
9-28.730 Obstructing the Investigation
9-28.740 Offering Cooperation: No Entitlement to Immunity
9-28.750 Qualifying for Immunity, Amnesty, or Reduced Sanctions Through Voluntary Disclosures
9-28.760 Oversight Concerning Demands for Waivers of Attorney-Client Privilege or Work Product By Corporations Contrary to This Policy

9-28.800 Corporate Compliance Programs

9-28.900 Restitution and Remediation

9-28.1000 Collateral Consequences

9-28.1100 Other Civil or Regulatory Alternatives

9-28.1200 Selecting Charges

9-28.1300 Plea Agreements with Corporations

9-28.000 Principles of Federal Prosecution of Business Organizations[1]

9-28.100 Duties of Federal Prosecutors and Duties of Corporate Leaders

The prosecution of corporate crime is a high priority for the Department of Justice. By investigating allegations of wrongdoing and by bringing charges where appropriate for criminal misconduct, the Department promotes critical public interests. These interests include, to take just a few examples: (1) protecting the integrity of our free economic and capital markets; (2) protecting consumers, investors, and business entities that compete only through lawful means; and (3) protecting the American people from misconduct that would violate criminal laws safeguarding the environment.

In this regard, federal prosecutors and corporate leaders typically share common goals. For example, directors and officers owe a fiduciary duty to a corporation's shareholders, the corporation's true owners, and they owe duties of honest dealing to the investing public in connection with the corporation's regulatory filings and public statements. The faithful execution of these duties by corporate leadership serves the same values in promoting public trust and confidence that our criminal cases are designed to serve.

A prosecutor's duty to enforce the law requires the investigation and prosecution of criminal wrongdoing if it is discovered. In carrying out this mission with the diligence and resolve necessary to vindicate the important public interests discussed above, prosecutors should be mindful of the common cause we share with responsible corporate leaders. Prosecutors should also be mindful that confidence in the Department is affected both by the results we achieve and by the real and perceived ways in which we achieve them. Thus, the manner in which we do our job as prosecutors—including the professionalism we demonstrate, our willingness to secure the facts in a manner that encourages corporate compliance and self-regulation, and also our appreciation that corporate prosecutions can potentially harm blameless investors, employees, and others—affects public perception of our mission. Federal prosecutors recognize that they must maintain public confidence in the way in which they exercise their charging discretion. This endeavor requires the thoughtful analysis of all facts and circumstances presented in a given case. As always, professionalism and civility play an important part in the Department's discharge of its responsibilities in all areas, including the area of corporate investigations and prosecutions.

9-28.200 General Considerations of Corporate Liability

A. General Principle: Corporations should not be treated leniently because of their artificial nature nor should they be subject to harsher treatment. Vigorous enforcement of the criminal laws against corporate wrongdoers, where appropriate, results in great benefits for law enforcement and the public, particularly in the area of white collar crime. Indicting corporations for wrongdoing enables the government to be a force for positive change of corporate culture, and a force to prevent, discover, and punish serious crimes.

B. Comment: In all cases involving corporate wrongdoing, prosecutors should consider the factors discussed further below. In doing so, prosecutors should be aware of the public benefits that can flow from indicting a corporation in appropriate cases. For instance, corporations are likely to take immediate remedial steps when one is indicted for criminal misconduct that is pervasive throughout a particular industry, and thus an indictment can provide a unique opportunity for deterrence on a broad scale. In addition, a corporate indictment may result in specific deterrence by changing the culture of the indicted corporation and the behavior of its employees. Finally, certain crimes that carry with them a substantial risk of great public harm—*e.g.*, environmental crimes or sweeping financial frauds—may be committed by a business entity, and there may therefore be a substantial federal interest in indicting a corporation under such circumstances.

In certain instances, it may be appropriate, upon consideration of the factors set forth herein, to resolve a corporate criminal case by means other than indictment. Non-prosecution and deferred prosecution agreements, for example, occupy an important middle ground between declining prosecution and obtaining the conviction of a corporation. These agreements are discussed further in Section X, *infra*. Likewise, civil and regulatory alternatives may be appropriate in certain cases, as discussed in Section XI, *infra*.

Where a decision is made to charge a corporation, it does not necessarily follow that individual directors, officers, employees, or shareholders should not also be charged. Prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation. Because a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. Only rarely should provable individual culpability not be pursued, particularly if it relates to high-level corporate officers, even in the face of an offer of a corporate guilty plea or some other disposition of the charges against the corporation.

Corporations are "legal persons," capable of suing and being sued, and capable of committing crimes. Under the doctrine of *respondeat superior*, a corporation may be held criminally liable for the illegal acts of its directors, officers, employees, and agents. To hold a corporation liable for these actions, the government must establish that the corporate agent's actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation. In all cases involving wrongdoing by corporate agents, prosecutors should not limit their focus solely to individuals or the corporation, but should consider both as potential targets.

Agents may act for mixed reasons—both for self-aggrandizement (both direct and indirect) and for the benefit of the corporation, and a corporation may be held liable as long as one motivation of its agent is to benefit the corporation. *See United States v. Potter*, 463 F.3d 9, 25 (1st Cir. 2006) (stating that the test to determine whether an agent is acting within the scope

[1] While these guidelines refer to corporations, they apply to the consideration of the prosecution of all types of business organizations, including partnerships, sole proprietorships, government entities, and unincorporated associations.

of employment is "whether the agent is performing acts of the kind which he is authorized to perform, and those acts are motivated, at least in part, by an intent to benefit the corporation."). In *United States v. Automated Medical Laboratories, Inc.*, 770 F.2d 399 (4th Cir. 1985), for example, the Fourth Circuit affirmed a corporation's conviction for the actions of a subsidiary's employee despite the corporation's claim that the employee was acting for his own benefit, namely his "ambitious nature and his desire to ascend the corporate ladder." *Id.* at 407. The court stated, "Partucci was clearly acting in part to benefit AML since his advancement within the corporation depended on AML's well-being and its lack of difficulties with the FDA." *Id.*; *see also United States v. Cincotta*, 689 F.2d 238, 241-42 (1st Cir. 1982) (upholding a corporation's conviction, notwithstanding the substantial personal benefit reaped by its miscreant agents, because the fraudulent scheme required money to pass through the corporation's treasury and the fraudulently obtained goods were resold to the corporation's customers in the corporation's name).

Moreover, the corporation need not even necessarily profit from its agent's actions for it to be held liable. In *Automated Medical Laboratories*, the Fourth Circuit stated:

> [B]enefit is not a "touchstone of criminal corporate liability; benefit at best is an evidential, not an operative, fact." Thus, whether the agent's actions ultimately redounded to the benefit of the corporation is less significant than whether the agent acted with the intent to benefit the corporation. The basic purpose of requiring that an agent have acted with the intent to benefit the corporation, however, is to insulate the corporation from criminal liability for actions of its agents which may be *inimical* to the interests of the corporation or which may have been undertaken solely to advance the interests of that agent or of a party other than the corporation.

770 F.2d at 407 (internal citation omitted) (quoting *Old Monastery Co. v. United States*, 147 F.2d 905, 908 (4th Cir. 1945)).

9-28.300 Factors to Be Considered

A. General Principle: Generally, prosecutors apply the same factors in determining whether to charge a corporation as they do with respect to individuals. *See* USAM § 9-27.220, *et seq.* Thus, the prosecutor must weigh all of the factors normally considered in the sound exercise of prosecutorial judgment: the sufficiency of the evidence; the likelihood of success at trial; the probable deterrent, rehabilitative, and other consequences of conviction; and the adequacy of noncriminal approaches. *See id.* However, due to the nature of the corporate "person," some additional factors are present. In conducting an investigation, determining whether to bring charges, and negotiating plea or other agreements, prosecutors should consider the following factors in reaching a decision as to the proper treatment of a corporate target:

1. the nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of

corporations for particular categories of crime (*see infra* section IV);

2. the pervasiveness of wrongdoing within the corporation, including the complicity in, or the condoning of, the wrongdoing by corporate management (*see infra* section V);
3. the corporation's history of similar misconduct, including prior criminal, civil, and regulatory enforcement actions against it (*see infra* section VI);
4. the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents (*see infra* section VII);
5. the existence and effectiveness of the corporation's pre-existing compliance program (*see infra* section VIII);
6. the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies (*see infra* section IX);
7. collateral consequences, including whether there is disproportionate harm to shareholders, pension holders, employees, and others not proven personally culpable, as well as impact on the public arising from the prosecution (*see infra* section X);
8. the adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and
9. the adequacy of remedies such as civil or regulatory enforcement actions (*see infra* section XI).

B. Comment: The factors listed in this section are intended to be illustrative of those that should be evaluated and are not an exhaustive list of potentially relevant considerations. Some of these factors may not apply to specific cases, and in some cases one factor may override all others. For example, the nature and seriousness of the offense may be such as to warrant prosecution regardless of the other factors. In most cases, however, no single factor will be dispositive. In addition, national law enforcement policies in various enforcement areas may require that more or less weight be given to certain of these factors than to others. Of course, prosecutors must exercise their thoughtful and pragmatic judgment in applying and balancing these factors, so as to achieve a fair and just outcome and promote respect for the law.

In making a decision to charge a corporation, the prosecutor generally has substantial latitude in determining when, whom, how, and even whether to prosecute for violations of federal criminal law. In exercising that discretion, prosecutors should consider the following

statements of principles that summarize the considerations they should weigh and the practices they should follow in discharging their prosecutorial responsibilities. In doing so, prosecutors should ensure that the general purposes of the criminal law—assurance of warranted punishment, deterrence of further criminal conduct, protection of the public from dangerous and fraudulent conduct, rehabilitation of offenders, and restitution for victims and affected communities—are adequately met, taking into account the special nature of the corporate "person."

9-28.400 Special Policy Concerns

A. General Principle: The nature and seriousness of the crime, including the risk of harm to the public from the criminal misconduct, are obviously primary factors in determining whether to charge a corporation. In addition, corporate conduct, particularly that of national and multi-national corporations, necessarily intersects with federal economic, tax, and criminal law enforcement policies. In applying these Principles, prosecutors must consider the practices and policies of the appropriate Division of the Department, and must comply with those policies to the extent required by the facts presented.

B. Comment: In determining whether to charge a corporation, prosecutors should take into account federal law enforcement priorities as discussed above. *See* USAM § 9-27-230. In addition, however, prosecutors must be aware of the specific policy goals and incentive programs established by the respective Divisions and regulatory agencies. Thus, whereas natural persons may be given incremental degrees of credit (ranging from immunity to lesser charges to sentencing considerations) for turning themselves in, making statements against their penal interest, and cooperating in the government's investigation of their own and others' wrongdoing, the same approach may not be appropriate in all circumstances with respect to corporations. As an example, it is entirely proper in many investigations for a prosecutor to consider the corporation's pre-indictment conduct, *e.g.*, voluntary disclosure, cooperation, remediation or restitution, in determining whether to seek an indictment. However, this would not necessarily be appropriate in an antitrust investigation, in which antitrust violations, by definition, go to the heart of the corporation's business. With this in mind, the Antitrust Division has established a firm policy, understood in the business community, that credit should not be given at the charging stage for a compliance program and that amnesty is available only to the first corporation to make full disclosure to the government. As another example, the Tax Division has a strong preference for prosecuting responsible individuals, rather than entities, for corporate tax offenses. Thus, in determining whether or not to charge a corporation, prosecutors must consult with the Criminal, Antitrust, Tax, Environmental and Natural Resources, and National Security Divisions, as appropriate.

9-28.500 Pervasiveness of Wrongdoing Within the Corporation

A. General Principle: A corporation can only act through natural persons, and it is therefore held responsible for the acts of such persons fairly attributable to it. Charging a corporation for even minor misconduct may be appropriate where the wrongdoing was pervasive

and was undertaken by a large number of employees, or by all the employees in a particular role within the corporation, or was condoned by upper management. On the other hand, it may not be appropriate to impose liability upon a corporation, particularly one with a robust compliance program in place, under a strict *respondeat superior* theory for the single isolated act of a rogue employee. There is, of course, a wide spectrum between these two extremes, and a prosecutor should exercise sound discretion in evaluating the pervasiveness of wrongdoing within a corporation.

B. Comment: Of these factors, the most important is the role and conduct of management. Although acts of even low-level employees may result in criminal liability, a corporation is directed by its management and management is responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged. As stated in commentary to the Sentencing Guidelines:

> Pervasiveness [is] case specific and [will] depend on the number, and degree of responsibility, of individuals [with] substantial authority . . . who participated in, condoned, or were willfully ignorant of the offense. Fewer individuals need to be involved for a finding of pervasiveness if those individuals exercised a relatively high degree of authority. Pervasiveness can occur either within an organization as a whole or within a unit of an organization.

USSG § 8C2.5, cmt. (n. 4).

9-28.600 The Corporation's Past History

A. General Principle: Prosecutors may consider a corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it, in determining whether to bring criminal charges and how best to resolve cases.

B. Comment: A corporation, like a natural person, is expected to learn from its mistakes. A history of similar misconduct may be probative of a corporate culture that encouraged, or at least condoned, such misdeeds, regardless of any compliance programs. Criminal prosecution of a corporation may be particularly appropriate where the corporation previously had been subject to non-criminal guidance, warnings, or sanctions, or previous criminal charges, and it either had not taken adequate action to prevent future unlawful conduct or had continued to engage in the misconduct in spite of the warnings or enforcement actions taken against it. The corporate structure itself (*e.g.*, the creation or existence of subsidiaries or operating divisions) is not dispositive in this analysis, and enforcement actions taken against the corporation or any of its divisions, subsidiaries, and affiliates may be considered, if germane. *See* USSG § 8C2.5(c), cmt. (n. 6).

9-28.700 The Value of Cooperation

A. General Principle: In determining whether to charge a corporation and how to resolve corporate criminal cases, the corporation's timely and voluntary disclosure of wrongdoing and its cooperation with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider, among other things, whether the corporation made a voluntary and timely disclosure, and the corporation's willingness to provide relevant information and evidence and identify relevant actors within and outside the corporation, including senior executives.

Cooperation is a potential mitigating factor, by which a corporation—just like any other subject of a criminal investigation—can gain credit in a case that otherwise is appropriate for indictment and prosecution. Of course, the decision not to cooperate by a corporation (or individual) is not itself evidence of misconduct, at least where the lack of cooperation does not involve criminal misconduct or demonstrate consciousness of guilt (*e.g.*, suborning perjury or false statements, or refusing to comply with lawful discovery requests). Thus, failure to cooperate, in and of itself, does not support or require the filing of charges with respect to a corporation any more than with respect to an individual.

B. Comment: In investigating wrongdoing by or within a corporation, a prosecutor is likely to encounter several obstacles resulting from the nature of the corporation itself. It will often be difficult to determine which individual took which action on behalf of the corporation. Lines of authority and responsibility may be shared among operating divisions or departments, and records and personnel may be spread throughout the United States or even among several countries. Where the criminal conduct continued over an extended period of time, the culpable or knowledgeable personnel may have been promoted, transferred, or fired, or they may have quit or retired. Accordingly, a corporation's cooperation may be critical in identifying potentially relevant actors and locating relevant evidence, among other things, and in doing so expeditiously.

This dynamic—*i.e.*, the difficulty of determining what happened, where the evidence is, and which individuals took or promoted putatively illegal corporate actions—can have negative consequences for both the government and the corporation that is the subject or target of a government investigation. More specifically, because of corporate attribution principles concerning actions of corporate officers and employees (*see, e.g., supra* section II), uncertainty about exactly who authorized or directed apparent corporate misconduct can inure to the detriment of a corporation. For example, it may not matter under the law which of several possible executives or leaders in a chain of command approved of or authorized criminal conduct; however, that information if known might bear on the propriety of a particular disposition short of indictment of the corporation. It may not be in the interest of a corporation or the government for a charging decision to be made in the absence of such information, which might occur if, for example, a statute of limitations were relevant and authorization by any one of the officials were enough to justify a charge under the law. Moreover, and at a minimum, a

protracted government investigation of such an issue could, as a collateral consequence, disrupt the corporation's business operations or even depress its stock price.

For these reasons and more, cooperation can be a favorable course for both the government and the corporation. Cooperation benefits the government—and ultimately shareholders, employees, and other often blameless victims—by allowing prosecutors and federal agents, for example, to avoid protracted delays, which compromise their ability to quickly uncover and address the full extent of widespread corporate crimes. With cooperation by the corporation, the government may be able to reduce tangible losses, limit damage to reputation, and preserve assets for restitution. At the same time, cooperation may benefit the corporation by enabling the government to focus its investigative resources in a manner that will not unduly disrupt the corporation's legitimate business operations. In addition, and critically, cooperation may benefit the corporation by presenting it with the opportunity to earn credit for its efforts.

9-28.710 Attorney-Client and Work Product Protections

The attorney-client privilege and the attorney work product protection serve an extremely important function in the American legal system. The attorney-client privilege is one of the oldest and most sacrosanct privileges under the law. *See Upjohn v. United States*, 449 U.S. 383, 389 (1981). As the Supreme Court has stated, "[i]ts purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice." *Id.* The value of promoting a corporation's ability to seek frank and comprehensive legal advice is particularly important in the contemporary global business environment, where corporations often face complex and dynamic legal and regulatory obligations imposed by the federal government and also by states and foreign governments. The work product doctrine serves similarly important goals.

For these reasons, waiving the attorney-client and work product protections has never been a prerequisite under the Department's prosecution guidelines for a corporation to be viewed as cooperative. Nonetheless, a wide range of commentators and members of the American legal community and criminal justice system have asserted that the Department's policies have been used, either wittingly or unwittingly, to coerce business entities into waiving attorney-client privilege and work-product protection. Everyone agrees that a corporation may freely waive its own privileges if it chooses to do so; indeed, such waivers occur routinely when corporations are victimized by their employees or others, conduct an internal investigation, and then disclose the details of the investigation to law enforcement officials in an effort to seek prosecution of the offenders. However, the contention, from a broad array of voices, is that the Department's position on attorney-client privilege and work product protection waivers has promoted an environment in which those protections are being unfairly eroded to the detriment of all.

The Department understands that the attorney-client privilege and attorney work product protection are essential and long-recognized components of the American legal system. What the government seeks and needs to advance its legitimate (indeed, essential) law enforcement

mission is not waiver of those protections, but rather the facts known to the corporation about the putative criminal misconduct under review. In addition, while a corporation remains free to convey non-factual or "core" attorney-client communications or work product—if and only if the corporation voluntarily chooses to do so—prosecutors should not ask for such waivers and are directed not to do so. The critical factor is whether the corporation has provided the facts about the events, as explained further herein.

9-28.720 Cooperation: Disclosing the Relevant Facts

Eligibility for cooperation credit is not predicated upon the waiver of attorney-client privilege or work product protection. Instead, the sort of cooperation that is most valuable to resolving allegations of misconduct by a corporation and its officers, directors, employees, or agents is disclosure of the relevant *facts* concerning such misconduct. In this regard, the analysis parallels that for a non-corporate defendant, where cooperation typically requires disclosure of relevant factual knowledge and not of discussions between an individual and his attorneys.

Thus, when the government investigates potential corporate wrongdoing, it seeks the relevant facts. For example, how and when did the alleged misconduct occur? Who promoted or approved it? Who was responsible for committing it? In this respect, the investigation of a corporation differs little from the investigation of an individual. In both cases, the government needs to know the facts to achieve a just and fair outcome. The party under investigation may choose to cooperate by disclosing the facts, and the government may give credit for the party's disclosures. If a corporation wishes to receive credit for such cooperation, which then can be considered with all other cooperative efforts and circumstances in evaluating how fairly to proceed, then the corporation, like any person, must disclose the relevant facts of which it has knowledge.[2]

(a) Disclosing the Relevant Facts – Facts Gathered Through Internal Investigation

Individuals and corporations often obtain knowledge of facts in different ways. An individual knows the facts of his or others' misconduct through his own experience and perceptions. A corporation is an artificial construct that cannot, by definition, have personal knowledge of the facts. Some of those facts may be reflected in documentary or electronic media like emails, transaction or accounting documents, and other records. Often, the corporation gathers facts through an internal investigation. Exactly how and by whom the facts

[2] There are other dimensions of cooperation beyond the mere disclosure of facts, of course. These can include, for example, providing non-privileged documents and other evidence, making witnesses available for interviews, and assisting in the interpretation of complex business records. This section of the Principles focuses solely on the disclosure of facts and the privilege issues that may be implicated thereby.

are gathered is for the corporation to decide. Many corporations choose to collect information about potential misconduct through lawyers, a process that may confer attorney-client privilege or attorney work product protection on at least some of the information collected. Other corporations may choose a method of fact-gathering that does not have that effect—for example, having employee or other witness statements collected after interviews by non-attorney personnel.

Whichever process the corporation selects, the government's key measure of cooperation must remain the same as it does for an individual: has the party timely disclosed the relevant facts about the putative misconduct? That is the operative question in assigning cooperation credit for the disclosure of information—*not* whether the corporation discloses attorney-client or work product materials. Accordingly, a corporation should receive the same credit for disclosing facts contained in materials that are not protected by the attorney-client privilege or attorney work product as it would for disclosing identical facts contained in materials that are so protected.[3] On this point the Report of the House Judiciary Committee, submitted in connection with the attorney-client privilege bill passed by the House of Representatives (H.R. 3013), comports with the approach required here:

> [A]n . . . attorney of the United States may base cooperation credit on the facts that are disclosed, but is prohibited from basing cooperation credit upon whether or not the materials are protected by attorney-client privilege or attorney work product. As a result, an entity that voluntarily discloses should receive the same amount of cooperation credit for disclosing facts that happen to be contained in materials not protected by attorney-client privilege or attorney work product as it would receive for disclosing identical facts that are contained in materials protected by attorney-client privilege or attorney work product. There should be no differentials in an assessment of cooperation (i.e., neither a credit nor a penalty) based upon whether or not the materials disclosed are protected by attorney-client privilege or attorney work product.

H.R. Rep. No. 110-445 at 4 (2007).

[3] By way of example, corporate personnel are typically interviewed during an internal investigation. If the interviews are conducted by counsel for the corporation, certain notes and memoranda generated from the interviews may be subject, at least in part, to the protections of attorney-client privilege and/or attorney work product. To receive cooperation credit for providing factual information, the corporation need not produce, and prosecutors may not request, protected notes or memoranda generated by the lawyers' interviews. To earn such credit, however, the corporation does need to produce, and prosecutors may request, relevant factual information—including relevant factual information acquired through those interviews, unless the identical information has otherwise been provided—as well as relevant non-privileged evidence such as accounting and business records and emails between non-attorney employees or agents.

In short, so long as the corporation timely discloses relevant facts about the putative misconduct, the corporation may receive due credit for such cooperation, regardless of whether it chooses to waive privilege or work product protection in the process.[4] Likewise, a corporation that does not disclose the relevant facts about the alleged misconduct—for whatever reason—typically should not be entitled to receive credit for cooperation.

Two final and related points bear noting about the disclosure of facts, although they should be obvious. First, the government cannot compel, and the corporation has no obligation to make, such disclosures (although the government can obviously compel the disclosure of certain records and witness testimony through subpoenas). Second, a corporation's failure to provide relevant information does not mean the corporation will be indicted. It simply means that the corporation will not be entitled to mitigating credit for that cooperation. Whether the corporation faces charges will turn, as it does in any case, on the sufficiency of the evidence, the likelihood of success at trial, and all of the other factors identified in Section III above. If there is insufficient evidence to warrant indictment, after appropriate investigation has been completed, or if the other factors weigh against indictment, then the corporation should not be indicted, irrespective of whether it has earned cooperation credit. The converse is also true: The government may charge even the most cooperative corporation pursuant to these Principles if, in weighing and balancing the factors described herein, the prosecutor determines that a charge is required in the interests of justice. Put differently, even the most sincere and thorough effort to cooperate cannot necessarily absolve a corporation that has, for example, engaged in an egregious, orchestrated, and widespread fraud. Cooperation is a relevant potential mitigating factor, but it alone is not dispositive.

(b) Legal Advice and Attorney Work Product

Separate from (and usually preceding) the fact-gathering process in an internal investigation, a corporation, through its officers, employees, directors, or others, may have consulted with corporate counsel regarding or in a manner that concerns the legal implications of the putative misconduct at issue. Communications of this sort, which are both independent of the fact-gathering component of an internal investigation and made for the purpose of seeking or dispensing legal advice, lie at the core of the attorney-client privilege. Such communications can naturally have a salutary effect on corporate behavior—facilitating, for example, a corporation's effort to comply with complex and evolving legal and regulatory regimes.[5] Except as noted in

[4] In assessing the timeliness of a corporation's disclosures, prosecutors should apply a standard of reasonableness in light of the totality of circumstances.

[5] These privileged communications are not necessarily limited to those that occur contemporaneously with the underlying misconduct. They would include, for instance, legal advice provided by corporate counsel in an internal investigation report. Again, the key measure of cooperation is the disclosure of factual information known to the corporation, not the

subparagraphs (b)(i) and (b)(ii) below, a corporation need not disclose and prosecutors may not request the disclosure of such communications as a condition for the corporation's eligibility to receive cooperation credit.

Likewise, non-factual or core attorney work product—for example, an attorney's mental impressions or legal theories—lies at the core of the attorney work product doctrine. A corporation need not disclose, and prosecutors may not request, the disclosure of such attorney work product as a condition for the corporation's eligibility to receive cooperation credit.

(i) Advice of Counsel Defense in the Instant Context

Occasionally a corporation or one of its employees may assert an advice-of-counsel defense, based upon communications with in-house or outside counsel that took place prior to or contemporaneously with the underlying conduct at issue. In such situations, the defendant must tender a legitimate factual basis to support the assertion of the advice-of-counsel defense. *See, e.g., Pitt v. Dist. of Columbia*, 491 F.3d 494, 504-05 (D.C. Cir. 2007); *United States v. Wenger*, 427 F.3d 840, 853-54 (10th Cir. 2005); *United States v. Cheek*, 3 F.3d 1057, 1061-62 (7th Cir. 1993). The Department cannot fairly be asked to discharge its responsibility to the public to investigate alleged corporate crime, or to temper what would otherwise be the appropriate course of prosecutive action, by simply accepting on faith an otherwise unproven assertion that an attorney—perhaps even an unnamed attorney—approved potentially unlawful practices. Accordingly, where an advice-of-counsel defense has been asserted, prosecutors may ask for the disclosure of the communications allegedly supporting it.

(ii) Communications in Furtherance of a Crime or Fraud

Communications between a corporation (through its officers, employees, directors, or agents) and corporate counsel that are made in furtherance of a crime or fraud are, under settled precedent, outside the scope and protection of the attorney-client privilege. *See United States v. Zolin*, 491 U.S. 554, 563 (1989); *United States v. BDO Seidman, LLP*, 492 F.3d 806, 818 (7th Cir. 2007). As a result, the Department may properly request such communications if they in fact exist.

9-28.730 Obstructing the Investigation

Another factor to be weighed by the prosecutor is whether the corporation has engaged in conduct intended to impede the investigation. Examples of such conduct could include: inappropriate directions to employees or their counsel, such as directions not to be truthful or to conceal relevant facts; making representations or submissions that contain misleading assertions or material omissions; and incomplete or delayed production of records.

disclosure of legal advice or theories rendered in connection with the conduct at issue (subject to the two exceptions noted in Section VII(2)(b)(i-ii)).

In evaluating cooperation, however, prosecutors should not take into account whether a corporation is advancing or reimbursing attorneys' fees or providing counsel to employees, officers, or directors under investigation or indictment. Likewise, prosecutors may not request that a corporation refrain from taking such action. This prohibition is not meant to prevent a prosecutor from asking questions about an attorney's representation of a corporation or its employees, officers, or directors, where otherwise appropriate under the law.[6] Neither is it intended to limit the otherwise applicable reach of criminal obstruction of justice statutes such as 18 U.S.C. § 1503. If the payment of attorney fees were used in a manner that would otherwise constitute criminal obstruction of justice—for example, if fees were advanced on the condition that an employee adhere to a version of the facts that the corporation and the employee knew to be false—these Principles would not (and could not) render inapplicable such criminal prohibitions.

Similarly, the mere participation by a corporation in a joint defense agreement does not render the corporation ineligible to receive cooperation credit, and prosecutors may not request that a corporation refrain from entering into such agreements. Of course, the corporation may wish to avoid putting itself in the position of being disabled, by virtue of a particular joint defense or similar agreement, from providing some relevant facts to the government and thereby limiting its ability to seek such cooperation credit. Such might be the case if the corporation gathers facts from employees who have entered into a joint defense agreement with the corporation, and who may later seek to prevent the corporation from disclosing the facts it has acquired. Corporations may wish to address this situation by crafting or participating in joint defense agreements, to the extent they choose to enter them, that provide such flexibility as they deem appropriate.

Finally, it may on occasion be appropriate for the government to consider whether the corporation has shared with others sensitive information about the investigation that the government provided to the corporation. In appropriate situations, as it does with individuals, the government may properly request that, if a corporation wishes to receive credit for cooperation, the information provided by the government to the corporation not be transmitted to others—for example, where the disclosure of such information could lead to flight by individual subjects, destruction of evidence, or dissipation or concealment of assets.

9-28.740 Offering Cooperation: No Entitlement to Immunity

A corporation's offer of cooperation or cooperation itself does not automatically entitle it to immunity from prosecution or a favorable resolution of its case. A corporation should not be able to escape liability merely by offering up its directors, officers, employees, or agents. Thus,

[6] Routine questions regarding the representation status of a corporation and its employees, including how and by whom attorneys' fees are paid, sometimes arise in the course of an investigation under certain circumstances—to take one example, to assess conflict-of-interest issues. Such questions can be appropriate and this guidance is not intended to prohibit such limited inquiries.

a corporation's willingness to cooperate is not determinative; that factor, while relevant, needs to be considered in conjunction with all other factors.

9-28.750 Qualifying for Immunity, Amnesty, or Reduced Sanctions Through Voluntary Disclosures

In conjunction with regulatory agencies and other executive branch departments, the Department encourages corporations, as part of their compliance programs, to conduct internal investigations and to disclose the relevant facts to the appropriate authorities. Some agencies, such as the Securities and Exchange Commission and the Environmental Protection Agency, as well as the Department's Environmental and Natural Resources Division, have formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions. Even in the absence of a formal program, prosecutors may consider a corporation's timely and voluntary disclosure in evaluating the adequacy of the corporation's compliance program and its management's commitment to the compliance program. However, prosecution and economic policies specific to the industry or statute may require prosecution notwithstanding a corporation's willingness to cooperate. For example, the Antitrust Division has a policy of offering amnesty only to the first corporation to agree to cooperate. Moreover, amnesty, immunity, or reduced sanctions may not be appropriate where the corporation's business is permeated with fraud or other crimes.

9-28.760 Oversight Concerning Demands for Waivers of Attorney-Client Privilege or Work Product Protection By Corporations Contrary to This Policy

The Department underscores its commitment to attorney practices that are consistent with Department policies like those set forth herein concerning cooperation credit and due respect for the attorney-client privilege and work product protection. Counsel for corporations who believe that prosecutors are violating such guidance are encouraged to raise their concerns with supervisors, including the appropriate United States Attorney or Assistant Attorney General. Like any other allegation of attorney misconduct, such allegations are subject to potential investigation through established mechanisms.

9-28.800 Corporate Compliance Programs

A. General Principle: Compliance programs are established by corporate management to prevent and detect misconduct and to ensure that corporate activities are conducted in accordance with applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own. However, the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal misconduct undertaken by its officers, directors, employees, or agents. In addition, the nature of some crimes, *e.g.*, antitrust violations, may be such that national law enforcement policies mandate prosecutions of corporations notwithstanding the existence of a compliance program.

B. Comment: The existence of a corporate compliance program, even one that specifically prohibited the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of *respondeat superior*. *See United States v. Basic Constr. Co.*, 711 F.2d 570, 573 (4th Cir. 1983) ("[A] corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if . . . such acts were against corporate policy or express instructions."). As explained in *United States v. Potter*, 463 F.3d 9 (1st Cir. 2006), a corporation cannot "avoid liability by adopting abstract rules" that forbid its agents from engaging in illegal acts, because "[e]ven a specific directive to an agent or employee or honest efforts to police such rules do not automatically free the company for the wrongful acts of agents." *Id.* at 25-26. *See also United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1007 (9th Cir. 1972) (noting that a corporation "could not gain exculpation by issuing general instructions without undertaking to enforce those instructions by means commensurate with the obvious risks"); *United States v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979) ("[A] corporation may be liable for acts of its employees done contrary to express instructions and policies, but . . . the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation.").

While the Department recognizes that no compliance program can ever prevent all criminal activity by a corporation's employees, the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. The Department has no formulaic requirements regarding corporate compliance programs. The fundamental questions any prosecutor should ask are: Is the corporation's compliance program well designed? Is the program being applied earnestly and in good faith? Does the corporation's compliance program work? In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal misconduct; the number and level of the corporate employees involved; the seriousness, duration, and frequency of the misconduct; and any remedial actions taken by the corporation, including, for example, disciplinary action against past violators uncovered by the prior compliance program, and revisions to corporate compliance programs in light of lessons learned.[7] Prosecutors should also consider the promptness of any disclosure of wrongdoing to the government. In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are internal audit functions conducted at a level sufficient to ensure their independence and accuracy; and have the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law. *See, e.g., In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968-70 (Del. Ch. 1996).

[7] For a detailed review of these and other factors concerning corporate compliance programs, *see* USSG § 8B2.1.

Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a "paper program" or whether it was designed, implemented, reviewed, and revised, as appropriate, in an effective manner. In addition, prosecutors should determine whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts. Prosecutors also should determine whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it. This will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the corporation's employees and agents or to mitigate charges or sanctions against the corporation.

Compliance programs should be designed to detect the particular types of misconduct most likely to occur in a particular corporation's line of business. Many corporations operate in complex regulatory environments outside the normal experience of criminal prosecutors. Accordingly, prosecutors should consult with relevant federal and state agencies with the expertise to evaluate the adequacy of a program's design and implementation. For instance, state and federal banking, insurance, and medical boards, the Department of Defense, the Department of Health and Human Services, the Environmental Protection Agency, and the Securities and Exchange Commission have considerable experience with compliance programs and can be helpful to a prosecutor in evaluating such programs. In addition, the Fraud Section of the Criminal Division, the Commercial Litigation Branch of the Civil Division, and the Environmental Crimes Section of the Environment and Natural Resources Division can assist United States Attorneys' Offices in finding the appropriate agency office(s) for such consultation.

9-28.900 Restitution and Remediation

A. General Principle: Although neither a corporation nor an individual target may avoid prosecution merely by paying a sum of money, a prosecutor may consider the corporation's willingness to make restitution and steps already taken to do so. A prosecutor may also consider other remedial actions, such as improving an existing compliance program or disciplining wrongdoers, in determining whether to charge the corporation and how to resolve corporate criminal cases.

B. Comment: In determining whether or not to prosecute a corporation, the government may consider whether the corporation has taken meaningful remedial measures. A corporation's response to misconduct says much about its willingness to ensure that such misconduct does not recur. Thus, corporations that fully recognize the seriousness of their misconduct and accept responsibility for it should be taking steps to implement the personnel, operational, and

organizational changes necessary to establish an awareness among employees that criminal conduct will not be tolerated.

Among the factors prosecutors should consider and weigh are whether the corporation appropriately disciplined wrongdoers, once those employees are identified by the corporation as culpable for the misconduct. Employee discipline is a difficult task for many corporations because of the human element involved and sometimes because of the seniority of the employees concerned. Although corporations need to be fair to their employees, they must also be committed, at all levels of the corporation, to the highest standards of legal and ethical behavior. Effective internal discipline can be a powerful deterrent against improper behavior by a corporation's employees. Prosecutors should be satisfied that the corporation's focus is on the integrity and credibility of its remedial and disciplinary measures rather than on the protection of the wrongdoers.

In addition to employee discipline, two other factors used in evaluating a corporation's remedial efforts are restitution and reform. As with natural persons, the decision whether or not to prosecute should not depend upon the target's ability to pay restitution. A corporation's efforts to pay restitution even in advance of any court order is, however, evidence of its acceptance of responsibility and, consistent with the practices and policies of the appropriate Division of the Department entrusted with enforcing specific criminal laws, may be considered in determining whether to bring criminal charges. Similarly, although the inadequacy of a corporate compliance program is a factor to consider when deciding whether to charge a corporation, that corporation's quick recognition of the flaws in the program and its efforts to improve the program are also factors to consider as to appropriate disposition of a case.

9-28.1000 Collateral Consequences

A. General Principle: Prosecutors may consider the collateral consequences of a corporate criminal conviction or indictment in determining whether to charge the corporation with a criminal offense and how to resolve corporate criminal cases.

B. Comment: One of the factors in determining whether to charge a natural person or a corporation is whether the likely punishment is appropriate given the nature and seriousness of the crime. In the corporate context, prosecutors may take into account the possibly substantial consequences to a corporation's employees, investors, pensioners, and customers, many of whom may, depending on the size and nature of the corporation and their role in its operations, have played no role in the criminal conduct, have been unaware of it, or have been unable to prevent it. Prosecutors should also be aware of non-penal sanctions that may accompany a criminal charge, such as potential suspension or debarment from eligibility for government contracts or federally funded programs such as health care programs. Determining whether or not such non-penal sanctions are appropriate or required in a particular case is the responsibility of the relevant agency, and is a decision that will be made based on the applicable statutes, regulations, and policies.

Virtually every conviction of a corporation, like virtually every conviction of an individual, will have an impact on innocent third parties, and the mere existence of such an effect is not sufficient to preclude prosecution of the corporation. Therefore, in evaluating the relevance of collateral consequences, various factors already discussed, such as the pervasiveness of the criminal conduct and the adequacy of the corporation's compliance programs, should be considered in determining the weight to be given to this factor. For instance, the balance may tip in favor of prosecuting corporations in situations where the scope of the misconduct in a case is widespread and sustained within a corporate division (or spread throughout pockets of the corporate organization). In such cases, the possible unfairness of visiting punishment for the corporation's crimes upon shareholders may be of much less concern where those shareholders have substantially profited, even unknowingly, from widespread or pervasive criminal activity. Similarly, where the top layers of the corporation's management or the shareholders of a closely-held corporation were engaged in or aware of the wrongdoing, and the conduct at issue was accepted as a way of doing business for an extended period, debarment may be deemed not collateral, but a direct and entirely appropriate consequence of the corporation's wrongdoing.

On the other hand, where the collateral consequences of a corporate conviction for innocent third parties would be significant, it may be appropriate to consider a non-prosecution or deferred prosecution agreement with conditions designed, among other things, to promote compliance with applicable law and to prevent recidivism. Such agreements are a third option, besides a criminal indictment, on the one hand, and a declination, on the other. Declining prosecution may allow a corporate criminal to escape without consequences. Obtaining a conviction may produce a result that seriously harms innocent third parties who played no role in the criminal conduct. Under appropriate circumstances, a deferred prosecution or non-prosecution agreement can help restore the integrity of a company's operations and preserve the financial viability of a corporation that has engaged in criminal conduct, while preserving the government's ability to prosecute a recalcitrant corporation that materially breaches the agreement. Such agreements achieve other important objectives as well, like prompt restitution for victims.[8] Ultimately, the appropriateness of a criminal charge against a corporation, or some lesser alternative, must be evaluated in a pragmatic and reasoned way that produces a fair outcome, taking into consideration, among other things, the Department's need to promote and ensure respect for the law.

9-28.1100 Other Civil or Regulatory Alternatives

A. General Principle: Non-criminal alternatives to prosecution often exist and prosecutors may consider whether such sanctions would adequately deter, punish, and rehabilitate a corporation that has engaged in wrongful conduct. In evaluating the adequacy of

[8] Prosecutors should note that in the case of national or multi-national corporations, multi-district or global agreements may be necessary. Such agreements may only be entered into with the approval of each affected district or the appropriate Department official. *See id.* § 9-27.641.

non-criminal alternatives to prosecution—*e.g.*, civil or regulatory enforcement actions—the prosecutor may consider all relevant factors, including:

1. the sanctions available under the alternative means of disposition;

2. the likelihood that an effective sanction will be imposed; and

3. the effect of non-criminal disposition on federal law enforcement interests.

B. Comment: The primary goals of criminal law are deterrence, punishment, and rehabilitation. Non-criminal sanctions may not be an appropriate response to a serious violation, a pattern of wrongdoing, or prior non-criminal sanctions without proper remediation. In other cases, however, these goals may be satisfied through civil or regulatory actions. In determining whether a federal criminal resolution is appropriate, the prosecutor should consider the same factors (modified appropriately for the regulatory context) considered when determining whether to leave prosecution of a natural person to another jurisdiction or to seek non-criminal alternatives to prosecution. These factors include: the strength of the regulatory authority's interest; the regulatory authority's ability and willingness to take effective enforcement action; the probable sanction if the regulatory authority's enforcement action is upheld; and the effect of a non-criminal disposition on federal law enforcement interests. *See* USAM §§ 9-27.240, 9-27.250.

9-28.1200 Selecting Charges

A. General Principle: Once a prosecutor has decided to charge a corporation, the prosecutor at least presumptively should charge, or should recommend that the grand jury charge, the most serious offense that is consistent with the nature of the defendant's misconduct and that is likely to result in a sustainable conviction.

B. Comment: Once the decision to charge is made, the same rules as govern charging natural persons apply. These rules require "a faithful and honest application of the Sentencing Guidelines" and an "individualized assessment of the extent to which particular charges fit the specific circumstances of the case, are consistent with the purposes of the Federal criminal code, and maximize the impact of Federal resources on crime." *See* USAM § 9-27.300. In making this determination, "it is appropriate that the attorney for the government consider, *inter alia*, such factors as the [advisory] sentencing guideline range yielded by the charge, whether the penalty yielded by such sentencing range . . . is proportional to the seriousness of the defendant's conduct, and whether the charge achieves such purposes of the criminal law as punishment, protection of the public, specific and general deterrence, and rehabilitation." *Id.*

9-28.1300 Plea Agreements with Corporations

A. General Principle: In negotiating plea agreements with corporations, as with individuals, prosecutors should generally seek a plea to the most serious, readily provable

offense charged. In addition, the terms of the plea agreement should contain appropriate provisions to ensure punishment, deterrence, rehabilitation, and compliance with the plea agreement in the corporate context. Although special circumstances may mandate a different conclusion, prosecutors generally should not agree to accept a corporate guilty plea in exchange for non-prosecution or dismissal of charges against individual officers and employees.

B. Comment: Prosecutors may enter into plea agreements with corporations for the same reasons and under the same constraints as apply to plea agreements with natural persons. *See* USAM §§ 9-27.400-530. This means, *inter alia*, that the corporation should generally be required to plead guilty to the most serious, readily provable offense charged. In addition, any negotiated departures or recommended variances from the advisory Sentencing Guidelines must be justifiable under the Guidelines or 18 U.S.C. § 3553 and must be disclosed to the sentencing court. A corporation should be made to realize that pleading guilty to criminal charges constitutes an admission of guilt and not merely a resolution of an inconvenient distraction from its business. As with natural persons, pleas should be structured so that the corporation may not later "proclaim lack of culpability or even complete innocence." *See* USAM §§ 9-27.420(b)(4), 9-27.440, 9-27.500. Thus, for instance, there should be placed upon the record a sufficient factual basis for the plea to prevent later corporate assertions of innocence.

A corporate plea agreement should also contain provisions that recognize the nature of the corporate "person" and that ensure that the principles of punishment, deterrence, and rehabilitation are met. In the corporate context, punishment and deterrence are generally accomplished by substantial fines, mandatory restitution, and institution of appropriate compliance measures, including, if necessary, continued judicial oversight or the use of special masters or corporate monitors. *See* USSG §§ 8B1.1, 8C2.1, *et seq*. In addition, where the corporation is a government contractor, permanent or temporary debarment may be appropriate. Where the corporation was engaged in fraud against the government (*e.g.*, contracting fraud), a prosecutor may not negotiate away an agency's right to debar or delist the corporate defendant.

In negotiating a plea agreement, prosecutors should also consider the deterrent value of prosecutions of individuals within the corporation. Therefore, one factor that a prosecutor may consider in determining whether to enter into a plea agreement is whether the corporation is seeking immunity for its employees and officers or whether the corporation is willing to cooperate in the investigation of culpable individuals as outlined herein. Prosecutors should rarely negotiate away individual criminal liability in a corporate plea.

Rehabilitation, of course, requires that the corporation undertake to be law-abiding in the future. It is, therefore, appropriate to require the corporation, as a condition of probation, to implement a compliance program or to reform an existing one. As discussed above, prosecutors may consult with the appropriate state and federal agencies and components of the Justice Department to ensure that a proposed compliance program is adequate and meets industry standards and best practices. *See supra* section VIII.

In plea agreements in which the corporation agrees to cooperate, the prosecutor should ensure that the cooperation is entirely truthful. To do so, the prosecutor may request that the corporation make appropriate disclosures of relevant factual information and documents, make employees and agents available for debriefing, file appropriate certified financial statements, agree to governmental or third-party audits, and take whatever other steps are necessary to ensure that the full scope of the corporate wrongdoing is disclosed and that the responsible personnel are identified and, if appropriate, prosecuted. *See generally supra* section VII. In taking such steps, Department prosecutors should recognize that attorney-client communications are often essential to a corporation's efforts to comply with complex regulatory and legal regimes, and that, as discussed at length above, cooperation is not measured by the waiver of attorney-client privilege and work product protection, but rather is measured by the disclosure of facts and other considerations identified herein such as making witnesses available for interviews and assisting in the interpretation of complex documents or business records.

These Principles provide only internal Department of Justice guidance. They are not intended to, do not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal. Nor are any limitations hereby placed on otherwise lawful litigative prerogatives of the Department of Justice.

Section 307 -- Rules of Professional Responsibility for Attorneys

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule--

1. requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
2. if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

AU Section 337

Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments[1]

Source: SAS No. 12.

See section 9337 for interpretations of this section.

Issue date, unless otherwise indicated: January, 1976.

.01 This section provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an audit in accordance with generally accepted auditing standards.

Accounting Considerations

.02 Management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with generally accepted accounting principles.

.03 The standards of financial accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments, are set forth in Statement of Financial Accounting Standards No. 5 [AC section C59], *Accounting for Contingencies*.[2]

Auditing Considerations

.04 With respect to litigation, claims, and assessments, the independent auditor should obtain evidential matter relevant to the following factors:

a. The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.

b. The period in which the underlying cause for legal action occurred.

c. The degree of probability of an unfavorable outcome.

d. The amount or range of potential loss.

---

[1] This section supersedes the commentary, "Lawyers' Letters," January 1974 (section 1001), and auditing interpretations of section 560.12 on lawyers' letters, January 1975 (section 9560.01-.26). It amends section 560.12(*d*) to read as follows: "Inquire of client's legal counsel concerning litigation, claims, and assessments (see section 337)."

[2] Pertinent portions are reprinted in Exhibit I, section 337B. FASB Statement No. 5 [AC section C59], also describes the standards of financial accounting and reporting for gain contingencies. The auditor's procedures with respect to gain contingencies are parallel to those described in this SAS for loss contingencies.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

Audit Procedures

.05 Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.

b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5 [AC section C59].

c. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.

d. Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59]. Also the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.[3]

.06 An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.07 The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Examples of such procedures are as follows:

a. Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited.

b. Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents.

---

[3] An example of a separate letter is as follows: We are writing to inform you that (name of company) has represented to us that (except as set forth below and excluding any such matters listed in the letter of audit inquiry) there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 [AC section C59] in its financial statements at (balance sheet date) and for the (period) then ended. (List unasserted possible claims, if any.) Such a letter should be signed and sent by the auditor.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

c. Obtaining information concerning guarantees from bank confirmation forms.

d. Inspecting other documents for possible guarantees by the client.

Inquiry of a Client's Lawyer[4]

.08 A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.[5] Evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration. However, evidential matter obtained from inside counsel is not a substitute for information outside counsel refuses to furnish.

.09 The matters that should be covered in a letter of audit inquiry include, but are not limited to, the following:

a. Identification of the company, including subsidiaries, and the date of the audit.

b. A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.

c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.

d. As to each matter listed in item *b*, a request that the lawyer either furnish the following information or comment on those matters as to which his views may differ from those stated by management, as appropriate:

(1) A description of the nature of the matter, the progress of the case to date, and the action the company intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement).

(2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

(3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

[4] An illustrative inquiry letter to legal counsel is contained in the Appendix (section 337A).

[5] It is not intended that the lawyer be requested to undertake a reconsideration of all matters upon which he was consulted during the period under audit for the purpose of determining whether he can form a conclusion regarding the probability of assertion of any possible claim inherent in any of the matters so considered.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

e. As to each matter listed in item *c*, a request that the lawyer comment on those matters as to which his views concerning the description or evaluation of the matter may differ from those stated by management.

f. A statement by the client that the client understands that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [AC section C59].

g. A request that the lawyer confirm whether the understanding described in item *f* is correct.

h. A request that the lawyer specifically identify the nature of and reasons for any limitation on his response.

Inquiry need not be made concerning matters that are not considered material, provided the client and the auditor have reached an understanding on the limits of materiality for this purpose.

.10 In special circumstances, the auditor may obtain a response concerning matters covered by the audit inquiry letter in a conference, which offers an opportunity for a more detailed discussion and explanation than a written reply. A conference may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or other complex judgments. The auditor should appropriately document conclusions reached concerning the need for accounting for or disclosure of litigation, claims, and assessments.

.11 In some circumstances, a lawyer may be required by his Code of Professional Responsibility to resign his engagement if his advice concerning financial accounting and reporting for litigation, claims, and assessments is disregarded by the client. When the auditor is aware that a client has changed lawyers or that a lawyer engaged by the client has resigned, the auditor should consider the need for inquiries concerning the reasons the lawyer is no longer associated with the client.

Limitations on the Scope of a Lawyer's Response[6]

.12 A lawyer may appropriately limit his response to matters to which he has given substantive attention in the form of legal consultation or representation. Also, a lawyer's response may be limited to matters that are considered

[6] The American Bar Association has approved a "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which explains the concerns of lawyers and the nature of the limitations an auditor is likely to encounter. That Statement of Policy is reprinted as Exhibit II (section 337C) for the convenience of readers, but is not an integral part of this Statement.

individually or collectively material to the financial statements, provided the lawyer and auditor have reached an understanding on the limits of materiality for this purpose. Such limitations are not limitations on the scope of the audit.

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (see paragraphs .09 and .10) would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion (see section 508.22 and .23).[7] A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (see paragraph .09*g*). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

Other Limitations on a Lawyer's Response

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation, and should look to the guidance in section 508.45 through .49 to determine the effect, if any, of the lawyer's response on the auditor's report. [Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

[The next page is 557.]

[7] A refusal to respond should be distinguished from an inability to form a conclusion with respect to certain matters of judgment (see paragraph .14). Also, lawyers outside the United States sometimes follow practices at variance with those contemplated by this section to the extent that different procedures from those outlined herein may be necessary. In such circumstances, the auditor should exercise judgment in determining whether alternative procedures are adequate to comply with the requirements of this section.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

AU Section 337A

Appendix—Illustrative Audit Inquiry Letter to Legal Counsel

Source: SAS No. 12.

Issue date, unless otherwise indicated: January, 1976.

.01 In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

AU Section 337B

Exhibit I—Excerpts from Statement of Financial Accounting Standards No. 5: Accounting for Contingencies

Source: SAS No. 12.

March, 1975.

The following excerpts are reprinted with the permission of the Financial Accounting Standards Board.

Introduction

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. . . .

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

a. *Probable*. The future event or events are likely to occur.

b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.

c. *Remote*. The chance of the future event or events occurring is slight. . . .

Standards of Financial Accounting and Reporting

Accrual of Loss Contingencies

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if *both* of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4]

[1] The term *loss* is used for convenience to include many charges against income that are commonly referred to as *expenses* and others that are commonly referred to as *losses*.

[3] [Superseded, effective for financial statements for fiscal years beginning after October 15, 1977, by FASB Statement No. 16.]

[4] *Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual[5] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 8(*a*) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of

[5] Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of *Accounting Terminology Bulletin No. 1*, "Review and Resume").

[6] For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(*a*) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(*b*)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(*a*)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.

the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements. . . .

Litigation, Claims, and Assessments

33. The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

b. The degree of probability of an unfavorable outcome.

c. The ability to make a reasonable estimate of the amount of loss.

34. As a condition for accrual of a loss contingency, paragraph 8(*a*) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph 11.

35. On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 8(*a*) is met and the amount of loss can be reasonably estimated.

36. If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(*a*) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(*a*) is met.

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(*a*) would be met if an unfavorable outcome is determined

to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.

39. As a condition for accrual of a loss contingency, paragraph 8(*b*) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(*a*)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of $2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of $8 million over and above the $2 million. In that case, paragraph 8 requires accrual of the $2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the $2 million that was accrued.

[The next page is 565.]

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

AU Section 337C

Exhibit II—American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

Source: SAS No. 12.

Preamble

The public interest in protecting the confidentiality of lawyer-client communications is fundamental. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.

Both the Code of Professional Responsibility and the cases applying the evidentiary privilege recognize that the privilege against disclosure can be knowingly and voluntarily waived by the client. It is equally clear that disclosure to a third party may result in loss of the "confidentiality" essential to maintain the privilege. Disclosure to a third party of the lawyer-client communication on a particular subject may also destroy the privilege as to other communications on that subject. Thus, the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Under the circumstances a policy of audit procedure which requires clients to give consent and authorize lawyers to respond to general inquiries and disclose information to auditors concerning matters which have been communicated in confidence is essentially destructive of free and open communication and early consultation between lawyer and client. The institution of such a policy would inevitably discourage management from discussing potential legal problems with counsel for fear that such discussion might become public and precipitate a loss to or possible liability of the business enterprise and its stockholders that might otherwise never materialize.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements.

Note: This document, in the form herein set forth, was approved by the Board of Governors of the American Bar Association in December 1975, which official action permitted its release to lawyers and accountants as the standard recommended by the American Bar Association for the lawyer's response to letters of audit inquiry.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

To meet this need the accounting profession must adopt and adhere to standards and procedures that will command confidence in the auditing process. It is not, however, believed necessary, or sound public policy, to intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence. On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between lawyer and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.

Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g., denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

It is recognized that the disclosure requirements for enterprises subject to the reporting requirements of the Federal securities laws are a major concern of managements and counsel, as well as auditors. It is submitted that compliance therewith is best assured when clients are afforded maximum encouragement, by protecting lawyer-client confidentiality, freely to consult counsel. Likewise, lawyers must be keenly conscious of the importance of their clients being competently advised in these matters.

Statement of Policy

NOW, THEREFORE, BE IT RESOLVED that it is desirable and in the public interest that this Association adopt the following Statement of Policy regarding the appropriate scope of the lawyer's response to the auditor's request, made by the client at the request of the auditor, for information concerning matters referred to the lawyer during the course of his representation of the client:

(1) *Client Consent to Response.* The lawyer may properly respond to the auditor's requests for information concerning loss contingencies (the term and concept established by Statement of Financial Accounting Standards No. 5, promulgated by the Financial Accounting Standards Board in March 1975 and discussed in Paragraph 5.1 of the accompanying Commentary), to the extent hereinafter set forth, subject to the following:

a. Assuming that the client's initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having apparent authority to make such a request, the lawyer may provide to the auditor information requested, without further consent, unless such information discloses a confidence or a secret or requires an evaluation of a claim.

b. In the normal case, the initial request letter does not provide the necessary consent to the disclosure of a confidence or secret or to the evaluation of a claim since that consent may only be given after full disclosure to the client of the legal consequences of such action.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

c. Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission.

d. In securing the client's consent to the disclosure of confidences or secrets, or the evaluation of claims, the lawyer may wish to have a draft of his letter reviewed and approved by the client before releasing it to the auditor; in such cases, additional explanation would in all probability be necessary so that the legal consequences of the consent are fully disclosed to the client.

(2) *Limitation on Scope of Response.* It is appropriate for the lawyer to set forth in his response, by way of limitation, the scope of his engagement by the client. It is also appropriate for the lawyer to indicate the date as of which information is furnished and to disclaim any undertaking to advise the auditor of changes which may thereafter be brought to the lawyer's attention. *Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon, and (b) if a law firm or a law department, the auditor may assume that the firm or department has endeavored, to the extent believed necessary by the firm or department, to determine from lawyers currently in the firm or department who have performed services for the client since the beginning of the fiscal period under audit whether such services involved substantive attention in the form of legal consultation concerning those loss contingencies referred to in Paragraph 5(a) below but, beyond that, no review has been made of any of the client's transactions or other matters for the purpose of identifying loss contingencies to be described in the response.**

(3) *Response may be Limited to Material Items.* In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.

(4) *Limited Responses.* Where the lawyer is limiting his response in accordance with the Statement of Policy, his response should so indicate (see Paragraph 8). If in any other respect the lawyer is not undertaking to respond to or comment on particular aspects of the inquiry when responding to the auditor, he should consider advising the auditor that his response is limited, in order to avoid any inference that the lawyer has responded to all aspects; otherwise, he may be assuming a responsibility which he does not intend.

(5) *Loss Contingencies.* When properly requested by the client, it is appropriate for the lawyer to furnish to the auditor information concerning the following matters if the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation or consultation:

a. *overtly threatened or pending litigation*, whether or not specified by the client;

b. *a contractually assumed obligation* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;

* As contemplated by Paragraph 8 of this Statement of Policy, this sentence is intended to be the subject of incorporation by reference as therein provided.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

c. *an unasserted possible claim or assessment* which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With respect to clause (*a*), overtly threatened litigation means that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote. With respect to clause (*c*), where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment, consistent with the considerations and concerns outlined in the Preamble and Paragraph 1 hereof, the client should request the lawyer to furnish information to the auditor only if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client. Examples of such situations might (depending in each case upon the particular circumstances) include the following: (i) a catastrophe, accident or other similar physical occurrence in which the client's involvement is open and notorious, or (ii) an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected, or (iii) a public disclosure by the client acknowledging (and thus focusing attention upon) the existence of one or more probable claims arising out of an event or circumstance. In assessing whether or not the assertion of a possible claim is probable, it is expected that the client would normally employ, by reason of the inherent uncertainties involved and insufficiency of available data, concepts parallel to those used by the lawyer (discussed below) in assessing whether or not an unfavorable outcome is probable; thus, assertion of a possible claim would be considered probable only when the prospects of its being asserted seem reasonably certain (i.e., supported by extrinsic evidence strong enough to establish a presumption that it will happen) and the prospects of nonassertion seem slight.

It would not be appropriate, however, for the lawyer to be requested to furnish information in response to an inquiry letter or supplement thereto if it appears that (*a*) the client has been required to specify unasserted possible claims without regard to the standard suggested in the preceding paragraph, or (*b*) the client has been required to specify all or substantially all unasserted possible claims as to which legal advice may have been obtained, since, in either case, such a request would be in substance a general inquiry and would be inconsistent with the intent of this Statement of Policy.

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote"; for purposes of any such judgment it is appropriate to use the following meanings:

(i) *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) *remote*—an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

The considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.

As indicated in Paragraph 4 hereof, the auditor may assume that all loss contingencies specified by the client in the manner specified in clauses *(b)* and *(c)* above have received comment in the response, unless otherwise therein indicated. The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5.

(6) *Lawyer's Professional Responsibility.* Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements[†] of FAS 5.

[†] Under FAS 5, when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, disclosure of an unasserted possible claim is required only if the enterprise concludes that (i) it is probable that a claim will be asserted, (ii) there is a reasonable possibility, if the claim is in fact asserted, that the outcome will be unfavorable, and (iii) the liability resulting from such unfavorable outcome would be material to its financial condition.

(7) *Limitation on Use of Response. Unless otherwise stated in the lawyer's response, it shall be solely for the auditor's information in connection with his audit of the financial condition of the client and is not to be quoted in whole or in part or otherwise referred to in any financial statements of the client or related documents, nor is it to be filed with any governmental agency or other person, without the lawyer's prior written consent.*[*] *Notwithstanding such limitation, the response can properly be furnished to others in compliance with court process or when necessary in order to defend the auditor against a challenge of the audit by the client or a regulatory agency, provided that the lawyer is given written notice of the circumstances at least twenty days before the response is so to be furnished to others, or as long in advance as possible if the situation does not permit such period of notice.*[*]

(8) *General.* This Statement of Policy, together with the accompanying Commentary (which is an integral part hereof), has been developed for the general guidance of the legal profession. In a particular case, the lawyer may elect to supplement or modify the approach hereby set forth. If desired, this Statement of Policy may be incorporated by reference in the lawyer's response by the following statement: "This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any 'loss contingencies' is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement)."

The accompanying Commentary is an integral part of this Statement of Policy.

Commentary

Paragraph 1 (Client Consent to Response)

In responding to any aspect of an auditor's inquiry letter, the lawyer must be guided by his ethical obligations as set forth in the Code of Professional Responsibility. Under Canon 4 of the Code of Professional Responsibility a lawyer is enjoined to preserve the client's confidences (defined as information protected by the attorney-client privilege under applicable law) and the client's secrets (defined as other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client). The observance of this ethical obligation, in the context of public policy, "... not only facilitates the full development of facts essential to proper representation of the client but also encourages laymen to seek early legal assistance." (Ethical Consideration 4-1).

The lawyer's ethical obligation therefore includes a much broader range of information than that protected by the attorney-client privilege. As stated in Ethical Consideration 4-4: "The attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidences and secrets of his

[*] See footnote * in paragraph (2) in this section.

client. This ethical precept, unlike the evidentiary privilege, exists without regard to the nature or source of information or the fact that others share the knowledge."

In recognition of this ethical obligation, the lawyer should be careful to disclose fully to his client any confidence, secret or evaluation that is to be revealed to another, including the client's auditor, and to satisfy himself that the officer or agent of a corporate client consenting to the disclosure understands the legal consequences thereof and has authority to provide the required consent.

The law in the area of attorney-client privilege and the impact of statements made in letters to auditors upon that privilege has not yet been developed. Based upon cases treating the attorney-client privilege in other contexts, however, certain generalizations can be made with respect to the possible impact of statements in letters to auditors.

It is now generally accepted that a corporation may claim the attorney-client privilege. Whether the privilege extends beyond the control group of the corporation (a concept found in the existing decisional authority), and if so, how far, is yet unresolved.

If a client discloses to a third party a part of any privileged communication he has made to his attorney, there may have been a waiver as to the whole communication; further, it has been suggested that giving accountants *access* to privileged statements made to attorneys may waive any privilege as to those statements. Any disclosure of privileged communications relating to a particular subject matter may have the effect of waiving the privilege on other communications with respect to the same subject matter.

To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.

A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.

Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.

Paragraph 2 (Limitation on Scope of Response)

In furnishing information to an auditor, the lawyer can properly limit himself to loss contingencies which he is handling on a substantive basis for the client in the form of legal consultation (advice and other attention to matters not in litigation by the lawyer in his professional capacity) or legal representation (counsel of record or other direct professional responsibility for a

matter in litigation). Some auditors' inquiries go further and ask for information on matters of which the lawyer "has knowledge." Lawyers are concerned that such a broad request may be deemed to include information coming from a variety of sources including social contact and third party contacts as well as professional engagement and that the lawyer might be criticized or subjected to liability if some of this information is forgotten at the time of the auditor's request.

It is also believed appropriate to recognize that the lawyer will not necessarily have been authorized to investigate, or have investigated, all legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem upon exploration and development. Thus, consideration in the form of preliminary or passing advice, or regarding an incomplete or hypothetical state of facts, or where the lawyer has not been requested to give studied attention to the matter in question, would not come within the concept of "substantive attention" and would therefore be excluded. Similarly excluded are matters which may have been mentioned by the client but which are not actually being handled by the lawyer. Paragraph 2 undertakes to deal with these concerns.

Paragraph 2 is also intended to recognize the principle that the appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client in a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond merely because of having become aware of its existence in a general or incidental way.

The internal procedures to be followed by a law firm or law department may vary based on factors such as the scope of the lawyer's engagement and the complexity and magnitude of the client's affairs. Such procedures could, but need not, include use of a docket system to record litigation, consultation with lawyers in the firm or department having principal responsibility for the client's affairs or other procedures which, in light of the cost to the client, are not disproportionate to the anticipated benefit to be derived. Although these procedures may not necessarily identify all matters relevant to the response, the evolution and application of the lawyer's customary procedures should constitute a reasonable basis for the lawyer's response.

As the lawyer's response is limited to matters involving his professional engagement as counsel, such response should not include information concerning the client which the lawyer receives in another role. In particular, a lawyer who is also a director or officer of the client would not include information which he received as a director or officer unless the information was also received (or, absent the dual role, would in the normal course be received) in his capacity as legal counsel in the context of his professional engagement. Where the auditor's request for information is addressed to a law firm as a firm, the law firm may properly assume that its response is not expected to include any information which may have been communicated to the particular individual by reason of his serving in the capacity of director or officer of the client. The question of the individual's duty, in his role as a director or officer, is not here addressed.

Paragraph 3 (Response May Cover only Material Items in Certain Cases)

Paragraph 3 makes it clear that the lawyer may optionally limit his responses to those items which are individually or collectively material to the

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

auditor's inquiry. If the lawyer takes responsibility for making a determination that a matter is not material for the purposes of his response to the audit inquiry, he should make it clear that his response is so limited. The auditor, in such circumstance, should properly be entitled to rely upon the lawyer's response as providing him with the necessary corroboration. It should be emphasized that the employment of inside general counsel by the client should not detract from the acceptability of his response since inside general counsel is as fully bound by the professional obligations and responsibilities contained in the Code of Professional Responsibility as outside counsel. If the audit inquiry sets forth a definition of materiality but the lawyer utilizes a different test of materiality, he should specifically so state. The lawyer may wish to reach an understanding with the auditor concerning the test of materiality to be used in his response, but he need not do so if he assumes responsibility for the criteria used in making materiality determinations. Any such understanding with the auditor should be referred to or set forth in the lawyer's response. In this connection, it is assumed that the test of materiality so agreed upon would not be so low in amount as to result in a disservice to the client and an unreasonable burden on counsel.

Paragraph 4 (Limited Responses)

The Statement of Policy is designed to recognize the obligation of the auditor to complete the procedures considered necessary to satisfy himself as to the fair presentation of the company's financial condition and results, in order to render a report which includes an opinion not qualified because of a limitation on the scope of the audit. In this connection, reference is made to SEC Accounting Series Release No. 90 [Financial Reporting Release No. 1, section 607.01(b)], in which it is stated:

> "A 'subject to' or 'except for' opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements, is not acceptable in certificates filed with the Commission in connection with the public offering of securities. The 'subject to' qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date."

Paragraph 5 (Loss Contingencies)

Paragraph 5 of the Statement of Policy summarizes the categories of "loss contingencies" about which the lawyer may furnish information to the auditor. The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified for the accounting profession in Statement of Financial Accounting Standards No. 5 ("FAS 5") issued by the Financial Accounting Standards Board in March, 1975.

5.1 Accounting Requirements

To understand the significance of the auditor's inquiry and the implications of any response the lawyer may give, the lawyer should be aware of the following accounting concepts and requirements set out in FAS 5:[||]

(a) A "loss contingency" is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise

[||] Citations are to paragraph numbers of FAS 5.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

that will ultimately be resolved when one or more events occur or fail to occur. Resolutions of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

(Para. 1)

(b) When a "loss contingency" exists, the likelihood that a future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. There are three areas within that range, defined as follows:

(i) *Probable*—"The future event or events are likely to occur."

(ii) *Reasonably possible*—"The chance of the future event or events occurring is more than remote but less than likely."

(iii) *Remote*—"The chance of the future event or events occurring is slight."

(Para. 3)

(c) *Accrual* in a client's financial statements by a charge to income of the period will be required if *both* the following conditions are met:

(i) "Information available prior to issuance of the financial statements indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss." (emphasis added; footnote omitted)

(ii) "The amount of loss can be reasonably estimated."

(Para. 8)

(d) *If there is no accrual* of the loss contingency in the client's financial statements because one of the two conditions outlined in (c) above are not met, *disclosure* may be required as provided in the following:

> "If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, *disclosure* of the contingency *shall be made when there is at least a reasonable possibility* that a loss or an additional loss may have been incurred. *The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of* a loss contingency involving *an unasserted claim* or assessment *when there has been no manifestation by potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.*" (emphasis added; footnote omitted)

(Para. 10)

(e) The accounting requirements recognize or specify that (i) the opinions or views of counsel are not the sole source of evidential matter in making determinations about the accounting recognition or treatment to be given to litigation, and (ii) the fact that the lawyer is not

able to express an opinion that the outcome will be favorable does not necessarily require an accrual of a loss. Paragraphs 36 and 37 of FAS 5 state as follows:

"If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(*a*) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(*a*) is met.

"The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(*a*) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement."

(*f*) Paragraph 38 of FAS 5 focuses on certain examples concerning the determination by the enterprise whether an assertion of an unasserted possible claim may be considered probable:

"With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other

hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10."

For a more complete presentation of FAS 5, reference is made to Exhibit I, section 337B, in which are set forth excerpts selected by the AICPA as relevant to a Statement on Auditing Standards, issued by its Auditing Standards Executive Committee, captioned "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

5.2 Lawyer's Response

Concepts of probability inherent in the usage of terms like "probable" or "reasonably possible" or "remote" mean different things in different contexts. Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict "probability" in any statistical, scientific or empirically-grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

Likewise, the "amount" of loss—that is, the total of costs and damages that ultimately might be assessed against a client—will, in most litigation, be a subject of wide possible variance at most stages; it is the rare case where the amount is precise and where the question is whether the client against which claim is made is liable either for all of it or none of it.

In light of the foregoing considerations, it must be concluded that, as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation. To provide content to the definitions set forth in Paragraph 5 of the Statement of Policy, this Commentary amplifies the meanings of the terms under discussion, as follows:

"*probable*"—An unfavorable outcome is normally "probable" if, but only if, investigation, preparation (including development of the factual data

and legal research) and progress of the matter have reached a stage where a judgment can be made, taking all relevant factors into account which may affect the outcome, that it is extremely doubtful that the client will prevail.

"remote"—The prospect for an unfavorable outcome appears, at the time, to be slight; i.e., it is extremely doubtful that the client will not prevail. Normally, this would entail the ability to make an unqualified judgment, taking into account all relevant factors which may affect the outcome, that the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law.

In other words, for purposes of the lawyer's response to the request to advise auditors about litigation, an unfavorable outcome will be "probable" only if the chances of the client prevailing appear slight and of the claimant losing appear extremely doubtful; it will be "remote" when the client's chances of losing appear slight and of not winning appear extremely doubtful. It is, therefore, to be anticipated that, in most situations, an unfavorable outcome will be neither "probable" nor "remote" as defined in the Statement of Policy.

The discussion above about the very limited basis for furnishing judgments about the outcome of litigation applies with even more force to a judgment concerning whether or not the assertion of a claim not yet asserted is "probable." That judgment will infrequently be one within the professional competence of lawyers and therefore the lawyer should not undertake such assessment except where such judgment may become meaningful because of the presence of special circumstances, such as catastrophes, investigations and previous public disclosure as cited in Paragraph 5 of the Statement of Policy, or similar extrinsic evidence relevant to such assessment. Moreover, it is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be in a position to make an informed judgment that assertion of a possible claim is "probable" as opposed to "reasonably possible" (in which event disclosure is not required). In light of the legitimate concern that the public interest would not be well served by resolving uncertainties in a way that invites the assertion of claims or otherwise causes unnecessary harm to the client and its stockholders, a decision to treat an unasserted claim as "probable" of assertion should be based only upon compelling judgment.

Consistent with these limitations believed appropriate for the lawyer, he should not represent to the auditor, nor should any inference from his response be drawn, that the unasserted possible claims identified by the client (as contemplated by Paragraph 5(c) of the Statement of Policy) represent all such claims of which the lawyer may be aware or that he necessarily concurs in his client's determination of which unasserted possible claims warrant specification by the client; within proper limits, this determination is one which the client is entitled to make—and should make—and it would be inconsistent with his professional obligations for the lawyer to volunteer information arising from his confidential relationship with his client.

As indicated in Paragraph 5, the lawyer also may be asked to estimate the potential loss (or range) in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the lawyer would provide an estimate only if he believes that the probability of inaccuracy of the estimate of the range or amount is slight. What is meant here is that the estimate of amount of loss presents the same difficulty as assessment of outcome and that the same formulation of "probability" should be used with respect to the determination of estimated loss amounts as should be used with respect to estimating the outcome of the matter.

In special circumstances, with the proper consent of the client, the lawyer may be better able to provide the auditor with information concerning loss contingencies through conferences where there is opportunity for more detailed discussion and interchange. However, the principles set forth in the Statement of Policy and this Commentary are fully applicable to such conferences.

Subsumed throughout this discussion is the ongoing responsibility of the lawyer to assist his client, at the client's request, in complying with the requirements of FAS 5 to the extent such assistance falls within his professional competence. This will continue to involve, to the extent appropriate, privileged discussions with the client to provide a better basis on which the client can make accrual and disclosure determinations in respect of its financial statements.

In addition to the considerations discussed above with respect to the making of any judgment or estimate by the lawyer in his response to the auditor, including with respect to a matter specifically identified by the client, the lawyer should also bear in mind the risk that the furnishing of such a judgment or estimate to any one other than the client might constitute an admission or be otherwise prejudicial to the client's position in its defense against such litigation or claim (see Paragraph 1 of the Statement of Policy and of this Commentary).

Paragraph 6 (Lawyer's Professional Responsibility)

The client must satisfy whatever duties it has relative to timely disclosure, including appropriate disclosure concerning material loss contingencies, and, to the extent such matters are given substantive attention in the form of legal consultation, the lawyer, when his engagement is to advise his client concerning a disclosure obligation, has a responsibility to advise his client concerning its obligations in this regard. Although lawyers who normally confine themselves to a legal specialty such as tax, antitrust, patent or admiralty law, unlike lawyers consulted about SEC or general corporate matters, would not be expected to advise generally concerning the client's disclosure obligations in respect of a matter on which the lawyer is working, the legal specialist should counsel his client with respect to the client's obligations under FAS 5 to the extent contemplated herein. Without regard to legal specialty, the lawyer should be mindful of his professional responsibility to the client described in Paragraph 6 of the Statement of Policy concerning disclosure.

The lawyer's responsibilities with respect to his client's disclosure obligations have been a subject of considerable discussion and there may be, in due course, clarification and further guidance in this regard. In any event, where in the lawyer's view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its non-disclosure in the client's financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer's withdrawal from employment in accordance with the Code of Professional Responsibility. (See, e.g., Disciplinary Rule 7-102 (A)(3) and (7), and Disciplinary Rule 2-110 (B)(2).) Withdrawal under such circumstances is obviously undesirable and might present serious problems for the client. Accordingly, in the context of financial accounting and reporting for loss contingencies arising from unasserted claims, the standards for which are contained in FAS 5, clients should be urged to disclose to the auditor information concerning an unasserted possible claim or assessment (not otherwise specifically identified by the client)

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable (employing the concepts hereby enunciated) and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required.

Paragraph 7 (Limitation on Use of Response)

Some inquiry letters make specific reference to, and one might infer from others, an intention to quote verbatim or include the substance of the lawyer's reply in footnotes to the client's financial statements. Because the client's prospects in pending litigation may shift as a result of interim developments, and because the lawyer should have an opportunity, if quotation is to be made, to review the footnote in full, it would seem prudent to limit the use of the lawyer's reply letter. Paragraph 7 sets out such a limitation.

Paragraph 7 also recognizes that it may be in the client's interest to protect information contained in the lawyer's response to the auditor, if and to the extent possible, against unnecessary further disclosure or use beyond its intended purpose of informing the auditor. For example, the response may contain information which could prejudice efforts to negotiate a favorable settlement of a pending litigation described in the response. The requirement of consent to further disclosure, or of reasonable advance notice where disclosure may be required by court process or necessary in defense of the audit, is designed to give the lawyer an opportunity to consult with the client as to whether consent should be refused or limited or, in the case of legal process or the auditor's defense of the audit, as to whether steps can and should be taken to challenge the necessity of further disclosure or to seek protective measures in connection therewith. It is believed that the suggested standard of twenty days advance notice would normally be a minimum reasonable time for this purpose.

Paragraph 8 (General)

It is reasonable to assume that the Statement of Policy will receive wide distribution and will be readily available to the accounting profession. Specifically, the Statement of Policy has been reprinted as Exhibit II to the Statement on Auditing Standards, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," issued by the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants. Accordingly, the mechanic for its incorporation by reference will facilitate lawyer-auditor communication. The incorporation is intended to include not only limitations, such as those provided by Paragraphs 2 and 7 of the Statement of Policy, but also the explanatory material set forth in this Commentary.

Annex A

[Illustrative forms of letters for full response by outside practitioner or law firm and inside general counsel to the auditor's inquiry letter. These illustrative forms, which are not part of the Statement of Policy, have been prepared by the Committee on Audit Inquiry Responses solely in order to assist those who may wish to have, for reference purposes, a form of response which

P1: JsY
AICP034-p473-584 AICPA034-PS.cls July 13, 2006 20:13

incorporates the principles of the Statement of Policy and accompanying Commentary. Other forms of response letters will be appropriate depending on the circumstances.]

Illustrative form of letter for use by outside practitioner or law firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter date [*insert date of request*] Mr. [*insert name and title of officer signing request*] of [*insert name of client*] [(the "Company") or (together with its subsidiaries, the "Company")] has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [*Federal income tax matters*] [*litigation*] [*real estate transactions*] [*describe other specific matters, as appropriate*] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [*insert date of beginning of fiscal period under audit*] we have not been engaged to give substantive attention to, or represent the Company in connection with, [*material*][††] loss contingencies coming within the scope of clause (*a*) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (*b*) or (*c*) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

[††] *Note:* See Paragraph 3 of the Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement]

Very truly yours,

Illustrative form of letter for use by inside general counsel:

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel** of [*insert name of client*] [(the "Company")] [(together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

I call your attention to the fact that as General Counsel** for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance should be placed on other sources.*] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]†† loss contingencies coming within the scope of clause (*a*) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (*b*) or (*c*) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by

** It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

†† See footnote †† earlier in this section.

P1: JsY
AICP034-p473-584 AICPA034-PS.cls June 30, 2006 11:3

Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

[The next page is 591.]

Reprinted from *Directors Monthly* with permission of the publisher: National Association of Corporate Directors (NACD) • 1133 21st Street, NW, Suite 700, Washington, D.C. 20036 • 202-775-0509 www.nacdonline.org

Audit & Finance

Addressing Auditor/Client Disputes in Engagement Letters: Cause for Concern or Much Ado About Nothing?

By Robert J. Kueppers
Deputy CEO, Deloitte & Touche USA LLP

In the last year the media, investors, regulators and members of the audit profession have been discussing the appropriateness of terms in some audit engagement letters that have been referred to as "legal protective clauses" or "liability limiting clauses." In my view neither term is accurate. This article explores the use of what I prefer to call "auditor/client dispute clauses" in engagement letters, and attempts to assist directors in understanding these provisions.

Governance reforms have placed responsibility for oversight of the external auditors with the audit committee. It is clear in practice that directors are taking this responsibility seriously. Today, detailed discussions between the auditors and the audit committee with respect to the terms of the annual audit engagement letter are not uncommon. After all, the letter is addressed to the audit committee and a proposed draft is usually presented by the audit team for the audit committee's review and approval. These discussions are healthy and welcomed. However, these discussions have revealed considerable confusion over auditor/client dispute clauses in audit engagement letters, such as whether such clauses benefit the audit firm at the expense of investors and under what circumstances might such clauses be disclosed in proxy statements.

Beyond boards, investors are often asked to ratify the selection of the audit firm. Institutional investors are under increasing pressure to demonstrate an appropriate level of diligence to support their voting records. Shareholder responsibility took center stage at the recent Yale Governance Forum, where the International Corporate Governance Network (ICGN) presented its Proposal on Shareholder Responsibilities. With regard to voting policies, the ICGN proposal stated, in part, "Institutional shareholders should seek to vote the shares that they own in a considered way. They should develop and publish a voting policy so that [interested parties] can understand what criteria are used to reach decisions. Voting decisions should, however, reflect the specific circumstances of the case."

Director Summary: The Deputy CEO of Deloitte & Touche USA LLP outlines steps directors should take with respect to audit engagement letters. Conduct a full discussion of terms and determine whether the terms should be fully disclosed in the proxy or elsewhere.

Diligent boards want to make sure that the annual audit engagement letter is fair and appropriate, and that shareholders have the information they need to make an informed decision regarding ratification. As more companies adopt policies for shareholder ratification of the independent auditors, we can expect institutional investors to seek more information about the relationships and contractual agreements between the company and its independent auditor.

The purpose of this article is to help directors, especially those serving on audit committees, understand certain terms and conditions that may be included in audit engagement letters. I will also suggest ways that companies can consider improving the transparency of the engagement process in an effort to better serve investors.

Clauses Used in Some Engagement Letters

There are a number of provisions that may be considered protective clauses in audit engagement letters. It may be helpful to begin with a brief description of certain terminology used in this article to establish a common understanding. Many of these terms are quite common in various types of service contracts and serve to allocate the risk of economic loss between the contracting parties. This article considers only agreements between auditors and their clients for the company's annual audit engagement. As a general rule, these two-party agreements cannot and do not affect the rights of third parties, such as investors.

The most common type of acceptable engagement letter provision describes an agreement between the client and the auditor regarding the

Make sure that the annual audit engagement letter is fair and appropriate.

procedural aspects of how a future dispute will be resolved. **Alternative dispute resolution,** or ADR, provisions typically require the parties to submit to mediation, and, if mediation is not successful, to arbitration. Another commonly used legal provision, **waiver of jury trial,** is an agreement by both parties to forgo a jury trial in the event there is a dispute, but rather have the case decided by a judge. These clauses are quite common in ordinary service contracts and are designed to promote efficiency and effectiveness of reaching an agreement regarding a dispute. By agreeing to these provisions, neither party is giving up the right to pursue a claim or the dollar amount of such claim. Rather they address either the venue or process by which possible future claims will be resolved.

Indemnification refers to the client's agreement to compensate the auditor for economic losses that result from third-party claims associated with the engagement or client management's conduct, without limiting the third-party's claim. A **limitation of liability** provision is intended to limit the direct damages a client can seek to recover from the auditor in the event that the client suffers a loss as a result of the auditor's actions relating to the audit.

Limiting Liability

Both a compensatory indemnification provision and a pure limitation of liability (for example a dollar limit on claims against the auditor) are problematic for public company audit engagements because the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) would view such protection of the auditor as contrary to the rules and policies they enforce. (See further discussion of Governing Regulations, below.) As a result, it is unlikely that one would encounter an annual audit engagement letter that contains such provisions. Rather, it is more likely that one would encounter language that, for example, excludes certain types of damages that go beyond compensating a client for its actual losses. Indirect or consequential damages, such as lost profits, are often excluded because such damages are highly speculative and not a direct result of the auditor's alleged actions. Likewise, punitive damages are often excluded because they are intended to punish the wrongdoer, rather than compensate the plaintiff for actual losses. It should also be noted that punitive damages are not permitted under actions brought pursuant to the Federal securities laws.

There are several important general points about the provisions discussed above:

- These provisions are between the auditor and the company and do NOT limit the ability of or methods by which third parties (investors, creditors) bring suits against the audit firm or the client.
- There is a regulatory framework that does not permit auditors to contractually cap liability or be protected by the client from third party claims.
- The actual occurrence of claims against the auditor by clients (or vice versa) is fairly rare.

Governing Regulations

Audit engagement letters for financial statement audits of *private* companies are subject to the rules, regulations, and auditor independence standards of the American Institute of Certified Public Accountants (AICPA). Financial statement audits of public companies are also subject to the AICPA rules, but are further subject to the rules, regulations, and auditor independence standards of the PCAOB and the SEC. Additional restrictions may exist for companies that are subject to governmental auditing rules promulgated by the United States Government Accountability Office. Regulatory and authoritative bodies related to certain industries may also provide guidance on auditor/client dispute clauses. For example, banking regulators issued an advisory on these provisions in February 2006.

Both the AICPA and the PCAOB are currently considering, or at least discussing, various independence-related topics in this area. In September 2006, the AICPA's Professional Ethics Executive Committee (PEEC) re-issued an exposure draft related to an interpretation of current independence rules regarding so-called legal protective clauses. The Exposure Draft is available on the AICPA's website, www.aicpa.org. The PCAOB's Standing Advisory Group (SAG) also discussed this topic at its meeting last February. Public briefing materials for the SAG meeting prepared by the staff of the Office of the Chief Auditor of the PCAOB include examples of certain "liability limiting clauses." These briefing materials are available on the PCAOB's website, www.pcaobus.org.

However, as I write this article, neither the PCAOB nor the AICPA has taken definitive action in this regard.

Although the AICPA's consideration of these matters is important to the auditing profession generally, the PCAOB's Interim Independence Standards state that registered public accounting firms are required to comply with the SEC's independence rules with respect to annual audits of SEC registrants. For many years, SEC guidance has seemingly prohibited the use of provisions in audit engagement letters providing for liability limits or indemnification of the auditor by the client. The prohibitions are described in the Codification of Financial Reporting Policies and in various staff guidance. SEC rules do not currently address auditor/client dispute resolution clauses that do not contain liability limits. Deloitte & Touche LLP's current standard engagement terms for audits of public companies generally include a provision for waiver of a trial by jury in the event of dispute with the client. Other firms have different policies.

Current AICPA rules do not preclude the use of clauses that govern auditor/client disputes. As mentioned earlier, the AICPA is considering a number of these clauses, and potential changes to existing guidance were included in their September 2006 exposure draft.

Improved Transparency

I admit to being surprised by the level of discussion that this topic has generated at public forums I have attended in the past year. It is especially surprising considering that there is general agreement about the SEC's apparent prohibition of indemnification or limitation of liability clauses in annual audit engagement letters. Part of the problem is the confusion between provisions that limit the financial responsibility of the auditor and those that simply provide for alternative forums for dispute resolution. Even the terminology used in these discussions has created some confusion. However, when one considers that sophisticated insiders (audit teams, audit committees, management) are sometimes confused, it is little wonder that investors might view these provisions as limiting their rights.

In an effort to counter this confusion, I think the time has come to improve transparency. Investors should have greater access to information regarding the terms under which the auditor is being engaged, particularly in instances where the shareholders are being asked to ratify the selection of auditors on an annual basis.

But, as is the case with many governance-related proposals, putting theory into practice can be vexing. Any proposal for additional disclosure, no matter how well-meaning, should take into consideration a number of important factors. Companies are awash in filing requirements that were enacted in response to investors' desire to receive more timely information. In addition, proxy statements have become longer and more detailed causing additional printing costs and the potential for information overload. Timing should also be considered if investors are to receive relevant information before ratifying the auditor.

After considering these factors, I believe the most practical approach may be to include a statement describing the existence of an auditor/client dispute clause in the audit committee's annual report to shareholders (typically included in the proxy statement). If there are no such clauses included in the audit engagement letter, a statement to that effect could be provided instead. Indeed, some audit committees have included this type of disclosure in their reports in recent years. I also believe that calls for providing the entire engagement letter to investors are overkill and not appropriate. Given the audit requirement under the federal securities laws, it is hard to imagine that the engagement letter is a "material contract" as contemplated by SEC rules. Besides, audit committees are wholly qualified to deal with the engagement of auditors on behalf of investors.

I recommend that directors take the following steps with respect to audit engagement letters:

- Obtain an understanding of the terms and conditions included in the draft engagement.
- Resolve any questions as to the appropriateness of terms and conditions.
- Consider whether the disclosure of permissible clauses is prudent, particularly in situations where the engagement of the auditor is being ratified by shareholders.
- If disclosure is made, determine whether to include such disclosure in the audit committee report in the proxy or in the description of the requested vote for auditor ratification.
- Request updates on regulatory developments from the auditor.

Regardless of the ultimate outcome of the discussion between the profession and regulators on this point, I support increased transparency of key terms of the audit engagement to investors and other interested parties. I would also urge that any such disclosure should make it clear whether or not these provisions impact possible future claims by third-party stakeholders. ■

Robert Kueppers is Deputy CEO of Deloitte &Touche USA LLP.

This publication contains general information only and Deloitte & Touche USA LLP is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte & Touche USA LLP, its affiliates and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

ETHICS & PRIVILEGE

Audit Letter Responses in the Wake of Sarbanes-Oxley

Your outside counsel has just called you in a panic. He has the company's outside auditor on hold on his other line. The auditor is demanding the law firm's evaluation of a very large and difficult lawsuit now pending against the company. The auditor won't accept the formulation from the ABA-AICPA treaty that allows counsel to decline to provide an evaluation unless the lawyer concludes that liability is either "probable" or "remote." The auditor claims that the lawyers can no longer "hide behind" the "treaty" and must provide a complete analysis because of Sarbanes-Oxley. You know that the law firm has a very negative evaluation of the case, which will result in a big reserve and a large hit to earnings if disclosed to the auditor. But you believe that it is too early to get a good estimate. So you tell the law firm auditor to "stick to the treaty." Your outside lawyer asks, "Have you read the Commission's new Rule 13b2-2 regulation"? No? Well, you had better do so.

By John K. Villa
Author of *Corporate Counsel Guidelines*, published by ACC and West

There is no question that § 303 of the Sarbanes-Oxley Act and the U.S. Security and Exchange Commission's ("SEC") recently issued regulations have dramatically altered the legal principles that govern dealing with auditors of public companies. Companies and their lawyers who have become accustomed to operating within the fairly well understood structure of the American Bar Association/American Institute of Certified Public Accountants ("ABA-AICPA") treaty governing lawyer's responses to audit inquiries must now rethink many of the rules that govern their conduct. And the results of this reconsideration will prove to be painful because companies may be placed in the untenable position of either directing their law firms to take actions that waive the attorney-client privilege or that tempt possible enforcement action under the Commission's new regulation implementing provisions of Sarbanes-Oxley.

John K. Villa, "Audit Letter Responses in the Wake of Sarbanes-Oxley," *ACC Docket* 21, no. 9 (October 2003): 164–169. Copyright © 2003 John K. Villa and the Association of Corporate Counsel. All rights reserved.

ABA-AICPA TREATY

Back to basics: let us review the legal landscape that predated § 303 of Sarbanes-Oxley and the SEC's regulations. The Commission has historically required that public companies file a form 10-K annually that included a financial statement certified by an independent auditor.[1] Two items that the independent auditor considers are whether there are adequate financial reserves for claims against the reporting company and whether there are material claims known to the company that are as yet unasserted. One aspect of the auditor's examination of these two issues is for the auditor to require that the company write its outside law firms and request that they describe claims (and possibly unasserted claims) and to evaluate or quantify those claims. The law firm responses are often referred to as "audit response letters" or "FASB 5 letters."

COMPANIES MAY BE PLACED IN THE UNTENABLE POSITION OF EITHER DIRECTING THEIR LAW FIRMS TO TAKE ACTIONS THAT WAIVE THE ATTORNEY-CLIENT PRIVILEGE OR THAT TEMPT POSSIBLE ENFORCEMENT ACTION UNDER THE COMMISSION'S NEW REGULATION IMPLEMENTING PROVISIONS OF SARBANES-OXLEY.

If the audit response letter discloses the substance of the law firm's evaluation of a claim, it may be argued that it is a waiver of the attorney-client privilege and/or work product protection that would otherwise insulate the lawyers' work from discovery. And as we know, once the attorney-client privilege is waived, it is probably lost for all purposes and as against all third parties.[2] How can a company reconcile the competing and apparently conflicting demands of the independent auditor to evaluate accurately the company's liabilities in order to certify its financials and the company's need to avoid a waiver of the attorney-client privilege that may prove very damaging?

Auditors, acting through the American Institute of Certified Public Accountants ("AICPA"), and lawyers, acting through the American Bar Association ("ABA"), reached a compromise of these positions in December 1975 and January 1976 in what has aptly been referred to as "the treaty." The compromise was memorialized in documents known formally as the AICPA "Statement on Auditing Standards Number 12" ("SAS 12") and the ABA "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" ("ABA Statement"). Most corporate lawyers are generally familiar with principles of the treaty, including the basic rule that the lawyer cannot respond to the auditor's request unless consented to by the company/client. More important for our analysis, the treaty provides that, in an audit response letter, the lawyer should "normally refrain from expressing judgments as to the outcome [of litigation] except in those relatively few cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote.'"[3] The terms

ETHICS & PRIVILEGE

"probable" and "remote" are defined very narrowly:

(i) *probable*—an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.
(ii) *remote*—an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

With respect to the important issue of estimating the amount of the potential loss, the ABA Statement cautions that

it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

Although there are many other aspects of the treaty that are worthy of review before responding to an audit letter, these are the key issues for purposes of our analysis.

If the lawyer follows this formulation, then the expectation is that the response does not waive the client company's attorney-client privilege or work product protection.[4] The treaty has, therefore, spawned literally millions of audit response letters that seldom provide substantive evaluations of cases because the claims cannot fairly be classified as "probable" or "remote" and the lawyer infrequently estimates the amount of the potential loss. This fragile compromise has been challenged, in part, by § 303 of Sarbanes-Oxley and, more importantly, by the SEC's surprising regulations recently issued under that provision.

SECTION 303 OF SARBANES-OXLEY AND THE NEW REGULATIONS

Section 303 of Sarbanes-Oxley is a relatively unremarkable provision that was apparently enacted by Congress because of perceived abuses in misleading auditors of public companies, which resulted in inaccurate financial statements. Section 303 provides as follows:

It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

A fair reading of the statute would indicate that, in order to violate this provision, a person must satisfy, among others, two basic intent elements: (1) the person must take an action to "fraudulently influence, coerce, manipulate or mislead" an auditor, and (2) the actor must have the "purpose of rendering the [issuer's] financial statements materially misleading." The problem, however, is that Congress gave to the SEC the authority to prescribe rules or regulations regarding § 303, and, on May 20, 2003, the Commission issued new regulations that will be codified in Rule 13b2-2 that purport to do just that but, in fact, go considerably further.[5] Rule 13b2-2 provides in part:

(b)(1) No officer or director of an insurer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.

IF THE AUDIT RESPONSE LETTER DISCLOSES THE SUBSTANCE OF THE LAW FIRM'S EVALUATION OF A CLAIM, IT MAY BE ARGUED THAT IT IS A WAIVER OF THE ATTORNEY-CLIENT PRIVILEGE AND/OR WORK PRODUCT PROTECTION THAT WOULD OTHERWISE INSULATE THE LAWYERS' WORK FROM DISCOVERY. AND AS WE KNOW, ONCE THE ATTORNEY-CLIENT PRIVILEGE IS WAIVED, IT IS PROBABLY LOST FOR ALL PURPOSES AND AS AGAINST ALL THIRD PARTIES[2]

The SEC's commentary on the new rule clearly highlights important policy decisions reflected in the text of the regulation.

First, although the statute prohibits actions that "fraudulently influence,

ETHICS & PRIVILEGE

coerce, manipulate or mislead . . . [an auditor] . . . ," the regulation has intentionally reordered the verbs so that it prohibits actions to "coerce, manipulate, mislead or fraudulently influence . . . [the auditor]"! Thus, the SEC has asserted that the fraudulent intent does not apply to all of the verbs ("coerce, manipulate, mislead") but only to "influence." This bit of editing is a remarkable sleight-of-hand and, if applied to many other federal statutes, would result in vastly broadening their reach.

IN ONE STROKE, THE STATUTE HAS BEEN MODIFIED FROM WHAT APPEARED TO BE A SPECIFIC INTENT PROVISION TO A MERE NEGLIGENCE STANDARD, AND THE REGULATION EMPLOYS A STANDARD ("COULD RESULT") THAT ADMITS TO A VERY BROAD READING. ONE CAN ARGUE THAT NEARLY ANY ACTION "COULD" HAVE A SPECIFIC RESULT, WHICH IS WHY STATUTES TYPICALLY AVOID SUCH LANGUAGE.

Furthermore, one can argue that the concept of coercion and manipulation may suggest some form of deception, but the same cannot be said for the word "mislead": one can fraudulently mislead another, negligently mislead another, or even innocently mislead another. Reading the statute to apply the "fraudulent" limitation only to "influence" thus opens up the regulation to a much broader application than the statute would appear to have contemplated.

Second, § 303 prohibits action only if it is shown that the conduct was "*for the purpose* of rendering [the issuer's] financial statements materially misleading;" the new rule, however, is applicable "if that person *knew or should have known* that such action, if successful, *could* result in rendering the issuer's financial statements materially misleading" (emphasis supplied). In one stroke, the statute has been modified from what appeared to be a specific intent provision to a mere negligence standard, and the regulation employs a standard ("could result") that admits to a very broad reading. One can argue that nearly any action "could" have a specific result, which is why statutes typically avoid such language.

Back to our hypothetical.

EFFECT OF REVISED RULE 13B2-2 ON THE PRIVILEGES AND PROTECTIONS OF ISSUERS

The implications of these and other changes to 13b2-2 are significant because they may erode the attorney-client privileges and protections of public companies. Outside counsel must now weigh seriously the question of whether they can decline to evaluate a claim merely because it does not fall within the "probable" or "remote" buckets in ¶ 5 of the ABA Statement. If the claim involves a large potential exposure relative to the assets of the company and the likelihood of an adverse result is high but not "probable" under the definitions of ¶ 5 of the ABA Statement, can outside counsel restrict itself to the confines of the treaty and respond merely that the matter is neither "remote" nor "probable" and that thus no evaluation will be provided? If the suit in question results in a catastrophic judgment that sends the stock price plummeting, will the Commission charge that the outside counsel, acting under the direction of the general counsel, "misled" the auditor with an incomplete response that the lawyer "should have known . . . could result in rendering the issuer's financial statements materially misleading"?

If outside counsel conclude that they are subject to personal liability under Rule 13b2-2 for failure to provide a fulsome description of the claims against the issuer, where does that conclusion leave the company and its privilege? Will the company lose its privilege when the opposing party subpoenas the audit response letters and finds that they far exceed what is permitted by the ABA Statement?

Alternatively, if the outside law firm seeks direction from the in-house counsel and the in-house counsel directs the law firm to "stick to the treaty and don't jeopardize my company's privilege" has the in-house counsel also violated Rule 13b2-2 by taking action that "directly or indirectly" causes an auditor to be misled into rendering a financial statement that could be materially misleading? Not a pretty picture.

Here are a few suggestions to alleviate problems:

- Monitor the Commission's activity under 13b2-2. Your company is only one of thousands of companies that will be affected, and the likelihood of clarification through enforcement action, subsequent releases, or modification of the regulation is high.
- Consult with your outside counsel and determine how they intend to balance their obligations under 13b2-2 and the treaty. Don't wait until the problem arises, which is often days before the audit closes, to deal with these sticky issues.
- Review your own responses to the auditors in light of the likelihood that outside counsel's response may be more expansive now than in the past. You should take care not to express one view to the auditor when

you know or suspect that your outside law firm will express another.

NOTES

1. 17 C.F.R. § 210.3-01; 17 C.F.R. § 240.13a-1.
2. The work-product protection, however, is not quite so inflexible in that disclosure of work-product materials to those who have a "common interest" with the client is often not considered a waiver of that protection.
3. ABA Statement at ¶ 5. Notably, SAS 12 does not define "probable" and "remote" quite so narrowly.
4. There is surprisingly little teaching on this issue. *See generally* Michael J. Sharp and Abraham M. Stranger, *Audit-Inquiry Responses in the Arena of Discovery*, 56 BUS. LAWYER 183 (Nov. 2000). *See also* Kidder Peabody & Co. v. IAG Int'l Acceptance Group N.V., 1999 WL 11553 (S.D.N.Y. Jan. 13, 1999) (excluding letter from Kidder and its law firm to outside auditors).
5. *See* Final Rule: Improper Influence on Conduct of Audits, S.E.C. Rel. No. 34-47890, May 20, 2003, at www.sec.gov/rules/final/34-47890.htm. The final rule will appear at 17 C.F.R. § 240.13b2-2.

CUOMO REACHES LANDMARK AGREEMENT WITH MAJOR ENERGY COMPANY, XCEL ENERGY, TO REQUIRE DISCLOSURE OF FINANCIAL RISKS OF CLIMATE CHANGE TO INVESTORS

First-Ever Binding and Enforceable Agreement Requiring a Company to Detail Financial Liabilities Related to Climate Change

Xcel Energy is One of Nation's Largest Utility Emitters of Carbon Dioxide

NEW YORK, NY (August 27, 2008) - Attorney General Andrew M. Cuomo today announced the first-ever binding and enforceable agreement requiring a major national energy company to disclose the financial risks that climate change poses to its investors. Cuomo's agreement with Xcel Energy (NYSE: XEL) ("Xcel") comes as many power companies, including Xcel, are investing in new coal-burning power generation that will significantly contribute to global warming emissions.

"This landmark agreement sets a new industry-wide precedent that will force companies to disclose the true financial risks that climate change poses to their investors," said Attorney General Andrew Cuomo. "Coal-fired power plants can significantly contribute to global warming and investors have the right to know all the associated risks. I commend Xcel Energy for working with my office to establish a standard that will improve our environment and our marketplace over the long-term."

The agreement includes binding and enforceable provisions that require Xcel to provide detailed disclosure of climate change and associated risks in its "Form 10-K" filings, the annual summary report on a company's performance required by the Securities and Exchange Commission ("SEC") to inform investors. These required disclosures include an analysis of financial risks from climate change related to:

- present and probable future climate change regulation and legislation;
- climate-change related litigation; and
- physical impacts of climate change.

Additionally, the agreement commits Xcel to a broad array of climate change disclosures, including:

- current carbon emissions; •
- projected increases in carbon emissions from planned coal-fired power plants;
- company strategies for reducing, offsetting, limiting, or otherwise managing its global warming pollution emissions and expected global warming emissions reductions from these actions; and
- corporate governance actions related to climate change, including whether environmental performance is incorporated into officer compensation.

Substantial financial risks for energy companies that emit large quantities of carbon dioxide are being created by a number of new or likely regulatory efforts, such as New York's newly adopted regional carbon regulations for power plants, and other future regulatory efforts, including federal regulation, Congressional action, and climate-change related litigation. These risks are especially

exacerbated for power companies that are building new coal-burning power plants or other large new sources of global warming pollution emissions. Knowledge of these risks is important for investors to make informed financial decisions.

Xcel Energy provides electricity and natural gas to commercial and residential customers in eight Midwestern and Western States. Its annual revenues are more than $9 billion. In 2006, Xcel was among the top ten largest emitters of global warming pollution by utilities in the United States. Xcel is building a new 750 megawatt, coal-fired power plant in Pueblo, Colorado.

In September 2007, Attorney General Cuomo subpoenaed the executives of Xcel and four other major energy companies for information on whether disclosures to investors in filings with the SEC adequately described the companies' financial risks related to their emissions of global warming pollution. The Attorney General issued subpoenas under New York State's Martin Act, a 1921 state securities law that grants the Attorney General broad powers to access the financial records of businesses. In addition to Xcel Energy, the companies that received subpoenas were AES Corporation, Dominion Resources, Dynegy, and Peabody Energy. The Attorney General's investigation of the remaining companies is ongoing.

Cuomo continued, "I will continue to fight for increased transparency and full disclosure of global warming financial risks to investors. Selectively revealing favorable facts or intentionally concealing unfavorable information about climate change is misleading and must be stopped."

The Attorney General petitioned the SEC last year to require better corporate disclosure of climate-related risks in securities filings. The petition was coordinated by Ceres, a national coalition of investors and environmental groups. It is supported by more than $6 trillion of investors, including the treasurers and comptrollers from New York, California, Florida, Maryland, Rhode Island and five additional states, and the nation's largest public pension funds, CalPERS and CalSTRS. The petition remains pending with the SEC.

Ceres President Mindy S. Lubber said, "This groundbreaking settlement will send ripples far beyond Xcel Energy. It serves notice that all companies face financial exposure from climate change and will be expected to better inform investors of their strategies for dealing with it."

Director of the Natural Resources Defense Council's State Climate Change Program Dale Bryk said, "As New York and other Northeastern states move forward with the nation's first cap and trade program for global warming, investors need full disclosure of the financial risks faced by power companies and others with large carbon footprints. Attorney General Cuomo's work to create an enforceable model for climate change disclosure is a game-changer on this important issue."

Environmental Defense Fund Deputy General Counsel Vickie Patton said, "Investors from Wall Street to Main Street have a right to know whether publicly traded companies are responsibly addressing the financial risks due to global warming. Federal regulators should take a hard look at the Attorney General's settlement and standardize companies' disclosure of climate-related financial risks to ensure a fair marketplace for all investors."

This case is being handled by Assistant Attorneys General Morgan Costello, Michael Myers, and Daniel Sangeap, under the supervision of Special Deputy Attorney General Katherine Kennedy, Executive Deputy Attorney General for Social Justice Mylan Denerstein and Executive Deputy Attorney General for Economic Justice Eric Corngold.

Section 303 -- Improper Influence on Conduct of Audits

a. **Rules To Prohibit.** It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.
b. **Enforcement.** In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.
c. **No Preemption of Other Law.** The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder.
d. **Deadline for Rulemaking.** The Commission shall--
    1. propose the rules or regulations required by this section, not later than 90 days after the date of enactment of this Act; and
    2. issue final rules or regulations required by this section, not later than 270 days after that date of enactment.

Section 307 -- Rules of Professional Responsibility for Attorneys

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule--

1. requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
2. if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

PART 205 - STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS APPEARING AND PRACTICING BEFORE THE COMMISSION IN THE REPRESENTATION OF AN ISSUER

Sec.

205.1 Purpose and scope.

205.2 Definitions.

205.3 Issuer as client.

205.4 Responsibilities of supervisory attorneys.

205.5 Responsibilities of a subordinate attorney.

205.6 Sanctions and discipline.

205.7 No private right of action.

Authority: 15 U.S.C. 77s, 78d-3, 78w, 80a-37, 80a-38, 80b-11, 7202, 7245, and 7262.

§205.1 Purpose and scope.

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

§205.2 Definitions.

For purposes of this part, the following definitions apply:

(a) Appearing and practicing before the Commission:

(1) Means:

(i) Transacting any business with the Commission, including communications in any form;

(ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;

(iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated

into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

(iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission; but

(2) Does not include an attorney who:

(i) Conducts the activities in paragraphs (a)(1)(i) through (a)(1)(iv) of this section other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or

(ii) Is a non-appearing foreign attorney.

(b) Appropriate response means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to §205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

(c) Attorney means any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.

(d) Breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at

common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.

(e) Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.

(f) Foreign government issuer means a foreign issuer as defined in 17 CFR 230.405 eligible to register securities on Schedule B of the Securities Act of 1933 (15 U.S.C. 77a et seq., Schedule B).

(g) In the representation of an issuer means providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

(h) Issuer means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn, but does not include a foreign government issuer. For purposes of paragraphs (a) and (g) of this section, the term "issuer" includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.

(i) Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

(j) Non-appearing foreign attorney means an attorney:

(1) Who is admitted to practice law in a jurisdiction outside the United States;

(2) Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and

(3) Who:

(i) Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or

(ii) Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

(k) Qualified legal compliance committee means a committee of an issuer

(which also may be an audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under §205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in §205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

(l) Reasonable or reasonably denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

(m) Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.

(n) Report means to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

§205.3 Issuer as client.

(a) Representing an issuer. An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.

(b) Duty to report evidence of a material violation. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

(2) The chief legal officer (or the equivalent thereof) shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. In lieu of causing an inquiry under this paragraph (b), a chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a qualified legal compliance committee under paragraph (c)(2) of this section if the issuer has duly established a qualified legal compliance committee prior to the report of evidence of a material violation.

(3) Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to:

(i) The audit committee of the issuer's board of directors;

(ii) Another committee of the issuer's board of directors consisting solely of

directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)) (if the issuer's board of directors has no audit committee); or

(iii) The issuer's board of directors (if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19))).

(4) If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's chief legal officer and chief executive officer (or the equivalents thereof) under paragraph (b)(1) of this section, the attorney may report such evidence as provided under paragraph (b)(3) of this section.

(5) An attorney retained or directed by an issuer to investigate evidence of a material violation reported under paragraph (b)(1), (b)(3), or (b)(4) of this section shall be deemed to be appearing and practicing before the Commission. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported under paragraph (b)(1), (b)(3), or (b)(4) of this section from a duty to respond to the reporting attorney.

(6) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if:

(i) The attorney was retained or directed by the issuer's chief legal officer (or the equivalent thereof) to investigate such evidence of a material violation and:

(A) The attorney reports the results of such investigation to the chief legal officer (or the equivalent thereof); and

(B) Except where the attorney and the chief legal officer (or the equivalent thereof) each reasonably believes that no material violation has occurred, is ongoing, or is about to occur, the chief legal officer (or the equivalent thereof) reports the results of the investigation to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph (b)(3) of this section, or a qualified legal compliance committee; or

(ii) The attorney was retained or directed by the chief legal officer (or the equivalent thereof) to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the chief legal officer (or the equivalent thereof) provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors, a committee thereof to whom a report could be made pursuant to paragraph

(b)(3) of this section, or a qualified legal compliance committee.

(7) An attorney shall not have any obligation to report evidence of a material violation under this paragraph (b) if such attorney was retained or directed by a qualified legal compliance committee:

(i) To investigate such evidence of a material violation; or

(ii) To assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

(8) An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section need do nothing more under this section with respect to his or her report.

(9) An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section shall explain his or her reasons therefor to the chief legal officer (or the equivalent thereof), the chief executive officer (or the equivalent thereof), and directors to whom the attorney reported the evidence of a material violation pursuant to paragraph (b)(1), (b)(3), or (b)(4) of this section.

(10) An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

(c) Alternative reporting procedures for attorneys retained or employed by an issuer that has established a qualified legal compliance committee. (1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the reporting requirements of paragraph (b) of this section, report such evidence to a qualified legal compliance committee, if the issuer has previously formed such a committee. An attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

(2) A chief legal officer (or the equivalent thereof) may refer a report of evidence of a material violation to a previously established qualified legal compliance committee in lieu of causing an inquiry to be conducted under paragraph (b)(2) of this section. The chief legal officer (or the equivalent thereof) shall inform the reporting attorney that the report has been referred to a qualified legal compliance committee. Thereafter, pursuant to the requirements under §205.2(k), the qualified legal compliance committee shall be responsible for responding to the evidence of a material

violation reported to it under this paragraph (c).

(d) Issuer confidences. (1) Any report under this section (or the contemporaneous record thereof) or any response thereto (or the contemporaneous record thereof) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with this part is in issue.

(2) An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

§205.4 Responsibilities of supervisory attorneys.

(a) An attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer is a supervisory attorney. An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.

(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in §205.5(a), that he or she supervises or directs conforms to this part. To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.

(c) A supervisory attorney is responsible for complying with the reporting requirements in §205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.

(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under §205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.

§205.5 Responsibilities of a subordinate attorney.

(a) An attorney who appears and practices before the Commission in the

representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)) is a subordinate attorney.

(b) A subordinate attorney shall comply with this part notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

(c) A subordinate attorney complies with §205.3 if the subordinate attorney reports to his or her supervising attorney under §205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.

(d) A subordinate attorney may take the steps permitted or required by §205.3(b) or (c) if the subordinate attorney reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation under §205.3(b) has failed to comply with §205.3.

§205.6 Sanctions and discipline.

(a) A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.

(b) An attorney appearing and practicing before the Commission who violates any provision of this part is subject to the disciplinary authority of the Commission, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices. An administrative disciplinary proceeding initiated by the Commission for violation of this part may result in an attorney being censured, or being temporarily or permanently denied the privilege of appearing or practicing before the Commission.

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.

(d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.

§205.7 No private right of action.

(a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b) Authority to enforce compliance with this part is vested exclusively in the Commission.

By the Commission.

Jill M. Peterson
Assistant Secretary

Date: January 29, 2003

Endnotes

[1] Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act") (15 U.S.C. 7245) mandates that the Commission:

> shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule --
>
> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
>
> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

[2] President Bush signed the Act on July 30, 2002.

[3] *See* Release 33-8150 (Nov. 21, 2002), 67 FR 71669 (Dec. 2, 2002).

[4] 67 FR 71670, 71697 (Dec. 2, 2002).

[5] *See* Comments of the Association of the Bar of the City of New York, at 28 ("There is nothing in Section 307 to suggest that Congress authorized the Commission to preempt state law and rules governing attorney conduct."); *see also* Comments of the American Bar Association, at 32; Comments of 77 law firms, at 2. While questioning the Commission's authority in this area, the American Bar Association ("ABA") nevertheless recognized that "the federal system of the United States may provide an arguable basis for the pre-emption of attorney-client and confidentiality obligations applicable to United States attorneys." *See* Comments of the American Bar Association, at 37.

[6] *See* Comments of Susan P. Koniak *et al.*, at 28-29.

[7] *See, e.g.*, Comments of Susan P. Koniak *et al.*, at 32; Comments of Richard W. Painter, at 8; Comments of Nancy J. Moore, at 3.

The Auditor's Need For The Client's Detailed Information vs. The Client's Need to Preserve the Attorney-Client Privilege and Work Product Protection:

The Debate, The Problems and Proposed Solutions

Presented by
David M. Brodsky
Pamela S. Palmer
Robert J. Malionek
Latham & Watkins LLP

©2004

TABLE OF CONTENTS

I. INTRODUCTION 1

II. THE PUBLIC INTEREST IN PRESERVING AND STRENGTHENING THE PUBLIC COMPANY AUDIT FUNCTION 3

III. THE PUBLIC INTEREST IN PRESERVING THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT PROTECTION 11

A. HISTORICAL SIGNIFICANCE OF THE ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT DOCTRINE 11

B. THE RISK OF EROSION OF THE ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT DOCTRINE 14

IV. THE WAIVER PROBLEM 17

A. CASE LAW REGARDING WAIVERS BASED UPON DISCLOSURE TO AUDITORS 17

1. Waivers of Attorney-Client Privilege 18
2. Waivers of Work Product Protection 19
3. Summary of Waiver Case Law: Lack of Uniformity, Growing Uncertainty 23

B. CLOSING THE FLOODGATES: CURRENT LEGISLATION DESIGNED TO MITIGATE SIMILAR WAIVERS OF PRIVILEGES 25

1. H.R. 2179 25
2. Section 105 of The Sarbanes-Oxley Act 26

V. CONCLUSION 28

I. INTRODUCTION

This paper addresses an emerging problem of vital public interest identified by a broad consortium of public companies:[1] that is, whether recent developments in the independent audit process are undermining the ability of public companies to have privileged communications with counsel and to secure the effective and confidential assistance of counsel in handling disputes. This issue arises out of changes in law and policy that have strengthened the role of independent auditors in detecting corporate wrongdoing and have increased expectations that companies, for their part, will strengthen internal controls for dealing with alleged wrongdoing and will provide their auditors with detailed information on a myriad of legal compliance issues that may affect financial reporting. Companies necessarily depend on legal counsel to give advice and handle inquiries relevant to legal compliance, from conducting comprehensive investigations of alleged fraud to advising about employment problems, answering questions about whistleblower letters, advising directors about their duties in connection with major corporate transactions or establishing the bases for tax positions. A problem surfaces, however, when auditors request access to records reflecting counsel's efforts and advice. In providing auditors with access to privileged information, companies risk waiving the privileges and being forced to turn the information over to litigation adversaries.

This situation poses a serious threat to the public interest in preserving the attorney-client privilege and work product protections, which companies have long expected will be maintained by the courts: If the privileges are lost, or even if there is a potential that counsel's work and advice may be exposed to adversaries, then companies may be deterred from seeking the advice of counsel regarding compliance with the law, or deterred from conducting thorough internal investigations of potentially illegal conduct, as necessary to take remedial action. That good corporate governance and full cooperation in the audit process would lead to this result is incongruous and inimical to the public interest. It is also, we believe, unnecessary, and we propose several solutions to this growing problem at the conclusion of this paper.

This paper proceeds from the propositions that auditors must be provided with as much information as is necessary to perform their important public functions in assuring the accuracy of financial reporting, and that, at the same time, it is in the public interest to protect the ability of companies to maintain the confidentiality of attorney-client communications and work product. Thus, this paper discusses these two vital public interests – the public company audit function on the one hand, and the attorney-client privilege and work product protection on the other hand – as well as their intersection.

---

[1] These companies participate, through their General Counsels, in the General Counsel Working Group, convened by The Association of the Bar of the City of New York. The Working Group is an informal group of approximately fifteen General Counsels of major public companies in the Metropolitan New York area. Led by Michael Fricklas, General Counsel of Viacom, the Working Group meets periodically to discuss issues of importance to General Counsels and the companies they advise. It was in the course of such a meeting that the present issue was identified. As a result of that discussion, Latham & Watkins was asked to prepare a White Paper on the issues. The authors of this White Paper – David M. Brodsky, a litigation partner in the New York office of Latham & Watkins, Pamela S. Palmer, a litigation partner in the Los Angeles office, and Robert J. Malionek, a senior litigation associate in the New York office – are members of the firm's Securities and Professional Liability Practice Group.

In summary, while auditors historically have planned and performed their audits to obtain reasonable assurance that a company's financial statements are not materially misstated due to error or corporate fraud – and auditors continue to do so – recent developments in federal law and policy have strongly encouraged auditors to intensify their vigilance. The corporate scandals of 2001 and 2002 sparked a firestorm of legislative action by Congress, rule-making and enforcement initiatives by the Securities and Exchange Commission ("SEC"), standard-setting by the Public Company Accounting Oversight Board ("PCAOB") and initiatives by other oversight bodies, all of which have heightened the scrutiny over auditors' procedures to verify company positions and representations. This has, in turn, impacted generally accepted auditing standards ("GAAS") and how auditors apply GAAS.[2]

These same developments in law and policy have led companies to step up their own efforts to establish and strengthen internal controls and procedures in order to detect and respond more effectively to allegations of inappropriate conduct and wrongdoing, including fraud. Companies retain counsel to redesign procedures, to advise of appropriate roles for officers and directors in corporate management and governance and, on occasion, to conduct investigations. Attorneys, in turn, generate work product and provide advice and results to corporate clients – in seeming confidence. To the extent that auditors, in performing their planned procedures, obtain access to this privileged information, however, companies increasingly lose any expectation that the information will remain confidential. Instead, companies must *expect* that otherwise privileged information will find its way into the hands of litigation adversaries – merely because companies have consulted with their attorneys, then cooperated with their independent auditors.

It has long been established that the ability of companies to obtain the advice and involvement of legal counsel in confidence is essential to the public interest in promoting corporate legal compliance and enabling companies to protect legitimate corporate interests. Whenever the privileges are debated, it is well-recognized that the kinds of advertent, inadvertent and sometimes virtually compelled privilege waivers that companies now are facing deny companies the effective assistance of counsel. This loss of privileges thereby undermines the public interest and presents a significant social detriment. Indeed, the thesis of this paper is that the recent and continuing shift in policy and regulations surrounding corporate America has thrown important public policies out of balance. While the public policy to detect and deter corporate fraud is being strengthened, the public policy to protect the confidentiality of attorney-client communications and work product is being weakened. This imbalance is at the heart of the emerging waiver problem.

The waiver problem is very real. Judicial development of the law governing waiver of privileges is, at best, mixed, affording no assurance to companies that privileged information disclosed to auditors will remain protected from adversaries. The solution is not that auditors should back off from obtaining clarification or substantiation of facts from their corporate clients. Rather, the solution – which has already been recognized in similar contexts

[2] SEC Enforcement Director Stephen M. Cutler recently referred to auditors as one of the three principal "gatekeepers" in our capital markets, or "sentries of the marketplace." *See* Stephen M. Cutler, Director of the Division of Enforcement at the SEC, Remarks at the UCLA School of Law, Los Angeles, CA (September 20, 2004), "The Themes of Sarbanes-Oxley as reflected in the Commission's Enforcement Program" (transcript available at http://www.sec.gov/news/speech/spch092004smc.htm**)**.

by the SEC and the PCAOB – is legislative protection of the privileges. Legislation is needed to strike the right balance in public policy by recognizing that it is just as important for companies to furnish all information to their auditors necessary for them to fulfill their role as "gatekeepers" as it is for companies to protect their privileged communications with counsel and litigation work product from disclosure to their adversaries.

II. THE PUBLIC INTEREST IN PRESERVING AND STRENGTHENING THE PUBLIC COMPANY AUDIT FUNCTION

Generally acceptable auditing standards have long recognized that auditors have particular responsibilities with respect to the discovery of corporate fraud during an audit. Statement of Auditing Standards ("SAS") 1, *Codification of Auditing Standards and Procedures*, in fact, provides that the auditor has a responsibility to plan and to perform financial statement audits in order to obtain "reasonable assurance" that the financial statements are free of material misstatement, whether caused by error or fraud.[3] In recent years, things have changed. In particular, the financial reporting scandals that have washed over the capital markets since 2001, leading to the Sarbanes-Oxley Act of 2002 and other laws and regulations, have placed new emphasis on assuring accurate financial reporting. Further, in today's political and regulatory environment, audit firms and individual auditors are exposed to vastly greater risk of draconian liability and professional sanctions for shortcomings in the performance of audits and reviews.

In October 2002, the American Institution of Certified Public Accountants ("AICPA") approved a new auditing standard designed to strengthen the role of the audit function in detecting fraud – SAS 99, *Consideration of Fraud in a Financial Statement Audit*.[4] This new standard heightened previous GAAS standards governing what auditors are expected to do to fulfill their responsibility with respect to the detection of fraud. SAS 99, consistent with its predecessor standard in GAAS, recognizes that "it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud." The auditor's "interest," however, is described as obtaining evidential matter regarding intentional acts that "result in a material misstatement of the financial statements." Thus, the auditor is required to exercise professional skepticism when planning and performing the audit, to consider whether the presence of certain "risk factors" – *i.e.*, red flags – indicate the possible presence of fraud and, if risks of fraudulent, material misstatement are identified, consider the impact of this finding on the audit report and whether reportable conditions relating to the company's internal controls

[3] *See* AICPA Professional Standards, AU § 110.02, *Responsibilities and Functions of the Independent Auditor*.

[4] SAS 99, adopted in October 2002 and codified at AU § 316, superceded SAS 82, which was adopted in 1997 and carried the same title. SAS 82 provided that "[t]he auditor has a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." AICPA, Auditing Standards Board, Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit* (codified in AU § 316). This standard, however, expressly disavowed any *per se* obligation on auditors to uncover all instances of corporate fraud; indeed, SAS 82 recognized that a properly performed and executed audit may fail to detect fraud. As it explained: "An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud." AU § 316.10.

exist and should be communicated to the company or its audit committee.[5] An auditor's obligations to gather evidential matter to satisfy itself regarding the presence of fraud includes making inquiries "about the existence or suspicion of fraud" to any appropriate personnel within the company, and SAS 99 suggests that the auditor "may wish to direct these inquiries" to the company's in-house legal counsel.[6]

Other recent developments have focused heightened attention on the function of the auditor in the discovery of public company fraud as well, and in the process have further urged auditors to seek greater disclosure of privileged communications and work product from clients. In 2004, the PCAOB, acting as the new standard-setter for public company audits, issued standards on audit documentation and on audits of internal controls over financial reporting, both of which encourage more rigorous audit inquiries into areas involving legal compliance and advice of counsel.[7] These developments in GAAS, spurred by the current political climate and legislative and regulatory developments, have generated a widely-held expectation that auditors are to apply more stringent efforts to uncover corporate fraud. But whatever the precise impetus, many public companies cite a sharp, recent increase in requests from independent auditors, not simply for relevant factual information to back up management's representations, but also for *privileged* information in order to perform financial statement audits and reviews.

Given the current regulatory climate and trends, the reported increase in such requests is not particularly surprising. Recent comments by the SEC's Deputy Chief Accountant, Scott Taub, pointedly suggest that auditors should seek out privileged information in auditing reserves or accruals for litigation losses and tax contingencies under FAS 5. Mr. Taub remarked as follows:

> The difficulty in auditing [loss contingency accruals under FAS 5], however, should cause the auditor to spend more time on them, not less. *If a company's outside counsel is unwilling or unable to provide its expert views, the auditor should consider whether sufficient alternate procedures can actually be performed to allow the audit to be completed*.[8]

5 SAS 99, ¶¶ 5, 12, 31, 80.

6 *Id.* at ¶¶ 24-25. Other guidance found in GAAS suggests that an auditor may wish to obtain evidential matter through company counsel. For example, pursuant to an auditor's obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS states that the "opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention . . . can be useful to the auditor in forming his own opinion." *See* AU § 9326.17 (warning further, however, that "it is not appropriate for the auditor to rely solely on such legal opinion" in conducting the audit regarding these issues).

7 Auditing Standard No. 2: An Audit of Internal Control over Financial Reporting Conducted In Conjunction with an Audit of Financial Statements (PCAOB, June 2004); Auditing Standard No. 3: Audit Documentation (PCAOB, August 2004).

8 SEC Deputy Chief Accountant Scott A. Taub, Remarks at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004) (emphasis added) (transcript available at http://www.sec.gov/news/speech/spch052704sat.htm).

As Mr. Taub suggested, "[a]udit documentation" in this area should "follow the same high standards that apply to other areas of the audit" and warned "*that the PCAOB inspection teams will be looking at the audit work done in these sensitive areas*."[9]

The PCAOB, in fact, has been given a public mandate to inspect, investigate and discipline auditors conducting public company audits.[10] Although the PCAOB has only a short track record on inspections and enforcement, it has signaled an intention to be tough-minded in enforcing this mandate. In an August 2, 2004 interview, PCAOB Chairman, William McDonough, stated his view on whether it is the auditor's *obligation* to detect client fraud.[11] He said:

> We have a very clear view that it *is* their job [to detect fraud]. If we see fraud that wasn't detected and should have been, we will be very big on the tough and not so [big] on the love. … [A]uditors [need to] understand that, with relatively few exceptions, they should find it. To me, the relatively few exceptions are those cases where you would have some extremely dedicated, capable crooks. In most cases, though, the crooks either are not that smart or they don't cover their tracks that well.[12]

Under the Sarbanes-Oxley Act and the PCAOB's implementing regulations, *any* violation of laws, rules or policies by individual auditors or firms detected during inspections by the PCAOB of selected audit and review engagements will be identified in a written report and may be handed over to the SEC or other regulatory authorities and become the subject of further investigation and disciplinary proceedings.[13] The PCAOB has stated that its inspections will assess compliance at all levels – *i.e.*, actions, omissions, policies and behavior patterns "from the

9 *See id*. (emphasis added).

10 The Sarbanes-Oxley Act, Sections 101-105, 15 U.S.C. §§ 7211-15.

11 GAAS expressly recognizes that a properly performed and executed audit may fail to detect fraud. SAS 99, *Consideration of Fraud in a Financial Statement Audit*, explains how fraud is less likely to be detected when it involves concealment and collusion: "[A]bsolute assurance [that financial statements are free of material misstatement caused by fraud] is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud. A material misstatement may not be detected because of the nature of audit evidence or because the characteristics of fraud as discussed above may cause the auditor to rely unknowingly on audit evidence that appears to be valid, but is, in fact, false and fraudulent." AU § 316.12.

12 *The Enforcer*, CFO.com (Aug. 2, 2004) (emphasis added).

13 When the PCAOB believes that an act, practice or omission by a registered firm or individual auditor may violate the Sarbanes-Oxley Act, PCAOB rules or other professional standards or any securities law or regulation pertaining to audit reports or to the duties of accountants, the PCAOB may open an investigation. *See* PCAOB R. 5101. Such an investigation can lead to disciplinary proceedings, exposing the offending auditor or firm to penalties ranging from compulsory training and mandated quality control procedures to heavy civil fines and temporary or permanent suspension from audit practice.

senior partners to the line accountants."[14] The inspections will allow the PCAOB, in its own words, to "apply pressure to improve a firm's audit practices."[15]

On August 26, 2004, the PCAOB released its first limited inspection reports on each of the four major accounting firms.[16] The Board "cheerfully admit[ted] it is being harsh" in acknowledging that the reports appear to be "laden with criticism" and "an unflinching candour with firms about the points on which we see a need for improvement."[17] Among its limited inspection reports, the PCAOB criticized two firms for audits that lacked adequate audit evidence, including the analysis of counsel regarding contingent liabilities under FAS 5.[18]

The public interest focus on the public company audit function has been mirrored in the SEC's recent initiatives to enforce federal securities laws as well. In January 2002, then-SEC Chairman Harvey Pitt, discussing what he called the "Enron situation," directed strong rhetoric towards auditors:

> [T]here is a need for reform of the regulation of our accounting profession. We cannot afford a system, like the present one, that facilitates failure rather than success. Accounting firms have important public responsibilities. We have had too many financial and accounting failures. ... [T]he potential loss of confidence in our accounting firms and the audit process is a burden our capital markets cannot and should not bear.[19]

This proved to be more than rhetoric. The Sarbanes-Oxley Act, enacted later that year, directed the SEC to study enforcement actions over the prior five years to identify areas of financial reporting most susceptible to fraud.[20] The SEC's review, presented in a January 2003 report to Congress (the "704 Report"), showed that of 515 enforcement actions in total, 18

14 Steven Berger, *PCAOB—Beyond The First Year*, 2004 WL 69983842, Monday Business Briefing (July 15, 2004).

15 Public Company Accounting Oversight Board 2003 Annual Report, p. 4, *available at* http://www.pcaobus.org/documents/PCAOB_2003_AR.pdf.

16 Each of the four 2003 Limited Inspection Reports issued by the PCAOB are available at http://www.pcaobus.org/Inspections.

17 *Watchdog Promises "Unflinching Candour*," The Financial Times, 2004 WL 90109536 (Aug. 27, 2004). In the inspection reports, all of the firms came in for criticism with respect to the adequacy of audit documentation. The PCAOB also criticized the firms for having insufficient audit support for corporate tax reserves and valuation allowances in specific audits. *See* PCAOB, Report on 2003 Limited Inspection of Ernst & Young LLP (Aug. 26, 2004) at 23-24, n.5, *available at* http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Ernst_Young.pdf; PCAOB, Report on 2003 Limited Inspection of KPMG LLP (Aug. 26, 2004) at 19, n.4, *available at* http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/KPMG.pdf.

18 PCAOB, Report on 2003 Limited Inspection of Deloitte & Touche LLP (Aug. 26, 2004) at 19-20, *available at* Hhttp://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Deloitte_Touche.pdfH; KPMG Report, *supra*, at 23, n.4.

19 SEC Chairman Harvey L. Pitt, Public Statement by SEC Chairman: Regulation of the Accounting Profession (Jan. 17, 2002) (transcript available at http://www.sec.gov/news/speech/spch535.htm.)

20 The Sarbanes-Oxley Act, Section 704, 107 P.L. 204, Title VII, Section 704, 116 Stat. 745.

actions were filed against audit firms and 89 against individual auditors.[21] In the vast majority of these actions, auditors were sanctioned, in the SEC's words, for "failing to gain sufficient evidence to support the issuer's accounting, failing to exercise the appropriate level of skepticism in responding to red flags, and failing to maintain independence."[22] The 704 Report concludes that "audit failures most often arise from auditors accepting management representations without verification, truncating analytical and substantive procedures, and failing to gain sufficient evidence to support the numbers in the financial statements."[23]

Administrative and enforcement actions filed in 2003 and 2004 reflect even greater scrutiny of the work of auditors who failed to catch fraud by their clients.[24] Recent

21 SEC, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), available at http://www.sec.gov/news/studies/sox704report.pdf.

22 *Id*. at 3.

23 *Id*. at 40.

24 For example, in Matter of Barbara Horvath, CPA, Admin. Proc. File No. 3-10665, Accounting and Auditing Enforcement Release No. 1483 (Dec. 27, 2001), the SEC censured a Deloitte & Touche auditor for placing reliance on management representations as her principal source of audit evidence for the company's capitalization of expenses which, it turned out, were fraudulent. The SEC contended that she should have demanded more supporting documentation and followed up on "red flags." The SEC imposed a two-year suspension from practice upon another auditor (involved in the same audit) for sampling too few items when auditing the company's contract acquisition costs. *See In the Matter of Jeffrey Bacsik, CPA*, Admin. Proc. File No. 3-10664, Accounting and Auditing Enforcement Release No. 1482 (Dec. 27, 2001). The SEC's enforcement record includes numerous similar cases. *See*, *e.g.*, *In the Matter of PricewaterhouseCoopers LLP*, Admin. Proc. File No. 3-11483, Accounting and Auditing Enforcement Release No. 2008 (May 11, 2004) (corporate fraud) (action against PwC in connection with audit of the Warnaco Group's financial statements from 1998 and alleged failure to correctly characterize the cause of an inventory overstatement as resulting from internal control deficiencies as opposed to changed accounting rules, as misrepresented by Warnaco in a press release); *In the Matter of Grant Thornton LLP, et al.*, Admin. Proc. File No. 3-11377, Accounting and Auditing Enforcement Release No. 1945 (Jan. 20, 2004) (corporate fraud) (administrative proceeding against Grant Thornton for aiding and abetting fraud and violating Section 10A, by allegedly failing to obtain sufficient audit evidence despite "red flags" that client failed to disclose material related party transactions); *In the Matter of Carroll A. Wallace, CPA*, Admin. Proc. File No. 3-9862, Accounting and Auditing Enforcement Release No. 1846 (Aug. 20, 2003) (probable corporate fraud) (KPMG auditor suspended for one year for undue reliance on management representations, failure to maintain an appropriate attitude of skepticism, failure to obtain sufficient evidential material to discover that the client investment fund's financial statements improperly stated that all of its shares were unrestricted); *In the Matter of Richard P. Scalzo, CPA*, Admin. Proc. File No. 3-11212, Accounting and Auditing Enforcement Release No. 1839 (Aug. 13, 2003) (corporate fraud) (auditor permanently barred from public practice based on audits of Tyco between 1997 and 2001 in which he became aware of facts that put him on notice regarding the integrity of Tyco's management but failed to perform additional audit procedures or reevaluate his risk assessment); *In the Matter of Warren Martin, CPA*, Admin. Proc. File No. 3-11211, Accounting and Auditing Enforcement Release No. 1835 (Aug. 8, 2003) (auditor suspended from public practice for two years for undue reliance upon management representations regarding the interpretation of contracts, thereby ignoring "unambiguous contractual language" that affected revenue recognition and led to a $66 million restatement); *In the Matter of Michael J. Marrie, CPA and Brian L. Berry, CPA*, Admin. Proc. File No. 3-9966, Accounting and Auditing Enforcement Release No. 1823 (July 29, 2003) (corporate fraud) (suspending two auditors from public practice for failing to act with sufficient skepticism and obtain enough audit evidence with respect to confirmation of accounts receivable, sales returns and allowances, and a $12 million write-off); *In the Matter of Phillip G. Hirsch, CPA*, Admin. Proc. File No. 3-11133, Accounting and Auditing Enforcement Release No. 1788 (May 22, 2003) (corporate fraud) (suspending PwC auditor for one year in settlement of

public statements by the Director of the Division of Enforcement, Stephen Cutler, called attention to the role of auditors, among others, being "the sentries of the marketplace."[25] The Director also described the hope of the Enforcement Division that "accounting firms will take an even greater role in ensuring that individual auditors are properly discharging their special and critical gate-keeping role."[26] All of these factors reflect the expectation that scrutiny on auditors will continue to increase as expectations for their increased role in monitoring and finding inappropriate corporate accounting behavior continue to grow.

The recent wave of scrutiny on auditors' detection of fraud has also extended to the companies themselves. Companies have always been obliged, of course, to cooperate fully with their independent auditors. Recent legislation and regulatory developments have focused additional pressure on companies to do so – again, in the interest of strengthening the functionality of audits. Underscoring the company's obligation to cooperate fully with its auditors, the SEC promulgated Regulation 13b2-2, "Representations and conduct in connection with the preparation of required reports and documents," effective June 27, 2003.[27] The Regulation prohibits officers and directors of public companies from making a "materially false or misleading statement [or a material omission] to an accountant in connection with" an audit or other filing with the SEC. It further provides that officers and directors may not "directly or indirectly take any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements."[28] Not surprisingly, auditors increasingly are asking companies to provide access to privileged information and attorney work product under various circumstances. For example, auditors are requiring clients to provide detailed information or open their files regarding whistleblower allegations, investigations and outcomes. These requests are often driven by Section 10A of the Exchange Act.[29] Section 10A, which was added by the Private Securities Litigation Reform Act of 1995 ("Reform Act"), requires auditors to plan "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."[30]

allegations that he did not ensure that sufficient audit procedures were conducted in light of PwC's risk of fraud assessment and that he placed undue reliance on management representations despite awareness of evidence "from which he should have realized further audit work was required."); *SEC v. KPMG,* Civil Action No. 02-cv-0671 (S.D.N.Y. January 29, 2003), Accounting and Auditing Enforcement Release No. 1709 (possible corporate fraud) (civil injunction against KPMG seeking disgorgement of fees and civil penalties in connection with the firm's audit of Xerox based on allegation that auditors had evidence of manipulation of financial results and failed to ask Xerox to justify departures from GAAP).

[25] SEC Enforcement Director, Stephen Cutler, Remarks at the UCLA School of Law, Los Angeles, CA (September 20, 2004), "The themes of Sarbanes-Oxley as reflected in the Commission's Enforcement Program" (*available at* http://www.sec.gov/news/speech/spch092004smc.htm).

[26] *Id.*

[27] 17 C.F.R. § 240.13b2-2.

[28] *Id.* at § 240.13b2-2(a) & (b).

[29] 15 U.S.C. § 78j-1. Section 10A was modeled after SAS 53, the predecessor to SAS 82.

[30] 15 U.S.C. § 78j-1. Section 10A is modeled after a predecessor of SAS 99, which provides that "[t]he auditor has a responsibility to obtain reasonable assurances about whether the financial statements are free of material misstatements, whether caused by error or fraud." SAS 99: Consideration of Fraud in a Financial Statement Audit (codified in AICPA Professional Standards, AU § 316). Section 10A imposes

Modeled on SAS 82, the predecessor of SAS 99, Section 10A requires auditors to report evidence of fraud up the corporate ladder to management and to the audit committee under certain circumstances, but Section 10A added a requirement that the auditor report not only up, but *out* to the SEC if – after investigation of evidence of an illegal act uncovered during an audit – the auditor determines that (1) the audit committee or board is adequately informed of the illegal act, (2) the illegal act has a material effect on the financial statements, (3) the illegal act has not been appropriately remediated and (4) as a result, the auditor will be required to issue a qualified audit opinion or resign.[31] Because auditors face potential civil liabilities imposed by the SEC under Section 10A for mere negligence – there is no scienter requirement for proceedings brought under Section 10A – this provision has grown, through the scandals of 2001, as a regulatory tool for increasing scrutiny of the performance of audits.

Because of their obligations under Section 10A, auditors require public company clients to provide information about potential illegal acts and remediation efforts. Under the Section 10A structure, if an auditor becomes aware of information "indicating that an illegal act (whether or not perceived to have material effect on the financial statements of the issuer) has or may have occurred," the auditor must take certain steps to inform itself, advise the audit committee and ultimately satisfy itself that the company has taken appropriate remedial action. When alerted to allegations of potential illegal conduct, companies and/or their audit committees typically launch internal investigations, led by legal counsel and resulting in an accumulation of attorney-client communications, witness interviews, advice of counsel and other legal work product and analyses. Auditors in turn, frequently press for access to these privileged attorney-client communications and work product.

Similarly, auditors are seeking attorney work product and the disclosure of attorney-client communications arising from internal investigations triggered by the SEC's August 2003 regulations implementing Section 307 of the Sarbanes-Oxley Act. In Section 307, Congress directed the SEC to set forth "minimum standards of professional conduct for attorneys appearing and practicing before the Commission." The SEC's regulations require attorneys to report "evidence of a material violation of securities law, or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or chief executive officer of the company."[32] Corporate counsel is required – much like auditors under Section 10A – to report evidence of misconduct up the corporate ladder and to satisfy itself that the company has taken appropriate remedial action. The Section 307 structure has therefore spawned internal investigations that generate attorney-client privileged communications and attorney work product. Increasingly, auditors are requiring public company clients to disclose this internal investigation information, including whether counsel has advised the company of evidence of any material violations of the law in the first place.

Moreover, internal investigations of potential misconduct frequently are undertaken by companies and their legal counsel as a matter of good corporate governance, irrespective of Sections 10A or 307. Indeed, companies' efforts to establish controls to detect

essentially the same auditing obligations, but adds a potential "reporting out" requirement to the SEC and explicitly exposes auditors to SEC sanctions for non-compliance.

[31] 15 U.S.C. § 78j-1.

[32] 17 C.F.R. Part 205.

and respond to allegations of fraud – through involvement of their audit committees – has grown considerably under the Sarbanes-Oxley Act. Pursuant to Section 301, audit committees are charged with establishing procedures for receiving and handling complaints "regarding accounting, internal controls or auditing matters" and confidential submissions by corporate employees "regarding questionable accounting or auditing matters."[33] In implementing these responsibilities, many public companies and their audit committees have gone beyond the minimum requirements of the law and established procedures for receiving and investigating all whistleblower complaints, on any subject relevant to the company, from any source. Internal investigations conducted pursuant to these procedures typically generate attorney-client privileged communications and attorney work product. On some occasions, auditors have required their corporate clients to share all information and work product, even confidential attorney communications and work product, regarding internal investigations of possible unlawful conduct within each company.

Auditors also may require public company clients to disclose legal advice and analyses concerning specific issues that could impact the financial statements. As part of an audit of the company's financial statement assertions regarding tax assets, liabilities and contingencies, auditors frequently require companies to disclose privileged legal advice, analyses and judgments, including the potential tax consequences of transactions.[34] As part of an audit inquiry into loss contingencies for litigation, claims and assessments,, auditors may ask that corporate legal counsel disclose their judgments and supporting information regarding potential outcomes, range of loss and other issues.

In light of the comments of Messrs. Taub, Cutler and McDonough, and others, and the criticisms levied in the PCAOB's limited inspection reports, noted above, auditors may conclude that it would be imprudent in this climate *not* to demand access to privileged information of the sort described above.

By both design and effect, these regulatory developments – Section 10A, SEC enforcement and PCAOB inspections and rule-making – have created a framework of enhanced government oversight of audits and auditors. These developments reflect government focus on the strong public interest in preserving and strengthening the audit function. These

[33] The Sarbanes-Oxley Act of 2002, Section 301, 15 U.S.C. § 78j-1.

[34] FAS 5, governing audits of loss contingencies for litigation, claims and assessments, specifically recognizes that the "opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention … can be useful to the auditor in forming his own opinion." *See* AU §9326.17. The same standard warns further, however, that "it is not appropriate for the auditor to rely solely on such legal opinion" in conducting the audit regarding these issues. *Id*.

It should be noted that because tax advice frequently is rendered by non-lawyer tax professionals, the Internal Revenue Code establishes a confidentiality privilege equivalent to the attorney-client privilege for taxpayer communications by non-lawyers in the context of certain non-criminal tax matters. *See* 26 U.S.C. § 7525(a)(1) ("With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney"). Thus, when auditors require disclosure of these communications, this raises essentially the same waiver issue presented by disclosure to auditors of attorney work product and communications..

developments also may be driving auditors to seek more privileged and work product-protected materials than in the past.

The public interest in assuring that auditors have access to all information required to conduct proper audits, including information relevant to corporate fraud, is undeniable. This is how the audit function has, as described above, always worked and how it should continue to work. But as the public interest in fraud prevention has led to new audit standards, laws and regulations heightening the auditors' need for access to privileged information, such access should not come at the expense of other public interests that are just as important.

The waiver problem is squarely presented when companies are required to provide their independent auditors with attorney work product and privileged communications. The question is whether the public interest in preserving the attorney work product doctrine and attorney-client privilege is important enough to be protected at the same time that the public interest in the public company audit function is being strengthened . . . or whether a company's good corporate governance and cooperation with its auditors should come at the cost of waiver of these protections.

III. THE PUBLIC INTEREST IN PRESERVING THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT PROTECTION

A. HISTORICAL SIGNIFICANCE OF THE ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT DOCTRINE

The public interest in protecting the confidentiality of attorney-client communications and work product should be, like the public interest in a strong public company audit function, incontrovertible.

The attorney-client privilege is "the oldest of the privileges for confidential communications known to the common law."[35] The purpose of the privilege is to "encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[36]

The strongest criticism of the attorney-client privilege – and, indeed, of any evidentiary privilege – is that, in court or other proceedings, potentially valuable evidence may be suppressed and the "truth" harder to find. This debate has been raised countless times, and no doubt it is being raised again now as the risk of waiver by companies increases in proportion with the volume of auditor requests for disclosure of the company's confidential information. But in our society, the debate has been settled consistently; as one court has described: "The social good derived from the proper performance of the functions of lawyers acting for their clients is believed to outweigh the harm that may come from the suppression of the evidence in

[35] *Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981).

[36] *Id.*

specific cases."[37] As the Supreme Court has held, this social good extends to corporations as well as to individuals.[38]

Protecting the confidentiality of work product likewise furthers vital public interests. "[T]he work product privilege [exists] … to promote the adversary system by safeguarding the fruits of an attorney's trial preparations from the discovery attempts of the opponent."[39] Work product protection encourages parties and their counsel to prepare for litigation and trial without concern that their work will be discoverable by the opposition. Work product protection supports a fair adversary system by "by affording an attorney 'a certain degree of privacy' so as to discourage 'unfairness' and 'sharp practices.'"[40] As one Supreme Court Justice wrote in a concurring opinion to the seminal decision supporting the doctrine, "[d]iscovery was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from the adversary."[41] The work-product doctrine is simply a recognition that a lawyer's work on behalf of a client preparing a response to litigation or a potential claim – even when not subject to the attorney-client privilege – must also be protected, lest all lawyers be discouraged from conducting those preparations effectively, the clients be punished and their adversaries be unfairly rewarded. Those who fear that the work product generated by their counsel in determining an appropriate response will be disclosed to their adversaries and promptly used against them may, not surprisingly, be reluctant to seek legal assistance at all.

Protection of attorney work product is codified in Federal Rule of Civil Procedure 26(b)(3), which extends protection to the work of a party's representatives, "including an attorney, consultant, surety, indemnitor, insurer, or agent" in anticipation of litigation or for trial. Work product is not discoverable by an opposing party absent a showing of "substantial need for the materials in the preparation of the party's case and [inability] without undue hardship to obtain the substantial equivalent of the materials by other means." But even when an opposing party makes this showing, courts must protect against disclosure of the "mental impressions, conclusions, opinions or legal theories of an attorney or other representative of a party."[42]

As Rule 26(b)(3) codifies, disclosure of the diligent work performed by an attorney to his client's litigation opponent would undermine the adversarial underpinnings of our legal system itself. It is because of this underlying rationale that work product protection may not be waived – unlike the attorney-client privilege – by mere disclosure to a third party, "but

---

37 *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357, 358 (D. Mass. 1950). *See Trammel v. United States*, 445 U.S. 40, 50 (1980) (the privilege "promotes a public goal transcending the normally predominant principle of utilizing all rational means for ascertaining the truth.").

38 *Upjohn*, 449 U.S. at 389-90.

39 *In re Raytheon Securities Litig.*, 218 F.R.D. 354, 359 (D. Mass. 2003) (quoting *United States v. Amer. Tel & Tel. Co.*, 642 F.3d 1286, 1299 (D.C. Cir. 1980)).

40 Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), at 6, quoting *Hickman v. Taylor*, 329 U.S. 495, 510-11 (1946).

41 *Hickman v. Taylor*, 329 U.S. 495, 516 (1946) (Jackson, J., concurring).

42 Fed. R. Civ. P. 26(b)(3).

rather only if a disclosure runs counter to the principles embodied by the adversary system."[43] The policy goal of the doctrine, grounded in fairness, is to protect work product from adversaries. Thus, it is *only when it would not be unfair* for an adversary to obtain that work product – *i.e.*, when the adversary meets its burden to show that it "has substantial need of the materials in the preparation of the party's case and is unable without undue hardship to obtain the substantial equivalent of the materials by other means"[44] – that the policy to protect work product will not apply.

Companies expect that the work product of their counsel prepared as a result of an internal investigation will be protected, and legitimately so. Increasingly, companies and, on occasion when the circumstances call for it, their audit committees or other independent committees, use counsel to investigate evidence of alleged corporate or employee wrongdoing by interviewing company employees, identifying relevant documents, analyzing the facts and law and formulating conclusions and recommendations. Internal investigations, conducted by and at the direction of legal counsel, are a critical tool by which companies and their boards assess potential violations of law, breaches of duty and other misconduct that may expose the company to liability and damages. Internal investigations are an essential predicate to enabling companies to take remedial action and to formulate defenses, where appropriate. Companies are, therefore, entitled to and afforded work product protection from adversaries, so long as the investigations are not merely being conducted in the ordinary course of business. As one commentator has noted: "The general rationale for finding work product protection is that litigation is virtually assured if the investigation confirms the allegations. Since the corporation would be required to report the results to shareholders and government agencies, the possibility of a suit following is considered inevitable."[45]

Work product protection does not mean that, where internal investigations involving legal counsel are conducted, all facts related to the issue under investigation are inherently protected against disclosure to auditors or third parties. The *facts*, including underlying documents, regarding an issue are properly discoverable, and routinely produced, in litigation. By contrast, what is protected from disclosure is the work performed, materials generated and considerations of the lawyers in connection with the investigation and any recommendations to the company – this is the heart of what is protected by the work product doctrine, due to the inherent unfairness of giving an adversary access to counsel's analysis of the facts, law, strengths and weaknesses of the company's position. The distinction is an important one that is well-accepted in the law.[46]

---

43 *Philippines v. Westinghouse Elec. Corp.*, 132 F.R.D. 384, 389 (D.N.J. 1990).

44 Fed. R. Civ. P. 26(b)(3).

45 John William Gergacz, *Attorney-Corporate Client Privilege* § 7.37 (West 2000), at 7-53 (reporting that "[m]ost of the cases hold that intracorporate investigations of possible corporate illegal activity are performed with sufficient anticipation of litigation to give rise to work product protection"). The author also reports that it is not only the inevitability of litigation, but also "the importance of not discouraging corporate self-investigation, [which] provides the underlying basis for the finding of work product protection." *Id.* at 7-54.

46 *See Sporck v. Peil*, 759 F.2d 312, 315 (3rd Cir. 1985) (lawyer's choice of documents with which to prepare deponent is work product even if the underlying documents themselves are not, "[b]ecause identification of

B. **THE RISK OF EROSION OF THE ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT DOCTRINE**

A legal system that fails to assure public companies the benefits of the attorney-client privilege and work product protection denies those companies the effective assistance of counsel when potentially illegal corporate behavior is discovered.[47] As the Supreme Court has stated, impairment of these privileges and protections would "not only make it difficult for corporate attorneys to formulate sound advice when their client is faced with a specific legal problem but also threaten to limit the valuable efforts of corporate counsel to ensure their client's compliance with the law."[48] Further, absent assurance that attorney-client communications and work product can be protected as confidential, companies that seek the assistance of legal counsel would only do so in the face of an unacceptable risk that counsel will be converted "into a conduit of information between the client" and its adversaries.[49]

These concepts supporting the protection of attorney work product and privileged communications are not incompatible with the function of auditors and their ability to obtain the information that they need to conduct proper audits. In 1975, the audit and legal professions debated the issue and reached an accord – or "Treaty," as it is sometimes called – regarding the waiver problem arising when auditors ask their clients for privileged information and the opinions of company counsel regarding loss contingencies for litigation, claims and assessments.[50] This "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," as adopted by the ABA and consented to by the AICPA, struck a balance between two very important public interests: first, to promote confidence in the capital markets by assuring reliable financial reporting of loss contingency accruals and disclosures under FAS 5, and second, to encourage companies to consult freely with counsel by protecting the confidentiality of lawyer-client communications. The ABA Statement of Policy struck the balance by limiting the range of acceptable disclosures that lawyers may make to auditors with the client's informed consent, and thus defined the scope of what the auditors may request from lawyers regarding confidential attorney information.[51] In 1977, the AICPA affirmed this protection and limitation regarding auditor access to privileged information and work product maintained by the client.[52]

---

documents as a group will reveal defense counsel's selection process, and thus his mental impressions…"); *see also In re Grand Jury Subpoenas Dated October 22, 1991 and November 1, 1991*, 959 F.2d 1158, 1166-67 (2d Cir. 1992) (noting that work product exception is only found when there is "real, rather than speculative concern that the thought process of [the client's] counsel… would be exposed," and allowing production of all telephone records from a specified period) (internal citations and quotations omitted); *In re Grand Jury Subpoenas Dated March 19, 2002 and August 2, 2002*, 318 F.3d 379, 386-87 (2d Cir. 2003) (finding that lower court was correct in allowing discovery of disputed materials because producing party had failed to disclose any strategy *ex parte* to the district court judge, making it impossible for judge to determine whether the responsive subset of documents reflected lawyers' selection or was simply the product of document retention policies); *Shelton v. American Motors Corp.*, 805 F.2d 1323, 1326 (8th Cir. 1987) ("We hold that where, as here, the deponent is opposing counsel and has engaged in a selective process of compiling documents from among voluminous files in preparation for litigation, the mere acknowledgment of the existence of those documents would reveal counsel's mental impressions, which are work product.").

47 For example, in disclosing information to auditors regarding the handling of whistleblower allegations, companies risk waiving privileges to the extent that the information includes attorney-client communications, witness interviews, advice of counsel, and other legal work and analyses. This type of information is at the heart of what companies reasonably expect – through long-standing and sound precedent – will be protected from actual and potential litigation adversaries.

48 *Upjohn Co. v. U.S.*, 449 U.S. 383, 392 (1981). This point was made forcefully in the recently-published *Comments of the ABA's Section of Antitrust Law On The Proposed Amendments To The Sentencing Guidelines For Organizations*, at 5-7, *available at* http://www.abanet.org/antitrust/comments/2004/sentencing guidelines0704.pdf.

49 *See United States v. Chen*, 99 F.3d 1495, 1500 (9th Cir. 1996) (the "valuable service of counseling clients and bringing them into compliance with the law cannot be performed effectively if clients are scared to tell their lawyers what they are doing, for fear that their lawyers will be turned into … informants"); Joint Drafting Committee of the American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations* (March 2002), at 11. In addition, the Antitrust Law Section's paper, cited above, makes the point if companies cannot protect privileged information from litigation adversaries, they naturally will be deterred from conducting thorough internal investigations and documenting findings, analyses and recommendations. Likewise, employees will be deterred from cooperating in investigations if they know that candor will only expose them to personal liability or make them witnesses for the company's adversaries. *See Comments of the ABA's Section of Antitrust Law*, *supra*, at 11-14.

50 American Bar Association, "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" (1975), *available at* htpp://www.abanet.org/buslaw/catalog/5070426i/secure.html.

Thoughtful texts and law review articles discuss the tensions that led to the Treaty, including incidents of auditors asking lawyers open-ended questions seeking general information about the client's potential illegal acts and liability exposures. *See* Erbstoesser and Matson, *Lawyers' Letters to Auditors,* Chpt. 8, Drafting Legal Opinion Letters, at 366, nn. 1 & 2 (2d ed. 1992); Deer, *Lawyers' Responses to Auditors' Requests for Information*, 28 Bus. Law. 947 (1973). The ABA Statement of Policy and SAS 12 ended these types of broad requests by clarifying that GAAS did not require them.

The Treaty involves three pieces of professional literature. The obligation of lawyers to limit their responses to auditor inquiries is set forth in the ABA Statement of Policy. The obligation of clients to accrue for and/or disclose loss contingencies properly is set forth in FAS 5, which is part of generally accepted accounting practices ("GAAP"). *See* Financial Accounting Standards Board, Statement of Accounting Standards No. 5: Accounting for Contingencies (March 1975). The obligation of auditors to inquire concerning litigation, claims and assessments is governed by GAAS and, specifically, SAS 12, adopted by Auditing Standards Executive Committee of the American Institute of Certified Public Accountants ("AICPA") in the wake of the ABA Statement of Policy. *See* AICPA, Auditing Standards Board, Statement on Auditing Standards No. 12: Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments (Jan. 1976) (codified in AICPA Professional Standards, AU § 337). The ABA Statement of Policy is an exhibit to SAS 12.

51 Pursuant to the ABA Statement of Policy, a lawyer may provide information to a client's auditors on matters to which the lawyer has devoted substantive attention regarding overtly threatened or pending litigation and, with the client's further specific consent, regarding unasserted possible claims or assessments or contractually-assumed obligations, and may provide specific confirmations regarding the lawyer's role for the client. Only in rare circumstances may the lawyer express to the auditors any professional judgment regarding the potential outcome of the matters. The lawyer may only provide information and evaluation of unasserted possible claims specifically identified by the client if the client has determined that it is "probable" the claims will be asserted, that there is a "reasonable possibility" that the outcome will be unfavorable and that the resulting liability will be material to the client's financial condition. ABA Statement of Policy, par. 5.

52 *See* AICPA Professional Standards, AU § 9337 (4), Documents Subject to Lawyer-Client Privilege (March 1977). The interpretive release poses the question: "[SAS 12 states:] "Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers." *Would this include a review of documents at the client's location considered by the lawyer and*

As recognized by both the auditing and legal professions through the continued viability of the Treaty today, promoting effective corporate governance and responsiveness to allegations of wrongdoing depends, in part, on protecting the attorney-client privilege and work product doctrine. The ABA Statement of Policy, in fact, begins with this recognition:

> *The public interest in protecting the confidentiality of lawyer-client communications is fundamental*. The American legal, political and economic systems depend heavily upon voluntary compliance with the law and upon ready access to a respected body of professionals able to interpret and advise on the law. The expanding complexity of our laws and governmental regulations increases the need for prompt, specific and unhampered lawyer-client communication. The benefits of such communication and early consultation underlie the strict statutory and ethical obligations of the lawyer to preserve the confidences and secrets of the client, as well as the long-recognized testimonial privilege for lawyer-client communication.[53]

Thus, while auditors require access to attorney-client information – as part of their job of performing audits – they recognize the importance of the privileges by cooperating in a "Treaty" designed to uphold the public interest in protecting these privileges in certain contexts.

The SEC is also on record promoting work product protection for the internal investigation files of public company counsel.[54] The SEC argued in *United States v. Bergonzi* that its responsibilities would be frustrated if companies were deterred from sharing their work product from internal investigations with the SEC, and because of this concern, such production "should not result in waiver of work-product protection because preserving work-product protection is in the public interest."[55] The SEC pointed out that there are "significant benefits to the public" when a company can share its work product with the SEC, thereby allowing the SEC to fulfill its oversight function, without fear by the company that its work product will end up in

the client to be subject to the lawyer-client privilege?" and answers as follows: "*No.* Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, *in recognition of the public interest in protecting the confidentiality of lawyer-client communications, [SAS 12] is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege.*" (Emphasis added)

53 ABA Statement of Policy, Preamble (emphasis added).

54 Indeed, a Practicing Law Institute conference on securities litigation and enforcement held September 1, 2004 included a panel of attorneys who practice before the SEC who commented that internal investigations conducted by a company to respond to fraud allegations "may cause more harm than good" because the SEC now regularly demands waiver of privileges, and "[t]hat information is then discoverable by plaintiffs' lawyers in civil litigation." *Conference Panelists Discuss Securities Litigation and Enforcement*, SEC Today (CCH Sept. 16, 2004), at 1. One panelist suggested that "the waivers of attorney/client privilege will have a chilling effect on the information provided by clients to their lawyers, which is what the privilege is intended to protect." *Id.* at 2.

55 *United States v. Bergonzi*, 9th Cir. Case No. 03-10024, Brief of the Securities and Exchange Commission, 2003 WL 22716310 (Apr. 29, 2003), at *3-4. The ABA Section of Antitrust Law recently echoed this same argument, stating its belief that a waiver of these protections based upon disclosure by a company of its privileged or work product materials to the government "will reduce the availability of information from an organization's management and employees, and impede the development and operation of effective compliance programs." *See Comments of the ABA's Section of Antitrust Law*, *supra*, at 2.

the hands of civil litigation adversaries: "The choice is thus between disclosure only to government agencies, which will increase the effectiveness and efficiency of governmental investigations, and no disclosure at all – not a choice between disclosure only to government agencies and disclosure to all parties."[56]

The same policies underlie public company disclosure of privileged communications and work product to independent auditors. Disclosure of such material may be part of an effective and comprehensive audit, but it would be *unfair* for companies to be forced to waive their privileges as to their adversaries – who stand ready to use this sensitive information to file civil lawsuits and obtain an immediate advantage in litigation – simply because the companies maintain effective internal controls for responding to allegations of wrongdoing and cooperate with their auditors. This is the waiver problem, and it is growing.

IV. THE WAIVER PROBLEM

While both the attorney-client protections and the public company audit function serve important public policies, it is not the case that, today, each is on equal footing with the other. In the wake of the recent, high-profile corporate scandals, the public and governmental response has been to strengthen the audit function – and appropriately so – as well as to strengthen the primary responsibility of companies to establish anti-fraud controls. This renewed focus has led to increased government scrutiny of the performance of audits and, as reported by many public companies, increased requirements by auditors for confidential information relevant to internal anti-fraud activities that go far beyond the exchange contemplated by the 1975 ABA Statement of Policy. It is becoming increasingly clear that corporations have reason to be concerned. The attorney work product and confidential communications generated through internal investigations involving counsel, recognized as privileged by long-standing law and policy, are being sacrificed to civil litigation adversaries for the mere reason that the corporation and their auditors are doing their jobs.

A. CASE LAW REGARDING WAIVERS BASED UPON DISCLOSURE TO AUDITORS

The ABA Statement of Policy expressed the drafter's expectation that judicial developments regarding disclosure of confidential information provided to auditors would not prejudice clients "engaged in or threatened with adversary proceedings," but also provided that if judicial developments were adverse, revision of the ABA Statement might be needed.[57] Indeed,

56 *United States v. Bergonzi*, SEC Brief, *supra*, at *16-17. The SEC also took the position that, "[t]he Commission cannot compel public companies to produce work product, and even cooperative companies generally will not produce work product for fear that production will waive work-product protection as to third parties." *Id.* at *22-23 (as support for this position, which the SEC stated was the "likely" result, *id.* at *30, the SEC cited to pages of the record on appeal but did not describe the information therein). This paper disclaims any suggestion that, as to its *auditors*, companies do not provide requested work product; indeed, companies have a vested interest in ensuring that their auditors obtain the information that is needed to assess whether an unqualified audit opinion may be given.

57 ABA Statement of Policy, Commentary, par. 1 ("The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between lawyers and auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary

the case law has been neither favorable nor consistent with respect to the protection of confidential information disclosed by clients to auditors.

With a few notable exceptions, the case law in this country concerning waiver of the attorney client privilege and work product based on disclosure to auditors has generally arisen in the narrow context of discovery of attorney analyses of litigation loss contingencies under the ABA Statement of Policy, made in response to auditor inquiries.

1. **Waivers of Attorney-Client Privilege**

Courts generally hold that disclosure of attorney-client communications to auditors, for purposes of providing litigation loss contingency information, waives the attorney-client privilege.[58] Courts reason that because the purpose of the privilege is to protect the confidentiality of the communications, almost any disclosure to an outsider breaches the confidence and waives the privilege. Thus, unless an accountant is helping the attorney to advise the client (a role that an auditor could rarely, if ever, undertake given independence constraints), disclosure to the outside accountant waives the privilege.[59]

The only jurisdictions in which disclosure may not result in a waiver are states that, by statute, recognize an accountant-client privilege. Only fifteen states have any such statute and, of those, only seven have expressly extended the privilege to independent auditors by statute or judicial ruling.[60] In every other jurisdiction, including all federal courts, the common law rule applies that communications between outside auditors and clients are not privileged.[61]

---

to this expectation, appropriate review and revision of the Statement of Policy may be necessary."). In 1989, following an early adverse court decision on the issue of waiver, another ABA committee sought to mitigate the risk of further waiver rulings. The committee issued a report advising lawyers to state expressly in their communications to auditors that neither the client nor the auditor intended any waiver of the attorney-client or work product privileges. *See* Subcommittee on Audit Inquiry Responses, Law and Accounting Comm., ABA Section of Business Law, Report by the American Bar Association's Subcommittee on Audit Inquiry Responses (1989), reprinted in *Lawyers' Letters to Auditors*, *supra*, at 381-84. As the committee said, such language "simply makes explicit what has always been implicit, namely … that neither the client nor the lawyer intended a waiver." The AICPA agreed with the ABA committee in a 1990 interpretation of SAS 12 advising auditors that such language in a lawyer's letter did not impose a scope limitation requiring a qualified audit opinion. *See* AICPA, Auditing Interpretation: Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments – Use of Explanatory Language about the Attorney-Client Privilege or the Attorney Work Product Privilege, J. Acct. (Feb. 1990), reprinted in *Lawyers' Letters to Auditors*, *supra*, at 384-85.

58 *See, e.g.*, *Gutter v. E.I. Dupont De Nemours and Co.*, 1998 WL 2017926, at *3 (S.D. Fla. May 18, 1998) ("[d]isclosure to outside accountants waives the attorney-client privilege"); *In re Pfizer Inc. Securities Litig.*, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) ("Disclosure of documents to an outside accountant destroys the confidentiality seal required of communications protected by the attorney-client privilege, notwithstanding that the federal securities laws require an independent audit").

59 *See Ferko Nat'l Assoc. for Stock Car Auto Racing*, 218 F.R.D. 125, 135 (E.D. Tex. 2003), citing *United States v. Kovel*, 296 F.2d 918, 921-22 (2d Cir. 1961), which extended the attorney client privilege to attorney-accountant communications for the purpose of assisting the lawyer to advise the client.

60 The fifteen states are listed below and the seven states that have clearly extended the privilege to the audit context are underlined: Arizona, ARIZ. REV. STAT. § 32-749; Colorado, COLO. REV. STAT. § 13-90-107; Florida, FLA. STAT. ANN. § 90.5055; Georgia, GA. CODE ANN. § 43-3-32; Idaho, IDAHO CODE § 9-203A AND IDAHO ST. REV., Rule 515; Illinois, 225 ILL. COMP. STAT. 450/27; Indiana, IND. CODE. § 34-46-2-18; Kansas, KS. STAT. ANN. § 1-401; Louisiana, LA. CODE EVID. ANN. art. 515; Maryland, MD. CODE ANN., CTS. & JUD. PROC. § 9-110; Michigan, MICH. COMP. LAWS § 339.732; Missouri, MO. REV. STAT. § 326.322; New Mexico, N.M. STAT. ANN. § 38-6-6; Pennsylvania, PA. STAT. ANN. tit. 63 § 9.11; and Tennessee, TENN. CODE ANN. § 62-1-116.

Other states have statutes requiring accountants and auditors to maintain the confidentiality of client materials, but not purporting to establish any evidentiary privilege from discovery. *See* Alabama, ALA. CODE § 34-1-21; California, 16 CAL. CODE REGS. tit. 16, § 54 ; Connecticut, CONN. GEN. STAT. ANN. § 20-281j; Iowa, IOWA CODE ANN. § 542.17; Kentucky, KY. REV. STAT. ANN. § 325.440; Massachusetts, MASS. GEN. LAWS ANN. ch. 112 § 87E; Minnesota, MINN. STAT. ANN. § 326A.12; Mississippi, MISS. CODE. ANN. § 73-33-16; Montana, MONT. CODE. ANN. § 37-50-402; New Jersey, N.J. STAT. ANN. § 45:2B-65; North Dakota, N.D. CENT. CODE § 43-02.2-16; Oregon, OR. REV. STAT. § 673.385; Rhode Island, R.I. GEN. LAWS § 5-3.1-23; Vermont, VT. CODE R. § 81; Washington, WASH. REV. CODE ANN. § 18.04.405.

2. **Waivers of Work Product Protection**

With respect to whether work product protection survives disclosure to auditors, courts have divided at several analytical points. Some courts never reach the question of waiver, but nonetheless refuse to compel third-party discovery on the grounds that attorney analyses of loss contingencies are neither evidence nor relevant – or, to the extent that these analyses have any probative value, that value is outweighed by unfair prejudice and public interest concerns.[62]

In another line of authority, courts have held that attorney evaluations of litigation risk and loss exposure prepared in response to an audit inquiry do not constitute work product at all because the work was prepared primarily for a business purpose (*i.e.*, auditing financial statements), rather than "in anticipation of litigation or for trial."[63] This line of authority, however, is older, has attracted no recent followers and reflects a minority view.

---

61 *See Couch v. United States*, 409 U.S. 322, 335 (1973) ("no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases").

62 In the following cases, courts rejected attempts by client adversaries to discover documents created by counsel and provided to auditors, generally consisting of audit-inquiry responses concerning assessment of pending and potential litigation. *See Laguna Beach County Water District v. Superior Court,* 124 Cal. App. 4th 1453, 1461 (2004)(attorney analysis of litigation position provided to auditors did not waive work product privilege as to litigation adversary because disclosure did not contravene the purpose of the work product doctrine*); Tronitech, Inc. v. NCR Corp.,* 108 F.R.D. 655, 655-56 (S.D. Ind. 1985) (attorney letter to auditors was not discoverable under Fed. R. Civ. Proc. 26(b)(1) because it was not legally relevant or reasonably calculated to lead to the discovery of admissible evidence); *United States v. Arthur Young & Co.*, 1984 U.S. Dist. LEXIS 22991, at *11 (N.D. Okla. Oct. 5, 1984) ("If some theory of relevance can be advanced concerning the documents under review, the Court would conclude its probative value is substantially outweighed by the danger of unfair prejudice and public interest concerns."); *In re Genentech, Inc. v. Securities Litig.*, Case No. C-99-4038 (N.D. Cal. 1999) (unpublished) (noting that attorney's opinions are not relevant or at issue in the lawsuit); *Comerica Bank of Calif. v. Lloyd Raymond Free*, Case No. 88-20880 (N.D. Cal. 1999) (unpublished) (noting "tangential relevance" of information and finding public policy in favor of protecting attorney's work-product to be more important); *Teberg v. Am. Pacific Int'l, Inc.*, Case No. C 196448 (Los Angeles Superior Ct., April 29, 1982) (unpublished) (relevance of documents was outweighed by the public policy of promoting candid and full disclosure by counsel to auditor and by the right of privacy).

63 *See* Fed. R. Civ. P. 26(b)(3); *United States v. Gulf Oil Corp.*, 760 F.2d 292, 296-97 (Temp. Emerg. CA 1985) (attorney letters in response to audit inquiries, although containing the mental impressions of defendant's attorney regarding litigation exposure, did not qualify for work product protection because they were not created in anticipation of litigation, but rather "created, at [the auditor's] request, in order to allow

The majority view, followed in several recent cases, is that work product includes any material prepared "because of" actual or potential litigation, thus encompassing analysis of litigation exposure prepared in response to an audit inquiry.[64] These authorities reject the earlier, parochial construction of "work product" and find the "because of" construction to be more faithful to the language of Rule 26(b)(3) and to the purpose of the work product doctrine.[65]

Where courts find that attorney letters to auditors are, indeed, work product, they also generally conclude that disclosure to auditors does not waive the protection *vis à vis* the client's litigation adversaries.[66] These courts acknowledge that, unlike the attorney-client privilege, which protects the confidentiality of the communication, work-product protection is "intended only to prevent disclosure to the opposing counsel and his client" – so, it is not necessarily waived by disclosure to other third-parties.[67] As one federal court explained:

> [T]he work product privilege does not exist to protect a confidential relationship, but rather to promote the adversary system by safeguarding the fruits of an attorney's trial preparations from the discovery attempts of the opponent. The purpose of the work product privilege is to protect information against *opposing parties*, rather than against *all others*, in order to encourage effective trial preparation.[68]

Under this analysis – which is consistent with the Supreme Court's decision establishing the doctrine in *Hickman v. Taylor* – waiver of work product protection only occurs if a disclosure substantially increases the opportunity for potential adversaries to obtain the information. Thus, most courts find that disclosure to auditors does not waive the protection because disclosure is made on an assurance of confidentiality and auditors are not considered to be conduits to potential adversaries.[69]

[the auditor] to prepare financial reports which would satisfy the requirements of the federal securities laws"); *United States v. El Paso Corp.*, 682 F.2d 530, 543-44 (5th Cir. 1982) (lawyer's analysis and memoranda "written ultimately to comply with SEC regulations" were prepared "with an eye on [the company's] business needs, not on its legal ones" and did not "contemplate litigation in the sense required to bring it within the work product doctrine"); *Independent Petrochemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292, 298 (D.D.C. 1987) (work product protection did not apply to lawyer's letters to an auditor because the letters were not prepared to assist the company in litigation but rather to assist the auditor "in the performance of regular accounting work").

64 The following courts rejected the narrow construction of "work product" and found that litigation analysis prepared for auditors is work product. *See United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998) (observing, in *dicta*, that the work-product doctrine would protect an audit-inquiry response and approving the rule adopted by the Third, Fourth, Seventh, Eighth, and D.C. Circuits that a document is work product if "in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation") (emphasis in original); *In re Honeywell Int'l, Inc. Securities Litig.,* 2003 WL 22722961, at *6 (S.D.N.Y. Nov. 18, 2003) (rejecting plaintiff's argument that the "preeminent business purpose" of an audit rendered the work product doctrine inapplicable and finding that defendant's "assertion of work product protection for … audit letters and litigation reports prepared by its internal and external counsel, as well as PWC documents memorializing … opinion work product, is proper."); *Southern Scrap Material Co. v. Fleming*, 2003 WL 21474516, at *9 (E.D. La. June 18, 2003) ("The audit letters … were prepared by outside counsel at the request of [party's] general counsel with an eye toward litigation then ongoing. [Thus] … they are attorney work product of the opinion/mental impression/litigation strategy genre."); *In re Raytheon Securities Litig.*, 218 F.R.D. at 358 (citing cases in the Third, Fourth, Seventh, Eighth and D.C. Circuits that have adopted the "because of" definition of work product); *Vanguard Sav. and Loan Assoc. v. Barton Banks*, 1995 U.S. Dist. LEXIS 13712, at *11-12 (E.D. Pa. 1995) (lawyer letters regarding litigation, prepared to assist client in reporting loss contingencies for a regulatory examination, were work product and protected even though created "primarily" for a business purpose); *Tronitech, Inc.*, 108 F.R.D. at 657 ("an audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation … [and] should be protected by the work product privilege").

65 Protection of work product under Rule 26(b)(3) reaches not only documents "prepared . . . for trial" but also prepared "in anticipation of litigation." As the Second Circuit observed, "[i]f the drafters intended to limit [work product] protection to documents made to assist in preparation for litigation, the 'prepared ... for trial' language would have adequately covered it." *Adlman*, 134 F.3d at 1198-99. Further, while an adverse party may obtain discovery of ordinary work product upon a showing of "substantial need," mental impression or opinion work product is not discoverable at all. Fed. R. Civ. P. 26(b)(3). Thus, "it would oddly undermine [the work product doctrine's] purposes if such documents were excluded from protection merely because they were prepared to assist in the making of a business decision expected to result in the litigation." *Id*. at 1199.

66 *See Southern Scrap*, 2003 WL 21474516, at *9 (finding no waiver because disclosure of legal analysis to auditors was not like "one of those cases where a party deliberately disclosed work product in order to obtain a tactical advantage or where a party made testimonial use of work product and then attempted to invoke the work product doctrine to avoid cross-examination"); *Gutter*, 1998 WL 2017926, at *5 ("[t]ransmittal of documents to a company's outside auditors does not waive the work product privilege because such a disclosure 'cannot be said to have posed a substantial danger at the time that the document would be disclosed to plaintiffs'"); *Vanguard Sav. and Loan Assoc. v. Barton Banks*, 1995 U.S. Dist. LEXIS 13712, at *13-14 (finding no waiver because company did not make disclosure to auditors with "conscious disregard of the possibility that an adversary might obtain the protected materials"); *In re Pfizer*, 1993 WL 561125, at *6 (finding no waiver because auditor was not reasonably viewed as a conduit to a potential adversary); *Gramm v. Horsehead Indus., Inc.*, 1990 U.S. Dist. LEXIS 773, at *19 (S.D.N.Y. Jan. 25, 1990) (finding no waiver upon disclosure to auditors because "disclosure to another person who has an interest in the information but who is not reasonably viewed as a conduit to a potential adversary will not be deemed a waiver of protection of the rule"); *Tronitech*, 108 F.R.D. at 657 (no waiver upon disclosure of work product to auditors since "audit letters are produced under assurances of strictest confidentiality"); *Arthur Young & Co.*, 1984 U.S. Dist. LEXIS 22991, at *10 ("[t]here is no waiver of the work product privilege where, as here, the documents were provided to [the auditors] under a specific assurance of confidentiality"). *See also Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 2004 WL 2389822 (S.D.N.Y. Oct. 26, 2004) (rejecting the notion that a company's disclosure to its auditors of attorney work product prepared in connection with an internal investigation waived the privilege afforded by the attorney work product doctrine).

67 *Tronitech, Inc.*, 108 F.R.D. at 657.

68 *In re Raytheon*, 218 F.R.D. at 359.

69 For example, in one recent decision, *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 2004 WL 2389822 (S.D.N.Y. Oct. 26, 2004), the court rejected the notion that a company's disclosure to its auditors, Deloitte & Touche of attorney work product prepared in connection with an internal investigation waived the privilege afforded by the attorney work product doctrine. The court stated that "the critical inquiry – to me – must be whether Deloitte & Touche should be conceived of as an adversary or a conduit to a potential adversary." *Id.* at *6. Concluding that a company and its auditors are not adversaries, notwithstanding the "tension between an auditor and a corporation that arises from an auditor's need to scrutinize and investigate a corporation's records and book-keeping practices," the court reasoned that "[a] business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud." Most importantly, the court recognized the influence that judicial process has over the effectiveness of this relationship by upholding privileges historically afforded to the work product and communications generated throughout the course of an effective attorney-client relationship: "Indeed, this is precisely the type of limited alliance that courts should encourage." *Id.* It is this logic – too infrequently employed in

Significantly, however, there is a split of authority on the issue of waiver of attorney work product protection. At least one federal court recently held that disclosure of work product to auditors waives the protection. In *Medinol, Ltd. v. Boston Scientific Group*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002), the defendant engaged counsel to perform an investigation into the termination of several high-ranking employees and to report the results of the investigation to a Special Litigation Committee ("SLC") of the Board. Minutes of the SLC meeting reflecting counsel's investigation were provided to the defendant's auditors in connection with their audit of loss contingency reserves. The court held that the disclosure waived the work product protection:

> While Boston Scientific held meetings of its Special Litigation Committee with an eye to litigation, the disclosures to the independent auditor had no such purpose. *Boston Scientific and its outside auditor Ernst & Young did not share 'common interests' in litigation*, and disclosures to Ernst & Young as independent auditors did not therefore serve the privacy interests that the work product doctrine was intended to protect.[70]

In holding that the auditor and client did not share "common interests," the court cited the "independent" role of the auditor as described by the Supreme Court:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[71]

The "common interest" concept on which *Medinol* relied is derived from authorities holding that co-parties or allies, such as co-defendants, may share work product without waiving the protection as to a common adversary.[72] Since the auditor-client relationship does not fit neatly into this analytical box, the *Medinol* court found a waiver.[73] The "common interest" analysis in *Medinol* also has been invoked by other federal courts in considering the issue of waiver following a disclosure to auditors.[74]

To summarize the case law, while most authorities support the argument that disclosure of work product to auditors should not waive the protection as to adversaries, the decisions are not uniform and some courts would hold that disclosure constitutes a waiver. The bottom line is that, while most authorities support the argument that disclosure of work product to auditors should not waive the protection as to litigation adversaries, some courts affirmatively hold that disclosure constitutes a waiver. Because the case law is not uniform, companies have no guarantee that courts will protect attorney work product from waiver as to the companies' adversaries if these materials are disclosed to auditors. This uncertainty undermines the purpose of the privilege: As the United States Supreme Court said, "[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."[75]

3. Summary of Waiver Case Law: Lack of Uniformity, Growing Uncertainty

To the extent that some courts *have* protected privileged information disclosed to auditors from discovery by third-party adversaries, the lynchpin has been the auditors'

---

recent months and years – which this paper wishes to advance. Notably, counsel for Merrill Lynch did not pursue an argument that there was no waiver of the attorney-client privilege.

70 214 F.R.D. at 116-17 (emphasis added).

71 *Id*. at 116 (quoting *Arthur Young & Co.*, 465 U.S. at 817-818).

72 *See*, *e.g.*, *Stix Prods. Inc. v. United Merch. and Mfrs., Inc.*, 47 F.R.D. 334, 338 (S.D.N.Y. 1969).

73 The argument which may be crafted in support of a "common interest" between a company and its auditors sufficient to preclude a waiver of the attorney-client privilege or work product protection is simply this: Auditors and clients share the common goal, under the strict scrutiny of regulators and watchful eyes of many others, of ensuring full and accurate financial disclosures to the public in accordance with GAAP. *See* North River Ins. Co. v. Columbia Casualty Co., 1995 WL 5792, *4 (S.D.N.Y. Jan. 5, 1995) ("[T]he determination of whether the common interest doctrine applies cannot be made categorically. . . . What is important is not whether the parties theoretically share similar interests but rather whether they demonstrate actual cooperation toward a common legal goal."). The common interest doctrine may attach even if two parties share interests which are not completely congruent, and which are part legal and part commercial. *See* Duplan Corp. v. Deering Milliken, Inc., 397 F. Supp. 1146, 1172 (D.S.C. 1975) ("The fact that there may be an overlap of a commercial and a legal interest for a third party does not negate the effect of the legal interest in establishing a community of interest.").

While it is true that outside auditors must be independent, the "independence in mental attitude" standards under GAAS do not preclude auditors from sharing a common legal and commercial goal with their client. As described by the AICPA, "independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness" to all those affected by a business, including management, owners and creditors. AICPA, AU §220.02. Auditors are not expected to have an *adversarial* relationship with the companies they audit; indeed, the AICPA Code of Conduct recognizes that even the threat of adversity between an auditor and client can itself impair independence. *See* AICPA, ET § 101.08.

It should be noted that a written agreement outlining two parties' common interests and need for confidentiality is persuasive (and sometimes mandatory) evidence that sharing of attorney-client privileged communications and work product will not constitute a waiver. *See* In re Bevill, Bressler & Schulman Asset Management Corp., 805 F.2d 120, 126 (3d Cir. 1986) (finding "no evidence that the parties had agreed to pursue a joint defense strategy"); United States v. Weissman, 1996 WL 751386 (S.D.N.Y. Dec. 26, 1996) (requiring either an explicit agreement or demonstrated cooperation in formulating a common defense strategy). There should be no reason that auditors cannot enter into such confidentiality agreements with clients with their "independence" intact.

74 Although the Massachusetts District Court in *In re Raytheon*, citing *Medinol*, noted that "the existence of common interests" was relevant to whether disclosure to auditors created a waiver, the court also found that "there is no evidence that materials disclosed to an independent auditor are likely to be turned over to the company's adversaries except to the extent that the securities laws and/or accounting standards mandate public disclosure," and concluded that the record was inconclusive on the ultimate waiver issue. 218 F.R.D. at 360-61. *But see In re Pfizer*, 1993 WL 561125, at *6 (finding that a company's legal counsel and outside auditors share "common interests" in information generated by counsel for purposes of an audit and, accordingly, there was no waiver of work product).

75 *Upjohn*, 449 U.S. at 392.

professional obligation to maintain the information in confidence.[76] Certified Public Accountants are members of the AICPA and thus bound by AICPA Code of Professional Conduct Rule 301, which prohibits disclosure of client confidential information without "the specific consent of the client."[77] The only exceptions under Rule 301 are when disclosure is compelled by legal process (*e.g.*, a subpoena), or required in connection with review of the auditor's professional practice or with investigative or disciplinary proceedings conducted by the AICPA or another oversight body. In the latter circumstances, Rule 301 prohibits the AICPA and other oversight bodies from disclosing any auditor's "confidential client information that comes to their attention in carrying out those activities."[78] Further, auditors have accepted the constraints on disclosure under the ABA Statement of Policy, which provides that a lawyer's responses may be used by the auditor only in connection with the audit, and may not be quoted or referenced in the client's financial statements, or filed with any government agency, or disclosed in response to any subpoena or other process without the lawyer's consent or upon at least 20 days' prior notice.[79] This expectation of confidentiality by the client has been key to court decisions rejecting the proposition that a company's cooperation with its auditors waives work product protection.[80]

Unfortunately, however, developments in the post-Sarbanes-Oxley Act world have arguably weakened this expectation of confidentiality. Under the Sarbanes-Oxley Act, it is the PCAOB – not the AICPA – which is charged with establishing standards (subject to SEC approval) for auditing, attestation, quality control, ethics and independence with respect to public company audits.[81] In April 2003, the PCAOB adopted interim, transitional standards which generally directed public company auditors to continue to comply with AICPA standards. The interim *ethics* standards, however, selectively identify only certain rules of the AICPA Code of Professional Conduct for adoption – *not* including Rule 301.[82] While auditors should abide by Rule 301 as members of the AICPA, the rule has not explicitly been adopted or endorsed by the

76 Lawyers, of course, are bound by rules of ethics and professional responsibility not to reveal client confidences without client consent; hence, informed consent is a central feature of the ABA Statement of Policy. *See* Rule 1.6 of the ABA Model Rules of Professional Conduct, available at http://www.abanet.org/cpr/mrpc/rule_1_6.html.

77 AICPA, Rules of Professional Conduct, ET Section 301: Confidential Client Information, Rule 301.01 (Jan. 1992, as amended) ("A member in public practice shall not disclose any confidential client information without the specific consent of the client.")

78 *Id.*

79 ABA Statement of Policy, par. 7.

80 Confidentiality agreements have likewise been crucial in the handful of decisions finding non-waiver despite disclosure of work product to government investigators. *See, e.g.*, *Saito v. McKesson HBOC, Inc.*, 2002 WL 31657622, at *6, 11 (Del. Ch. Ct. Nov. 13, 2002) ("[P]ublic policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies."); *Maruzen Co., Ltd. v. HSBC USA, Inc.*, 2002 WL 1628782, at *2 (S.D.N.Y. June 23, 2002) (denying motion to compel because defendants had confidentiality agreements with U.S. Attorney's Office to whom documents were disclosed (citing *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2nd Cir. 1993)).

81 The Sarbanes-Oxley Act, Section 103, 15 U.S.C. § 7214.

82 *See* PCAOB R. 3500T, adopting Interim Ethics Standards. The complete standards and rules of the PCAOB are available at http://www.pacobus.org/documents/rules_of_the_board/all.pdf.

PCAOB. This omission may place public companies at greater risk that courts will find waivers when privileged information is disclosed to auditors.

B. CLOSING THE FLOODGATES: CURRENT LEGISLATION DESIGNED TO MITIGATE SIMILAR WAIVERS OF PRIVILEGES

The real and significant waiver problem presented by auditor requests for access to privileged information is underscored by legislative efforts to ensure that the government agencies charged with overseeing compliance with the securities laws and accounting standards – the SEC and PCAOB – may be exempted from the waiver problem, thereby increasing their potential effectiveness. This has been addressed through two significant pieces of federal legislation – H.R. 2179, currently pending before Congress, and Section 105 of the Sarbanes Oxley Act. Both pieces of legislation provide that disclosure of privileged information to the government does not waive privileges as to anyone else. Both are designed to enable the government to obtain work product and attorney-client communications from regulated entities without exposing those entities to claims of waiver and wholesale discovery by other adversaries. Both recognize that preservation of privileges following disclosure to the government cannot be left to the courts, which are bound to apply common law principles of waiver. Neither, however, solves the waiver problem presented in this paper.

1. H.R. 2179

The SEC will consider a company's voluntary cooperation with an investigation as a mitigating factor in determining appropriate enforcement action, if any. The SEC has promulgated guidelines identifying factors that it will consider in assessing the quality of a company's cooperation, and those guidelines emphasize the importance of a company's decision to waive attorney-client privileges and work product protections.[83] The threat of an enforcement action that might be avoided by cooperating fully places strong pressure on companies to waive privileges, which, in turn, risks further waiver and compelled disclosure to other adversaries.

Recognizing this serious dilemma for companies, the SEC has adopted the position that waiver of privileges in order to cooperate with the SEC should not result in a broader waiver as to other parties.[84] This "selective waiver" concept, however, has been rejected by many courts which hold that a company's production of privileged information to the SEC or

83 One of the questions the SEC asks itself is "Did the company produce a thorough and probing written report detailing the findings of its internal review?" *In the Matter of Gisela de Leon-Meredith*, Exchange Act Release No. 44970 (October 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm.

The DOJ has taken a similar position on cooperation; thus, under its guidelines, "[o]ne factor the prosecutor may weigh in assessing the adequacy of a corporation's cooperation is the completeness of its disclosure including, if necessary, a waiver of the attorney-client privilege and work product protections, both with respect to its internal investigation and with respect to communications between specific officers, directors, and employees, and counsel." Memorandum Regarding Principles of Federal Prosecution of Business Organizations, U.S. Deputy Attorney General Larry D. Thompson, January 20, 2003, *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

84 *See* Amicus Brief of the United States Securities and Exchange Commission, *McKesson HBOC, Inc. v. Adler*, No. 99-C-7980-3 (Ga. Ct. App. Filed May 13, 2001).

another government agency constitutes a full waiver of all privileges and protections that otherwise might have applied against any other adversaries.[85]

Given the SEC's strong desire to obtain the fruits of investigation by a company's lawyers and other privileged information – and recognizing that the waiver problem is a serious impediment to this – the SEC recommended that Congress enact legislation to "enhance the Commission's access to significant, otherwise unobtainable, information."[86] Members of Congress responded with H.R. 2179, introduced on May 21, 2003, which, as currently drafted, proposes an amendment to the 1934 Securities and Exchange Act, as follows:

> Notwithstanding any other provision of law, whenever the Commission or an appropriate regulatory agency and any person agree in writing to terms pursuant to which such person will produce or disclose to the Commission or the appropriate regulatory agency any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, *such production or disclosure shall not constitute a waiver of the privilege or protection as to any person other than the Commission or the appropriate regulatory agency to which the document or information is provided*.[87]

This legislation is designed to help the SEC secure maximum cooperation from companies in the form of disclosure of privileged communications and work product by alleviating the potential harm to companies from a waiver of privileges as to other adversaries.

But even if H.R. 2179 becomes law, the contemplated protection for companies may be illusory. While a company's privileges would be intact with respect to information provided to the SEC, if the *auditors* obtain disclosure of the same information, the company will face the same waiver problem. H.R. 2179 does not shield any disclosure to the auditors from operating as a waiver: Thus, the company's adversaries will simply look to the company and its auditors for the privileged information.

2. **Section 105 of The Sarbanes-Oxley Act**

The Sarbanes-Oxley Act establishes a blanket evidentiary privilege and discovery immunity for all information provided to the PCAOB or prepared in connection with PCAOB inspections and investigations of registered audit firms. Section 105(b)(5) provides:

[85] *See*, *e.g.*, *In re Columbia/HCA Healthcare Corp. Billing Practices Litig*., 293 F.3d 289, 291 (6th Cir. 2002); *Bank of America, N.A. v. Terra Nova Ins. Co.*, 212 F.R.D. 166, 167 (S.D.N.Y. 2002); *United States v. Massachusetts Inst. of Tech*., 129 F.3d 681, 687 (1st Cir. 1997); *Westinghouse Elec. Corp. v. Philippines*, 951 F.2d 1414 , 1458 (3d Cir. 1992); *In re Martin Marietta Corp.*, 856 F.2d 619, 622-23 (4th Cir. 1988).

[86] U.S. Securities and Exchange Commission, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), *available at* Hhttp://www.sec.gov/news/studies/sox704report.pdfH, at p. 45.

[87] H.R. 2179, 108th Cong. 1st Sess. (May 21, 2003). On June 1, 2004, H.R. 2179 was discharged by the House Committee on the Judiciary and placed on the Union Calendar for a vote. *See* Securities Regulation & Law Report (July 5, 2004), vol. 36, no. 27 (BNA), at 1225 (emphasis added).

> [A]ll documents and information prepared or received by or specifically for the [PCAOB], and deliberations of the [PCAOB] and its employees and agents, in connection with an inspection under section 104 or with an investigation under this section, *shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency, and shall be exempt from disclosure …*[88]

Section 105(b)(5) goes on to provide that, "without the loss of its status as confidential and privileged in the hands of the [PCAOB]," the foregoing information may be provided to the SEC and, at the discretion of the PCAOB, to other federal and state regulators. State regulators are tasked with maintaining "such information as confidential and privileged."[89] This provision has been implemented in the PCAOB's Ethics Code and Rules.[90]

Section 105(b)(5) addresses the same waiver problem that gave rise to H.R. 2179. It reflects Congress' recognition that disclosure of confidential information by audit firms to an oversight body exposes the audit firm to waivers of privilege.[91] This provision is designed to facilitate effective oversight by the PCAOB and cooperation by audit firms by assuring that confidential information will not be discoverable by others.

As with H.R. 2179, however, this provision does nothing to address the waiver problem facing companies whose *auditors* obtain privileged information. If a company's privileged information winds up in the hands of the PCAOB during an inspection or investigation of the audit firm, Section 105(b)(5) assures that no one can take discovery from the PCAOB. But the company remains exposed to the risk of waiver by having provided privileged information to its auditors in the first place. Both the company and its auditors may be subject to discovery attempts by the company's adversaries, simply because of the company's good corporate governance and compliance with its obligations to cooperate fully with its auditors.

[88] The Sarbanes-Oxley Act, Section 105(b)(5)(A), 15 U.S.C. § 7215(b)(5)(A) (emphasis added).

[89] *Id*. at § 105(b)(5)(B), 15 U.S.C. § 7215(b)(5)(B).

[90] *See* EC9 ("Unless authorized by the Board, no Board member or staff shall disseminate or otherwise disclose any information obtained in the course and scope of his or her employment, and which has not been released, announced, or otherwise made available publicly." The requirement of confidentiality extends even after the member's or staff's termination of employment with PCAOB.); *see also* PCAOB R. 5108(a) ("Informal inquiries and formal investigations, and any documents, testimony or other information prepared or received specifically for the Board or the staff of the Board in connection with inquiries and investigations, shall be confidential unless and until presented in public proceedings or released in connection with Section 105(c) of the Act, and the Board's Rules thereunder").

[91] A May 17, 2002 report by the General Accounting Office, based on a study by an agency then-charged with oversight of the public accounting profession, found that "[t]he self-regulatory system lacks the power to protect the confidentiality of investigative information regarding alleged audit failures or other disciplinary matters concerning members of the accounting profession. As the Panel reported, the lack of such protective power hinders the timing of investigations." U.S. Gen. Accounting Office, "The Accounting Profession: Status of the Panel on Audit Effectiveness Recommendations to Enhance the Self-Regulatory System," GAO Rep. No. 02-411 (May 17, 2002).

V. CONCLUSION

The Preamble to the ABA Statement of Policy eloquently presents the public interests at stake in the waiver problem. While "our legal, political and economic systems depend to an important extent on public confidence in published financial statements," this confidence should not come by means of intrusion upon the relationship between companies and their legal counselors:

> On the contrary, the objective of fair disclosure in financial statements is more likely to be better served by maintaining the integrity of the confidential relationship between attorney and client, thereby strengthening corporate management's confidence in counsel and encouraging its readiness to seek advice of counsel and to act in accordance with counsel's advice.[92]

In other words, the importance of the public company audit function, as well as the oversight functions of the SEC and PCAOB, must not be allowed to jeopardize a company's ability to utilize one of the primary tools it has at its disposal to comply with its corporate governance obligations – its legal counsel. Unless the attorney work-product doctrine and attorney-client privilege are maintained when companies provide otherwise-protected information to their auditors, companies will be penalized for their compliance efforts and for engaging in full and complete audit cooperation by laying the groundwork for their litigation adversaries to obtain sensitive and otherwise privileged information. Under prevailing legal doctrine, the courts do not provide assurance that disclosure of privileged information to auditors will not result in waivers as to others.

This result is untenable and, we submit, unnecessary. Instead, we offer proposals for resolving the tension between cooperation with auditors and protecting appropriate privileges:

1. The principle proposal – the one with the promise of greatest effectiveness – is for the SEC and PCAOB, joined by the corporate counsel community and the principal auditors of the vast majority of U.S. public companies, to propose and support federal legislation, modeled on H.R. 2179, that would permit companies to provide privileged attorney-client communications and work product to their auditors in connection with audits, reviews, attestations and compliance with Section 10A of the 1934 Securities and Exchange Act without waiving any privileges as to others.

2. The PCAOB should issue interpretive guidance, with approval by the SEC, advising that an auditor is generally expected to obtain adequate evidence to support its conclusions without demanding information protected by the attorney-client privilege or work product doctrine. An auditor should only require such information if it determines that there are no other sources from which it can fulfill its professional obligations.[93]

[92] ABA Statement of Policy, Preamble.

[93] This approach is consistent with the AICPA's 1977 guidance regarding SAS 12, discussed above.

By issuing such guidance, the PCAOB and the SEC would acknowledge and support the compelling public interest served by protecting the confidentiality of attorney-client communications and work product, as did the AICPA in issuing its guidance that auditors need not seek access to a client's privileged information under SAS 12, beyond the Treaty, in order to audit litigation contingency reserves.

3. The PCAOB should adopt an ethical rule, modeled on Rule 301 of the AICPA Code of Professional Conduct requiring auditors to maintain the confidentiality of all client information, and carving out the exceptions set forth in Rule 301 – *i.e.*, compliance with compulsory legal process and the auditor's obligation to cooperate with its own oversight bodies. The rule should also provide that auditors must give clients notice before producing client information pursuant to compulsory legal process in order to provide clients with adequate time to seek judicial protection against disclosure.[94]

In taking this action, the PCAOB would assist companies that are forced to seek judicial protection of privileged information that has been disclosed to auditors. When auditors do require access to privileged information in order to perform professional services, the risk of waiver is squarely presented. Those courts that have been willing to protect work product from waiver (if not attorney-client communications) after disclosure to auditors have relied heavily on the auditor's obligation to maintain the information in confidence.

4. The PCAOB should promulgate guidance that an auditor does not violate independence standards by entering into a written agreement with a client providing for the confidential treatment of client information provided to the auditor, subject to the auditor's professional obligation to cooperate with the PCAOB and other oversight bodies.

In taking this step, the PCAOB would further assist companies that must make their case in court for non-waiver by allowing auditors to enter into confidentiality agreements with clients. Confidentiality agreements have been crucial in the handful of decisions finding non-waiver despite disclosure of work product to government investigators.[95]

NY\990067.3
02-03-2005

[94] The rule should also recognize that auditors are entitled to use client information in connection with disputes between the client and auditor or arising out of the professional services engagement.

[95] *See, e.g.*, *Saito v. McKesson HBOC, Inc.*, 2002 WL 31657622, at *6, 11 (Del. Ch. Ct. Nov. 13, 2002) ("[P]ublic policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies."); *Maruzen Co., Ltd. v. HSBC USA, Inc.*, 2002 WL 1628782, at *2 (S.D.N.Y. June 23, 2002) (denying motion to compel because defendants had confidentiality agreements with U.S. Attorney's Office to whom documents were disclosed (citing *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 236 (2nd Cir. 1993)).

News Releases

08/27/2008

Xcel Energy, New York attorney general resolve carbon disclosure issues

MINNEAPOLIS - Xcel Energy and New York Attorney General Andrew Cuomo today announced an agreement that resolves greenhouse gas disclosure issues raised by Cuomo last fall.

“Xcel Energy voluntarily has reduced its carbon emissions by large amounts in recent years and plans to continue making significant reductions in CO2 emissions in the future,” said Dick Kelly, chairman, president and CEO.

“We previously provided detailed information concerning the expected impact of climate change and greenhouse gas emissions regulations on our operations, and under this agreement we will make even more detailed disclosures. This agreement will enhance our already aggressive efforts to be responsible environmental stewards.”

In a Sept. 14 subpoena, Cuomo sought information about Xcel Energy’s public disclosures in filings with the U.S. Securities and Exchange Commission regarding the expected impact of climate change and the regulation of greenhouse gas emissions on the company’s operations, financial condition and plans to construct a new coal-fired electricity generating unit at the Comanche station in Pueblo, Colo.

In response, Xcel Energy provided documents including its 2006 response to a questionnaire from the Carbon Disclosure Project, an independent not-for-profit organization that solicits information and makes corporate responses publicly available; its Triple Bottom Line report, which describes the company’s social, environmental and economic impacts, and information filed with the Colorado Public Utilities Commission about the Comanche plant addition.

“Xcel Energy represents that it has voluntarily reduced its GHG (greenhouse gas) emissions by a cumulative total of over 18 million tons since 2003,” the agreement states. “Xcel Energy is the largest utility provider of wind energy in the United States, according to the American Wind Energy Association. The Company also has announced plans to expand its renewable energy portfolio by at least 6,000 MW (megawatts) of additional renewable electric generating capacity by 2020.”

Without admitting or denying any violation of law or wrongdoing, Xcel Energy agreed to resolve the attorney general’s investigation voluntarily by agreeing to expand and/or continue to provide a discussion of climate change and possible attendant risks in its 10-K filings with the Securities and Exchange Commission.

The disclosures are to include analyses of financial risks from current and probable future laws, from litigation and from physical impacts of climate change, and strategic analysis of climate change risk and emissions management.

Xcel Energy (NYSE: XEL) is a major U.S. electricity and natural gas company with regulated operations in eight Western and Midwestern states. Xcel Energy provides a comprehensive portfolio of energy-related products and services to 3.3 million electricity customers and 1.8 million natural gas customers through its regulated operating companies. Company headquarters are located in Minneapolis. More information is available at www.xcelenergy.com.

AUDITING STANDARD No. 3 – Audit Documentation

June 9, 2004
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 3 –

Audit Documentation

[Note: The Board made conforming amendments to Auditing Standard No. 3 when it adopted Auditing Standard No. 5. These conforming amendments are not reflected in this version of Auditing Standard No. 3. The conforming amendments are available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Conforming_Amendments_AS5.pdf

[Effective pursuant to SEC Release No. 34-50253; File No. PCAOB-2004-05, August 25, 2004]

Auditing and Related Professional Practice Standards

Auditing Standard No. 3, *Audit Documentation*
[supersedes SAS No. 96, *Audit Documentation*]

Introduction

1. This standard establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"). Such engagements include an audit of financial statements, an audit of internal control over financial reporting, and a review of interim financial information. This standard does not replace specific documentation requirements of other standards of the PCAOB.

Objectives of Audit Documentation

2. *Audit documentation* is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor. Audit documentation also may be referred to as *work papers* or *working papers*.

Note: An auditor's representations to a company's board of directors or audit committee, stockholders, investors, or other interested parties are usually included in the auditor's report accompanying the financial statements of the company. The auditor also might make oral representations to the company or others, either on a voluntary basis or if necessary to comply with professional standards, including in connection with an engagement for which an auditor's report is not issued. For example, although an auditor might not issue a report in connection with an engagement to review interim financial information, he or she ordinarily would make oral representations about the results of the review.

3. Audit documentation is reviewed by members of the engagement team performing the work and might be reviewed by others. Reviewers might include, for example:

a. Auditors who are new to an engagement and review the prior year's documentation to understand the work performed as an aid in planning and performing the current engagement.

b. Supervisory personnel who review documentation prepared by assistants on the engagement.

c. Engagement supervisors and engagement quality reviewers who review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions.

d. A successor auditor who reviews a predecessor auditor's audit documentation.

e. Internal and external inspection teams that review documentation to assess audit quality and compliance with auditing and related professional practice standards; applicable laws, rules, and regulations; and the auditor's own quality control policies.

f. Others, including advisors engaged by the audit committee or representatives of a party to an acquisition.

Audit Documentation Requirement

4. The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues.[1/] Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

5. Because audit documentation is the written record that provides the support for the representations in the auditor's report, it should:

a. Demonstrate that the engagement complied with the standards of the PCAOB,

---

[1/] See paragraph 12 of this standard for a description of significant findings or issues.

b. Support the basis for the auditor's conclusions concerning every relevant financial statement assertion, and

c. Demonstrate that the underlying accounting records agreed or reconciled with the financial statements.

6. The auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions.[2] Audit documentation must clearly demonstrate that the work was in fact performed. This documentation requirement applies to the work of all those who participate in the engagement as well as to the work of specialists the auditor uses as evidential matter in evaluating relevant financial statement assertions. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:

a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and

b. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review.

Note: An *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

7. In determining the nature and extent of the documentation for a financial statement assertion, the auditor should consider the following factors:

- Nature of the auditing procedure;
- Risk of material misstatement associated with the assertion;
- Extent of judgment required in performing the work and evaluating the results, for example, accounting estimates require greater judgment and commensurately more extensive documentation;
- Significance of the evidence obtained to the assertion being tested; and

[2] *Relevant financial statement assertions* are described in paragraphs 68-70 of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.*

- Responsibility to document a conclusion not readily determinable from the documentation of the procedures performed or evidence obtained.

Application of these factors determines whether the nature and extent of audit documentation is adequate.

8. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions. The relevant records to be retained include, but are not limited to, procedures performed in response to the information, and records documenting consultations on, or resolutions of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted.

9. If, after the documentation completion date (defined in paragraph 15), the auditor becomes aware, as a result of a lack of documentation or otherwise, that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. To accomplish this, the auditor must have persuasive other evidence. Oral explanation alone does not constitute persuasive other evidence, but it may be used to clarify other written evidence.

- If the auditor determines and demonstrates that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached, but that documentation thereof is not adequate, then the auditor should consider what additional documentation is needed. In preparing additional documentation, the auditor should refer to paragraph 16.
- If the auditor cannot determine or demonstrate that sufficient procedures were performed, sufficient evidence was obtained, or appropriate conclusions were reached, the auditor should comply with the provisions of AU sec. 390, *Consideration of Omitted Procedures After the Report Date*.

Documentation of Specific Matters

10. Documentation of auditing procedures that involve the inspection of documents or confirmation, including tests of details, tests of operating effectiveness of controls, and walkthroughs, should include identification of the items inspected. Documentation

of auditing procedures related to the inspection of significant contracts or agreements should include abstracts or copies of the documents.

Note: The identification of the items inspected may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- If an audit sample is selected from a population of documents, the documentation should include identifying characteristics (for example, the specific check numbers of the items included in the sample).
- If all items over a specific dollar amount are selected from a population of documents, the documentation need describe only the scope and the identification of the population (for example, all checks over $10,000 from the October disbursements journal).
- If a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of sales invoices was selected from the sales journal for the period from October 1 to December 31, starting with invoice number 452 and selecting every 40th invoice).

11. Certain matters, such as auditor independence, staff training and proficiency and client acceptance and retention, may be documented in a central repository for the public accounting firm ("firm") or in the particular office participating in the engagement. If such matters are documented in a central repository, the audit documentation of the engagement should include a reference to the central repository. Documentation of matters specific to a particular engagement should be included in the audit documentation of the pertinent engagement.

12. The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached in connection with each engagement. *Significant findings or issues* are substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached, and include, but are not limited to, the following:

a. Significant matters involving the selection, application, and consistency of accounting principles, including related disclosures. Significant matters include, but are not limited to, accounting for complex or unusual transactions, accounting estimates, and uncertainties as well as related management assumptions.

b. Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements, omissions in the financial statements, the existence of significant deficiencies, or material weaknesses in internal control over financial reporting.

c. Audit adjustments. For purposes of this standard, an *audit adjustment* is a correction of a misstatement of the financial statements that was or should have been proposed by the auditor, whether or not recorded by management, that could, either individually or when aggregated with other misstatements, have a material effect on the company's financial statements.

d. Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters.

e. Circumstances that cause significant difficulty in applying auditing procedures.

f. Significant changes in the assessed level of audit risk for particular audit areas and the auditor's response to those changes.

g. Any matters that could result in modification of the auditor's report.

13. The auditor must identify all significant findings or issues in an *engagement completion document*. This document may include either all information necessary to understand the significant findings, issues or cross-references, as appropriate, to other available supporting audit documentation. This document, along with any documents cross-referenced, should collectively be as specific as necessary in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues.

Note: The engagement completion document prepared in connection with the annual audit should include documentation of significant findings or issues identified during the review of interim financial information.

Retention of and Subsequent Changes to Audit Documentation

14. The auditor must retain audit documentation for seven years from the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements (*report release date*), unless a longer period of time is required by law. If a report is not issued in connection with an engagement, then the audit documentation must be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then

the audit documentation must be retained for seven years from the date the engagement ceased.

15. Prior to the report release date, the auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report. A complete and final set of audit documentation should be assembled for retention as of a date not more than 45 days after the report release date (*documentation completion date*). If a report is not issued in connection with an engagement, then the documentation completion date should not be more than 45 days from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the documentation completion date should not be more than 45 days from the date the engagement ceased.

16. Circumstances may require additions to audit documentation after the report release date. Audit documentation must not be deleted or discarded after the documentation completion date, however, information may be added. Any documentation added must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.

17. Other standards require the auditor to perform procedures subsequent to the report release date in certain circumstances. For example, in accordance with AU sec. 711, *Filings Under Federal Securities Statutes*, auditors are required to perform certain procedures up to the effective date of a registration statement.[3/] The auditor must identify and document any additions to audit documentation as a result of these procedures consistent with the previous paragraph.

18. The office of the firm issuing the auditor's report is responsible for ensuring that all audit documentation sufficient to meet the requirements of paragraphs 4-13 of this standard is prepared and retained. Audit documentation supporting the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms), must be retained by or be accessible to the office issuing the auditor's report.[4/]

19. In addition, the office issuing the auditor's report must obtain, and review and retain, prior to the report release date, the following documentation related to the work

[3/] Section 11 of the Securities Act of 1933 makes specific mention of the auditor's responsibility as an expert when the auditor's report is included in a registration statement under the 1933 Act.

[4/] Section 106(b) of the Sarbanes-Oxley Act of 2002 imposes certain requirements concerning production of the work papers of a foreign public accounting firm on whose opinion or services the auditor relies. Compliance with this standard does not substitute for compliance with Section 106(b) or any other applicable law.

performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or non-affiliated firms):

a. An engagement completion document consistent with paragraphs 12 and 13.

Note: This engagement completion document should include all cross-referenced, supporting audit documentation.

b. A list of significant fraud risk factors, the auditor's response, and the results of the auditor's related procedures.

c. Sufficient information relating to any significant findings or issues that are inconsistent with or contradict the final conclusions, as described in paragraph 8.

d. Any findings affecting the consolidating or combining of accounts in the consolidated financial statements.

e. Sufficient information to enable the office issuing the auditor's report to agree or to reconcile the financial statement amounts audited by the other auditor to the information underlying the consolidated financial statements.

f. A schedule of audit adjustments, including a description of the nature and cause of each misstatement.

g. All significant deficiencies and material weaknesses in internal control over financial reporting, including a clear distinction between those two categories.

h. Letters of representations from management.

i. All matters to be communicated to the audit committee.

If the auditor decides to make reference in his or her report to the audit of the other auditor, however, the auditor issuing the report need not perform the procedures in this paragraph and, instead, should refer to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

20. The auditor also might be required to maintain documentation in addition to that required by this standard.[5/]

[5/] For example, the SEC requires auditors to retain, in addition to documentation required by this standard, memoranda, correspondence, communications (for example, electronic mail), other documents, and records (in the

Effective Date

21. This standard is effective for audits of financial statements, which may include an audit of internal control over financial reporting, with respect to fiscal years ending on or after November 15, 2004. For other engagements conducted pursuant to the standards of the PCAOB, including reviews of interim financial information, this standard takes effect beginning with the first quarter ending after the first financial statement audit covered by this standard.

form of paper, electronic, or other media) that are created, sent, or received in connection with an engagement conducted in accordance with auditing and related professional practice standards and that contain conclusions, opinions, analyses, or data related to the engagement. (*Retention of Audit and Review Records*, 17 CFR §210.2-06, effective for audits or reviews completed on or after October 31, 2003.)

APPENDIX A

Background and Basis for Conclusions

Table of Contents ***Paragraph***

Introduction A1-A2
Background A3-A7
Objective of This Standard A8-A10
Audit Programs A11-A12
Reviewability Standard A13-A19
Audit Documentation Must Demonstrate That the Work was Done A20-A33
Audit Adjustments A34-A36
Information That is Inconsistent with or Contradicts the Auditor's Final Conclusions A37-A38
Retention of Audit Documentation A39-A41
Section 802 of Sarbanes-Oxley and the SEC's Implementing Rule A42-A50
Changes to Audit Documentation A51-A59
Multi-Location Audits and Using the Work of Other Auditors A60-A67
Effective Date A68-A70
Reference to Audit Documentation As the Property of the Auditor A71
Confidential Client Information A72

Introduction

A1. This appendix summarizes considerations that the Public Company Accounting Oversight Board ("PCAOB" or "Board") deemed significant in developing this standard. This appendix includes reasons for accepting certain views and rejecting others.

A2. Section 103(a)(2)(A)(i) of the Sarbanes-Oxley Act of 2002 (the "Act") directs the Board to establish auditing standards that require registered public accounting firms to prepare and maintain, for at least seven years, audit documentation "in sufficient detail to support the conclusions reached" in the auditor's report. Accordingly, the Board has made audit documentation a priority.

Background

A3. Auditors support the conclusions in their reports with a work product called *audit documentation*, also referred to as *working papers* or *work papers*. Audit documentation supports the basis for the conclusions in the auditor's report. Audit documentation also facilitates the planning, performance, and supervision of the engagement and provides the basis for the review of the quality of the work by providing the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

A4. The Board's standard on audit documentation is one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The Board believes that the quality and integrity of an audit depends, in large part, on the existence of a complete and understandable record of the work the auditor performed, the conclusions the auditor reached, and the evidence the auditor obtained that supports those conclusions. Meaningful reviews, whether by the Board in the context of its inspections or through other reviews, such as internal quality control reviews, would be difficult or impossible without adequate documentation. Clear and comprehensive audit documentation is essential to enhance the quality of the audit and, at the same time, to allow the Board to fulfill its mandate to inspect registered public accounting firms to assess the degree of compliance of those firms with applicable standards and laws.

A5. The Board began a standards-development project on audit documentation by convening a public roundtable discussion on September 29, 2003, to discuss issues and hear views on the subject. Participants at the roundtable included representatives from public companies, public accounting firms, investor groups, and regulatory organizations.

A6. Prior to this roundtable discussion, the Board prepared and released a briefing paper on audit documentation that posed several questions to help identify the objectives – and the appropriate scope and form – of audit documentation. In addition, the Board asked participants to address specific issues in practice relating to, among other things, changes in audit documentation after release of the audit report, essential elements and the appropriate amount of detail of audit documentation, the effect on audit documentation of a principal auditor's decision to use the work of other auditors, and retention of audit documentation. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard on audit documentation, Statement on Auditing Standards ("SAS") No. 96, *Audit Documentation*, was insufficient for the Board to discharge appropriately its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued for comment, on November 17, 2003, a proposed auditing standard titled, *Audit Documentation*.

A7. The Board received 38 comment letters from a variety of interested parties, including auditors, regulators, professional associations, government agencies, and others. Those comments led to some changes in the requirements of the standard. Also, other changes made the requirements easier to understand. The following sections summarize significant views expressed in those comment letters and the Board's responses to those comments.

Objective of This Standard

A8. The objective of this standard is to improve audit quality and enhance public confidence in the quality of auditing. Good audit documentation improves the quality of the work performed in many ways, including, for example:

- Providing a record of actual work performed, which provides assurance that the auditor accomplishes the planned objectives.
- Facilitating the reviews performed by supervisors, managers, engagement partners, engagement quality reviewers,[1/] and PCAOB inspectors.
- Improving effectiveness and efficiency by reducing time-consuming, and sometimes inaccurate, oral explanations of what was done (or not done).

[1/] The engagement quality reviewer is referred to as the concurring partner reviewer in the membership requirements of the AICPA SEC Practice Section. The Board adopted certain of these membership requirements as they existed on April 16, 2003. Some firms also may refer to this designated reviewer as the second partner reviewer.

A9. The documentation requirements in this standard should result in more effective and efficient oversight of registered public accounting firms and associated persons, thereby improving audit quality and enhancing investor confidence.

A10. Inadequate audit documentation diminishes audit quality on many levels. First, if audit documentation does not exist for a particular procedure or conclusion related to a significant matter, it casts doubt as to whether the necessary work was done. If the work was not documented, then it becomes difficult for the engagement team, and others, to know what was done, what conclusions were reached, and how those conclusions were reached. In addition, good audit documentation is very important in an environment in which engagement staff changes or rotates. Due to engagement staff turnover, knowledgeable staff on an engagement may not be available for the next engagement.

Audit Programs

A11. Several commenters suggested that audit documentation should include audit programs. Audit programs were specifically mentioned in SAS No. 96 as a form of audit documentation.

A12. The Board accepted this recommendation, and paragraph 4 in the final standard includes audit programs as an example of documentation. Audit programs may provide evidence of audit planning as well as limited evidence of the execution of audit procedures, but the Board believes that signed-off audit programs should generally not be used as the sole documentation that a procedure was performed, evidence was obtained, or a conclusion was reached. An audit program aids in the conduct and supervision of an engagement, but completed and initialed audit program steps should be supported with proper documentation in the working papers.

Reviewability Standard

A13. The proposed standard would have adapted a standard of reviewability from the U.S. General Accounting Office's ("GAO") documentation standard for government and other audits conducted in accordance with generally accepted government auditing standards ("GAGAS"). The GAO standard provides that "Audit documentation related to planning, conducting, and reporting on the audit should contain sufficient information to enable an experienced auditor who has had no previous connection with the audit to ascertain from the audit documentation the evidence that supports the auditors' significant judgments and conclusions."[2/] This requirement has been important in the field of government auditing because government audits have long been reviewed by

[2/] U.S. General Accounting Office, *Government Auditing Standards*, "Field Work Standards for Financial Audits" (2003 Revision), paragraph 4.22.

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS3

GAO auditors who, although experienced in auditing, do not participate in the actual audits. Moreover, the Panel on Audit Effectiveness recommended that sufficient, specific requirements for audit documentation be established to enable public accounting firms' internal inspection teams as well as others, including reviewers outside of the firms, to assess the quality of engagement performance.[3/] Audits and reviews of issuers' financial statements will now, under the Act, be subject to review by PCAOB inspectors. Therefore, a documentation standard that enables an inspector to understand the work that was performed in an audit or review is appropriate.

A14. Accordingly, the Board's proposed standard would have required that audit documentation contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, the name of the person(s) who performed it, the date it was completed, and the conclusions reached. This experienced auditor also should have been able to determine who reviewed the work and the date of such review.

A15. Some commenters suggested that the final standard more specifically describe the qualifications of an experienced auditor. These commenters took the position that only an engagement partner with significant years of experience would have the experience necessary to be able to understand all the work that was performed and the conclusions that were reached. One commenter suggested that an auditor who is reviewing audit documentation should have experience and knowledge consistent with the experience and knowledge that the auditor performing the audit would be required to possess, including knowledge of the current accounting, auditing, and financial reporting issues of the company's industry. Another said that the characteristics defining an experienced auditor should be consistent with those expected of the auditor with final responsibility for the engagement.

A16. After considering these comments, the Board has provided additional specificity about the meaning of the term, *experienced auditor*. The standard now describes an experienced auditor as one who has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry.

A17. Some commenters also suggested that the standard, as proposed, did not allow for the use of professional judgment. These commenters pointed to the omission of a statement about professional judgment found in paragraph 4.23 of GAGAS that states, "The quantity, type, and content of audit documentation are a matter of the auditors' professional judgment." A nearly identical statement was found in the interim auditing standard, SAS No. 96, *Audit Documentation*.

[3/] Panel on Audit Effectiveness, *Report and Recommendations* (Stamford, Ct: Public Oversight Board, August 31, 2000).

A18. Auditors exercise professional judgment in nearly every aspect of planning, performing, and reporting on an audit. Auditors also exercise professional judgment in the documentation of an audit and other engagements. An objective of this standard is to ensure that auditors give proper consideration to the need to document procedures performed, evidence obtained, and conclusions reached in light of time and cost considerations in completing an engagement.

A19. Nothing in the standard precludes auditors from exercising their professional judgment. Moreover, because professional judgment might relate to any aspect of an audit, the Board does not believe that an explicit reference to professional judgment is necessary every time the use of professional judgment may be appropriate.

Audit Documentation Must Demonstrate That the Work was Done

A20. A guiding principle of the proposed standard was that auditors must document procedures performed, evidence obtained, and conclusions reached. This principle is not new and was found in the interim standard, SAS No. 96, *Audit Documentation*, which this standard supersedes. Audit documentation also should demonstrate compliance with the standards of the PCAOB and include justification for any departures.

A21. The proposed standard would have adapted a provision in the California Business and Professions Code which provides that if documentation does not exist, then there is a rebuttable presumption that the work had not been done.

A22. The objections to this proposal fell into two general categories: the effect of the rebuttable presumption on legal proceedings and the perceived impracticality of documenting every conversation or conclusion that affected the engagement. Discussion of these issues follows.

Rebuttable Presumption

A23. Commenters expressed concern about the effects of the proposed language on regulatory or legal proceedings outside the context of the PCAOB's oversight. They argued that the rebuttable presumption might be understood to establish evidentiary rules for use in judicial and administrative proceedings in other jurisdictions.

A24. Some commenters also had concerns that oral explanation alone would not constitute persuasive other evidence that work was done, absent any documentation. Those commenters argued that not allowing oral explanations when there was no documentation would essentially make the presumption "irrebuttable." Moreover, those commenters argued that it was inappropriate for a professional standard to predetermine for a court the relative value of evidence.

A25. The Board believes that complete audit documentation is necessary for a quality audit or other engagement. The Board intends the standard to require auditors to document procedures performed, evidence obtained, and conclusions reached to improve the quality of audits. The Board also intends that a deficiency in documentation is a departure from the Board's standards. Thus, although the Board removed the phrase *rebuttable presumption*, the Board continues to stress, in paragraph 9 of the standard, that the auditor must have persuasive other evidence that the procedures were performed, evidence was obtained, and appropriate conclusions were reached with respect to relevant financial statement assertions.

A26. The term *should* (presumptively mandatory responsibility) was changed to *must* (unconditional responsibility) in paragraph 6 to establish a higher threshold for the auditor. Auditors have an unconditional requirement to document their work. Failure to discharge an unconditional responsibility is a violation of the standard and Rule 3100, which requires all registered public accounting firms to adhere to the Board's auditing and related professional practice standards in connection with an audit or review of an issuer's financial statements.

A27. The Board also added two new paragraphs to the final standard to explain the importance and associated responsibility of performing the work and adequately documenting all work that was performed. Paragraph 7 provides a list of factors the auditor should consider in determining the nature and extent of documentation. These factors should be considered by both the auditor in preparing the documentation and the reviewer in evaluating the documentation.

A28. In paragraph 9 of this standard, if, after the documentation completion date, as a result of a lack of documentation or otherwise, it appears that audit procedures may not have been performed, evidence may not have been obtained, or appropriate conclusions may not have been reached, the auditor must determine, and if so demonstrate, that sufficient procedures were performed, sufficient evidence was obtained, and appropriate conclusions were reached with respect to the relevant financial statement assertions. In those circumstances, for example, during an inspection by the Board or during the firm's internal quality control review, the auditor is required to demonstrate with persuasive other evidence that the procedures were performed, the evidence was obtained, and appropriate conclusions were reached. In this and similar contexts, oral explanation alone does not constitute persuasive other evidence. However, oral evidence may be used to clarify other written evidence.

A29. In addition, more reliable, objective evidence may be required depending on the nature of the test and the objective the auditor is trying to achieve. For example, if there is a high risk of a material misstatement with respect to a particular assertion, then the auditor should obtain and document sufficient procedures for the auditor to conclude on the fairness of the assertion.

Impracticality

A30. Some commenters expressed concern that the proposed standard could be construed or interpreted to require the auditor to document every conversation held with company management or among the engagement team members. Some commenters also argued that they should not be required to document every conclusion, including preliminary conclusions that were part of a thought process that may have led them to a different conclusion, on the ground that this would result in needless and costly work performed by the auditor. Commenters also expressed concern that an unqualified requirement to document procedures performed, evidence obtained, and conclusions reached without allowing the use of auditor judgment would increase the volume of documentation but not the quality. They stated that it would be unnecessary, time-consuming, and potentially counterproductive to require the auditor to make a written record of everything he or she did.

A31. The Board's standard distinguishes between (1) an audit procedure that must be documented and (2) a conversation with company management or among the members of the engagement team. Inquiries with management should be documented when an inquiry is important to a particular procedure. The inquiry could take place during planning, performance, or reporting. The auditor need not document each conversation that occurred.

A32. A final conclusion is an integral part of a working paper, unless the working paper is only for informational purposes, such as documentation of a discussion or a process. This standard does not require that the auditor document each interim conclusion reached in arriving at the risk assessments or final conclusions. Conclusions reached early on during an audit may be based on incomplete information or an incorrect understanding. Nevertheless, auditors should document a final conclusion for every audit procedure performed, if that conclusion is not readily apparent based on documented results of the procedures.

A33. The Board also believes the reference to *specialists* is an important element of paragraph 6. Specialists play a vital role in audit engagements. For example, appraisers, actuaries, and environmental consultants provide valuable data concerning asset values, calculation assumptions, and loss reserves. When using the work of a specialist, the auditor must ensure that the specialist's work, as it relates to the audit objectives, also is adequately documented. For example, if the auditor relies on the work of an appraiser in obtaining the fair value of commercial property available for sale, then the auditor must ensure the appraisal report is adequately documented. Moreover, the term *specialist* in this standard is intended to include any specialist the auditor relies on in conducting the work, including those employed or retained by the auditor or by the company.

Audit Adjustments

A34. Several commenters recommended that the definition of *audit adjustments* in this proposed standard should be consistent with the definition contained in AU sec. 380, *Communication with Audit Committees*.

A35. Although the Board recognizes potential benefits of having a uniform definition of the term *audit adjustments*, the Board does not believe that the definition in AU sec. 380 is appropriate for this documentation standard because that definition was intended for communication with audit committees. The Board believes that the definition should be broader so that the engagement partner, engagement quality reviewer, and others can be aware of all proposed corrections of misstatements, whether or not recorded by the entity, of which the auditor is aware, that were or should have been proposed based on the audit evidence.

A36. Adjustments that should have been proposed based on known audit evidence are material misstatements that the auditor identified but did not propose to management. Examples include situations in which (1) the auditor identifies a material error but does not propose an adjustment and (2) the auditor proposes an adjustment in the working papers, but fails to note the adjustment in the summary or schedule of proposed adjustments.

Information That Is Inconsistent with or Contradicts the Auditor's Final Conclusions

A37. Paragraph .25 of AU sec. 326, *Evidential Matter*, states: "In developing his or her opinion, the auditor should consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements." Thus, during the conduct of an audit, the auditor should consider all relevant evidential matter even though it might contradict or be inconsistent with other conclusions. Audit documentation must contain information or data relating to significant findings or issues that are inconsistent with the auditor's final conclusions on the relevant matter.

A38. Also, information that initially appears to be inconsistent or contradictory, but is found to be incorrect or based on incomplete information, need not be included in the final audit documentation, provided that the apparent inconsistencies or contradictions were satisfactorily resolved by obtaining complete and correct information. In addition, with respect to differences in professional judgment, auditors need not include in audit documentation preliminary views based on incomplete information or data.

Retention of Audit Documentation

A39. The proposed standard would have required an auditor to retain audit documentation for seven years after completion of the engagement, which is the

minimum period permitted under Section 103(a)(2)(A)(i) of the Act. In addition, the proposed standard would have added a new requirement that the audit documentation must be assembled for retention within a reasonable period of time after the auditor's report is released. Such reasonable period of time should not exceed 45 days.

A40. In general, those commenting on this documentation retention requirement did not have concerns with the time period of 45 days to assemble the working papers. However, some commenters suggested the Board tie this 45-day requirement to the filing date of the company's financial statements with the SEC. One commenter recommended that the standard refer to the same trigger date for initiating both the time period during which the auditor should complete work paper assembly and the beginning of the seven-year retention period.

A41. For consistency and practical implications, the Board agreed that the standard should have the same date for the auditor to start assembling the audit documentation and initiating the seven-year retention period. The Board decided that the seven-year retention period begins on the *report release date*, which is defined as the date the auditor grants permission to use the auditor's report in connection with the issuance of the company's financial statements. In addition, auditors will have 45 days to assemble the complete and final set of audit documentation, beginning on the report release date. The Board believes that using the report release date is preferable to using the filing date of the company's financial statements, since the auditor has ultimate control over granting permission to use his or her report. If an auditor's report is not issued, then the audit documentation is to be retained for seven years from the date that fieldwork was substantially completed. If the auditor was unable to complete the engagement, then the seven-year period begins when the work on the engagement ceased.

Section 802 of Sarbanes-Oxley and the SEC's Implementing Rule

A42. Many commenters had concerns about the similarity in language between the proposed standard and the SEC final rule (issued in January 2003) on record retention, *Retention of Records Relevant to Audits and Reviews*.[4/] Some commenters recommended that the PCAOB undertake a project to identify and resolve all differences between the proposed standard and the SEC's final rule. These commenters also suggested that the Board include similar language from the SEC final rule, Rule 2-06 of Regulation S-X, which limits the requirement to retain some items.

Differences between Section 802 and This Standard

A43. The objective of the Board's standard is different from the objective of the SEC's rule on record retention. The objective of the Board's standard is to require auditors to

[4/] SEC Regulation S-X, 17 C.F.R. § 210.2-06 (SEC Release No. 33-8180, January 2003). (The final rule was effective in March 2003.)

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS3

create certain documentation to enhance the quality of audit documentation, thereby improving the quality of audits and other related engagements. The records retention section of this standard, mandated by Section 103 of the Act, requires registered public accounting firms to "prepare and maintain for a period of not less than 7 years, *audit work papers, and other information related to any audit report*, in sufficient detail to support the conclusions reached in such report." (emphasis added)

A44. In contrast, the focus of the SEC rule is to require auditors to *retain* documents that the auditor does create, in order that those documents will be available in the event of a regulatory investigation or other proceeding. As stated in the release accompanying the SEC's final rule (SEC Release No. 33-8180):

> Section 802 of the Sarbanes-Oxley Act is intended to address the destruction or fabrication of evidence and the preservation of "financial and audit records." We are directed under that section to promulgate rules related to the retention of records relevant to the audits and reviews of financial statements that companies file with the Commission.

A45. The SEC release further states, "New rule 2-06 ... addresses the retention of documents relevant to enforcement of the securities laws, Commission rules, and criminal laws."

A46. Despite their different objectives, the proposed standard and SEC Rule 2-06 use similar language in describing documentation generated during an audit or review. Paragraph 4 of the proposed standard stated that, "Audit documentation ordinarily consists of *memoranda, correspondence*, schedules, and *other documents created* or obtained *in connection with* the engagement and may be in the form of paper, electronic files, or other media." Paragraph (a) of SEC Rule 2-06 describes "records relevant to the audit or review" that must be retained as, (1) "workpapers and other documents that form the basis of the audit or review and (2) *memoranda, correspondence*, communications, *other documents*, and records (including electronic records), which: [a]re *created*, sent or received *in connection with* the audit or review and [c]ontain conclusions, opinions, analyses, or financial data related to the audit or review. ..." (numbering and emphasis added).

A47. The SEC makes a distinction between the objectives of categories (1) and (2). Category (1) includes audit documentation. Documentation to be retained according to the Board's standard clearly falls within category (1). Items in category (2) include "desk files" which are more than "what traditionally has been thought of as auditor's 'workpapers'." The SEC's rule requiring auditors to retain items in category (2) have the principal purpose of facilitating enforcement of securities laws, SEC rules, and criminal laws. This is not an objective of the Board's standard. According to SEC Rule 2-06, items in category (2) are limited to those which: (a) are created, sent or received in connection with the audit or review, and (b) contain conclusions, opinions, analyses, or

financial data related to the audit or review. The limitations, (a) and (b), do not apply to category (1).

A48. Paragraph 4 of the final standard deletes the reference in the proposed standard to "other documents created or obtained in connection with the engagement." The Board decided to keep "correspondence" in the standard because correspondence can be valid audit evidence. Paragraph 20 of the standard reminds the auditor that he or she may be required to maintain documentation in addition to that required by this standard.

Significant Matters and Significant Findings or Issues

A49. Some commenters asked how the term *significant matters*, in Rule 2-06, relates to the term *significant findings or issues* in the Board's standard. The SEC's release accompanying its final Rule 2-06 states that "... *significant matters* is intended to refer to the documentation of substantive matters that are important to the audit or review process or to the financial statements of the issuer. ..." This is very similar to the term *significant findings or issues* contained in paragraph 12 of the Board's standard which requires auditors to document *significant findings or issues*, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached. Examples of significant findings or issues are provided in the standard.

A50. Based on the explanation in the SEC's final rule and accompanying release, the Board believes that *significant matters* are included in the meaning of *significant findings or issues* in the Board's standard. The Board is of the view that *significant findings or issues* is more comprehensive and provides more clarity than *significant matters* and, therefore, has not changed the wording in the final standard.

Changes to Audit Documentation

A51. The proposed standard would have required that any changes to the working papers after completion of the engagement be documented without deleting or discarding the original documents. Such documentation must indicate the date the information was added, by whom it was added, and the reason for adding it.

A52. One commenter recommended that the Board provide examples of auditing procedures that should be performed before the report release date and procedures that may be performed after the report release date. Some commenters also requested clarification about the treatment of changes to documentation that occurred after the completion of the engagement but before the report release date. Many commenters recommended that the Board more specifically describe post-issuance procedures. The Board generally agreed with these comments.

A53. The final standard includes two important dates for the preparation of audit documentation: (1) the report release date and (2) the documentation completion date.

- Prior to the report release date, the auditor must have completed all necessary auditing procedures, including clearing review notes and providing support for all final conclusions. In addition, the auditor must have obtained sufficient evidence to support the representations in the auditor's reports before the report release date.
- After the report release date and prior to the documentation completion date, the auditor has 45 calendar days in which to assemble the documentation.

A54. During the audit, audit documentation may be superseded for various reasons. Often, during the review process, reviewers annotate the documentation with clarifications, questions, and edits. The completion process often involves revising the documentation electronically and generating a new copy. The SEC's final rule on record retention, *Retention of Records Relevant to Audits and Reviews*,[5/] explains that the SEC rule does not require that the following documents generally need to be retained: superseded drafts of memoranda, financial statements or regulatory filings; notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking; previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees; and duplicates of documents. This standard also does not require auditors to retain such documents as a general matter.

A55. Any documents, however, that reflect information that is either inconsistent with or contradictory to the conclusions contained in the final working papers may not be discarded. Any documents added must indicate the date they were added, the name of the person who prepared them, and the reason for adding them.

A56. If the auditor obtains and documents evidence after the report release date, the auditor should refer to the interim auditing standards, AU sec. 390, *Consideration of Omitted Procedures After the Report Date* and AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. Auditors should not discard any previously existing documentation in connection with obtaining and documenting evidence after the report release date.

A57. The auditor may perform certain procedures subsequent to the report release date. For example, pursuant to AU sec. 711, *Filings Under Federal Securities Statutes,* auditors are required to perform certain procedures up to the effective date of a registration statement. The auditor should identify and document any additions to audit

5/ See footnote 4.

documentation as a result of these procedures. No audit documentation should be discarded after the documentation completion date, even if it is superseded in connection with any procedures performed, including those performed pursuant to AU sec. 711.

A58. Additions to the working papers may take the form of memoranda that explain the work performed, evidence obtained, and conclusions reached. Documentation added to the working papers must indicate the date the information was added, the name of the person adding it, and the reason for adding it. All previous working papers must remain intact and not be discarded.

A59. Documentation added to the working papers well after completion of the audit or other engagement is likely to be of a lesser quality than that produced contemporaneously when the procedures were performed. It is very difficult to reconstruct activities months, and perhaps years, after the work was actually performed. The turnover of both firm and company staff can cause difficulty in reconstructing conversations, meetings, data, or other evidence. Also, with the passage of time memories fade. Oral explanation can help confirm that procedures were performed during an audit, but oral explanation alone does not constitute persuasive other evidence. The primary source of evidence should be documented at the time the procedures are performed, and oral explanation should not be the primary source of evidence. Furthermore, any oral explanation should not contradict the documented evidence, and appropriate consideration should be given to the credibility of the individual providing the oral explanation.

Multi-Location Audits and Using the Work of Other Auditors

A60. The proposed standard would have required the principal auditor to maintain specific audit documentation when he or she decided not to make reference to the work of another auditor.

A61. The Board also proposed an amendment to AU sec. 543 concurrently with the proposed audit documentation standard. The proposed amendment would have required the principal auditor to review the documentation of the other auditor to the same extent and in the same manner that the audit work of all those who participated in the engagement is reviewed.

A62. Commenters expressed concerns that these proposals could present conflicts with certain non-U.S. laws. Those commenters also expressed concern about the costs associated with the requirement for the other auditor to ship their audit documentation to the principal auditor. In addition, the commenters also objected to the requirement that principal auditors review the work of other auditors as if they were the principal auditor's staff.

Audit Documentation Must be Accessible to the Office Issuing the Auditor's Report

A63. After considering these comments, the Board decided that it could achieve one of the objectives of the proposed standard (that is, to require that the issuing office have access to those working papers on which it placed reliance) without requiring that the working papers be shipped to the issuing office. Further, given the potential difficulties of shipping audit documentation from various non-U.S. locations, the Board decided to modify the proposed standard to require that audit documentation either be retained by or be accessible to the issuing office.

A64. In addition, instead of requiring that all of the working papers be shipped to the issuing office, the Board decided to require that the issuing office obtain, review, and retain certain summary documentation. Thus, the public accounting firm issuing an audit report on consolidated financial statements of a multinational company may not release that report without the documentation described in paragraph 19 of the standard.

A65. The auditor must obtain and review and retain, prior to the report release date, documentation described in paragraph 19 of the standard, in connection with work performed by other offices of the public accounting firm or other auditors, including affiliated or non-affiliated firms, that participated in the audit. For example, an auditor that uses the work of another of its offices or other affiliated or non-affiliated public accounting firms to audit a subsidiary that is material to a company's consolidated financial statements must obtain the documentation described in paragraph 19 of the standard, prior to the report release date. On the other hand, an auditor that uses the work of another of its offices or other affiliated or non-affiliated firms, to perform selected procedures, such as observing the physical inventories of a company, may not be required to obtain the documentation specified in paragraph 19 of the standard. However, this does not reduce the need for the auditor to obtain equivalent documentation prepared by the other auditor when those instances described in paragraph 19 of the standard are applicable.

Amendment to AU Sec. 543, *Part of Audit Performed by Other Independent Auditors*

A66. Some commenters also objected to the proposed requirement in the amendment to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, that the principal auditor review another auditor's audit documentation. They objected because they were of the opinion such a review would impose an unnecessary cost and burden given that the other auditor will have already reviewed the documentation in accordance with the standards established by the principal auditor. The commenters also indicated that any review by the principal auditor would add excessive time to the SEC reporting

process, causing even more difficulties as the SEC Form 10-K reporting deadlines have become shorter recently and will continue to shorten next year.

A67. The Board accepted the recommendation to modify the proposed amendment to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*. Thus, in the final amendment, the Board imposes the same unconditional responsibility on the principal auditor to obtain certain audit documentation from the other auditor prior to the report release date. The final amendment also provides that the principal auditor should consider performing one or more of the following procedures:

- Visit the other auditors and discuss the audit procedures followed and results thereof.
- Review the audit programs of the other auditors. In some cases, it may be appropriate to issue instructions to the other auditors as to the scope of the audit work.
- Review additional audit documentation of the other auditors relating to significant findings or issues in the engagement completion document.

Effective Date

A68. The Board proposed that the standard and related amendment would be effective for engagements completed on or after June 15, 2004. Many commenters were concerned that the effective date was too early. They pointed out that some audits, already begun as of the proposed effective date, would be affected and that it could be difficult to retroactively apply the standard. Some commenters also recommended delaying the effective date to give auditors adequate time to develop and implement processes and provide training with respect to several aspects of the standard.

A69. After considering the comments, the Board has delayed the effective date. However, the Board also believes that a delay beyond 2004 is not in the public interest.

A70. The Board concluded that the implementation date of this standard should coincide with that of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, because of the documentation issues prevalent in PCAOB Auditing Standard No. 2. Therefore, the Board has decided that the standard will be effective for audits of financial statements with respect to fiscal years ending on or after November 15, 2004. The effective date for reviews of interim financial information and other engagements, conducted pursuant to the standards of the PCAOB, would occur beginning with the first quarter ending after the first financial statement audit covered by this standard.

Reference to Audit Documentation As the Property of the Auditor

A71. Several commenters noted that SAS No. 96, *Audit Documentation*, the interim auditing standard on audit documentation, referred to audit documentation as the property of the auditor. This was not included in the proposed standard because the Board did not believe ascribing property rights would have furthered this standard's purpose to enhance the quality of audit documentation.

Confidential Client Information

A72. SAS No. 96, *Audit Documentation*, also stated that, "the auditor has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information," and referenced Rule 301, *Confidential Client Information*, of the AICPA's Code of Professional Conduct. Again, the Board's proposed standard on audit documentation did not include this provision. In adopting certain interim standards and rules as of April 16, 2003, the Board did not adopt Rule 301 of the AICPA's Code of Professional Conduct. In this standard on audit documentation, the Board seeks neither to establish confidentiality standards nor to modify or detract from any existing applicable confidentiality requirements.

Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

June 12, 2007
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 5 –

An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

[Effective pursuant to SEC Release No. 34-56152; File No. PCAOB-2007-02; July 27, 2007]

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

Table of Contents

Paragraph
Introduction 1-8
Integrating the Audits 6-8

Planning the Audit 9-20
Role of Risk Assessment 10-12
Scaling the Audit 13
Addressing the Risk of Fraud 14-15
Using the Work of Others 16-19
Materiality 20

Using a Top-Down Approach 21-41
Identifying Entity-Level Controls 22-27
Control Environment 25
Period-end Financial Reporting Process 26-27
Identifying Significant Accounts and Disclosures and Their Relevant Assertions 28-33
Understanding Likely Sources of Misstatement 34-38
Performing Walkthroughs 37-38
Selecting Controls to Test 39-41

Testing Controls 42-61
Testing Design Effectiveness 42-43
Testing Operating Effectiveness 44-45
Relationship of Risk to the Evidence to be Obtained 46-56
Nature of Tests of Controls 50-51
Timing of Tests of Controls 52-53
Extent of Tests of Controls 54
Roll-Forward Procedures 55-56
Special Considerations for Subsequent Years' Audits 57-61

Evaluating Identified Deficiencies 62-70
Indicators of Material Weaknesses 69-70

Wrapping-Up 71-84
Forming an Opinion 71-74
Obtaining Written Representations 75-77
Communicating Certain Matters 78-84

Reporting on Internal Control 85-98
Separate or Combined Reports 86-88
Report Date 89
Material Weaknesses 90-92
Subsequent Events 93-98

APPENDICES

APPENDIX A – DEFINITIONS A1-A11

APPENDIX B – SPECIAL TOPICS B1-B33
Integration of Audits B1-B9
Multiple Locations Scoping Decisions B10-B16
Use of Service Organizations B17-B27
Benchmarking of Automated Controls B28-B33

APPENDIX C – SPECIAL REPORTING SITUATIONS C1-C17
Report Modifications C1-C15
Filings Under Federal Securities Statutes C16-C17

Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment**[1/] of the effectiveness of **internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.[2/]

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.[3/] If one or more **material weakness**es exist, the company's internal control over financial reporting cannot be considered effective.[4/]

3. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance[5/] about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2/] This auditing standard supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements,* and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

[3/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f); Paragraph A5.

[4/] See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

[5/] See AU sec. 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance in an audit.

4. The general standards[6/] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.[7/]

Integrating the Audits

6. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

7. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously –

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

6/ See AU sec. 150, *Generally Accepted Auditing Standards.*

7/ See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as control criteria) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

8. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (See Appendix B for additional direction on integration.)

> Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;

- Control deficiencies previously communicated to the audit committee[8/] or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and
- The relative complexity of the company's operations.

Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

8/ If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its **control objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.[9/]

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10/] As part of identifying and testing entity-level controls, as discussed

9/ The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

10/ See paragraphs .19 through .42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* regarding identifying risks that may result in material misstatement due to fraud.

beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include –

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU sec. 316.44 and .45.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

> Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

> Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.[11/]

Using a Top-Down Approach

21. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

> Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

22. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

23. Entity-level controls vary in nature and precision –

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement

[11/] See AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, which provides additional explanation of materiality.

will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include –

- Controls related to the control environment;

- Controls over management override;

  Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- The company's risk assessment process;

- Centralized processing and controls, including shared service environments;

- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

25. *Control Environment.* Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

26. *Period-end Financial Reporting Process.* Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following –

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and

- Procedures for preparing annual and quarterly financial statements and related disclosures.

  Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. As part of evaluating the period-end financial reporting process, the auditor should assess –

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;
- The locations involved in the period-end financial reporting process;
- The types of adjusting and consolidating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

  Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a

reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include[12/] –

- Existence or occurrence
- Completeness
- Valuation or allocation
- Rights and obligations
- Presentation and disclosure

Note: The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include –

- Size and composition of the account;
- Susceptibility to misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

[12/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- Existence of related party transactions in the account; and
- Changes from the prior period in account or disclosure characteristics.

30. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

31. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[13/]

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

[13/] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 and AU sec. 316.50 for further discussion about predictability of auditing procedures).

33. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;
- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;
- Identify the controls that management has implemented to address these potential misstatements; and
- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU sec. 322.

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to

identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this standard.

37. *Performing Walkthroughs.* Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

39. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

40. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**).

Testing Controls

Testing Design Effectiveness

42. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

43. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

44. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

> Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

45. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

> Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

47. Factors that affect the risk associated with a control include –

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

  Note: A less complex company or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.
- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

  Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

48. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent

of testing may provide sufficient evidence in relation to the risk associated with the control.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

50. *Nature of Tests of Controls*. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control.

Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

51. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

52. *Timing of Tests of Controls*. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

53. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (See additional direction on integration beginning at paragraph B1.)

54. *Extent of Tests of Controls*. The more extensively a control is tested, the greater the evidence obtained from that test.

55. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors –

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special Considerations for Subsequent Years' Audits

57. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 46 through 56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following –

- The nature, timing, and extent of procedures performed in previous audits,
- The results of the previous years' testing of the control, and
- Whether there have been changes in the control or the process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.
60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

62. The auditor must evaluate the severity of each control **deficiency** that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management's assessment. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

63. The severity of a deficiency depends on –

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

64. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

65. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following –

- The nature of the financial statement accounts, disclosures, and assertions involved;
- The susceptibility of the related asset or liability to loss or fraud;
- The subjectivity, complexity, or extent of judgment required to determine the amount involved;
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies; and
- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following –

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

67. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include –

- Identification of fraud, whether or not material, on the part of senior management;[14]

- Restatement of previously issued financial statements to reflect the correction of a material misstatement;[15]

- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

70. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

[14] For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

[15] See Financial Accounting Standards Board Statement No. 154, *Accounting Changes and Error Corrections*, regarding the correction of a misstatement.

Wrapping-Up

Forming an Opinion

71. The auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

> Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[16]

73. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

74. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (see paragraphs C3 through C7).

Obtaining Written Representations

75. In an audit of internal control over financial reporting, the auditor should obtain written representations from management –

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

[16] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 78 and 80 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

76. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor

should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in the audit of the company's financial statements.

77. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

79. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.

80. The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are **significant deficiencies** and must communicate such deficiencies, in writing, to the audit committee.

81. The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[17/]

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18/] –

a. A title that includes the word *independent*;

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

e. A definition of internal control over financial reporting as stated in paragraph A5;

f. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

[17/] See 15 U.S.C. § 78j-1.

[18/] See Appendix C, which provides direction on modifications to the auditor's report that are required in certain circumstances.

g. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;

k. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

l. The manual or printed signature of the auditor's firm;

m. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

n. The date of the audit report.

Separate or Combined Reports

86. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8

and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].
[*Signature*]

[*City and State or Country*]

[*Date*]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

Report Date

89. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

90. Paragraphs 62 through 70 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[19/]

91. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include –

- The definition of a material weakness, as provided in paragraph A7.
- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

  Note: If the material weakness has not been included in management's assessment, the report should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor

[19/] See paragraph C3 for direction when the scope of the engagement has been limited.

concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

92. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

Subsequent Events

93. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 75h.

94. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following –

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,
- Independent auditor reports (if other than the auditor's) of deficiencies in internal control,
- Regulatory agency reports on the company's internal control over financial reporting, and

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

95. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provide direction on subsequent events for a financial statement audit that also may be helpful to the auditor performing an audit of internal control over financial reporting.

96. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

97. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal control over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

98. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

***APPENDIX A* – Definitions**

A1. For purposes of this standard, the terms listed below are defined as follows –

A2. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A3. A **deficiency** in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("GAAP"). References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[1/]

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

A6. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2/]

[1/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

[2/] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

A7. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a **reasonable possibility** of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS 5").[3/]

A8. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A9. A **relevant assertion** is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.

A10. An account or disclosure is a **significant account or disclosure** if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

A11. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

3/ See FAS 5, paragraph 3.

***APPENDIX B* – Special Topics**

Integration of Audits

B1. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the

company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements

detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B10. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

> Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's consolidated financial statements.

B11. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B13. The direction in paragraph 61 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B14. *Special Situations.* The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

B17. AU sec. 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of the company's information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B18. AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the

service organization when determining the evidence required to support his or her opinion.

B19. AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include –

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

B20. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU sec. 324.12. These procedures include –

a. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

   Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU sec. 324.24b). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU sec. 324.24a) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

b. Performing tests of the user organization's controls over the activities of the service organization (e.g., testing the user organization's independent re-performance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

c. Performing tests of controls at the service organization.

B21. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in AU sec. 324.16.

B22. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B23. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed

in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

B24. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B25. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include –

- Evaluating procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

B27. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Benchmarking of Automated Controls

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

B31. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application.
- The extent to which the application is stable (i.e., there are few changes from period to period).
- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B32. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote – e.g., when the vendor does not allow access or modification to the source code.

B33. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.
- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.
- The nature and timing of other related tests.
- The consequences of errors associated with the application control that was benchmarked.
- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed

with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

***APPENDIX C* – Special Reporting Situations**

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented,

b. There is a restriction on the scope of the engagement,

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report,

d. There is other information contained in management's annual report on internal control over financial reporting, or

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented.* If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 91.

C3. *Scope Limitations.* The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 85 g, h, and i); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include –

- The definition of a material weakness, as provided in paragraph A7.
- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 91.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 89 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements must participate sufficiently in the audit of

internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1/]

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 72 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU sec. 317,

[1/] See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

Illegal Acts by Clients and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2]

> Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated.* If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3] the auditor should follow the communication responsibilities as described in AU sec. 722 *Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU sec. 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU sec. 711 with respect to the auditor's report on internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on internal control over financial reporting in the securities

[2] See 15 U.S.C. § 78j-1.

[3] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

Public Company Accounting Oversight Board
Bylaws and Rules – Standards – AS5

filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

LESSONS LEARNED THE HARD WAY

Ten Flags of Possible Financial Mismanagement and Fraud

BY DEBORAH M. HOUSE

"History is a guide to navigation in perilous times."
—David McCulloch, author and historian

"Those who cannot remember the past are condemned to repeat it."
—George Santayana, author and philosopher

As chief legal officers (CLOs) watch the corporate financial debacles that ushered in this century and continue today, a silent prayer can nearly be heard: "Please. Not here. Not on my watch." For a very small few, such a request is about not getting caught. But for the vast majority, it is probably wishful thinking, closely linked to a silent admission that they do not really understand the CFO's complicated, green-eyeshade world.

Unquestionably, today's in-house counsel must have a greater knowledge of the accounting rules that affect the company. As Stasia Kelly, ACC board member, general counsel of American International Group, Inc., and former general counsel of MCI, Sears, and Fannie Mae advises: "Ten years ago, I would read an earnings release and trust that the CFO and the accounting folks knew what they were doing. Now, I make sure that I understand all the accounting items in the release, and I ask the questions: Are the one-time events truly one-time events? Are the reserve releases appropriate? Is there an earnings management issue?"[1]

This advice is well taken. However, the need for new expertise does not necessarily mean a return to school to acquire an accounting degree. There is much to be learned from examining history, including the publicly available reports of major corporate financial disasters (Independent Reports).[2] Lessons taken from these experiences instruct us on how to navigate in these perilous times and avoid repeating the past. Find out how to flag the activities that will alert us to potential dangerous waters ahead.[3]

The Stakes Are Too High

Wait a minute, you say. Don't in-house counsel already have enough on their plate? Must we have accounting expertise as well? Shouldn't accounting be left to the accountants? Won't increased knowledge subject me to increased liability? The answers to these questions, respectively, are:

1. You bet!
2. Afraid so.
3. No, it's like leaving war solely to the generals; scary to contemplate.
4. Perhaps, but it will also give you an opportunity to significantly decrease your liability by addressing these issues. The ostrich approach simply does not work well.

When a company goes under for financial mismanagement or fraud, or even if it survives, the human toll is significant. For a significant number shareholders—many of whom are employees—retirement nest eggs disappear, college savings collapse, and mortgages go unpaid. Employees who have absolutely nothing to do with the financial misdeeds suffer the loss of their jobs or disruptive relocations, and humiliation by association. Those who may or may not have responsibility are the subject of extensive regulatory inquiry and may even be prosecuted.

The company itself fares no better. Even if it does not completely collapse, the practical impact of financial mismanagement—for good or for bad, deserved or undeserved—may be extreme. The corporation's reputation takes a nosedive. The stock plummets and languishes. Managers are replaced in droves. Internal reorganizations run rampant. A severe brain drain occurs as faulted and faultless long-time employees—involuntarily or voluntarily—leave the company for greener pastures. An army of independent investigators descends, and the sky is darkened with consultants who recalculate the company's numbers and redo its policies and systems. All of them bill by the hour in amounts that shock and cause a severe drain on the corporate treasury.[4]

Time previously spent by employees actually doing the work of the company is now focused on responding to investigators, regulators, consultants, plaintiffs, and prosecutors. For some, standing around the water cooler contemplating the company's gloomy outlook may become the favorite pastime. Other employees ruin their health and/or their home life working 24/7 to pull the company back up by its tattered bootstraps.

In-house counsel are not immune to any of this, as they too are shareholders and employees. For some, the price has been even higher. Their reputations are besmirched and they suddenly may find themselves in the deponent chair at the deposition table.

In-house Counsel Have Much to Contribute

The good news is that in-house counsel are well situated to address important aspects of many accounting matters.

- We are often able to see the big picture by having a vantage point that defies traditional corporate silos.
- Many of the factors underlying improper financial management belong to both the legal and the accounting worlds (e.g., what constitutes materiality, whether a conflict of interest exists, or whether risk has passed in a sale of assets).

- The CLO continues to play a significant role in corporate compliance, acting either as the chief compliance officer (CCO), as supervisor for the CCO, or as counsel to the compliance function. This is important because establishing and maintaining a corporate culture committed to compliance, providing compliance training, and monitoring for compliance—tasks often spearheaded by the CCO—are essential to avoiding financial mismanagement and fraud.
- The CLO often manages or participates in relationships relevant to proper financial management, including interaction with the SEC, other regulators, auditors, and the board's audit committee.
- Many transactions used as the tools to perpetrate accounting fraud cannot be accomplished without the participation or acquiescence of in-house counsel (e.g., establishing special-purpose entities that are used to move debt off the balance sheet). Where these transactions are structured and papered by outside counsel, in-house counsel are likely to be managing and consulting with them.
- In-house counsel understand how to establish rules, processes, and systems, combined with the overall corporate knowledge that helps assure compliance. In the post-Sarbanes world, these are essential talents.
- Because in-house counsel regularly deal with the ambiguities attendant to interpreting and applying the law, they may have a greater level of comfort raising questions about accounting concepts that also are not black and white.

To date, the role played by lawyers has gotten some bad

> A company that **does not** have a culture committed to **compliance** just **"talks the talk,"** it doesn't **"walk the walk."**

press. As Stephen Cutler, former director of the SEC's Division of Enforcement, observed, "We have seen too many lawyers who twisted themselves into pretzels to accommodate the wishes of company management and failed to insist that their company comply with the law."

Perhaps this image could be transformed for the better if, as lawyer and statesman Elihu Root suggested, in-house counsel would tell their clients "they are damned fools and should stop."[5] Granted the message should be delivered a little more diplomatically, but certainly to the same effect if required. And required it may be—if your company is engaging in activities that may set the scene for or actually constitute financial mismanagement or fraud.

The Ten Flags

An examination of the Independent Reports reveals that companies who are alleged to have engaged in financial mismanagement and/or fraud evidence multiples of the following attributes in their operations and activities. Spotting one or more of these characteristics is certainly not determinative of possible mismanagement or fraud. However, they do serve as warning flags that should cause you to be alert.

1. The company does not have a culture committed to ethical conduct and compliance with the law.

The US Sentencing Commission was created in 1985 for the purpose of developing sentencing guidelines (Guidelines) to assure that comparable misconduct by similar offenders received similar sentences. Organizations are given a sentencing credit if they have an effective ethics and compliance program (Program). However, the Guidelines are not just about sentencing; they also serve as a benchmark for prosecutors and regulators in determining whether they are going to take action against a company.

Under the Guidelines, an effective Program "promotes an organizational culture that encourages ethical conduct and a commitment to compliance with the law. . ."[6] The Advisory Group recommending the 2004 revisions to the Guidelines stated that an appropriate organizational culture:

> *. . . is one in which compliance with the law is the expected behavior. Rather than solely emphasizing conduct restrictions and information gathering activities aimed at preventing and detecting violations of law, an organizational culture that encourages a commitment to compliance with the law also includes positive actions which demonstrate that law compliance is a key value within the organization. In general, organizational culture, in this context, has come to be defined as the shared set of norms and beliefs that guide individual and organizational behavior. These norms and beliefs are shaped by the leadership of the organization, are often expressed as shared values or guiding principles, and are reinforced by various systems and procedures throughout the organization.*[7]

Companies that allegedly engage in financial mismanagement or fraud do not have an appropriate corporate culture. This could be evidenced by the lack of an "open working environment," meaning that employees do not have opportunities to raise issues of concern and do not feel free to do so; employees justifiably fear retaliation, and retaliation is tolerated. Another attribute is the uneven application of the company's standards and procedures among the rank-and-file employees and senior management. Executives at these companies may enter into transactions and use corporate assets in a way that conflicts with the company's best interests, violates its standards of conduct, and generously lines their own pockets.

Another common attribute cited in the Independent Reports are arrogant CEOs (and CFOs) who portray a sense of entitlement and tend to "reign" rather than preside over the company's activities, who engage in strategies designed to tightly control the information provided to the board and limit its oversight, and who are not open to good-faith consideration of the views of others, including their own senior management. A company that does not have a culture committed to compliance just "talks the talk," it doesn't "walk the walk." Enron had the corporate slogan of "Respect, Integrity, Community, Excellence." Enough said.

In fact, rather than having a culture committed to compliance, the companies reviewed in the Independent Reports had the antithesis. They had financially driven cultures. Among the cultures cited were those committed to steady or double-digit earnings, consistently meeting Wall Street expectations, or constantly hitting targets that triggered lucrative executive compensation. Sometimes the culture had a mix of all of these characteristics.

2. The company is engaging in inappropriate earnings management.

Unquestionably the application of generally accepted accounting principles (GAAP) allows companies a great deal of flexibility in calculating earnings and other items of financial information. There are numerous legitimate variables in how companies value their accounts (e.g., is it collectible? when is it collectible?), their inventory (e.g., which cost valuation method to use? has the value changed, given new consumer

tastes?), their assets (e.g., which depreciation method should be used? what is its useful life? what is the conversion rate for foreign cash?), and even their liabilities (e.g., what will happen to interest rates? what is the possibility of a plaintiff's success in a lawsuit?) Moreover, the line between treating an item as an asset or a liability, for example, can be razor thin.

However, quality financial information should reflect economic reality. When a company manipulates its financial information so that it achieves a desired target to the detriment of economic reality, that constitutes inappropriate earnings management and potentially constitutes fraud.[8] An example of such an activity would be WorldCom's alleged improper capitalization of operating expenses with the intended resultant effect of increasing its earnings per share to meet analysts' expectations. [9]

The questionable practice of inappropriate earnings management was highlighted as early as 1998 by then SEC Chairman Arthur Levitt, who warned that:

> *[Earnings management] has evolved over the years into what best can be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system. . . Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. . . . Managing may be giving way to manipulation; Integrity may be losing out to illusion.*[10]

Inappropriate earnings management has its genesis in the pressure placed on companies to meet Wall Street's projections. Because these projections are based in part on information provided by the companies themselves, meeting them not only speaks to the value of the company's shares, but the company's credibility as well. And the stakes are very high. Levitt cites an incident where a company's failure to "meet its numbers" **by one penny** resulted in a loss of 6 percent of its stock value in one day.

What form may inappropriate earnings management take? The Independent Reports, Levitt, other experts,[11] and the SEC[12] cite a significant number of approaches that are inappropriate if engaged in for improper reasons (e.g., meeting analysts' expectations, triggering executive compensation) and if not reflecting financial reality. They include:

- **Big Bath Charges:** Companies significantly restructure themselves with the intent of cleaning up their balance sheet. Sometimes the cost of such an effort is intentionally overestimated, and this cushioning subsequently becomes income when estimates change or earnings fall short. Analysts tend to treat the "big bath" as a one-time event and focus on future earnings.
- **Creative Acquisition Accounting:** Companies classify a portion of an acquisition cost as "in-process" research and development so that the amount can be written off in a one-time charge, removing any earnings drag. More recently, this has been replaced with goodwill impairment (i.e., marking down the carrying value to the fair market value).
- **Use of Cookie Jar Reserves:** Companies use unrealistic assumptions or intentionally oversize reserves for future liabilities. These reserves are then used to boost earnings during difficult times. Companies also purposefully understate reserve liabilities to improve their overall financial picture.
- **Accelerating (or Delaying) Revenue:** Companies intentionally recognize revenue prematurely or delay its recognition. Companies may accelerate or delay revenue by mischaracterizing contractual benefits and obligations. Accounting treatments may be particularly suspect where companies recognize revenue for one period while attributing associated expenses for another.
- **Accelerating (or Delaying) Expenses:** Companies intentionally prematurely recognize or unjustifiably delay expense recognition. One significant way that companies have accelerated expenses is recognizing a "nonrecurring" expense (a one-time charge-off). Expenses are often delayed by inappropriately capitalizing them.
- **Inappropriate Use of Special Purpose Entities (SPEs):** SPEs have long been used legitimately to isolate financial risk and remove associated debt from the reporting company's balance sheet. However, the SPE has to meet certain criteria relating to ownership, independence, and the transfer of assets. If these criteria are not met, off-balance sheet treatment is not appropriate.
- **Pro Forma Earnings:** This describes a financial statement prepared on a basis defined by the company and not in accordance with GAAP. Some would argue that it is a useful method of clarifying the company's financial picture. Others have dubbed it as "EEBS" for "earnings excluding bad stuff." Significant differences between GAAP and pro forma statements should be scrutinized.
- **Immaterial Accounting Errors:** Earnings management is often achieved through the misuse of the concept of "materiality." A subject near and dear to the hearts of accountants and attorneys alike, as a general rule it must be determined whether omissions or misstatements in a financial statement are material or immaterial deviations from GAAP accounting. If they are determined to be immaterial, then an auditor will allow them to be reported without taking issue with them.

Levitt criticized the practice of using a rule of thumb that deviations within a certain percentage of a registrant's net income or net earnings per share (e.g., under 5 percent) are immaterial. In repudiating this analysis, he noted that, "In markets where missing an earnings projection by a

penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called nonevents simply don't matter. . . . I reject the notion that the concept of materiality can be used to excuse deliberate misstatements of performance."

At Levitt's direction, the SEC subsequently issued an accounting bulletin on this issue. It specifically rejects the notion that materiality determinations may be based on a quantitative analysis alone. Rather, it requires that "all the relevant circumstances" must be considered and concludes that "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." Included among the qualitative considerations identified by the SEC are whether the misstatement:

- masks a change in earnings or other trends;
- hides a failure to meet analysts' consensus expectations for the enterprise;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- affects the registrant's compliance with regulatory requirements;
- affects the registrant's compliance with loan covenants or other contractual requirements;
- has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation;
- involves concealment of an unlawful transaction;
- may result in a significant positive or negative market reaction; and
- involves a segment of the registrant's operations that is significant to the financial statements as a whole.[13]

ACC Extras on . . . Financial Mismanagement and Fraud

ACC Committees:

More information about these ACC committees is available on ACC Online[SM] at *www.acca.com/networks/committee.php,* or you can contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or *windley@acca.com.*

- Financial Services Committee: *http://www.acca.com/php/cms/index.php?id=107*

Annual Meeting Course Materials:

Program material is available from the following courses at ACC's 2005 Annual meeting. *Vampires of the Bottom Line: A Look at Corporate Fraud,* ACCA, 2002.

Description: Discussion of various types of fraud, red flags that may indicate fraud, and factors that can contribute to or deter fraud *www.acca.com/resource/v3355.*

Quick Reference

Indicia of Corporate Fraud, http://www.acca.com/resource/v3685.

3. The board does not function independently or exercise appropriate oversight and permits management to determine the information it receives.

Serving on a board of directors, particularly on the audit committee, is not a task for the faint-hearted. Sarbanes-Oxley, the New York Stock Exchange listing reforms, the Federal Sentencing Guidelines, and other statutory and regulatory provisions have imposed a plethora of new requirements that must be met. Among other things they include: new elements of independence for the board's directors and its committees; executive session meetings; limiting board compensation; active board oversight of company activities; ensuring that audit committee members have appropriate financial expertise; publication of corporate governance guidelines and charters for key committees; board and key committee annual evaluations; and board training. Corporate boards have also been the subject of extreme criticism. The Delaware Chancery Court's decision in the *Disney* case, while finding that the board had not breached its fiduciary duty, lambasted it for having a culture that was "unwholesome" and in which "ornamental passive directors contribute[d] to sycophantic tendencies among directors."[14] The Independent Reports have similarly characterized the respective boards reviewed as "failing in its oversight duties," "deferring to management almost completely," and "not overseeing management's processes and decisions with an appropriately skeptical eye."

At a minimum, a properly operating board should demonstrate the following characteristics:

- Members are prepared and informed, request additional information when needed, and exercise appropriate oversight. They do not let executive management dictate their agenda or direct their course. Appropriate time is dedicated to their activities.
- Director qualifications and the activities and effectiveness of board committees are taken seriously.
- The criteria for executive compensation are carefully considered and established, and the compensa-

tion process and associated accounting concepts are monitored.
- Independent advice is acquired when needed.
- Board decisions (including the process) and other activities are appropriately documented.
- Conflicts of interests of executive management and appropriate use of corporate assets are considered and monitored.
- Corporate governance is taken seriously, benchmarked against appropriate standards, and modified as appropriate.

4. The financial or internal audit functions lack qualified personnel.

There are two aspects to this issue: (1) whether financial and audit personnel have the proper qualifications and competencies; and (2) whether they have sufficient staff and other resources.

As to the first, consider the likelihood that a CLO might not have a law degree. "Less than none" is the foregone answer. However, the Independent Reports reflect instances where the CFOs for huge corporations with complex financial activities were not CPAs and did not have other appropriate experience; similar situations existed with regard to the controller and the individual heading the internal audit function. In some instances, there was also rapid turnover or protracted periods during which no one held these positions at all.

As to the second aspect, the failure of a company to invest in appropriate financial or internal audit staffing can be financially disastrous if not fatal. It also reflects a lack of corporate concern with those things for which it should be concerned. The Independent Reports reflect that this was a recurring problem. Most telling is that after the axe fell, a frequent remedial measure was to rapidly staff up the financial and internal audit positions, sometimes to the tune of hundreds of employees.

5. Organizational structures with inherent conflicts of interests.

Many companies carefully establish appropriate standards and procedures to guard against potential conflicts of interests that might arise between the company and its employees' personal interests. However, they do not consider the conflicts of interests inherent in their organizational structures and certain internal practices and the problems these may present. Conflicts of this nature may cause companies to act in inappropriate ways. Examples reflected in the Independent Reports include:
- The personnel responsible for establishing financial standards and monitoring their appropriate use are also the ones responsible for applying them.
- Personnel are charged with monitoring the actions of their superiors (and their superiors' direct reports). For example, where the head of internal audit reports to the CFO who also supervises the financial activities of the company.
- Personnel who report to the audit committee (e.g., internal audit) have their performance evaluated and their compensation determined by the executive management whose activities they scrutinize.
- Where internal audit reports to the audit committee but has its communications with the board tightly controlled by the CEO or CFO.

Delegations of authority for making accounting-related decisions are not clear, if they exist at all. This allows accounting changes to be made "on the top" without the concurrence or knowledge of responsible personnel, and sometimes with their objection.

6. The company lacks adequate internal controls.

Section 404 of Sarbanes Oxley required the SEC to issue rules requiring registered companies to evaluate their "internal controls" and report on that assessment annually. While the SEC's response focused only on internal controls related to financial reporting, given the breadth of what goes into financial reporting, its practical effect was to require companies to take a hard look at many significant systems.

However, where financial control issues have not been identified or have not been corrected—or where the controls are nonfinancial in character and haven't been addressed—the lack of such controls can act as a factor in financial mismanagement or fraud for several reasons:
- It contributes to a corporate culture of "anything goes" rather than a culture committed to ethical conduct and compliance.
- It enables *ad hoc* decisions to be made that are designed to address the most pressing objective at the moment—perhaps an impermissible one.
- It enables individuals to exceed their authority and make decisions which they should not be making or which should not be made without the input of others (e.g., the review and approval of the CLO).
- It permits a Band-Aid® and chewing-gum approach to corporate activities, which may be based on the analysis of the moment, may not be properly documented, and may change radically and without explanation when the next problem arises.
- It disempowers lower level employees who might otherwise rely on the controls, standards and procedures to assure that an activity is carried out properly.

7. The executive compensation system is based on inappropriate incentives and has inadequate checks and balances.

A Delaware court recently noted that "[w]hile there may be instances in which a board may act with deference to corporate officers' judgments, executive compensation is not one of those instances."[15] From a financial mismanagement viewpoint, there are several significant reasons why this should be true.

First, under the Federal Sentencing Guidelines, one required component of an effective compliance and ethics program (which the board oversees) is to provide "appropriate incentives to perform in accordance with the compliance and ethics program."[16] Thus, it is imperative that the board

SEC and Criminal Proceedings Against Inside Corporate Counsel Increasing

By John K. Villa, *ACC Docket "Ethics & Privilege"* columnist

SEC Civil Proceedings

The SEC initiated more than 30 enforcement proceedings against corporate attorneys from early 2002 through mid-2005. In the intervening 12 months, the SEC has initiated four more actions. The new actions allege fraudulent accounting and market-timing schemes and the making of false and misleading statements in filings and press releases. Two of the actions involve the companies' general counsel while the other two implicate senior in-house lawyers. In all of the actions, counsel's role involved the preparation of the false or misleading documentation to support and/or conceal the allegedly fraudulent scheme.

For example, the SEC alleges that the assistant general counsel of a reinsurance company drafted sham reinsurance contracts, and assisted in developing and then concealing side agreements. In a case that arose from a market-timing scheme, the SEC alleged that the general counsel of a hedge fund created entities with accounts having names designed to hide the fund's relationship to these accounts, and prepared annuity contracts that named himself and other employees as annuitants to further conceal the fund's identity.

In a fraudulent revenue recognition scheme, the SEC alleges that a senior in-house attorney drafted the terms of the transaction and supporting documents so as to ensure that the wording did not expose the schemers' efforts to circumvent GAAP, and actively sought to prevent the disclosure of undocumented side agreements. Finally, the SEC alleges that the general counsel of a biotechnology company drafted and approved SEC filings and press releases that failed to disclose or falsely described the regulatory status of a company product. The SEC also alleges that counsel sought outside counsel's advice, but failed to heed that advice. Two of the actions remain pending; two have settled. One counsel faces criminal prosecution for his conduct.

Criminal Proceedings

From 2002 through mid-2005, approximately eight criminal actions were brought against in-house counsel for their roles in fraudulent schemes. Since mid-2005, five more in-house counsel have been indicted. In a departure from prior prosecutions, two criminal prosecutions involve more than one in-house counsel: one involves two inside counsel who were employed by separate but related companies in which they held the position of general counsel; the other involves two inside counsel from the same company, the general counsel, and the associate general counsel.

One of the recent criminal prosecutions alleges a scheme to defraud the company for personal gain; all of them involve the manipulation of the company's financial statements. For example, one prosecution has alleged fraudulent diversion from a public company of millions of dollars through noncompetition agreements executed in connection with the sales of operations. The indictment alleges that the general counsel of the company, along with the general counsel of a related entity, prepared the closing documents and noncompetition agreements that falsely benefited another entity which was not entitled to compensation. Similarly, in another prosecution involving a scheme to mislead investors through fraudulent reinsurance contracts, the indictment alleges that the assistant general counsel crafted the sham contracts and the undisclosed side agreements that were part of the scheme.

The trend line evident in the last 12 months is that both SEC regulatory sanctions and criminal prosecution of inside counsel are increasing sharply, the nature of the conduct that prompts criminal prosecution for one lawyer is not distinguishable from conduct that elicits only SEC sanctions against another lawyer, and it can no longer be said with confidence that only the general counsel is at risk. All of these are disturbing trends and are not likely to change in the future.

Editor's Note: Mr. Villa's study excluded insider trading cases against corporate counsel. Mr. Villa's "Ethics & Privilege" column appears monthly in the *ACC Docket*.

link executive compensation to ethical and legal conduct. Compliance-related performance standards should be both qualitative (e.g., creating and maintaining an appropriate corporate culture) and quantitative (e.g., implementing internal controls, responding to audit findings). Moreover, these standards should be real and truly applied: "A college football coach can be told that the graduation rates of his players are what matters, but he'll know differently if the sole focus of his contract extension talks or the decision to fire him is his win-loss record."[17]

The importance of these standards is underscored by observations such as those of Boeing's chairman and CEO W. James McNerney, who indicated that the incidents that led to criminal investigations of the company, in part occurred because Boeing's previous management didn't place enough emphasis on ethical behavior. As a result, he scrapped an executive-compensation plan under which executives were rewarded for meeting primarily financial goals, and replaced it with one tied to broader criteria, including integrity and ethical leadership.[18]

Second, the board should take steps to assure that compensation is not linked to factors that may encourage inappropriate earnings management. The Independent Reports are replete with examples of earnings management by senior and executive management to achieve higher compensation. Accordingly, compensation linked solely to EPS or other Wall Street expectations may be problematic. The trend is to use specific targets that are less likely to be manipulated, fewer stock options, and more restricted stock and cash compensation. This is a subject suitable for experts, and the board should secure independent advice uncontrolled by management.

Third, the board should exercise independent judgment in evaluating whether appropriate performance standards have successfully been met. Such evaluations might be based on 360-degree reviews, employee surveys, and input from the compliance function.

8. There is a lack of candor and provision of information between the company's financial and business operations and internal and/or external audit.

A number of factors establish the foundation for the relationship between the financial and business operations and internal and/or external audit.

- Do senior managers set a good example in their relationship with the audit function (e.g., are they respectful of the function, do they exercise candor and provide full appropriate information in their own responses—and require it in responses they may supervise—to internal and external audit inquiries)?

> Thus, it is **imperative** that the board link executive compensation to **ethical** and **legal** conduct.

- Do the internal/external auditors have the qualifications and level of competency that will create appropriate respect?
- Have adequate resources been allocated to the internal audit function?
- Is senior management's response to audit findings to appropriately address them in a timely fashion?
- Does the organizational structure for internal audit provide it with appropriate independence?
- Does internal audit have a place at the table in the company's power structure and within its operations?

Negative responses to the above questions may foreshadow financial and operational problems.

9. There is too much reliance on the external auditors.

"Run it past the auditors" is a common corporate phrase, as if securing their blessing is the appropriate final word on any accounting decision. However, external auditors may not always have the right answer. Look at KPMG's $22 million settlement with the SEC for its alleged role in Xerox's accounting problems, or Deloitte & Touche's $50 million SEC settlement of charges stemming from its audit of Adelphia Communications. Companies currently under fire for matters relating to stock option dating cite their auditors' approval of their actions. Finally, the Independent Reports are also strewn with instances where external auditors allegedly assured their clients that the actions subsequently criticized were appropriate, or allegedly failed to detect the mismanagement or fraud that was occurring that might have changed audit opinions. They also cite instances where external audit denied having reviewed a matter, although management asserted they had. Moreover, as Lynn Turner, former chief accountant of the SEC put it, the defense of relying on the auditors "isn't plausible anymore."[19]

This is not to say that the expertise of external auditors is not a valuable thing. It is. However, that expertise cannot be relied on as an alternative to having qualified, competent, corporate internal auditors and financial staff who have adequate resources. In short, while external audit's opinions are going to be helpful, total reliance on their advice may be a trip down a dangerous road.

10. Something is rotten in the state of Denmark.

The *Oxford English Dictionary* defines *corporation* as "a body corporate legally authorized to act as a single individual." But while it may be acting as a "single individual," company operations are carried out by many individuals. And those people write memos, make presentations, talk around the water cooler and in the conference room, and blanket electronic pathways with a rich abundance of emails. Some of the content of these communications is honest truth, some part fact and part fiction, and some unfounded gossip.

But it behooves in-house counsel to pay attention to these communications. For, as the palace guard advised Hamlet, sometimes what you observe and what you hear will cause you to know that "something is rotten in the state of Denmark." That information may alert you to the possibility of financial mismanagement or fraud. Examples from the Independent Reports include:

- Excessive use of corporate assets by executive management, including using corporate money for acquisitions of personal real estate, personal property, and payment of other expenses that individuals would normally be expected to pay for themselves.
- Use of corporate assets to make large donations to charitable organizations outside of a corporate-approved program, particularly where the contribution is attributed to the individual.
- Exclusions, intentional or otherwise, of the legal department from important decision-making processes—particularly if they relate to disclosure matters and complex, structured financial transactions.
- "Slush funds" or other initiatives that have no corporate-approved procedures and standards, which are used to reward employees as the CEO deems fit.
- Transactions that are primarily undertaken for accounting reasons and that have no other substantive benefit to the company, particularly at quarter or year's end.
- Transactions personally benefiting company employees (or their significant others) in a way that is detrimental to the company and excessive for the services rendered (if any) by the employee or related third party.
- Patterns of favorable earnings or other financial results that are inconsistent with the overall market or cannot otherwise be legitimately explained. If it seems too good to be true—it usually is not.

What Can In-house Counsel Do?

Quite a bit. For example:

- There should be an open working environment in the legal department where staff can raise important issues without fear of retaliation. This will not only help flush out issues to be resolved for the benefit of the company, but serve as an example to others.
- In-house counsel can use their big-picture vantage point to help assure that all the pieces come together for the greater good. Some of the fraud that was allegedly perpetuated was facilitated by isolating the financial management activities of one corporate unit from the other, or permitting one silo to act without scrutiny.
- In-house counsel can assure that the legal issues underlying proper financial management are properly and reasonably addressed. Delegations of authority should be clear and inviolate except in prescribed circumstances. "Materiality" determinations should consider qualitative factors. Conflicts of interest should be avoided or carefully monitored with appropriate checks and balances. Waivers of corporate standards (e.g., codes of conduct) should be few and far between and disclosed as required.
- The CLO can play a significant role in assuring that the corporate compliance program meets the requirements of the Federal Sentencing Guidelines.[20] Among other things, such a program should: include a corporate culture conducive to proper financial management; establish, communicate, and train personnel about appropriate financial and audit standards; establish compliance-related performance standards and evaluations; and monitor adherence to the program. When problems are encountered, they should be remedied immediately and the program adjusted accordingly.
- The CLO can play an important part in assuring that any internal investigations, including responses to whistleblowers, are appropriately conducted using the right resources—which may mean bringing in outside experts or being subject to criticism for failure to do so.
- Relationships in which the CLO participates—including those with the SEC, regulators, auditors, the CEO, the CFO, and the board—should be conducted in a manner that promotes appropriate financial management. Openness and integrity should be keystones.
- In-house counsel should review complex financial transactions. As part of that process they should raise appropriate questions about the accounting treatment for them. If the transaction is being undertaken simply for accounting purposes, without any other reasonable corporate purpose or benefit, they should take steps to terminate them.
- In-house counsel can assist clients in establishing internal written rules and processes that help promote financial good health. For example, there should be rules for posting on top changes to the general ledger or establishing and using reserves.
- In-house counsel know how to make reasonable legal interpretations. As part of the process, we weigh an-

swers to questions like: What is the plain language of the applicable statutes and regulations? What does (or would) our regulator(s) say about it? Is there case law on point or that is at least instructive? Is the proposed interpretation being driven by a desired result? Would I feel comfortable about the proposed interpretation if I read about it in *The Wall Street Journal*? Lawyers can assist in making sure a modified form of this analysis is brought to accounting decisions as well.

Finally, in-house counsel can raise the questions that need to be raised when they spot one or more of the ten flags. It is ugly work, but somebody has to do it. The alternatives shouldn't happen on your watch.

Notes

1. A. Kelly, *"Tips & Insights on: How to Manage Smoking Guns with Stasia Kelly*, ACC Docket, 92-95, Volume 24, No. 4 (April 2006), *available at http://www.acca.com/protected/pubs/docket/apr06/tips.pdf.*
2. The Reports reviewed for this article included: *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (February 2002); *NASA- Report of the Columbia [Accident] Investigation Board* (August 2003)*; Tyco International Ltd. 8K-Current Report* (September 17, 2002); *Report of the Special Examination of Freddie Mac* (August 2003); *Restoring Trust, Report on Corporate Governance for the Future of MCI, Inc.*, (August 2003)*; Report of the Special Audit Committee of the Board of Directors of HealthSouth Corporation* (May 2004); *Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc.* (March 2005)(WorldCom Report); *Summary of the Independent Investigation by the Special Committee of the Board of Directors of Krispy Kreme Doughnuts, Inc.*(August 2005); and *Report of the Special Examination of Fannie Mae* (May 2006).
3. Many of the allegations set forth in the Independent Reports have not been proven or are the subject of settlement agreements or consent orders where wrongdoing has not been admitted or denied. Thus the references in this article are to "alleged" mismanagement and/or fraud.
4. Earlier this year, Fannie Mae CFO Robert Blakely estimated the "costs associated with restatement and related investigations will total over $600 million for 2006." *Fannie Mae Investor/Analyst Conference Call* (May 9, 2006), *available at http://www.fanniemae.com/ir/pdf/issues/2006/050906transcript.pdf.*
5. Stephen M. Cutler, Director, SEC Division of Enforcement, *Remarks before the UCLA School of Law: The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program* (Sept. 20, 2004), *available at http://www.sec.gov/news/speech/spch092004smc.htm* .
6. USSG §8B2.1 (a) (1&2).
7. The Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines (October 7, 2003), available at *http://www.ussc.gov/corp/advgrprpt/AG_FINAL.pdf* .
8. S.D. Makar and M.A. Pearson, *Earnings Management: When does Juggling the Numbers become Fraud?* Association of Certified Fraud Examiners (January/February 2000), available at *http://www.acfe.com/fraud/view.asp?ArticleID=124* ; and S.D. Makar and M.A. Pearson, *Earnings Management Revisited: Further Suggestions in the Wake of Corporate Meltdowns* Association of Certified Fraud Examiners (March/April 2004), available at *http://www.acfe.com/fraud/view.asp?ArticleID=245* .
9. WorldCom Report at 11-16.
10. *See* Arthur Levitt, SEC Chairman, *Remarks before the New York University Center for Law and Business: The Numbers Game* (September 21, 1998), *available at http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt.*
11. *See* R. J. Wayman, *Earnings Management: Accounting Red Flags,* Forbes.com (February 2002), available at *http://www.forbes.com/2002/02/27/0227wayman_print.html.*; and J. Vorhies, *The New Importance of Materiality,* Journal of Accounting (May 2005) *available at http://www.aicpa.org/pubs/jofa/May2005/vories.htm.*
12. *See e.g.,* SEC v. Huntington Bancshares, Inc., Litigation Release No. 19243 (June 2, 2005), available at *http://www.sec.gov/litigation/litreleases/lr19243.htm;* In the matter *of* Global Crossing Ltd., Order Instituting Cease and Desist Proceedings, Making Findings and Imposing a Cease and Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Securities Act of 1934, Release No. 5157 (April 11, 2005), *available at http://www.sec.gov/litigation/admin/34-51517.pdf.* In the matter of KPMG LLP, Order Instituting Public Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings and Imposing Remedial Sanctions, Securities Exchange Act of 1934 Release No. 50564 (October 20, 2004), available at *http://www.sec.gov/litigation/admin/34-50564.htm*; SEC v. Bristol-Myers Squibb Company, Litigation Release No. 18820 (August 2004), *available at http://www.sec.gov/litigation/litreleases/lr18822.htm*; and SEC v. W.R. Grace & Co., Litigation Release No. 16008 (December 1998), *available at http://www.sec.gov/litigation/litreleases/lr16008.txt.*
13. SEC Staff Accounting Bulletin No. 99- Materiality, Release No. SAB 99, Staff Accounting Bulletin No. 99 (August 12, 1999), *available at http://www.sec.gov/interps/account/sab99.htm*
14. *In Re* the Walt Disney Company Derivative Litigation, Consolidated CA No. 15452, Delaware Chancery Court (August 9, 2005).
15. *Haywood v. AmBase Corp.*, Del. Ch., No. 342-N, 2005 WL 2130614 (August 22, 2005).
16. USSG §8B2.1(b)(6)
17. *See* Stephen M. Cutler, Director, SEC Division of Enforcement, *Remarks to the Second Annual General Counsel Roundtable: Tone at the Top: Getting it Right* (Dec. 3, 2004), *available at http://www.sec.gov./news/speech/spch120304smc.htm.*
18. Andy Pasztor, *Boeing to Settle Federal Probes For $615 Million Deal Allows Defense Giant To Avoid Criminal Charges In Contracting Scandals*, *Wall Street Journal*, May 15, 2006.
19. Greg Farrell, *Jurors: Ex-Enron Execs Not Credible, USA Today,* May 26, 2006.
20. *See* ACC InfoPAK *"Effective Compliance and Ethics Programs for the Small Law Department: Doing More with Less," available at http://www.acca.com/vl/infopak.php?documenttype=InfoPAK.*

PCAOB®

Enforcement Documents

Adopting Release - PCAOB 2003-015

Enforcement

Section 105 of the Sarbanes-Oxley Act of 2002 grants the PCAOB broad investigative and disciplinary authority over registered public accounting firms and persons associated with such firms. To implement this authority, Section 105(a) directs the Board to establish, by rule, fair procedures for the investigation and discipline of registered public accounting firms and associated persons of such firms. As directed by the Act, the Board adopted rules relating to investigations and adjudications on Sept. 29, 2003. The Securities and Exchange Commission approved the rules on May 14, 2004.

Investigations and Adjudications

Under the adopted rules, the Board and its staff may conduct investigations concerning any acts or practices, or omissions to act, by registered public accounting firms and persons associated with such firms, or both, that may violate any provision of the Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards. The Board's rules require registered public accounting firms and their associated persons to cooperate with Board investigations, including producing documents and providing testimony. The rules also permit the Board to seek information from other persons, including clients of registered firms.

When violations are detected, the Board will provide an opportunity for a hearing, and in appropriate cases, impose sanctions designed to deter a possible recurrence and to enhance the quality and reliability of future audits. The sanctions may be as severe as revoking a firm's registration or barring a person from participating in audits of public companies. Lesser sanctions include monetary penalties and requirements for remedial measures, such as training, new quality control procedures, and the appointment of an independent monitor.

© Copyright 2003 - 2008 Public Company Accounting Oversight Board All Rights Reserved

LETTER OF COMMENT NO. 36

William H. Neukom
President

AMERICAN BAR ASSOCIATION
321 North Clark Street
Chicago, Illinois 60610-4714
(312) 988-5109
FAX: (312) 988-5100
E-mail: abapresident@abanet.org

August 5, 2008

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Sir David Tweedy
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements 5 and 141(R); File Reference 1600-100

Gentlemen:

On behalf of the American Bar Association (ABA) and its more than 400,000 members, I am pleased to present our enclosed Comments on the Financial Accounting Standards Board (FASB) exposure draft titled "Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements 5 and 141(R)" (Exposure Draft). The ABA's Comments were prepared, with input from a broad range of in-house and outside lawyers, by several leading members and advisors of our Task Force on Attorney-Client Privilege, including Task Force Chair and former ABA President Bill Ide of McKenna, Long & Aldridge LLP in Atlanta; Stanley Keller of Edwards Angell Palmer & Dodge LLP in Boston; Lewis H. Ferguson of Gibson, Dunn & Crutcher in Washington, D.C. (the former General Counsel of the Public Company Accounting Oversight Board); and Giovanni Prezioso of Cleary Gottlieb Steen & Hamilton LLP in Washington, D.C. (the former General Counsel of the Securities and Exchange Commission).

As explained more fully in the enclosed Comments, although the ABA shares FASB's goal of providing investors with meaningful current information regarding contingent liabilities, we have a number of serious concerns regarding the Exposure Draft's approach to disclosure of non-financial liabilities, particularly those involving litigation. Therefore, we urge the Board not to adopt the proposed amendment to FASB Statements 5 and 141(R). In addition, the ABA respectfully requests the opportunity to present its views on this matter before the Board, including at an upcoming public roundtable meeting.

Thank you for considering our views on this critical subject. If you have any questions or need additional information, please contact ABA Task Force Chair Bill Ide at 404-527-4650.

Sincerely,

William H. Neukom

Enclosure

August 5, 2008
Page 2

cc: R. William Ide III, Past President, American Bar Association and current Chair, ABA Task Force on Attorney-Client Privilege
Thomas M. Susman, Director, ABA Governmental Affairs Office
R. Larson Frisby, Senior Legislative Counsel, ABA Governmental Affairs Office

COMMENTS OF THE AMERICAN BAR ASSOCIATION

ON THE

FINANCIAL ACCOUNTING STANDARDS BOARD EXPOSURE DRAFT TITLED "DISCLOSURE OF CERTAIN LOSS CONTINGENCIES: AN AMENDMENT OF FASB STATEMENTS 5 AND 141(R)"

August 5, 2008

The American Bar Association ("ABA") is submitting these comments on the exposure draft released by the Financial Accounting Standards Board ("FASB" or the "Board") on the Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements No. 5 and 141(R) ("Exposure Draft"). We will confine our comments to those aspects of the Exposure Draft that raise problems when dealing with loss contingencies involving litigation.[1] For the reasons outlined below, the ABA urges the Board not to adopt the amendments as proposed because we believe that these amendments will have a number of harmful unintended consequences, including further erosion of the protections of the attorney-client privilege and the work product doctrine during the audit process.[2]

The Exposure Draft explains that the amendments are intended to respond to concerns that "disclosures about loss contingencies under existing guidance in FASB Statement No. 5, *Accounting for Contingencies,* do not provide adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies." (Exposure Draft at v). As discussed below, we are not aware of persuasive evidence establishing that these concerns are well-founded or, even if there is a basis for them, that they justify the changes proposed in the Exposure Draft given the serious problems those changes would create.

The Present Disclosure System for Contingent Liabilities

Currently, under SFAS 5, a liability must be accrued for a loss contingency when a loss is probable and can be estimated and disclosure, but not a liability accrual, must be made when there is:

> at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. (SFAS 5, paragraph 10)

According to the Exposure Draft, the proposed amendment will (a) expand the population of loss contingencies that are required to be disclosed, (b) require disclosure of specific quantitative and qualitative information about those loss contingencies, (c) require a tabular reconciliation of changes in recognized loss contingencies, (d) require disclosure of available insurance and indemnification and (e) provide an exemption for disclosures of certain required information that would be prejudicial to an entity's position in a dispute if disclosed.

The Exposure Draft would require disclosures of all loss contingencies within its scope, except for those that are remote and unasserted claims that either will probably not be asserted or where, if asserted, the likelihood of loss is remote (Exposure Draft, paragraph 5). The Exposure Draft would also require disclosure of even remote contingencies that are likely to be resolved in the near term (defined as the next twelve months in AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) and could have a severe impact, defined as significantly financially disruptive, on the normal functioning of the entity. (Exposure Draft, paragraph 6). The requirement to disclose even remote contingencies in these circumstances is a change from present standards and goes further than the corresponding provision in International Accounting Standards No. 37, *Provisions, Contingent Liabilities and Contingent Assets,* that only requires disclosure of contingencies that are more than remote.

Under the Exposure Draft, both quantitative and qualitative disclosures of contingent exposures would be required. Entities would be required to disclose the claim amount or, in the absence of a claim amount, an estimate of the maximum potential exposure to loss. (Exposure Draft, paragraph 7(a)). The reporting entity could also provide a supplemental disclosure of its best estimate of the possible range of loss if it believes that the claim or maximum exposure amount is not indicative of the actual exposure. In addition to the quantitative disclosure, the entity must disclose information to help the reader understand the facts surrounding the contingency and the risks it poses to the entity. Such disclosures would have to include, "at a minimum": (1) a description of how the claim arose; (2) its legal or contractual basis; (3) its current status; (4) the anticipated timing of its resolution; (5) a description of the factors that are likely to affect the ultimate outcome of the contingency, (6) the entity's qualitative assessment of the most likely outcome of the contingency, and (7) any assumptions made by the entity in estimating the amount of the most likely outcome. (Exposure Draft, paragraph 7(b)). Finally, a qualitative and quantitative description of the terms of relevant insurance or indemnification arrangements covering the possible loss, including caps, limitations and deductibles, would be required. (Exposure Draft, paragraph 7(c)).

[1] We focus our comments on SFAS 5 and do not address SFAS 141(R) as currently adopted and proposed to go into effect for fiscal years beginning after December 15, 2008. Some of the concerns identified in these comments apply to SFAS 141(R).

[2] In August 2006, the ABA adopted Resolution 302A that calls for the preservation of the attorney-client privilege and work product doctrine in connection with audits of company financial statements and urges the Securities and Exchange Commission, the Public Company Accounting Oversight Board, and other relevant organizations to adopt standards and take other steps to ensure that these fundamental rights are preserved throughout the audit process. See ABA Resolution 302A and the related background report at http://www.abanet.org/poladv/documents/report302A.pdf.

For certain contingencies, such as pending or threatened litigation, where disclosure of certain information about the contingency required under the Exposure Draft would be prejudicial to an entity's position, disclosures could be aggregated at a higher level or, in "rare" circumstances, the reporting entity's qualitative assessment of the likely outcome of the contingency and its assumptions used to estimate that outcome could be omitted altogether. In such cases, the entity must disclose "the fact that, and the reason why, the information has not been disclosed." (Exposure Draft, paragraph 11).

The Exposure Draft changes both the basic disclosure threshold in SFAS 5, namely that a possible loss is reasonably possible (i.e., more than remote), and the content of the required disclosures. It also appears to eliminate the option for a reporting entity to conclude that the magnitude of the contingent loss, whatever its likelihood of occurrence, cannot be estimated currently. In essence, compliance with the Exposure Draft will require entities to value all material contingencies in order to provide the detailed information required.

Concerns about the Exposure Draft.

We support the Board's goal of improving the transparency, timeliness and usefulness of financial information that is disclosed to investors and other users of financial statements. We also understand that some commentators, including members of the Board and the International Accounting Standards Board, have been concerned that, under SFAS 5, disclosure of loss contingencies takes places too long after a claim is made or a lawsuit is commenced and that some users of financial statements are seeking greater quantification of non-financial contingent liabilities. We are also aware of efforts towards international convergence of accounting standards and the general trend in financial accounting (as evidenced recently by the adoption of SFAS 157, *Fair Value Measurements* (September 2006) and SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (February 2007), among other things) to require more robust disclosure and current fair valuation of most assets and liabilities that are recorded in the financial statements or disclosed in notes to them. We are not aware, however, of empirical data that suggests that the current standards of SFAS 5 and the reporting practices that have developed under it are inadequate in addressing the tension between the search for transparency, while avoiding unreliable and misleading information, and recognizing the interest of a reporting entity and its shareholders in appropriately protecting the entity's legal position and maintaining the protection for privileged or confidential information about litigation and regulatory and enforcement matters.

The Exposure Draft, particularly as applied to contingencies arising from pending and threatened legal claims, raises a number of problems and will likely have unintended but seriously adverse consequences for reporting entities. We are particularly concerned with its requirements to provide current quantitative disclosures of estimates of possible losses and qualitative disclosures about the likely future course of events in pending claims without regard to whether a reasonable basis exists for making such estimates and predictions. The Exposure Draft fails to take into account certain basic aspects of the adversarial system of justice in the United States and threatens to put reporting entities at

a serious disadvantage in that process. This is one of those unusual situations where the potential harm to reporting entities and their shareholders from the required disclosures outweighs the potential benefits to investors and other users of financial reports. Moreover, much of the newly required information would be either highly speculative leading to misleading disclosures or prejudicial without adequate protection against such prejudice. For reasons that are discussed below, we do not believe that the Exposure Draft's proposed solution, aggregation at a higher level or omission of certain information in rare circumstances, will solve the problem. There are many reasons for our concern.

1. The Exposure Draft does not adequately take into account the unique nature of the United States legal system.

The United States employs an adversarial system of justice and has a uniquely active litigation and regulatory environment and plaintiffs' bar that make prediction about the outcome of a pending or threatened claim, particularly early in the proceeding, very difficult. In this environment, claims are often filed making demands that far exceed the amount of real harm suffered by plaintiffs and the amounts, if any, that will ultimately be paid in settlement or judgment. Litigation in the United States is more prolific than in most of the rest of the developed world, with many more large, complex cases, class actions, derivative suits, and claims for punitive and treble damages. Also, in the United States, many complaints do not state a specific amount of recovery the plaintiff is seeking, beyond any jurisdictional threshold for the specific court. Indeed, in some jurisdictions, it is impermissible to state an amount of damages in the complaint.[3] In many significant cases, the plaintiff may not indicate with any precision what relief it is seeking until the proceedings are well underway, for example, in response to defendant's damages interrogatories. These attributes of the United States litigation environment should be compared to the judicial systems in other countries—in Europe and in Asia—with well-developed sophisticated economies. For example, it is noteworthy that in Europe and Asia, unlike the United States, commercial cases are rarely decided by juries. Given the inherent unpredictability of juries, the risk of attempting to estimate litigation outcomes in jury cases is greater than in cases tried to a court or administrative tribunal. Moreover, the United States has far more liberal discovery rules than any other country that will permit plaintiffs to inquire into the facts underlying the disclosures and, likely, lead to claims in many cases that applicable privileges have been waived by the reporting entity. To the extent that the proposed new standard leads to findings that companies have waived applicable privileges by disclosing confidential communications with counsel in their quantitative and qualitative assessments of litigation (see below), the proposed new disclosure standards threaten to subject companies and their counsel to broad-ranging discovery by adversaries regarding the disclosures.

[3] Thirty states impose prohibitions on stating claim amounts in at least some types of cases such as those involving unliquidated damages, punitive damages, personal injury claims, tort claims, or claims in excess of a certain threshold. Two states, Colorado and Missouri, prohibit the statement of claim amounts in all cases. See Colo. R. Civ. P. 8(a)(2008) and Mo. Rev. Stat. Section 509.050 (2008).

Sometimes cases are brought for reasons having nothing to do with economic harm and are subsequently dropped or dismissed. Sometimes verdicts and judgments are much larger than could reasonably have been expected at the outset of a case. Commonly, the real exposure posed by a lawsuit can only be determined as the action progresses through discovery and decisions are made about matters such as venue, forum, choice of law, class certification, the survival of claims, admissibility of evidence, and a host of similar matters, often a lengthy and very unpredictable process. Likewise, examinations and investigations by civil regulators and law enforcement authorities often begin with a long period of factual investigation followed by lengthy and sometimes contentious negotiations with each side taking strong opposing positions that work themselves out over time. The entire process is surrounded by protections, some among the most ancient in origin, such as the attorney-client privilege and work product doctrine that allow parties to communicate candidly with their expert advisors, those most able to assess the real exposure of a claim, without the contents of those communications being discoverable publicly. Where both sides seek every advantage in the proceeding, even-handed implementation of our adversary system depends on parties being able to maintain their own counsel as to their intentions, assessments and strategies rather than provide them to their adversaries.

Viewed against that background, the Exposure Draft raises several serious problems.

A. *The quantitative and qualitative disclosure requirements of the Exposure Draft are unrealistic and the disclosures would be extremely difficult to prepare.*

Under the Exposure Draft, a company would be required to disclose the amount of the plaintiff's damage claim, if known. If there is no amount claimed, the company is required to disclose its "best estimate of the maximum exposure to loss." If the company believes, however, that either the amount claimed by the plaintiff or the maximum exposure is not representative of its actual exposure, the company would also be permitted to disclose its "best estimate of the possible loss or range of loss." Compliance with these quantitative disclosure standards is more difficult than might appear.

Where a complaint actually states the amount of damages sought, disclosing that amount might seem a straightforward exercise, but it can result in information that is out of context and misleading.[4] Amounts initially sought by plaintiffs are often highly inflated and do not necessarily reflect the company's true exposure. Just mentioning an unrealistic inflated amount, even with ameliorating language, can have an adverse

[4] To illustrate the problematic nature of the proposed requirement, assume a claim against a bank for improperly honoring a $100 check, with the claimant asserting emotional distress, consequential damages and punitive damages totaling $100,000,000. Assume further that the bank determines that it could be required to pay up to $100,000 of damages, even though it believes it should only have to pay $100. If the disclosure thresholds are met, the bank would have to disclose the $100,000,000 claim, regardless of its unreality. Presumably, it might seek to mitigate that disclosure by indicating its best estimate of the possible range of loss (assuming it were able to make that determination). The disclosure of the $100,000 possibility would be beneficial to the claimant and prejudicial to the bank, which still believes its real exposure should be $100.

impact. That is especially the case when the amount is claimed by a regulatory or enforcement agency and therefore is susceptible to being afforded disproportionate credibility. It is far better to allow reporting entities, as they do now, to make materiality judgments regarding disclosure based on all the particular facts and circumstances. In addition, while the Exposure Draft would allow a company faced with such a demand to disclose its "best estimate of the possible loss or range of loss," this is likely to be a highly problematic, if not wholly illusory, alternative. For one thing, it is often difficult for a company and its counsel to formulate such a "best estimate" – particularly in the early stages of a litigation or enforcement proceeding before factual investigation of the basis for a claim has been completed. The reporting entity generally will (and should) be reluctant to provide a "best estimate of loss" where it lacks a reasonable basis to do so because it risks exposing itself to future litigation if the "best estimate" ultimately proves to be incorrect even if it was reasonable when made.

In many cases, the plaintiffs' complaint does not contain a demand for a specific amount of damages. In such cases, the Exposure Draft would require the reporting entity to disclose its "best estimate of the maximum exposure to loss," and, if it believes the maximum exposure is not representative of its actual exposure, the company may also disclose its "best estimate of the possible loss or range of loss." In this circumstance, too, reporting entities may thus be required to disclose damage estimates that are wholly speculative because, at the early stages of the proceeding, the reporting entity lacks sufficient information to make a reasonable estimate of either its "maximum exposure to loss" or even the "possible loss or range of loss."[5]

The Exposure Draft also would require companies to disclose qualitative information about their litigation contingencies, including a "description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome," "a qualitative assessment of the most likely outcome", and the "significant assumptions" underlying these assessments. These mandatory qualitative disclosures would likewise be difficult for companies to make, particularly when they come early in the litigation process.

For example, unless damages have been specified by the plaintiff or there has been discovery, it would be pure guesswork to estimate the plaintiff's damages (except perhaps in infrequent circumstances, such as where a contract that allegedly has been breached has a liquidated damages provision, the law caps damages, or the facts and information needed to estimate damages are entirely in the possession of the defendant). How could a reporting entity reliably estimate the plaintiff's economic loss (such as lost profits), the potential governmental fines and penalties, or punitive damages? How could it reliably estimate damages or determine the most likely outcome where relevant facts

[5] Using the bank scenario in note 4 above, assume the bank receives a claim for wrongfully dishonoring a $100 check with a statement that the claimant will seek substantial damages for emotional distress, consequential damages and punitive damages but without specification of amount. Assume further that the bank believes a $100 loss is probable, a $100,000 loss is reasonably possible and there is a remote chance of a $10,000,000 loss (of course these determinations can themselves be highly uncertain and speculative). The Exposure Draft would seem to require the bank to disclose a loss exposure of $10,000,000.

are in the plaintiff's possession and there has been no opportunity for discovery? Even in the rare case where the facts are entirely in the reporting entity's possession and it has enough information to estimate damages, how can it determine the "most likely outcome" before there has been an opportunity to interview witnesses, review and analyze documents (which, in this era of electronic discovery, can include millions of e-mails) or do a thorough analysis of the legal defenses available? How can a reporting entity determine the "most likely outcome" before there have been judicial rulings on potentially dispositive legal issues, that could result in the case being narrowed or dismissed altogether? In such situations, any estimate or prediction by the reporting entity is likely to be pure guesswork based on incomplete facts and without the ability for meaningful analysis.[6]

The Exposure Draft does not indicate what standard is to be applied to determining maximum exposure – is it the most likely amount, the reasonably possible amount or the highest possible amount even if considered remote? The Exposure Draft also does not suggest how to evaluate lawsuits seeking injunctive or other forms of non-monetary relief. The determination of the possible exposure to a reporting entity of an injunction would generally require making assumptions not only about the nature of the relief finally awarded but also about future business opportunities in the absence of an injunction and the value of those that would be lost as a result of its issuance.

B. *The Exposure Draft, in requiring expanded quantitative and qualitative disclosure, would seriously disadvantage reporting entities and their shareholders in the proceeding itself without providing sufficient offsetting benefits to users of the financial statements.*

The requirement in the Exposure Draft that the reporting entity reveal its own estimates of its exposure if the plaintiff does not state a claim amount alone may have a significant impact on the outcome of the matter and make the contingency more probable. The estimate itself, for example, will tip the reporting entity's hand in a case where the plaintiff itself may not have been able to estimate the potential outcome. A high estimate may alert a plaintiff to facts, known by the reporting entity, of which the plaintiff was unaware but that will shape the course of discovery in the matter. In the early stages of evaluating a claim or the facts revealed by an investigation, even if a reporting entity concludes that exposure is more than remote (but not probable), it may have no idea what the likely range of outcomes would be. Under those circumstances it would presumably have to disclose a range so wide as to be meaningless. But, since it is the reporting entity's own assessment, the high end of the range would have an implied credibility that could be deleterious to it and its shareholders. The disclosure itself may create evidence that will be used in the proceeding by the plaintiff as an admission against interest by the reporting entity or as a source for discovery, and it will almost certainly distort the course

[6] To take just one example, a reporting entity sued for patent infringement can only guess at how a jury will find on several critical variables, such as the scope of the patent's claims, the period over which damages will be assessed, the revenues included in infringing sales, and the royalty rate that will be found to apply. There is the further uncertainty that the reporting entity could be found to have "willfully" infringed and that a court will impose treble damages.

of possible settlement or resolution by putting a floor under the amount that will be required to resolve the matter. Indeed, the mere requirement to value and make extensive quantitative and qualitative disclosures may force settlements in cases that otherwise would await resolution in the normal course of the proceeding. Finally, to the extent that disclosures and estimates turn out to be wrong as a result of changes that occur in the course of the proceeding, those disclosures themselves may be sources of additional exposure to the reporting entity and its management.

Plaintiffs may use the Exposure Draft's disclosure requirements for tactical advantage. Thus, a plaintiff might use the risk to the reporting entity from the disclosure requirements to coerce quick and costly settlements. For example, very high demands by plaintiffs that must be disclosed pose their own risks to reporting entities—including reputational risk, market overreaction, and the like—particularly where the demand is out of proportion to a realistic result. In these cases, reporting entities may feel under pressure to resolve the matter prior to the first required disclosure of the demand at a significantly higher cost than would occur in the absence of the required disclosure. Alternatively, a plaintiff might seek to gain an advantage by refraining from specifying a claim amount in order to force the reporting entity to be the first party to place a value on the case, and thereafter see that value fluctuate up and down on a quarterly basis as the reporting entity revisits its assessment with each periodic report.

These expanded disclosure requirements could interfere with the ability of reporting entities to complete and issue their financial statements on a timely basis when, for example, claims are made towards the end of accounting periods or shortly before the financial statements are issued. Such delays would deprive the markets of important financial disclosures unrelated to the speculative impact of the claims. Furthermore, such timing issues would present undesirable opportunities for gamesmanship by claimants. In addition to the difficulty of handling claims made towards the end of a reporting period, even in cases where there is a reasonable basis for making an exposure estimate, it may take several months or longer to complete a review of the underlying facts sufficient to form any estimate of the possible exposure. The difficulty in complying with SEC disclosure deadlines thus will often be present even when a lawsuit is commenced well before a required filing date. In some cases, it may take substantially more than an entire quarter to complete such an analysis at a level sufficient to support public disclosure.

In some cases, multiple defendants potentially share joint and several liability, which will present the risk to each defendant of responsibility for the whole exposure, and thus would require disclosure of that amount, even where the likelihood is that the parties will share on some basis whatever liability is ultimately found. Disclosure of potential exposure, the most likely outcome and the reporting entity's underlying assumptions is also prejudicial in multi-defendant cases where a plaintiff seeks to impose joint and several liability on all defendants. The defendant whose disclosure suggests the highest risk will raise the cost of resolution for all other defendants. Similarly, in situations where a defendant faces lawsuits from multiple plaintiffs based on related legal theories or facts, disclosure pertaining to the possible exposure in one case could have an

adverse impact on the result in the other cases. This would particularly be a risk if the defendant's disclosure had the effect of providing information regarding its settlement proposals in one of the cases.

C. *The Exposure Draft significantly increases the risks of waiver of long established protective privileges and disclosure of the reporting entity's theories of defense.*

Civil litigation in the United States is predicated on the adversary system, whereby the responsibility for initiating the suit, shaping the issues and producing the evidence rests almost entirely upon the parties to the controversy. Fundamental to the adversary system are privileges and immunities, the attorney-client privilege and the work product doctrine, that strike a balance between the information that must be disclosed and the information that may be withheld from one's litigation adversaries. The Exposure Draft threatens to upset this balance by making it more likely that reporting entities will be forced to disclose publicly both the advice received from their counsel with respect to litigation and counsel's assessment of the strengths and weaknesses of their clients' litigation positions in order to comply with the new disclosure requirements.

To report the "factors that are likely to affect the ultimate outcome of the [litigation] contingency along with their potential effect on the outcome" and the company's "qualitative assessment of the most likely outcome," reporting entities are likely to have to seek the assistance of the counsel handling the matter. The resulting disclosures will trigger discovery by plaintiffs of the source of and bases for the disclosures, which, if they have been based on conversations with counsel, will put in jeopardy the privilege protections and create the risk of the reporting entity having to reveal protected communications. The standard for determining privilege waivers is not well defined, and varies among jurisdictions and from court to court, but there is a real risk that once a privileged communication has been found to have been disclosed, a much broader range of communications relating to the same subject matter will be found to have lost their confidentiality privileges. Even if disclosures can be crafted that preserve the privileges in most cases, two consequences of the Exposure Draft are foreseeable: (i) there will be a substantial increase in litigation over privilege matters and communications between reporting entities and their counsel relating to these disclosures and (ii) reporting entities may feel inhibited in their ability to communicate freely with counsel about these disclosures fearing that such communication may lead to loss of privilege. Neither of these would be a desirable result. As discussed below, the need of the reporting entity's independent auditor to audit the disclosures will create another source of potential waiver of privileges since communications to auditors may be treated as disclosures to third parties.

D. *The disclosures required by the Exposure Draft, in addition to being costly and time consuming, would be subject to substantial risk of error and consequently could be misleading to investors.*

Most items involving contingencies that are reported on in financial statements are subject to a limited number of valuation factors such as interest rates, credit risk, volatility, market conditions and prices for similar items and other identifiable factors that are known or knowable. Litigation, on the other hand, is subject to an almost infinite number of subjective and non-economic factors, many of which may not even be known, but that can affect its outcome, timing and financial impact. Case law, statutes and regulations, venue, prior history of similar or analogous cases, the judge involved, the strength of legal theories, factual discovery, litigation costs and many other factors must be weighed when a lawsuit is assessed. Measuring these subjective and non-economic factors can be a difficult, unreliable, costly and time consuming process. Even after the cost and effort has been incurred to assess the litigation, particularly at an early stage, the resulting assessments and analyses are likely in at least some relevant respects to be inaccurate particularly when measured against the ultimate outcome. It seems highly questionable to require reporting entities to incur these costs to produce information of dubious value.

The quantitative and qualitative disclosures called for by the Exposure Draft would inevitably require reporting entities to turn to their lawyers for information if they are to act responsibly, but the kind of speculation and estimation contemplated by the Exposure Draft goes beyond what lawyers can do in a professionally responsible way even if they are willing to risk the possibility of privilege waivers by advising on the disclosure process. As a result, reporting entities often would be left to engage in their own speculation and estimating with the attendant uncertainties and potential exposure to additional liability.

Unreliable information presents numerous problems. Such information can be disadvantageous to investors because they may make investment decisions without fully appreciating the information's unreliability and thus the disclosures can be misleading. It can be harmful to companies and their shareholders because that information, especially when it overstates the potential exposure, can adversely impact the company's share value. The predictive information often will turn out to be incorrect because of the uncertainties inherent in litigation. This inevitably will increase the exposure of companies and their management to further litigation, including litigation of a type that Congress has sought to discourage in the Private Securities Litigation Reform Act as burdensome and abusive.

2. In many cases, the Exposure Draft's solution to prejudicial disclosures, aggregation at a higher level or omission of certain information in "rare" circumstances, will not solve the problem.

There are at least two problems with aggregation as a solution. First, for many entities, either a single claim or a group of claims (such as a group of mass tort claims or

a major shareholder's class action suit) will constitute a disproportionate part of the total exposure from such matters with the consequence that aggregation may not provide a meaningful shield for the information. Typically, large claims are known publicly and anyone evaluating the aggregate disclosure is likely to know that the great bulk of the exposure comes from a particular claim or group of claims. Second, if a new, large claim is filed that significantly changes the aggregate exposure, a mere comparison of reported amounts among periods will alert careful readers to that claim and prompt further inquiries. In addition, to the extent that all estimates of claims are uncertain, aggregation may merely compound the possibility of error that is inherent in each individual evaluation, leading to a composite disclosure that is so prone to error as to be nearly meaningless.

The additional exception permitting omissions in "rare" circumstances when aggregation is not a solution does not adequately mitigate the prejudice because the minimum required disclosure will frequently still contain prejudicial information of the types described above. Moreover, the standard provides no guidance as to who will ultimately determine whether a particular case presents the "rare" circumstance justifying omission of the information, but concern about getting that judgment wrong and about the consequences of doing so will surely limit its use.

3. The proposed standard would result in disclosures that are very difficult to audit and would increase potential erosion of critical attorney-client privilege and work product protections.

Unlike disclosures under Items 103 ("Legal Proceedings") and 303 ("Management's Discussion and Analysis of Financial Condition and Results of Operations") of Regulation S-K that relate to material litigation and disclosures of loss contingencies, but do not have to be audited, disclosures of estimates of litigation contingencies that appear either in reserves in the financial statements or in notes to them will be subject to audit by a reporting entity's independent auditor. Because of the numerous subjective factors that go into an assessment of a lawsuit, as well as the possibility of critical factors that are not presently known, auditing quantitative disclosures about litigation will be very challenging. To the extent that the reporting entity's judgments and estimates are based on privileged communications between a disclosing entity and its counsel, auditors may feel obliged to seek privileged information from counsel or the company in order to test the disclosures. Even where the reporting entity has not relied on its counsel for the estimates, counsel representing the entity in the matter is likely to be a useful source of information to test those assertions. In either case, disclosure of privileged information to an independent auditor could lead to loss of the privilege. At the least, the need for the auditor to audit the information is likely to put strains on the "Treaty" between the American Bar Association and the AICPA that has governed lawyers' responses to auditors' inquiries since the 1970s.[7] The Treaty was

[7] The "Treaty" is comprised of two documents: the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, adopted by the ABA Board of Governors in 1975, and the AICPA Statement on Auditing Standards No. 12, adopted in 1976. Statement on Auditing Standards No. 12 has been adopted as an interim auditing standard for public companies by the Public Company

designed to ensure preservation of the attorney-client privilege and work product protections that are cornerstones of our adversarial system of justice. The inevitable increase in pressure on auditors as a result of these new disclosure requirements will risk erosion of those fundamental protections.

Enabling auditors to meet their audit requirements under the Exposure Draft standards will frequently require companies to disclose to their auditors details regarding their analyses of the law and facts surrounding their litigation. Many courts have held that providing documents to an accounting firm acting as a public auditor waives whatever work product protection would otherwise attach to such document. *See, e.g., In re Diasonics Secs. Litig.*, 1986 U.S. Dist. LEXIS 24177, at *3-4 (N.D. Cal. June 15, 1986). Some courts have also held that the inclusion of attorney work product in publicly available securities law filings gives rise to a waiver of work product protection. *See, e.g., In re Royal Ahold N.V. Sec. & ERISA Litig.*, 230 F.R.D. 433, 436-37 (D. Md. 2005). As the United States Supreme Court said in *Upjohn Co. v. United States* 449 U.S. 383, 393 (1981) "an uncertain privilege...... is little better than no privilege at all".

The loss of the protections of the attorney-client privilege and work product doctrine for this type of detailed analysis will often be extraordinarily detrimental. Once the privilege is lost, the subject of the once privileged communication becomes fair game for discovery in the litigation. The reporting entity's adversaries will be given a potential roadmap to victory since the privileged information will reveal counsel's assessment of the strengths and weaknesses of the reporting entity's litigation position.

4. The existing standard of SFAS 5 works reasonably well and strikes the right balance between competing interests.

Even today, if a matter is material and is deemed to be probable and capable of being estimated (the latter being a fairly low standard),[8] it is difficult to meet disclosure obligations and protect the issuer's legal position. Current SFAS 5 strikes the right balance, i.e., requiring reporting entities to reveal highly sensitive information in material situations where loss is probable and estimable, but giving them the ability to protect their shareholders in situations where the exposure is less certain and/or unlikely to be material. Under SFAS 5 today, a contingency must be disclosed when its occurrence is "reasonably possible", but it only needs to be valued if it is capable of being valued. The "reasonably possible" standard is being applied consistently and effectively today. It is our experience that affected constituents understand current disclosure practices as they relate to legal matters and understand that detailed descriptions and predictions about such matters would not only be imprecise and potentially wrong, but could prejudice the reporting entity. Users recognize the inherent uncertainties of litigation and often do their own analysis, sometimes using their own professional resources to assist in that

Accounting Oversight Board. The ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information and the related background report is available at http://www.abanet.org/buslaw/attorneyclient/policies/aicpa.pdf.

[8] The meaning of estimable has been amplified in FIN 14 and its principles should continue to govern.

assessment. The current standard has the advantages of ease of application, cost effectiveness, auditability, and protecting the legal rights and strategies of the disclosing entity. The Exposure Draft falls short under each of these measures and is inconsistent with reliability and consistency of financial reporting and avoidance of unnecessary volatility.

Unlike the prescriptive approach of the Exposure Draft, current SFAS 5 is principles based. A principles based approach is preferable in an area like litigation involving so much uncertainty, judgment and potential prejudice to reporting entities. To illustrate the current operation of SFAS 5 and the problems of the Exposure Draft, we have included as Appendix A a chronology of an actual lawsuit and the reporting defendant's related disclosures. It illustrates how the nature of disclosure evolves as a lawsuit progresses.

Both under the SEC's current MD&A reporting rules and under SFAS 5, specific disclosure of the risks related to and reserves taken with respect to litigation are required if "material." This sets a higher threshold for disclosure than that imposed by the Exposure Draft, but does address those situations likely to be of the most interest to investors. Indeed, in 2000, the SEC proposed expanded financial disclosure of litigation reserves that met with strong opposition for many of the reasons set forth in this letter.[9] As a result, the SEC did not pursue that proposal.

5. Requiring even limited disclosures of remote contingencies may change existing and well established definitions of materiality.

In *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), the United States Supreme Court defined materiality for purposes of the federal securities, saying:

> The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. Id. at 449.

In requiring the disclosure and discussion of remote contingencies (whether asserted or probable of assertion) that are likely to be resolved in the near term and having a severe financial impact, the Exposure Draft seems to circumscribe significantly the reporting entity's judgment in assessing materiality under the Supreme Court standard. Many reporting entities and securities practitioners have long believed that if an event is remote, even if it could have a major impact, it would not be material to a reasonable shareholder. This view finds support in the Supreme Court's decision in *Basic v. Levinson,* 485 U.S. 224 (1988), in which the Court described "materiality" as involving a two-fold test of likelihood of an event's occurrence and its significance if it did occur. The Supreme Court has also cautioned about the mischievous effects of setting materiality thresholds too low, saying in *TSC Industries, Inc. v. Northway, Inc.:*

[9] See SEC Release No. 33-7793 (January 21, 2000).

> We are aware, however, that the disclosure policy embodied in the proxy regulations is not without limit. (citing *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375 at 384 (1970)). Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information --- a result that is hardly conducive to informed decision making. Id. at 448-449.

We are concerned that the Exposure Draft's requirement to disclose certain remote contingencies changes the accepted principles of materiality under *Basic v. Levinson* and *TSC Industries, Inc. v. Northway* and will provoke a flood of frivolous cases. Requiring disclosure of remote, unasserted contingencies that could have a near term severe effect compounds the problem. The existing disclosure system works reasonably well and we have seen no persuasive evidence (and FASB has provided none beyond the anecdotal complaints of certain investors) that it requires overhaul. The present disclosure regime for contingent losses is both well understood and protects important interests under our legal system. The quantification and qualitative disclosure requirements in the Exposure Draft will cause serious prejudice to reporting entities and will result in disclosures that may be so error prone as to be misleading rather than informative and thus be in conflict with the objectives of existing law to provide full and fair disclosure.

6. Specific Comments.

A. The requirement for quarterly reporting of changes in loss contingencies is likely to lead to disclosures that are volatile and misleading, as well as prejudicial.

The Exposure Draft requires the inclusion of a tabular reconciliation in both annual and interim reports of changes in "recognized" loss contingencies. In addition, quantification of loss exposures will be required in the notes to financial statements for other material loss contingencies including litigation. Both types of disclosures will have to be updated quarterly under the Exposure Draft. Because complex litigation and regulatory matters can involve so many interim outcomes that can increase or reduce possible exposures at a point in time before final resolution, disclosures about the financial impact of such litigation, under the approach in the Exposure Draft, would have to be re-evaluated quarterly and would likely change, potentially numerous times before a final outcome is reached. Reporting entities would be required to change their estimates of exposures based on what may prove to be transient events in the litigation. Although

current disclosure as circumstances change may usually be desirable, when litigation is involved temporary vicissitudes in a proceeding, viewed at a moment in time, can give a very misleading view of the likely ultimate outcome of the matter. Litigation is an inherently unpredictable endeavor and, if it runs full course, often leads to an all or nothing outcome. In any case, short term valuation exercises are likely to yield erroneous and misleading results.

B. The requirement for insurance and indemnity disclosure can be prejudicial and unreliable.

Requiring disclosure of potential insurance and indemnity recoveries could be prejudicial to reporting entities and raise the cost of settlements. Such potential recoveries are excludable under the rules of evidence for the very reason that they can be prejudicial. They can, for example, raise the cost of resolution if a plaintiff believes that the defendant will not bear the full cost of the settlement or judgment. Moreover, insurance and indemnity rights can themselves be fraught with uncertainty, and requiring their disclosure would compound the speculative and possibly misleading nature of the disclosures. We believe it is better to allow reporting entities to decide on the appropriateness or need for disclosure of potential sources of recovery based upon prevailing materiality standards.

Conclusion and Recommendations.

In summary, we are concerned that the Exposure Draft's approach to disclosure of non-financial liabilities, particularly those involving litigation, would be cumbersome and expensive to apply, could be prejudicial to reporting entities, would be subject to error, could lead to meaningless volatility in financial disclosures, would undermine fundamental attorney-client privilege and work product protections, would spawn further litigation, and would in fact be a backward step in the journey toward achieving more transparent, timely and useful financial reports. That said, we are sympathetic to the Board's goal to give investors meaningful current information regarding contingent liabilities. We do believe that SFAS 5 represents a good, long tested, and well understood balance between an appropriate protection of a reporting entity's legal rights and interests and the needs of investors for current, informative financial information. If there is empirical data indicating that there are disclosure problems under the existing SFAS 5 structure, we suggest that the problem lies with the implementation of SFAS 5, not with the approach that it takes. We are not aware of such data, but would be willing to work the FASB on ways to improve disclosure under SFAS 5. We would also be willing to assist in a study of the relevant information, if such a study is needed.

We recommend that the Exposure Draft, as proposed, not be adopted, but if FASB determines to go forward with revisions to SFAS 5, we have a number of specific recommendations.

- FASB should undertake a systematic study of existing disclosure practices under SFAS 5 as it exists today to determine whether disclosures about loss contingencies are in fact adequate to give users of financial statements sufficient information to evaluate those contingencies. We would be pleased to participate in such a study.

- FASB should also consider whether any disclosure problems found to exist stem from improper or inadequate implementation of the existing requirements of SFAS 5, as amplified by FIN 14, or from inherent weaknesses in the standard itself. As part of this analysis, FASB should consider whether any existing problems could be ameliorated by further guidance under SFAS 5 or FIN 14.

- FASB should coordinate its efforts in this regard with the Securities and Exchange Commission since the Commission mandates disclosures concerning both material litigation and loss contingencies under Items 103 and 303 of Regulation S-K. Particular consideration should be given to the consequences resulting from the fact that the forward looking statements required to be disclosed under the Exposure Draft, unlike disclosures under Regulation S-K, would not enjoy the protections of the safe harbor of Section 27A of the Securities Exchange Act of 1934. In addition, the fact that disclosures under the Exposure Draft will be subject to audit, while those under Regulation S-K are not, should be considered.

- Because the disclosures required by the Exposure Draft will need to be audited, FASB should coordinate with the Public Company Accounting Oversight Board and the American Institute of Certified Public Accountants to insure that appropriate auditing standards exist to guide auditors in auditing the new disclosures.

- Finally, we suggest that any revision to SFAS 5 be undertaken only in connection with the resolution of the issue of convergence between generally accepted accounting principles and international accounting standards. It makes little sense to impose the costs and difficulties that the Exposure Draft will inevitably impose on reporting entities only to find that the standard changes again in the reasonably near future if and when convergence is mandated.

We appreciate this opportunity to present our views and would be happy to discuss them with the Board or its staff or to provide additional information that might be useful as you consider this important subject. In addition, we confirm our request to present our views on this matter before the Board at an upcoming public roundtable meeting.

Appendix A

Summary of JDS Uniphase Federal Securities Class Action Litigation

Beginning on March 27, 2002, numerous federal securities class actions were filed in the U.S. District Court for the Northern District of California against JDS Uniphase Corp. ("JDSU") and several current and former officers and directors on behalf of a class of purchasers of JDSU's common stock during the period July 22, 1999 through July 26, 2001, as well as subclasses consisting of shareholders who acquired JDSU common stock through several merger transactions. The suits alleged that the defendants made material misstatements and omissions concerning demand for JDSU's products and JDSU's expected financial performance. The suits also claimed that JDSU improperly recognized revenue and failed to write off goodwill and inventory timely, and that the individual defendants sold stock based on material adverse non-public information.

Typical of this type of suit, the action sought unspecified damages. Plaintiffs did not disclose any damages estimate until nearly five years later, as part of expert discovery. Plaintiffs' estimates ranged from $10 billion to $26 billion and changed numerous times up to and through trial. At trial, plaintiffs' expert testified that his preferred method for calculating damages would result in total damages of approximately $20 billion.

After a jury trial in the Fall of 2007, the jury rendered a verdict in favor of defendants, awarding no damages to the plaintiffs.

During the over five years that the cases were pending, the court ordered mediation, which was unsuccessful. JDSU did not accrue any reserves for losses under FIN 14.

In our view, it would have been materially misleading to shareholders and/or prejudicial to the company to quantify a possible range of loss or estimate the outcome of the litigation. Plaintiffs themselves did not estimate any damages until several months before trial. At earlier stages, JDSU could only speculate about possible damages estimates that plaintiffs would ultimately offer, which were dependent on numerous complex variables. Estimating the outcome of the litigation would have revealed the most basic type of attorney work product, to the detriment of defendants in any attempt to negotiate a settlement. It would also have misled shareholders, as estimating the outcome of any particular litigation matter is notoriously difficult.

A chronology of events in the federal securities litigation and accompanying disclosures in JDSU's SEC filings follows.

BOS111 12302955.1

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
3/27/02	First Class Action Complaint filed in the Northern District of California.	
5/14/2002		Legal Proceedings from Form 10-Q: On March 27, 2002, a purported securities class action captioned *Pipefitters Local 522 & 633 Pension Trust Fund v. JDS Uniphase Corp., et al.*, Civil Action No. C-02-1486-CW was filed in the United States District Court for the Northern District of California against the Company, one of its stockholders, and several of its current and former officers and directors. Additional purported securities class actions containing similar allegations have since been filed in the Northern District. These complaints allege violations of the federal securities laws, specifically Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934, and seek unspecified damages on behalf of a purported class of purchasers of the Company's common stock during the period from July 27, 1999 through July 26, 2001. The various actions have not yet been consolidated and no trial date has been scheduled. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including several securities class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity, or results of operations and seriously harm our financial condition. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions recently filed in late March, April and May, could be quite significant. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
8/7/2002	Court grants motion to consolidate related actions and appoints Plaintiff Connecticut Retirement Plans and Trust Funds (Connecticut) as Lead Plaintiff	

DATE	LITIGATION EVENT	DISCLOSURE
9/17/2002		Legal Proceedings from Form 10-K: Beginning on March 27, 2002, twenty-six securities class actions were filed in the United States District Court for the Northern District of California against us and several of our current and former officers and directors by stockholders purporting to represent a class of purchasers of our common stock during the period from July 27, 1999 through July 26, 2001. Some of these lawsuits also named one of our stockholders as a defendant. On April 23, 2002, a similar lawsuit was filed in the District Court for the Southern District of New York. That lawsuit also named our independent auditors, Ernst & Young LLP, as a defendant. It was transferred to the Northern District of California on June 25, 2002. The lawsuits described above seek unspecified damages and allege various violations of the federal securities laws, specifically Sections 10(b), 14(a) and 20(a) of the Securities Exchange Act of 1934 and Sections 11 and 15 of the Securities Act of 1933. On July 26, 2002, the Northern District of California consolidated all the actions under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. A consolidated complaint is due to be filed on October 7, 2002. No trial date has been set. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including several securities class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity or results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, could be quite significant and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
10/11/2002	First Amended Consolidated Complaint filed in the Northern District of California.	

DATE	LITIGATION EVENT	DISCLOSURE
11/12/2002		Legal Proceedings from Form 10-Q: Beginning on March 27, 2002, the first of numerous federal securities class actions was filed against the Company and several of its current and former officers and directors. On July 26, 2002, the Northern District of California consolidated all the actions filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. An amended consolidated complaint was filed on October 11, 2002. It purports to be brought on behalf of a class consisting of those who acquired the Company's securities from July 27, 1999 through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a) and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. It also names one of its stockholders as a defendant. The Company's motion to dismiss the amended consolidated complaint is due to be filed on December 13, 2002 and to be heard on March 14, 2003. No trial date has been set. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including several securities class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity or results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, has been costly, will continue to be costly, and could be quite significant and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
12/13/2002	Defendants file motion to dismiss First Amended Consolidated Complaint	

DATE	LITIGATION EVENT	DISCLOSURE
2/11/2003		Legal Proceedings from Form 10-Q: Beginning on March 27, 2002, the first of numerous federal securities class actions was filed against the Company and several of its current and former officers and directors. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. An amended consolidated complaint was filed on October 11, 2002. It purports to be brought on behalf of a class consisting of those who acquired the Company's securities from July 27, 1999 through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a) and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. It also names one of its stockholders as a defendant. On December 13, 2002, the Company moved to dismiss the amended consolidated complaint. On January 23, 2003, plaintiffs filed an opposition. The Company's reply brief is due on February 24, 2003, and a hearing is scheduled for March 14, 2003. No trial date has been set. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
3/14/2003	Court grants motion to dismiss First Amended Consolidated Complaint	

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
	with leave to amend	
5/13/2003		Legal Proceedings from Form 10-Q: Beginning on March 27, 2002, the first of numerous federal securities class actions was filed against the Company and several of its current and former officers and directors. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as lead plaintiff. An amended consolidated complaint was filed on October 11, 2002. It purports to be brought on behalf of a class consisting of those who acquired the Company's common stock from July 27, 1999 through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a) and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In addition, it named one of the Company's stockholders as a defendant. On December 13, 2002, the Company moved to dismiss the amended consolidated complaint. On March 14, 2003, the court dismissed the complaint with leave to amend and set a schedule for the filing of an amended complaint. No trial date has been set. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
9/24/2003		Legal Proceedings from Form 10-K: Beginning on March 27, 2002, the first of numerous federal securities class actions was filed against us and several of our current and former officers and directors. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. An amended consolidated complaint was filed on October 11, 2002. It purports to be brought on behalf of a class consisting of those who acquired our securities from July 27, 1999 through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired our common stock pursuant to our acquisitions of OCLI, E-TEK and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a) and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. It also names one of our stockholders as a defendant. On December 13, 2002, we moved to dismiss the amended consolidated complaint. On March 14, 2003, the court dismissed the complaint with leave to amend. No trial date has been set. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
11/3/2003	Court grants in part and denies in part Defendants' motion to dismiss First Amended Consolidated Complaint	

7

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
11/12/2003		Legal Proceedings from Form 10-Q: As discussed in our previous filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On March 14, 2003, the court entered a minute order dismissing the complaint in *In re JDS Uniphase Securities Litigation*, Master File Co. C-02-1486 CW (N.D. Cal.), with leave to amend. On November 3, 2003, the court issued an opinion confirming the dismissal, with leave to amend, of the claims under the Securities Exchange Act of 1934. The November 3, 2003 opinion denied the motion to dismiss the claims under the Securities Act of 1933, however. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
1/9/2004	Second Amended Consolidated Complaint filed in the Northern District of California	
2/17/2004		Legal Proceedings from Form 10-Q: As discussed in our previous filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On January 9, 2004, plaintiffs filed a second amended complaint. It purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities *laws, specifically Sections* 10(b), 14(a), 20(a), *and* 20A *of the* Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. Defendants plan to move to dismiss the

8

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		complaint on February 23, 2004, and a hearing on that motion is set for May 7, 2004. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these *lawsuits could also result in continued diversion of our management's time and attention away from* business operations, which could harm our business.
3/9/2004	Defendants file motion to dismiss Second Amended Consolidated Complaint	
5/13/2004		Legal Proceedings from Form 10-Q: As discussed in our previous filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On March 9, 2004, Defendants moved to dismiss the second amended complaint in *In re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.). Briefing on the motion will continue through April and May. A hearing on the motion and a case management conference is set for June 4, 2004. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these

DATE	LITIGATION EVENT	DISCLOSURE
		lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
6/4/2004	Court conducts hearing regarding Defendants' motions to dismiss Second Amended Consolidated Complaint	
9/16/2004		Legal Proceedings from Form 10-K: As discussed in our previous SEC filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On June 4, 2004, the court heard Defendants' motions to dismiss the second amended complaint in *In re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.). The court has not issued a ruling on the motions yet. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		business operations, which could harm our business.
11/10/2004		Legal Proceedings from Form 10-Q: As discussed in our previous filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. No activity has occurred in *In re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.), since our last filing. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
1/6/2005	Court grants in part and denies in part Defendants' motion to dismiss Second Amended Consolidated Complaint	
2/10/2005		Legal Proceedings from Form 10-Q: As discussed in our previous filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On January 6, 2005, the Court issued rulings on Defendants' motions to dismiss Plaintiffs' Second Amended Complaint in *In re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.). The Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants' answers to the complaint are due

DATE	LITIGATION EVENT	DISCLOSURE
		by February 25, 2005. A case management conference is scheduled for April 29, 2005. Risk Factors .... We face certain litigation risks that could harm our business: *We have had numerous lawsuits filed* against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
2/28/2005	Defendants file answer to Second Amended Consolidated Complaint	
5/12/2005		Legal Proceedings from Form 10-Q: As discussed in our previous filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On February 28, 2005, Defendants in *In re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.), answered the Second Amended Complaint. Both Lead Plaintiff and JDSU have propounded discovery. JDSU has served written responses and has begun document production. The parties also have served initial disclosures pursuant to Rule 26(a) (1) of the Federal Rules of Civil Procedure and have produced some documents in connection with their disclosures. A case management conference is scheduled for June 24, 2005. *Risk Factors* .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims as noted in Part II of this filing, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
7/15/2005	Court conducts hearing regarding Lead Plaintiffs' motion to strike certain averments of Defendants' answers and Defendants' motion for partial judgment on the pleadings; Court orders parties to mediate	
7/21/2005	Court denies Lead Plaintiff's motion to strike certain averments In Defendant's answers and denies Defendants' motion for partial judgment on the pleadings	
8/12/2005	Lead Plaintiffs file motion for class certification	
9/30/2005		Legal Proceedings from Form 10-K: As discussed in our previous filings, litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. The complaint *in re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.), purports to be brought on behalf of a class consisting of those who acquired our securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the our common stock pursuant to our acquisitions of OCLI, E-TEK, and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. On July 15, 2005, the Court denied Lead Plaintiff's motion to strike parts of our answer to the complaint and also denied our motion for partial judgment on the pleadings. The Court also held a case management conference on

13

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		July 15, 2005. At that conference, the Court ordered the parties to mediate, but declined to set a discovery cut-off or trial date. On July 22, 2005, the Oklahoma Firefighters Pension and Retirement System moved to intervene, seeking to represent the purported subclass of plaintiffs who exchanged shares of OCLI stock for shares of JDSU stock in connection with the merger. No hearing on that motion has been set. On August 12, 2005, Lead Plaintiff moved for class certification. That motion will be heard on November 18, 2005. A further case management conference is also scheduled for November 18, 2005. Document discovery is ongoing. Each party has noticed depositions of both party and non-party witnesses. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims as noted in Part II of this filing, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
11/15/2005		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. The complaint *in re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.), purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. On July 15, 2005, the Court denied Lead Plaintiffs

14

DATE	LITIGATION EVENT	DISCLOSURE
		motion to strike parts of JDSU's answer to the complaint and also denied JDSU's motion for partial judgment on the pleadings. The Court also held a case management conference on July 15, 2005. At that conference, the Court ordered the parties to mediate, but declined to set a discovery cut-off or trial date. Pursuant to the Court's order, the parties have agreed to appear at a mediation session before the Hon. Daniel Weinstein (Ret.) on November 29, 2005. On July 22, 2005, the Oklahoma Firefighters Pension and Retirement System moved to intervene, seeking to represent the purported subclass of plaintiffs who exchanged shares of OCLI stock for shares of JDSU stock in connection with the merger. On October 12, 2005, the Court granted that motion. On August 12, 2005, Lead Plaintiff moved for class certification. That motion will be heard on November 18, 2005. A further case management conference is also scheduled for November 18, 2005. Document discovery is ongoing. Each party has noticed depositions of both party and non-party witnesses. Risk Factors .... <u>We face certain litigation risks that could harm our business:</u> We have had numerous lawsuits filed against us asserting various claims as noted in Part II of this filing, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
11/18/2005	Court conducts hearing regarding Lead Plaintiffs' class certification motion	

DATE	LITIGATION EVENT	DISCLOSURE
11/29/2005	Mediation before the Hon. Daniel Weinstein (Ret.) and Catherine Yanni	
12/21/2005	Court grants motion to appoint Lead Plaintiff and Lead Counsel and grants Lead Plaintiff's motion to certify class	
1/23/2006	Lead Plaintiffs move for an order approving the proposed notice of class certification	
2/8/2006		<u>Legal Proceedings from Form 10-Q:</u> Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. The complaint in *In re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.), purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. At a case management conference on July 15, 2005, the Court ordered the parties to mediate. Pursuant to the Court's order, the parties appeared at a mediation session on November 29, 2005, before the Hon. Daniel Weinstein (Ret.) and Catherine Yanni, but did not succeed in resolving their differences. Another session is scheduled for March 28 and 29, 2006. On November 18, 2005, the Court held a case management conference. At that conference the Court ordered that fact discovery be completed by September 29, 2006, and that expert discovery be completed by January 29, 2007. The Court also set a trial date of August 13, 2007. On December 21, 2005, the Court granted Lead Plaintiff's motion for class certification. On January 6, 2006, Defendants petitioned the Ninth Circuit Court of Appeals for permission to appeal the Court's class certification order. The Ninth Circuit has not ruled on Defendants' petition as of the date of this filing. Meanwhile, on January 23, 2006, Lead Plaintiff moved in the trial court for approval of its proposed plan for providing notice of class certification to members of the Plaintiff class. A hearing on that motion is scheduled for March 3, 2006. The next case management conference is scheduled for May 4, 2007. Document discovery is ongoing. Each party has noticed and taken depositions of both party and non-party witnesses. Risk Factors

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		.... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims as noted in Part II of this filing, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
3/28/2006	Mediation held before the Hon. Daniel Weinstein (Ret.) and Catherine Yanni	
4/6/2006	Court grants Lead Plaintiff's motion for approval of its proposed notice of class certification	
5/9/2006		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff or Connecticut's Treasurer's Office or CTO. The complaint in *In re JDS Uniphase Corporation Securities Litigation*, C-02-1486 (N.D. Cal.), purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that defendants made material misstatements and omissions concerning demand for the company's products, improperly recognized revenue, overstated the value of inventory, and failed

17

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		to timely write down goodwill. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. At a case management conference on July 15, 2005, the Court ordered the parties to mediate. Pursuant to the Court's order, the parties appeared at mediation sessions on November 29, 2005, and March 28, 2006, before the Hon. Daniel Weinstein (Ret.) and Catherine Yanni, but did not succeed in resolving their differences. On November 18, 2005, the Court held a case management conference. At that conference the Court ordered the fact discovery be completed by September 29, 2006, and that expert discovery be completed by January 29, 2007. On December 21, 2005, the Court granted CTO's motion for class certification. On January 23, 2006, CTO moved for approval of its proposed plan for providing notice of class certification to members of the Plaintiff class. On April 6, 2006, the Court granted CTO motion for approval of its proposed plan for providing notice of class certification to members of the Plaintiff class. Discovery is ongoing. The next case management conference is scheduled for May 4, 2007, and trial is set to begin on August 13, 2007. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.

18

DATE	LITIGATION EVENT	DISCLOSURE
9/14/2006		Legal Proceedings from Form 10-K: Litigation under the federal securities laws has been pending *against the Company and certain former and current officers and directors since March 27, 2002.* On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that Defendants made material misstatements and omissions concerning demand for the company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write down goodwill. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. On December 21, 2005, the Court granted Plaintiffs' motion for class certification. On April 6, 2006, the Court granted Plaintiffs' motion for approval of its proposed plan for providing notice of class certification to members of the Plaintiff class. Discovery in *In re JDS Uniphase Corporation Securities Litigation* is ongoing. Each party has noticed and taken depositions of both party and non-party witnesses. The deadline for fact discovery, except for depositions and discovery arising from new information obtained at depositions, is September 29, 2006. The closing date for completion of depositions and discovery arising from new information obtained at depositions is December 1, 2006. The closing date for expert discovery is March 19, 2007. The next case management conference is scheduled for May 4, 2007, and trial is scheduled for October 1, 2007. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these

DATE	LITIGATION EVENT	DISCLOSURE
		lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
11/9/2006		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that Defendants made material misstatements and omissions concerning demand for the Company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write down goodwill. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. On December 21, 2005, the Court granted Plaintiffs' motion for class certification. Discovery in *In re JDS Uniphase Corporation Securities Litigation* is ongoing. Each party has noticed and taken depositions of both party and non-party witnesses. The deadline for fact discovery, except for depositions and discovery arising from new information obtained at depositions, was September 29, 2006. The closing date for completion of depositions and discovery arising from new information obtained at depositions is December 1, 2006. The closing date for expert discovery is March 19, 2007. The next case management conference is scheduled for May 4, 2007, and trial is set to begin on October 1, 2007.

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
2/6/2007		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that Defendants made material misstatements and omissions concerning demand for the Company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write down goodwill. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. On December 21, 2005, the Court granted Plaintiffs' motion for class certification.

DATE	LITIGATION EVENT	DISCLOSURE
		Fact discovery in *In re JDS Uniphase Corporation Securities Litigation* is substantially complete. Each party has noticed and taken depositions of both party and non-party witnesses. The closing date for expert discovery is March 23, 2007. The next case management conference is scheduled for June 22, 2007, and trial is set to begin on October 1, 2007. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
4/26/2007	Defendants file motions for summary judgment	
5/9/2007		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that Defendants made material misstatements and omissions concerning demand for the Company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write

DATE	LITIGATION EVENT	DISCLOSURE
		down goodwill. The complaint seeks unspecified damages and alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. On December 21, 2005, the Court granted Plaintiffs' motion for class certification. Fact and expert discovery in *In re JDS Uniphase Corporation Securities Litigation* is substantially complete. Each party has noticed and taken depositions of experts and both party and non-party witnesses. On April 26, 2007, Defendants moved for summary judgment on all claims against them. Those motions are scheduled to be heard on July 26, 2007. The next case management conference is also scheduled for July 26, 2007, and trial is set to begin on October 1, 2007. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial position, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation can be costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
7/26/2007	Court conducts hearing on parties' *summary judgment motions*	
8/24/2007	Court grants in part and denies in part motions for summary judgment and defers Lead Plaintiff's motion for	

DATE	LITIGATION EVENT	DISCLOSURE
	partial summary judgment	
8/29/2007		Legal Proceedings from Form 10-K: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that Defendants made material misstatements and omissions concerning demand for the company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write down goodwill. The complaint alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. Although the complaint does not specify the amount of damages sought, Plaintiffs stated in recent court filings that they seek more than $20 billion in alleged damages. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. On December 21, 2005, the Court granted Plaintiffs' motion for class certification. Fact and expert discovery in *In re JDS Uniphase Corporation Securities Litigation* is complete. Each party has noticed and taken depositions of experts and both party and non-party witnesses. On August 24, 2007, the Court granted in part and denied in part Defendants' motions for summary judgment and deferred ruling on Plaintiffs' motion for partial summary judgment. Trial is set to begin on October 22, 2007. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to

DATE	LITIGATION EVENT	DISCLOSURE
		substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial condition, liquidity and results of operations. In particular, the securities class actions discussed in Item 3, "Legal Proceedings," contained in Part I of this report, claim damages that exceed the total current assets of the Company and thus an unfavorable outcome or settlement of one or more of these securities class action lawsuits could have a substantial material adverse effect on our financial condition, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation is costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
9/25/2007	Court denies Lead Plaintiff's cross-motion for partial summary judgment	
10/23/2007	Trial begins	
11/7/2007		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that Defendants made material misstatements and omissions concerning demand for the company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write down goodwill. The complaint alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. On December 21, *2005, the Court granted Plaintiffs' motion for class certification.*

DATE	LITIGATION EVENT	DISCLOSURE
		Fact and expert discovery in *In re JDS Uniphase Corporation Securities Litigation* is complete. Each party has noticed and taken depositions of experts and both party and non-party witnesses. On August 24, 2007, the Court granted in part and denied in part Defendants' motions for summary judgment. On September 25, 2007, the Court denied Plaintiffs' motion for partial summary judgment. A jury trial began on October 23, 2007. The trial is currently scheduled to last for nineteen Court days. Although the complaint does not specify the precise amount of damages sought, Plaintiffs have stated in recent court filings that they intend to seek a verdict of more than $20 billion in alleged damages. Plaintiffs' expert witness on damages has generally testified to that effect in the pending jury trial. While there are many potential outcomes of the pending trial, in the event of a final, non-appealable and enforceable judgment against the Company that is in an amount commensurate with the Plaintiffs' maximum theory of damages, it would not have sufficient assets to pay such a judgment. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial condition, liquidity and results of operations. In particular, the securities class actions discussed in Item 1, "Legal Proceedings," contained in Part II of this report, claim damages that exceed the total current assets of the Company and thus an unfavorable outcome or settlement of one or more of these securities class action lawsuits (such as, for example an adverse judgment in the *In re JDS Uniphase Corporation Securities Litigation* trial which commenced on October 23, 2007) could have a substantial material adverse effect on our financial condition, liquidity and results of operations, credit ratings, and ability to access capital markets and comply with existing debt obligations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation is costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.

DATE	LITIGATION EVENT	DISCLOSURE
11/27/2007	Court enters jury verdict in favor of the defense on all counts; no financial damages awarded	
11/28/2007		Press Release: JDSU Wins Class Action Jury Verdict
2/7/2008		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purports to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs allege that Defendants made material misstatements and omissions concerning demand for the Company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write down goodwill. The complaint alleges various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. In January 2005, the Court denied the motion to dismiss claims against the Company, Jozef Straus, Anthony R. Muller, and Charles Abbe, and granted in part and denied in part the motion to dismiss claims against Kevin Kalkhoven. Defendants subsequently filed answers denying liability for the claims asserted against them. On December 21, 2005, the Court granted Plaintiffs' motion for class certification. A jury trial began on October 23, 2007. At trial, plaintiffs sought more than $20 billion in alleged damages. On November 27, 2007, the jury returned a unanimous verdict in favor of Defendants. The deadline for Plaintiffs to appeal will begin to run once the Court enters judgment. An unfavorable outcome on appeal, if any, could result in a new trial seeking damages that exceed the Company's assets. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. The results of complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these

DATE	LITIGATION EVENT	DISCLOSURE
		lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial condition, liquidity and results of operations. In particular, the plaintiffs in *In re JDS Uniphase Corporation Securities Litigation* claim damages that exceed the total current assets of the Company. A jury rendered a unanimous verdict in favor of the Company and the other defendants in that case on November 27, 2007, though the plaintiffs have the right to appeal the verdict. An unfavorable outcome of an appeal, if any, could have a substantial material adverse effect on the Company's financial condition, liquidity and results of operations, credit ratings, and ability to access capital markets and comply with existing debt obligations. Even if this and other lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation is costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.
3/21/2008	Court enters judgment	
3/28/2008	Court enters corrected final judgment	
5/6/08		Legal Proceedings from Form 10-Q: Litigation under the federal securities laws has been pending against the Company and certain former and current officers and directors since March 27, 2002. On July 26, 2002, the Northern District of California consolidated all the securities actions then filed in or transferred to that court under the title *In re JDS Uniphase Corporation Securities Litigation*, Master File No. C-02-1486 CW, and appointed the Connecticut Retirement Plans and Trust Funds as Lead Plaintiff. The complaint in *In re JDS Uniphase Corporation Securities Litigation* purported to be brought on behalf of a class consisting of those who acquired the Company's securities from October 28, 1999, through July 26, 2001, as well as on behalf of subclasses consisting of those who acquired the Company's common stock pursuant to its acquisitions of OCLI, E-TEK, and SDL. Plaintiffs alleged that Defendants made material misstatements and omissions concerning demand for the Company's products, improperly recognized revenue, overstated the value of inventory, and failed to timely write down goodwill. The complaint alleged various violations of the federal securities laws, specifically Sections 10(b), 14(a), 20(a), and 20A of the Securities Exchange Act of 1934 and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933. On December 21, 2005, the Court granted Plaintiffs' motion for class certification.

Chronology Comparing Events in the JDSU Federal Securities Litigation with JDSU Public Disclosures

DATE	LITIGATION EVENT	DISCLOSURE
		A jury trial in *In re JDS Uniphase Corporation Securities Litigation* began on October 23, 2007. At trial, plaintiffs sought more than $20 billion in alleged damages. On November 27, 2007, the jury returned a unanimous verdict in favor of Defendants. On March 28, 2008, the Court entered a corrected final judgment in favor of Defendants. The judgment ordered that Plaintiffs recover no damages or any other form of relief, that the action was dismissed on the merits, and that Defendants were entitled to recover their costs. On the same date, the Court approved a stipulation and proposed order in which all parties agreed to not appeal the judgment or any other issue and Defendants agreed to not seek their recoverable costs from Plaintiffs. Risk Factors .... We face certain litigation risks that could harm our business: We have had numerous lawsuits filed against us asserting various claims, including securities and ERISA class actions and stockholder derivative actions. For example, although all claims in *In re JDS Uniphase Corporation Securities Litigation* have been dismissed pursuant to the Court's final judgment and the plaintiffs in that action have agreed to not appeal the judgment, several lawsuits against the Company based on the same facts alleged in *In re JDS Uniphase Corporation Securities Litigation* remain unresolved. The results of those and other complex legal proceedings are difficult to predict. Moreover, many of the complaints filed against us do not specify the amount of damages that plaintiffs seek, and we therefore are unable to estimate the possible range of damages that might be incurred should these lawsuits be resolved against us. While we are unable to estimate the potential damages arising from such lawsuits, certain of them assert types of claims that, if resolved against us, could give rise to substantial damages. Thus, an unfavorable outcome or settlement of one or more of these lawsuits could have a material adverse effect on our financial condition, liquidity and results of operations. Even if these lawsuits are not resolved against us, the uncertainty and expense associated with unresolved lawsuits could seriously harm our business, financial condition and reputation. Litigation is costly, time-consuming and disruptive to normal business operations. The costs of defending these lawsuits, particularly the securities class actions and stockholder derivative actions, have been significant, will continue to be costly and may not be covered by our insurance policies. The defense of these lawsuits could also result in continued diversion of our management's time and attention away from business operations, which could harm our business.

1025 Connecticut Avenue, NW, Suite 200
Washington, DC 20036-5425
tel 202.293.4103
fax 202.293.4701
www.acc.com

LETTER OF COMMENT NO. 16

August 8, 2008

Mr. Robert H. Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Sir David Tweedy
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R) -- File Reference No. 1600-100

Gentlemen:

The Association of Corporate Counsel ("ACC") appreciates the opportunity to present its views on the June 5, 2008 draft known as the "Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)" which we will refer to as the proposed amendments. ACC is addressing these comments to the IASB as well, because we believe these issues are to equal concern to them. The proposed amendments dramatically alter the disclosure requirements of certain loss contingencies in current FASB 5 ("FAS 5"), including lawsuits. In our view, and the view of our membership, the quality of the information that would result from the proposed amendments would not warrant the harm that they would inflict on companies and their shareholders.

ACC is a bar association serving and representing attorneys within the in-house legal departments of corporations and private sector organizations worldwide. ACC has over 24,000 members employed by over 10,000 organizations across 77 countries. Of particular relevance here, ACC is a recognized leader in protecting and preserving the attorney-client privilege rights of the many companies and organizations represented by our members.[1] In addition, our membership brings to these important issues the unique views of in-house counsel who are often at the intersection of the outside lawyers, auditors and executive management in both the disclosure and litigation function. As such, our membership speaks not only for in-house counsel, but also for the interests of their client organizations and the shareholders, members and owners who will be impacted by the proposed amendments. Because the proposed amendments would damage the companies ACC members represent, they necessarily injure those who have invested in these companies – a principal constituency that FASB seeks to protect.

ACC's membership has followed closely the proposed amendments to FAS 5, which has governed for decades the disclosure of litigation-related loss contingencies in corporate financial statements. The proposed amendments have generated a greater response from our membership, in a shorter period of time, than any other single issue within memory. Indeed, an unprecedented

[1] *See, e.g.,* ACC's amicus briefs before the courts (US and abroad) seeking protection of privilege in the corporate context, our advocacy in redressing the "culture of waiver" promulgated by cooperation standards issued by governmental prosecutorial and enforcement policies and guidelines, ACC's Blue Ribbon Task Force of leading Chief Legal Officers and Auditors (with the particiipation of the Center for Audit Quality), addressing increased and disturbing trends toward waiver of privilege in the audit context, and our extensive educational and resource materials on this subject: all are avilable online at http://www.acc.com/php/cms/index.php?id=84.

number of members have been actively involved in commenting on this letter. Without exception, our members and their clients have expressed profound opposition to the proposed amendments. A representative selection of those members join me in signing this letter.

ACC benefits from the assistance of Professor Daniel R. Fischel and Mr. John K. Villa in the preparation of this submission. Professor Fischel is a professor of law and business at Northwestern University Law School and the Kellogg School of Management, and a professor emeritus of law and business and the former dean of the University of Chicago Law School. He is also the Chairman and President of Compass Lexecon, one of the world's leading economic consulting firms.[2] Mr. Villa is a partner at Williams & Connolly LLP, as well as an adjunct professor of law at Georgetown University Law School and the author of several legal treatises. He has written and spoken widely on the issues raised by the proposed amendments and has litigated many of the most prominent securities cases of our era, including the *Enron* case. His practice focuses on the duties and responsibilities of corporate fiduciaries, including inside and outside counsel. Professor Fischel and Mr. Villa volunteered their time to address the difficulties posed by the proposed amendments.

ACC respectfully requests an opportunity for Professor Fischel, Mr. Villa, and/or another ACC representative to present the views of ACC on this matter before the Board at an upcoming public roundtable meeting.

Executive Summary of ACC's Position

The proposed amendments to FASB Statements No. 5 and 141(R), as applied to litigation-related contingencies, fail the key test for a standards change because the grave problems they create far outweigh any doubtful benefit that may accrue. The proposed amendments are a "solution" in search of a problem. There is no systemic failure that warrants the proposed change. Investors are not suffering from inadequate disclosure of litigation-related loss contingencies in financial statements. Both the recent and the historical problems that affected some companies result not from misperception of litigation-related loss contingencies, but rather from more fundamental issues such as the valuation of assets and the impact of financial engineering. To the limited extent that the risk in material litigation can be quantified, there is a substantial group of analysts who monitor such litigation and provide sophisticated analysis that quickly is reflected in the stock values. The analysis available to investors from this objective cadre of observers provides adequate insight into the risks of litigation. Proposals seeking greater precision are not feasible given the nature of the risks involved.

Even if the disclosure of litigation-related loss contingencies were a serious systemic problem, it is extremely doubtful that compelling companies and their lawyers to quantify litigation risks would yield more accurate financial statements. As every trial lawyer knows, litigation anywhere in the world — but especially in American courts and before American juries— inherently is unpredictable. The reaction of a single juror or the impact of a single ruling can have a dramatic and unanticipated impact. Indeed, it is highly doubtful that any company or lawyer who ever lost a billion-dollar case ***expected*** that result -- they were presumably surprised

[2] Professor Fischel has been cited often by the Supreme Court in its leading securities decisions. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 169, 184, 191 (1994); *Basic, Inc. v. Levinson*, 485 U.S. 224, 247 n.24 (1988); and *Edgar v. MITE Corp.*, 457 U.S. 624, 643-44 (1982).

by the extent of the negative outcome. Had they expected to lose or to lose so badly, they surely would have settled. In this instance, requiring the losing lawyer or company to have produced a more precise description of the outcome would not have provided more accurate disclosure to investors. In short, the case has not been made for change.

Forcing the extensive and detailed disclosures mandated by the proposed amendments in a far broader range of cases than FAS 5 now requires will cause serious harm to the disclosing companies and their shareholders. The proposed disclosures create a substantial risk of waiver of the attorney-client privilege and work-product immunity, with catastrophic consequences to the corporation. Confidential legal advice, lawyer thought processes, and legal analysis disclosed in public filings allow an adversary in litigation to essentially review the files and strategies of the company's defense counsel. This would inflict serious damage on the company and its shareholders. Opposing parties easily can leverage such information to extract higher settlements or otherwise disadvantage the corporation.

Underestimating a large loss will be painted as a professional failure laid at the feet of lawyers who are forced to provide concrete estimates about remote and undeveloped matters. Bad numbers could also create new potential liability for the company whose stakeholders relied on mistaken estimates. To avoid these failures, the natural tendency for those responsible for estimates may be to err on the side of caution, resulting in safe (i.e., high) estimates and thus *inflated loss reserves. The company's stock price will reflect those unnecessarily high loss* reserves and the safe estimate will become a self-fulfilling prophecy: the well-advised corporation will settle for that figure rather than risk a greater loss at verdict or judgment, even if the odds of an unfavorable verdict or judgment are low. Thus, the pressures generated by the evaluation and disclosure process may themselves impact negatively the outcome of the litigation (or more likely settlement) – a variant of the "observer effect."

Finally, as we explain below, under the new rule, the financial statement consequences of a suit with huge potential losses, albeit a low likelihood of prevailing, will inflict immediate injury on the company and its shareholders. A sophisticated plaintiff may be able to exploit that problem by threatening a suit and then withdrawing it in exchange for an unjustified and extortionate settlement.

The many harms caused by the proposed amendments by requiring disclosure in the broad range of cases where it would not currently be required by FAS 5 are not accompanied by any appreciable benefits. Requiring companies to quantify litigation risks and to share detailed privileged information regarding claims against them will not yield more accurate financial statements than those available under the current rules.

Investors Are Not in Need of the Required Information Concerning Litigation-Related Loss Contingencies.

The proposed amendments assume that there is a problem that can be remedied by expanded disclosures of loss contingency information; in fact no problem exists. Perhaps the best measure of whether the current FAS 5 regime has been successful is the paucity of litigation resulting from loss contingency disclosures of litigation claims pursuant to FAS 5. Our review of the publicly available FAS 5 proceedings fails to show demonstrable evidence of a serious problem.

This is consistent with recent economic history: the problems that have plagued companies are not a function of misperceived litigation-related loss contingencies but rather of more fundamental issues such as the valuation of assets and the impact of financial engineering. Some level of understanding of material litigation risk is of course important but that role is already served by a sophisticated corps of analysts who follow and evaluate major corporate litigation; because of their research, knowledgeable assessments of major litigation already exist.[3] (Minor litigation is not tracked because it is not material.) By using publicly available historical information on settlements, analysts independently estimate costs to resolve pending or potential litigation.[4] Other analysts research and publish reports on litigation trends affecting companies with massive tort exposure involving tobacco, asbestos, lead paint, or other products.

Rating agency Standard & Poor's publishes a detailed guide to evaluating litigation risk and how it affects credit ratings.[5] And market participants include hedge funds or "litigation arbs" who invest or advise their clients to invest based on their evaluation of special situations.[6] All of this extensive activity confirms that the market already incorporates non-privileged information regarding claims or prospective claims into share prices; a corporation and its counsel can add nothing to this evaluation apart from privileged information. Any compelled quantification, necessarily speculative, will be vested with greater meaning than is warranted, and is more likely to distort the market's assessment of a claim than to improve it.

No doubt, some unexpected results will occur—but that is because litigation is unpredictable by nature. Juries and judges often reach surprising and unanticipated results. Experienced trial lawyers may differ dramatically as to the expected result of a particular case—if everyone agreed on the value of a claim, there would be nothing to litigate. Any quantification of expected loss therefore suffers from the fact that most outcomes cannot be predicted with precision and may vary based on a single judicial ruling or the views of one juror.

The unpredictability of jury verdicts is well-known. Two recent high-profile cases serve to show that even federal appellate rulings may have dramatic and unanticipated impacts. First, within the past month, the US Supreme Court drastically reduced the punitive damages arising out of a 1989 Alaska oil spill. The jury had awarded $5 billion in punitive damages. The United States Court of Appeals for the Ninth Circuit cut that amount in half. The US Supreme Court then reduced the award to $500 million; had one Justice not owned Exxon stock and recused himself,

---

[3] For examples of litigation analysis, see, e.g., Elizabeth Albanese, *Analysts: Lawsuits Unlikely to Affect Tobacco Bond Deals*, The Bond Buyer, March 26, 2003; Elizabeth Albanese, *Analysts: Successful Anti-MSA Suit Could Spur News Laws*, The Bond Buyer, Oct. 3, 2005, at 31; *Lead Pigment Litigation Clouds Some Chemical Sector Ratings*, Standard & Poor's, May 21, 2007; Sally Roberts, *Blumenthal lawsuit won't roil industry*, Business Insurance, Jan. 31, 2005 (discussing industry-wide effect of lawsuit alleging secret payments in the insurance industry).

[4] *See, e.g.*, Carlos Marquez, *Settlement of class action lawsuits could cost Doral $125 million*, Caribbean Business, Nov. 30, 2006, at 8.

[5] *How Litigation Risk Affects Corporate Ratings*, Standard & Poor's, Nov. 28, 2005.

[6] For example, Goldman Sachs Hedge Fund Partners LLC Form 10-Q (Sept. 30, 2004) disclosed that "litigation situations . . . provided good opportunities for GED Advisors." As another example, ING Investment Management Hedge Funds use "Event Driven" strategies that center on investing in securities of companies facing major corporate events, such as significant litigation.

Textron, Inc., No. 06-198T (US District Court of Rhode Island August 29, 2007). (ACC filed amicus briefs in both the *Textron* and *Stone & Webster* cases.)

Of particular concern to in-house counsel is the potential and impact of the waiver of the work-product immunity which ordinarily protects materials prepared by an attorney in anticipation of litigation. The attorney-client privilege protects communications between attorney and client, while the related attorney work product doctrine shields from production materials which disclose the attorney's theory or strategy regarding anticipated or pending litigation. The potential effect of the proposed amendments on the work-product doctrine is perhaps even more problematic for in-house counsel than the proposed amendment's potential to erode the larger attorney-client privilege. Much of the most sensitive work of in-house counsel lies in the evaluation and formulation of judgments about legal matters that would – under the proposed amendments – be included in a company's financial statements. If the in-house counsel is required to "bake" her analysis into the disclosure process contemplated by the proposed amendments, then the auditor is provided with an entry into the mental impressions or analysis of the lawyer, and the protections traditionally accorded to the lawyer's thought processes and case development vanish if deemed a waiver by the courts – again with the calamitous result of revealing the company's legal work to its adversaries.

Indeed, an unanticipated effect of the proposed amendments could be that management will be incented to exclude lawyers from fully engaging on sensitive matters to avoid risks of waiver that the lawyer's required disclosure would create. Thus, ACC argues that the proposed amendments will likely have the unintended outcome of chilling full and frank discussions between companies and their counsel, to the detriment of corporate clients. And, of course, waiver of the privileges protecting such information from adversaries would be catastrophic.

The Proposed Amendments Will Reveal Trial Strategies and Disadvantage Companies in Settlement Negotiations.

The information required to be disclosed under the proposed amendments often will reveal key aspects of litigation strategy, since the company will be obliged to reveal its "qualitative assessment of the most likely outcome," the "anticipated timing of [the claim's] resolution," and the "significant assumptions" made by the company in estimating the amounts disclosed. And because underestimating a large loss will be professionally embarrassing for those providing the estimate, and could even result in claims against them, those individuals naturally may err on the side of caution, offering high estimates which would translate into inflated loss reserves. This will cause friction between corporations and their counsel, and present serious conflicts that will be time-consuming, disruptive and expensive for the corporate client.

There can be little doubt that the additional required disclosures inevitably will both impact and impair a company's settlement posture. The disclosures will serve as a settlement floor—since the corporation itself valued the claim at that amount, a plaintiff will refuse to accept anything less. Once the company values the claim, that liability instantly will be reflected in the stock valuation. The company will risk severe adverse market reaction if it chooses to proceed to trial on the claim and suffers a significantly worse outcome. All factors point toward the initial valuation as determinative in fixing, as a practical matter, the ultimate outcome of the settlement process—yet such valuations are done at an early point in the pre-litigation process when little may be known. This "observer effect" in which the process of evaluation itself impacts or

determines the event observed, is neither desirable as a matter of disclosure policy nor beneficial to the company or its shareholders.

Indeed, even a baseless claim could prove damaging to the company under the proposed amendments if wielded by a plaintiff asserting a large but weak claim. It may be months or years before defense counsel can gather the information necessary and enter a courtroom to refute such a claim. Until that occurs, the company may be required to include the large claim in footnote disclosures in its financial statements, in tabular reconciliations and possibly in other reports, which would depress the stock price. Thus, the simple threat of a claim could be sufficient for a sophisticated plaintiff to extract unwarranted settlement dollars by threatening a large claim and offering to settle it quickly.

On the other hand, a company may possess information that a claim against it is strong, perhaps stronger than the plaintiff suspects. The company's adversary may not possess this information. Since the financial statement disclosures mandated by the proposed revisions must reflect a candid assessment of the claim by the corporation and, in all likelihood, its counsel, the mandated disclosures will provide a road map to opposing counsel regarding how to extract the maximum amount in settlement. If the opposing party cannot obtain settlement on these terms, the disclosures will still encourage counsel to pursue a claim to verdict. In other words, sophisticated plaintiffs' counsel will be able to use effectively, to the disadvantage of a disclosing corporation and its shareholders, any information contained in the expanded disclosures.

The Proposed Disclosures Will Fuel Litigation.

Not only will these expanded disclosures compromise the litigation of existing claims, but they threaten to spark claims of their own. When some disclosures, attempting to quantify fundamentally unpredictable outcomes, inevitably prove inaccurate, new claimants will emerge and will seize upon the mistaken disclosures as a basis for liability. And by compelling the disclosure of significant detail regarding the circumstances of the claim, the factors that may affect the result, the most likely outcome, and the anticipated timing for resolution, the proposed revisions invite Monday morning quarterbacking. Parties who purport to have relied upon these litigation disclosures and predictions will use them as the basis for claims of their own. Defending against such claims may require a wholesale waiver of the attorney-client privilege and work product doctrine with respect to the disclosed claim that brought about the misrepresentation claim; otherwise, the defending corporation will be pressed to show that its disclosures were reasonable.

The Board's Exemptions Fail to Mitigate These Concerns.

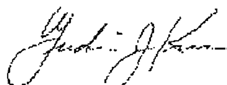
The proposed amendments recognize that for certain loss contingencies, such as threatened or pending litigation, disclosure of certain information may be prejudicial to the company's litigation position. In those circumstances, the proposed rules allow a company to disclose an estimate or range of possible loss, to aggregate disclosures or, in "rare instances," to omit the disclosures altogether. As we have pointed out, a realistic assessment of the practicalities of litigation shows that the "rare instance" exception applies in nearly every case. Aggregating data will not solve that problem; sophisticated plaintiffs' counsel can isolate and identify anomalies and certainly can make educated guesses as to the source and reason for a surprising aggregation.

Conclusion

FAS 5 has balanced the interests of disclosure and privilege for more than thirty years. The proposed amendments would do far more harm than good, and address "concerns" from which no one suffers. We urge the Board to decline the proposed amendments.

The following in-house counsel co-sign this letter in support of these comments; please recognize that given the breadth of issues and diversity of interests they represent, they may not agree with every point as stated, but wish the FASB to understand how strongly they share the general concerns expressed.

Very truly yours,



Frederick J. Krebs
President

Laura Stein
Chair

cc: SEC Commissioners Chairman Cox
Commissioner Atkins
Commissioner Casey
Commissioner Walter

The following companies (including several who signed on after the initial filing date, but prior to the August 8, 2008 comment deadline) sign this letter to show their support. Please recognize that given the breadth of issues and diversity of interests they represent, not every company may agree with every point as stated, but all wish for the FASB and IASB to understand how strongly they share the general concerns expressed.

Douglas G. Scrivner
General Counsel and Secretary
Accenture

Karen O. Cottle
Senior Vice President, General Counsel & Corporate Secretary
Adobe Systems Incorporated

D. Craig Nordlund
Senior Vice President, General Counsel and Secretary
Agilent Technologies, Inc.

Donald Duncan
Vice President and General Counsel
Alamo Group Inc.

Michele Coleman Mayes
Vice President and General Counsel
The Allstate Corporation

Katherine E. Schuelke
Vice President, General Counsel, and Secretary
Altera Corporation

Kevin Connor
Senior Vice President, General Counsel & Secretary
AMC Entertainment, Inc.

Damian Olthoff
General Counsel & Corporate Secretary
Animal Health International, Inc.

David L. Hausrath
Senior Vice President and General Counsel
Ashland Inc.

Edwin Herbert
General Counsel
Asset Acceptance Capital Corp.

Bart Schwartz
Executive Vice President and Chief Legal Officer
Assurant, Inc.

Richard T. White
Senior Vice President, Secretary & General Counsel
The Auto Club Group

Bruce J. Hector
Associate General Counsel and Chief Litigation Counsel
Becton, Dickinson and Company

Sandra Leung
Senior Vice President, General Counsel and Corporate Secretary
Bristol-Myers Squibb Company

Ivan K. Fong
Chief Legal Officer & Secretary
Cardinal Health, Inc.

Steven C. Euller
Corporate Vice-President, General Counsel and Corporate Secretary
Cargill Incorporated

James B. Buda
Vice President, General Counsel and Secretary
Caterpillar Inc.

Michael W. Gleespen
General Counsel and Corporate Secretary
CBIZ, Inc.

Jeanne E. Walker
Associate General Counsel
Celanese Corporation

Russell B. Stevenson, Jr.
Senior Vice President & General Counsel
Ciena Corporation

Carol Ann Petren
Executive Vice President & General Counsel
CIGNA Corporation

Neal Rubin
Vice President, Litigation
Cisco Systems, Inc.

Laura Stein
Senior Vice President & General Counsel
The Clorox Company

Jennifer L. Vogel
Sr. VP, General Counsel, Secretary & Chief Compliance Officer
Continental Airlines, Inc.

Douglas L. Lawing
Senior Vice President and General Counsel
Copano Energy

Steven R. Wilson
Vice President & General Counsel
DataPath, Inc.

Thomas L. Sager
Senior Vice President & General Counsel
E.I. du Pont de Nemours and Company

Claudia S. Toussaint
General Counsel & Corporate Secretary
Embarq Corporation

Keith Kosco
Chief Legal Officer and Corporate Secretary
EMCORE Corporation

William A. Von Hoene, Jr.
Executive Vice President and General Counsel
Exelon Corporation

Gary D. Cohen
Executive Vice President, General Counsel & Secretary
The Finish Line, Inc.

Carrie L. Schiff
Senior Vice President, General Counsel
Flextronics International Ltd.

Jeffrey W. Carr
Vice President, General Counsel & Secretary
FMC Technologies, Inc.

David G. Leitch
Senior Vice President & General Counsel
Ford Motor Company

David L. Korman
Executive Vice President & General Counsel
Ford Motor Credit Company, LLC

Andrew R. Etkind
Vice President and General Counsel
Garmin Ltd.

David Drummond
Senior Vice President, Corporate Development and Chief Legal Officer
Kent Walker
Vice President and General Counsel
Google Inc.

David B. Jaffe
General Counsel and Secretary
Guardian Industries Corp.

Brian Gardner
Executive Vice President, General Counsel
Hallmark Cards, Incorporated

Larry C. Boyd
Senior Vice President, Secretary & General Counsel
Ingram Micro Inc.

Kent B. Magill
Executive Vice President, General Counsel and Corporate Secretary
Interstate Bakeries Corporation

Laura A. Fennell
Senior Vice President, General Counsel and Corporate Secretary
Intuit, Inc.

Matthew K. Fawcett
Vice President & General Counsel
JDS Uniphase Corporation

Russell C. Deyo
Vice President, General Counsel
Johnson & Johnson

Stephen M. Cutler
Executive Vice President
JPMorgan Chase & Co.

Wendy C. Shiba
Executive Vice President, General Counsel and Secretary
KB Home

Hilary K. Krane
SVP and General Counsel
Levi Strauss & Co.

Charlene A. Ripley
Senior Vice President, General Counsel and Corporate Secretary
Linn Energy, LLC

Simon M. Lorne
Vice Chairman & Chief Legal Officer
Millennium Management LLC

Patricia R. Hatler
Executive Vice President, Chief Legal and Governance Officer
Nationwide Insurance and Nationwide Financial Services

Lee Cheng
General Counsel
Newegg Inc.

Maureen A. Mosh
Assistant General Counsel
Northern Trust Corporation

Douglas S. Horan
Senior Vice President, Secretary & General Counsel
NSTAR

Stan Soper
Vice President, Legal Affairs
Nutraceutical International Corporation

David Shannon
Senior Vice President & General Counsel
NVIDIA Corporation

Mary E. Doyle
Senior Vice President, General Counsel and Secretary
Palm, Inc.

Thomas G. Dagger
Senior Vice President, General Counsel & Corporate Secretary
Phibro Animal Health Corporation

Karen E. Shaff
Executive Vice President and General Counsel
Principal Financial Group, Inc.

Susan L. Blount
Senior Vice President & General Counsel
Prudential Financial, Inc.

Kevin P. Delaney
Senior Vice President, General Counsel & Secretary
Quanex Building Products Corporation

Michael Vaughn
Vice President & General Counsel
Quest Software, Inc.

Alexander G. Simpson
Vice President & General Counsel
Reis, Inc.

David Allgood
Executive Vice President and General Counsel
Royal Bank of Canada

Michael A. Brizel
Executive Vice President & General Counsel
Saks Incorporated

Thomas J. Sabatino, Jr.
Executive Vice President & General Counsel
Schering-Plough Corporation

Javade Chaudhri
Executive Vice President & General Counsel
Sempra Energy

Albert Lohse
Vice President Litigation & Risk Management
Service Corporation International

Scott M. Davis
Senior Vice President & General Counsel
Sun Life Financial U.S.

Michael A. Dillon
Executive Vice President, General Counsel & Corporate Secretary
Sun Microsystems, Inc.

Simon Y. Leung
General Counsel
SYNNEX Corporation

Chris B. Heaphy
Senior Vice President, General Counsel & Secretary
The Taubman Company LLC

Christopher A. Montague
Executive Vice President & General Counsel
TD Bank Financial Group

Paul S. Leslie
Assistant General Counsel, Law
Tenet Healthcare Corporation

Eric I. Cohen
Senior Vice President, Secretary and General Counsel
Terex Corporation

M. Gayle Packer
Senior Principal
Vice President, Director of Corporate Services
Roger R. Herting
Executive Vice President and Chief Financial Officer
Terracon

Frank A. Sherer, Jr.
Senior Vice President, General Counsel and Secretary
TIMEX GROUP

John S. Jenkins, Jr.
Vice President & Corporate Secretary
Dennis P. Lynch
Vice President & Chief Litigation Counsel
Tyco International Management Company

Steven L. Philpott
Executive Vice President & General Counsel
Umpqua Holdings Corporation

Morris W. Hirsch
SVP, General Counsel & Secretary
Union Bank of California, N.A.

Joseph Masters
Vice President, General Counsel and Secretary
URS Corporation

James H. Bramble
General Counsel & Secretary
USANA Health Sciences, Inc.

Susan Marsch
Vice President and General Counsel
UTStarcom, Inc.

Burt M. Martin
Senior Vice President and General Counsel
Weatherford International Ltd.

Raymond M. Bukaty
Senior Vice President, Administration,
General Counsel & Secretary
Western Digital Corporation

James J. Bender
Senior Vice President and General Counsel
The Williams Companies

Don H. Liu
Senior Vice President, General Counsel and Secretary
Xerox Corporation

Donald Winn
Vice President, Finance
Yazaki North America Inc.

Daniel J. Churay
Executive Vice President, General Counsel & Secretary
YRC Worldwide Inc.

August 7, 2008

LETTER OF COMMENT NO. 82

Technical Director – File Reference No. 1600-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to comment on the FASB Proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141 (R)* (the proposal). While AcSEC applauds the Board's objective of providing enhanced disclosures related to loss contingencies, we question whether the proposal has gone too far. Our primary concerns are that (1) companies would be forced to disclose numbers that are inherently unreliable and (2) certain of the required disclosures might compromise a company's litigation strategy by providing information to an adversary or causing a breach of attorney-client privilege. AcSEC believes that the benefits of achieving the objectives should be weighed against the challenges to preparers, the legal system, and the capital markets. As drafted, we do not believe the Board has reached the appropriate balance to meet the objective.

'e, along with the AICPA's Auditing Standards Board (ASB) are also concerned with the impact of the proposal on an auditor's ability to obtain sufficient appropriate audit evidence regarding management's assertions underlying the proposed disclosures. Management will need to balance the proposed disclosure requirements with its fiduciary duty to protect the interests of the company. The company's legal counsel will undoubtedly be concerned that by disclosing certain information to the auditor and/or including such information within the financial statements, the company may be harming its legal defenses. A letter of audit inquiry to a client's lawyer is often the auditor's primary means of obtaining corroboration of information furnished by management concerning litigation, claims, and assessments. (See paragraph .09 of AU section 337, Inquiry of a Client's Lawyer.) The American Bar Association's (ABA) "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" (December 1975) ("ABA/AICPA treaty") explains the concerns of lawyers and the nature of the limitations an auditor is likely to encounter, and provides guidance to lawyers on responding to auditors' letters of audit inquiry. The information that would need to be developed to comply with the proposed disclosure requirements were not contemplated when the existing audit standards and interpretations and the ABA/AICPA treaty were developed. Lawyers may assert that they are constrained by the ABA Statement of Policy and more generally by attorney-client privilege in responding to auditors' requests for information that would corroborate certain of the proposed disclosures. We believe audit standard-setters need to evaluate the need for revisions to auditing standards and/or for other guidance for auditors. Such a standard-setting project will necessarily involve input from the audit profession, the legal profession, and the preparer community, and may involve a revision of the ABA/AICPA treaty. We believe that project needs to be completed before finalizing the changes to the existing disclosure requirements in FASB Statement No. 5.

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, NY 10036-8775 • (212) 596-6200 • fax (212) 596-6213 • www.aicpa.org
ISO 9001 Certified

The CPA. Never Underestimate The Value.®

Technical Director
August 7, 2008
Page - 2 -

For the primary reasons discussed above, we do not believe the proposal should go forward unless significant revisions are made. In particular, AcSEC recommends that in certain instances, the Statement permit the omission of quantitative information when such information is not reasonably estimable or would be prejudicial to the company. The prejudicial exemption, as currently drafted, does not achieve its objective and should be revised.

That said, assuming the Board was to make the significant revisions we have suggested, we believe the final Standard would benefit financial statement users and would represent an incremental improvement in practice. This is because a more thorough disclosure of facts about a pending contingency will provide meaningful information to investors and will allow a more detailed assessment to be made of the magnitude of such contingencies as well as the potential timing of their resolution.

A more complete response to the Board's specific questions, including AcSEC's recommended alternatives, is included in Appendix A. Representatives of AcSEC (and ASB with respect to auditing issues) are available to discuss our comments with the Board members and staff.

Yours truly,

Ben Neuhausen, Chair
Accounting Standards Executive Committee

Brett Cohen, Chair
Disclosures of Certain Loss Contingencies Task Force

- 2 -

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)

1. **Will the proposed Statement meet the project's objective of providing enhanced disclosures about loss contingencies so that the benefits of those disclosures justify the incremental costs? Why or why not? What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?**

   AcSEC generally agrees with the Board's objective of providing enhanced disclosures about loss contingencies. However, AcSEC is concerned that the proposed Statement fails to achieve the right balance and that the benefit of some of the required disclosures does not outweigh the incremental costs. In our view, those incremental "costs" include:

   - Forcing a company to breach attorney-client privilege and other legal protections,
   - Harming a company's negotiating position by disclosing sensitive information,
   - Potentially exposing the company to further litigation when disclosed estimates ultimately prove unreliable, and
   - Creating undue tension between the auditor and the company's legal counsel as the auditor attempts to obtain sufficient corroborating evidence while the attorneys strive to protect their client's legal positions. In a worst case scenario, this might cause the auditor to be unable to issue a "clean" audit opinion.

   In addition, certain structural changes will be required for the proposed Statement to be operational. Chief among those is the development of appropriate auditing guidance, which may involve the renegotiation of the 1975 ABA/AICPA treaty in light of these additional required disclosures.

   To make the proposed Statement operational, we recommend that certain changes be made to the proposal, as described below in our responses to the respective questions.

   We also recommend that the Board continue to solicit input from affected constituents to help in evaluating the benefits vs. incremental costs of the proposed disclosures. In particular, we would encourage the Board to solicit additional input from long-term investors, as well as from users in the private company marketplace. While certain financial statement users might desire extensive additional information, AcSEC believes that the objective of enhanced transparency in this area needs to be carefully balanced with the legitimate need of a company to avail itself of legal protections (including attorney-client privilege) and not jeopardize its position by providing potentially damaging information to an adversary in a legal proceeding.

2. **Do you agree with the Board's decision to include within the scope of this proposed Statement obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligation, which are currently subject to the provisions of Statement 5? Why or why not?**

3

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)

AcSEC agrees with the Board's decision to include within the scope of the proposed Statement obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligation, as we believe it would be more confusing to further segregate what loss contingencies are included in the scope of the proposed Statement.

Similarly, AcSEC believes that additional guidance, aside from that listed in Appendix B of the proposal, may need to be amended to indicate whether such loss contingencies are included in the scope of the proposed Statement. For example, the following standards contain references to items that are accounted for as loss contingencies under FASB Statement No. 5, but are not listed in Appendix B:

a. FASB Statement No. 43, *Accounting for Compensated Absences* (paragraph 1)
b. FASB Statement No. 48, *Revenue Recognition When Return Rights Exists* (paragraph 7),
c. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation* (paragraphs 38 and 45)

Additionally, with respect to the scope of the proposal, we recommend that paragraph 3(c) be rephrased to clearly state that all contingent liabilities related to insurance contracts be excluded. As currently worded, paragraph 3(c) indicates that "liabilities for unpaid claim costs related to insurance" are excluded from its scope; however, we believe the intent of the Board (based on the discussion in paragraph A8) was to exclude *all* contingent liabilities related to insurance contracts and not just those related to unpaid claim costs.

3. **Should an entity be required to provide disclosures about loss contingencies, regardless of the likelihood of loss, if the resolution of the contingencies is expected to occur within one year of the date of the financial statements and the loss contingencies could have a severe impact upon the operations of the entity? Why or why not?**

AcSEC believes that an entity should not be required to provide disclosures about loss contingencies for which the risk of loss is remote, notwithstanding the fact that resolution is expected to occur within one year and could be severe. We are concerned that if the final Statement requires a large volume of disclosures related to remote contingencies, there is a risk of boilerplate disclosure (similar to what is often seen in required SEC disclosures of risks and uncertainties). Accordingly, AcSEC recommends deleting the requirement in paragraph 6 of the proposal.

If the Board decides to retain paragraph 6, AcSEC requests that the Board clarify what is meant by "…or combination of loss contingencies…" We assume the Board intended this to apply to situations such as a class-action lawsuit, covering a large numbers of claimants whose cases involve common questions of law and/or fact. However, if left as stated, it is unclear how the Board intends this guidance to be applied.

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)

4. **Paragraph 10 of Statement 5 requires entities to "give an estimate of the possible loss range or range of loss or state that such an estimate cannot be made." One of financial statement users' most significant concerns about disclosures under Statement 5's requirements is that the disclosures rarely include quantitative information. Rather, entities often state that the possible loss cannot be estimated. The Board decided to require entities to disclose the amount of the claim or assessment against the entity, or, if there is no claim or assessment amount, the entity's best estimate of the maximum possible exposure to loss. Additionally, entities would be permitted, but not required, to disclose the possible loss or range of loss if they believe the amount of the claim or assessment is not representative of the entity's actual exposure.**
   a. **Do you believe that this change would result in an improvement in the reporting of quantitative information about loss contingencies? Why or why not?**
   b. **Do you believe that disclosing the possible loss or range of loss should be required, rather than optional, if an entity believes the amount of the claim or assessment or its best estimate of the maximum possible exposure to loss is not representative of the entity's actual exposure? Why or why not?**
   c. **If you disagree with the proposed requirements, what quantitative disclosures do you believe would best fulfill users' needs for quantitative information and at the same time not reveal significant information that may be prejudicial to an entity's position in a dispute?**

AcSEC generally agrees with the requirement to disclose the amount of the claim or assessment against the entity; however, in certain instances, disagrees with the requirement to disclose the entity's best estimate of the maximum possible exposure to loss (in the absence of a stated claim or assessment). In particular, AcSEC believes that an estimate of the maximum exposure to loss should only be provided if such amounts can be either determined by operation of law or reasonably estimated. However, in many instances, AcSEC believes that it will not be possible to calculate a reliable best estimate of the maximum possible exposure to loss. This is particularly relevant as it relates to unasserted claims or early stage litigation. Furthermore, the ABA/AICPA treaty currently provides guidance to lawyers not to confirm an estimated settlement amount unless the range provided has "only a slight chance of being inaccurate." Therefore, we recommend that the Board continue to permit disclosure that a reasonable estimate cannot be made, if such a statement is factual.

AcSEC agrees with the Board's decision that disclosing the possible loss or range of loss should be optional because the information disclosed may be prejudicial to the company's position and could create a breach of attorney-client privilege. In AcSEC's view, if management were to provide such information in its financial statements, the disclosures may be used by claimants as a roadmap to settlement and may be admissible evidence in a court proceeding.

However, in cases where a maximum exposure to loss cannot be reasonably estimated, AcSEC recommends that the proposed Statement require disclosure of the entity's best estimate of the loss or range of loss (refer to our response to question 5 below), presuming such amounts would not otherwise be considered prejudicial and thus subject to the exemption.

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)

Accordingly, in limited circumstances where quantitative information cannot be reasonably estimated or if disclosure of such amounts would be prejudicial, AcSEC believes that no quantitative information would be disclosed. In these cases, AcSEC recommends that the company be required to state that a reasonable estimate of loss cannot be made and the reasons for such omission (refer to our response to question 5 below).

5. **If a loss contingency does not have a specific claim amount, will an entity be able to provide a reliable estimate of the maximum exposure to loss (as required by paragraph 7(a)) that is meaningful to users? Why or why not?**

In cases where there is no specific claim amount, AcSEC is concerned that companies may not have the ability to provide a reliable estimate of the maximum exposure to loss in all instances. AcSEC agrees with the Board in requiring disclosure of the claim amount if it is available; however, AcSEC believes that no quantitative disclosure should be provided in cases where the information is not subject to reasonable estimation or is prejudicial to the company. This would be most apparent in cases of early-stage litigation or unasserted claims. Under these circumstances, how does a company reliably estimate its maximum exposure to loss? This requirement is in essence forcing a defendant company to quantify and disclose its potential maximum exposure in an adversary proceeding in instances where the claimant has either been unwilling or unable to quantify the exposure.

Assessments of pending litigation are highly uncertain and subject to factors outside the control of the company and in many cases, litigation tends to be highly dependent on individual facts and circumstances. Furthermore, AcSEC is not sure how meaningful it would be for a company to disclose its maximum exposure to other non-litigation-related loss contingencies.

AcSEC believes that if a specific claim amount does not exist, an entity should only provide quantitative disclosure of the maximum loss if the loss can be determined either by operation of law, or can be reasonably estimated. AcSEC further recommends that if a company cannot reasonably estimate its *maximum* exposure to loss but can estimate its actual exposure to loss or the range of loss, then those amounts should be disclosed in lieu of the maximum exposure to loss, presuming such amounts would not otherwise be considered prejudicial.

In instances where a company cannot reasonably estimate its maximum exposure to loss, its best estimate of loss, or a range of loss, AcSEC recommends that the company disclose that such estimates cannot be made at that time and the reasons why.

Therefore, AcSEC recommends revising paragraph 7a in the final Statement as follows:

7. An entity shall disclose the following information about loss contingencies required to be disclosed under paragraph 5~~ or 6:~~

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)

a. Quantitative information about the entity's exposure to loss from the contingency (including any amounts already recognized in the financial statements but excluding potential recoveries disclosed under paragraph 7(c)), as follows:

(1) The amount of the claim or assessment against the entity (including damages, such as treble or punitive damages), if applicable
(2) If there is no claim or assessment amount, the entity's best estimate of the maximum exposure to loss determined in the following manner:
- Operation of law; or
- A reasonable basis of calculation.

(3) If no reasonable basis exists upon which to develop an estimate of the maximum exposure to loss, an entity shall disclose its best estimate of the possible loss or range of loss;
(4) If no reasonable basis exists to quantify either the maximum exposure to loss, possible loss or range of loss, the entity shall state that such estimates cannot be made and the reasons why.

An entity may disclose its best estimate of the possible loss or range of loss if it believes that the amount of the claim or assessment or the maximum exposure to loss is not representative of the entity's actual exposure.

6. **Financial statement users suggested that the Board require disclosure of settlement offers made between counterparties in a dispute. The Board decided not to require that disclosure because often those offers expire quickly and may not reflect the status of negotiations only a short time later. Should disclosure of the amount of settlement offers made by either party be required? Why or why not?**

AcSEC agrees with the Board's decision not to require disclosures of settlement offers made between counterparties in a dispute, as we believe it would be difficult in many cases to accurately convey the relevance of a settlement offer. This could lead to disclosure of potentially misleading information.

7. **Will the tabular reconciliation of recognized loss contingencies, provided on an aggregated basis, provide useful information about loss contingencies for assessing future cash flows and understanding changes in the amounts recognized in the financial statements? Why or why not?**

When information would not be prejudicial, AcSEC agrees that an aggregated tabular reconciliation will generally allow the user of the financial statements to make a judgment about the company's risk profile and possible future outflows of resources.

As it relates to the interaction of the prejudicial exemption and the tabular reconciliation, AcSEC requests clarification on how the proposal is intended to be applied. For example, if a company is compelled to invoke the prejudicial exemption, does that exempt the company from disclosing a tabular reconciliation in its entirety or will it only exempt the company from disclosing the prejudicial information? If the latter is

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)

true, then a complete population of recognized loss contingencies will not be captured in the table and the beginning and ending balances will not reconcile to the balance sheet.

On balance, the majority of AcSEC members believe that in cases where disclosure of information in the tabular reconciliation is considered prejudicial, there should be no requirement to disclose an aggregated tabular reconciliation of the non-prejudicial information, as omission of significant (prejudicial) information or cases would cause the table to become potentially misleading to financial statement users.

8. **This proposed Statement includes a limited exemption from disclosing prejudicial information. Do you agree that such an exemption should be provided? Why or why not?**

   AcSEC agrees with including a prejudicial exemption in the final Statement; however, we are concerned that the minimum disclosures required, regardless of the use of the prejudicial exemption, may still be prejudicial to a company and its litigation strategy. In addition, AcSEC struggles to see the usefulness of such an exemption in many cases. This is because companies often either have a single case or class of exposures (e.g., asbestos) that pose a significant threat to the company. In many instances, users of the financial statements could decipher those significant cases from others even in the aggregate thereby not solving a company's problem of disclosing prejudicial information.

   Additionally, deciding which disclosures meet such an exemption will require a great deal of judgment by preparers, their legal counsel, and their auditors. Auditors will need to consider the type of evidence that will be needed to corroborate management's assertions to support their use of the exemption.

9. **If you agree with providing a prejudicial exemption, do you agree with the two-step approach in paragraph 11? Why or why not? If not, what approach would you recommend and why?**

   AcSEC generally agrees with the two-step approach, as described in paragraph A27 of the proposed Statement. However, AcSEC questions how aggregation will be applied as it relates to the qualitative disclosures. AcSEC is also concerned that when the prejudicial exemption is invoked, certain of the required minimum quantitative and qualitative disclosures would nonetheless prove to be prejudicial.

   As it relates to the first step, it is not clear if the Board intended aggregation to apply to both quantitative and qualitative disclosures. And if it is intended to apply to qualitative disclosures, how would a company go about aggregating to a level higher than by the nature of the contingency, while still providing meaningful information to users?

   In regards to the second step, AcSEC believes that even after applying the prejudicial exemption, the minimum quantitative and qualitative requirements could still be prejudicial to the outcome of the contingency. AcSEC recommends the removal of some of the less generic mandatory disclosures prescribed in paragraph 11 of the proposed Statement that "in no circumstances may an entity forgo disclosing." In particular, AcSEC is concerned that the following minimum disclosures could indeed be prejudicial:

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)

- An estimate of the entity's maximum exposure to loss, and
- A description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact to the outcome

10. **The International Accounting Standards Board (IASB) continues to deliberate changes to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, but have not yet reconsidered the disclosure requirements. The existing disclosure requirements of IAS 37 include a prejudicial exemption with language indicating that the circumstances under which that exemption may be exercised are expected to be *extremely rare*. This proposed Statement includes language indicating that the circumstances under which the prejudicial exemption may be exercised are expected to be *rare* (instead of *extremely rare*). Do you agree with the Board's decision and, if so, why? If not, what do you recommend as an alternative and why?**

    AcSEC agrees with the Board's decision to not include the word *extremely* to describe the circumstances under which the prejudicial exemption may be exercised. However, AcSEC recommends that the word *rare* also be deleted from paragraph 11 to read as follows:

    > In those ~~rare~~ instances in which the disclosure of information required by paragraph 7, when aggregated at a level higher than by the nature of the contingency, or of the tabular reconciliation would be prejudicial (for example, if an entity is involved in only one legal dispute), the entity may forgo disclosing only the information that would be prejudicial to the entity's position.

    AcSEC believes that the use of the prejudicial exemption will be more frequent than anticipated as companies often only have one major litigation pending. Therefore, if the Board intended the word *rare* not to mean *never*, as disclosed in a footnote to the proposed Statement, then AcSEC recommends that the word *rare* be removed. Including the word *rare* only serves to confuse rather than clarify the applicability of the exemption. AcSEC believes that by removing the word *rare*, a more consistent application of the exemption will result.

    AcSEC also appreciates the Board's goal of moving towards convergence with International Accounting Standards but believes that the U.S. is a very different environment from that in which IAS 37 is currently being applied. This is in part due to the more highly litigious environment in the U.S. where lawsuits (or the threat of them) are often used to resolve disputes. We also believe that the majority of enterprises that are currently applying IAS 37 tend to be large multinationals, whereas the vast majority of U.S. companies that would be required to apply the proposed Statement would be small, privately-held companies. Accordingly, AcSEC believes that in the U.S. marketplace it would not be rare for companies to be compelled to invoke the prejudicial exemption.

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)*

11. **Do you agree with the description of prejudicial information as information whose "disclosure … could affect, to the entity's detriment, the outcome of the contingency itself"? If not, how would you describe or define prejudicial information and why?**

   AcSEC agrees with the description of prejudicial information as described in the proposed Statement; however, consideration should be given to the Statement providing more guidance on "prejudicial" information, including examples of what would or would not constitute such information.

12. **Do you believe it is operational for entities to disclose all of the proposed requirements for interim and annual reporting periods? Should the tabular reconciliation be required only annually? Why or why not?**

   AcSEC acknowledges the requirements in APB 28, *Interim Financial Reporting,* paragraph 22, that essentially requires repeating contingency disclosures in interim and annual reports until the contingency has been resolved, as well as similar guidance for public registrants in Regulation S-X, Rule 10-01. Therefore, we are generally supportive of requiring the proposed disclosures in both interim and annual reporting periods. However, AcSEC questions whether there is sufficient incremental benefit to financial statement users from providing the tabular reconciliation during interim periods. On balance, we believe the tabular reconciliation should only be provided for annual reporting periods. We note that this is consistent with the requirements in both FIN 48, *Accounting for Uncertainty in Taxes* and SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises.*

   In addition, AcSEC requests clarification of the term *period,* as used in the last sentence of paragraph 8 of the proposed Statement. For example, would a loss contingency that arose in the first quarter but was settled in a later quarter of the same fiscal year be excluded from the reconciliation? And would the answer differ if the company were subject to interim reporting requirements?

13. **Do you believe other information about loss contingencies should be disclosed that would not be required by this proposed Statement? If so, what other information would you require?**

   AcSEC believes that proposed disclosures in paragraph 9 related to recoveries from insurance or indemnification arrangements be expanded to include a description of the line items in the statement of financial position in which the recoveries are included.

14. **Do you believe it is operational for entities to implement the proposed Statement in fiscal years ending after December 15, 2008? Why or why not?**

   AcSEC does not believe it is operational for entities to implement the proposed Statement in the current fiscal year. If finalized, as proposed, companies will have insufficient time to adopt and implement the new requirements. Many of the new disclosures will be highly sensitive and judgmental and will require companies to immediately begin working with legal counsel to ensure they are able to provide the appropriate level of information. Management may also not be in a position to provide some of the

Appendix A

Response to Questions:
FASB Proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)*

required disclosures on its own and will need to seek input from outside experts (e.g., engineers and environmental specialists). Companies will need to support and document their analysis and related judgments. Lastly, auditors will need to audit the new disclosures. This will almost certainly necessitate additional correspondence and dialogue between the company's auditors and its internal and external counsel.

AcSEC also notes that to comply with the requirements of the Statement as proposed, the beginning period of the tabular reconciliation will precede the issuance date of the final Statement. In discussing the need for presenting comparative information for earlier periods, the Board concluded that it would be impractical for entities to gather the necessary information (paragraph A30). For the same reasons, AcSEC believes it would be inappropriate for the tabular reconciliation to be required for retroactive periods that precede the issuance date of the final Statement.

Lastly, AcSEC believes that necessary audit standard-setting, including discussions related to revisions of the ABA/AICPA treaty, and what can be confirmed to auditors under that treaty may take a significant amount of time and effort to finalize. AcSEC recommends that the Board not proceed with determining an effective date until auditing guidance is developed regarding how auditors should obtain audit evidence to corroborate management's assertions. In any event, AcSEC recommends that the Statement be effective no sooner than for annual periods ending after December 15, 2009, with retrospective applicability to the beginning-of-the-year.

Deloitte & Touche LLP
Ten Westport Road
P.O. Box 820
Wilton, CT 06897-0820
USA
www.deloitte.com

August 7, 2008

LETTER OF COMMENT NO. 70

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: 1600-100
Re: Proposed Statement — *Disclosure of Certain Loss Contingencies* — an amendment of FASB Statements No. 5 and 141(R)

Dear Mr. Golden:

Deloitte & Touche LLP is pleased to comment on the FASB's proposed Statement, *Disclosure of Certain Loss Contingencies* — an amendment of FASB Statements No. 5 and 141(R).

While we support the FASB's objective to provide investors and users of financial information with more transparent disclosures about loss contingencies, we do not support issuance of the proposed Statement because, among other things, we are concerned about an auditor's ability to audit some of the proposed disclosures. In the body of this comment letter, we discuss pervasive concerns related to some of the proposed disclosures that we believe need to be addressed. In the Appendix, we articulate our responses to each of the questions posed by the FASB in its request for comments on the proposed Statement.

Preparers' Ability to Make Reliable Estimates

Based on our discussions with entities and our experience in the past, we are concerned about preparers' ability to make reliable estimates of their exposure to loss in many circumstances. By nature, many types of contingencies are affected by a number of factors that are difficult to predict and estimate. In many cases, there are not established methods for estimating an entity's exposure to loss and any estimate is likely to be highly subjective. Therefore, we do not support the proposed requirement for entities to disclose an estimate of their maximum exposure to loss.

Auditing Concerns

We are concerned about an auditor's ability to obtain a reasonable level of assurance in auditing some of the proposed disclosures, such as (1) estimates of the entity's maximum

Member of
Deloitte Touche Tohmatsu

exposure to loss, (2) underlying assumptions used in arriving at that estimate, (3) the most likely outcome, and (4) whether a disclosure meets the prejudicial exemption. The information that management might use to develop estimates and support amounts included in the related disclosures could come from sources to which the auditor does not have access. For example, management may have conversations with attorneys that are covered by attorney-client privilege and in which auditors would not be able to participate.

Lawyers' responses to letters of audit inquiry are typically the primary evidence auditors use to corroborate managements' assertions associated with these types of contingencies. These communications fall within the scope of the AICPA's and the PCAOB's auditing standards in *Professional Standards,* AU Section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," and the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975) ("ABA Statement of Policy") (see AICPA and PCAOB *Professional Standards*, AU Section 337C). As noted in the ABA Statement of Policy, a "lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by [the ABA Statement of Policy]." We believe that the current form of lawyers' responses would not provide the auditor with sufficient, appropriate audit evidence to corroborate management's assertions about the proposed disclosures because the ABA's guidance in the ABA Statement of Policy is based on the existing accounting and disclosure requirements in Statement 5 and not on the proposed expanded disclosures.

Therefore, an appropriately revised ABA Statement of Policy would need to be in place before the FASB proceeds with proposed disclosures that rely on legal judgments. We believe that revisions to the proposed Statement should be accomplished through a dialogue between the ABA and the PCAOB, with input from the auditing profession, the SEC, and the preparer community. Renegotiation of the ABA Statement of Policy could take a significant amount of time and may prove difficult when a lawyer's response could be viewed as a breach of attorney-client privilege, an admission, or otherwise prejudicial to a client. Accordingly, the effective date of the proposed Statement is too aggressive.

If the enhanced disclosures would be useful to others (see our comments below), the FASB may wish to consider whether the disclosures would be more appropriately furnished outside the audited financial statements and footnotes. For example, the SEC could amend its MD&A requirements to enhance current disclosures about loss contingencies.

Usefulness to Users of Financial Statements

While we agree that some type of qualitative disclosure is warranted about loss contingencies, including certain remote loss contingencies, we believe that the proposed quantitative disclosures would have limited usefulness, could be misleading, and may unnecessarily alarm some users of financial statements. In many circumstances, it will be difficult for preparers to develop reliable estimates of maximum exposure to loss and determine whether a contingency is expected to be resolved within one year, even if they were to engage outside specialists.

August 7, 2008
Page 3
File Reference No. 1600-100

Although disclosure of the claim amount, if stated, may be verified objectively and may not be prejudicial, we urge the FASB to consider further whether this information is meaningful to financial statement users. Specifically, the claim amount (1) often bears little relation to the ultimate outcome, (2) may increase or decrease repeatedly over time, and (3) is a number for which a plaintiff has minimal accountability. Such amounts are often inflated, and the proposed Statement might encourage inflation of them for sensational or tactical purposes. In addition, the claim amount is often likely to have no or very limited usefulness in the assessment of likelihood, timing, and amount of future cash flows associated with loss contingencies. This is particularly true for cases that have only a remote likelihood of succeeding.

We do not agree that, when there is no claim amount, an entity should be required to disclose an estimate of the maximum exposure to loss and its assumptions in arriving at that estimate. In many cases, any estimate of the maximum exposure to loss is likely to be highly subjective and difficult to verify objectively. The ABA Statement of Policy states that "the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss . . . only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight." Moreover, we question why a defendant should be required to estimate the maximum exposure to loss and describe its assumptions in estimating that amount if the plaintiff has not quantified the amount of its claim. In addition, the maximum exposure to loss may be boundless because of the unpredictability of the legal process.

Legal Concerns

The proposed Statement raises legal issues that preparers of financial statements may not easily overcome. The FASB should consult with legal specialists to determine whether the required disclosures and auditing thereof could harm an entity's defense, specifically the requirements to provide (1) an estimate of the maximum exposure to loss and assumptions in arriving at that estimate and (2) an evaluation of the most likely outcome. For example, the ABA Statement of Policy states, "Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission."

The proposed Statement includes an exemption in "rare instances" from providing information that may be deemed prejudicial. We agree that an exemption from disclosing prejudicial information should be provided; however, we anticipate that it would be used more often than in "rare instances," and that auditing these types of assertions may prove challenging and potentially harmful to an entity's defense because of potential breach of attorney-client privilege.

* * * * * *

August 7, 2008
Page 4
File Reference No. 1600-100

We appreciate the opportunity to comment on the proposed Statement. If you have any questions concerning our comments, please contact Magnus Orrell at (203) 761-3402.

Yours truly,

Deloitte & Touche LLP

cc: Robert Uhl

August 7, 2008
File Reference No. 1600-100

Appendix A

APPENDIX A
Deloitte & Touche LLP
Responses to Proposed Statement's Questions

Question 1: Will the proposed Statement meet the project's objective of providing enhanced disclosures about loss contingencies so that the benefits of those disclosures justify the incremental costs? Why or why not? What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?

We support the FASB's objective of providing enhanced disclosures about loss contingencies as an interim measure until the FASB addresses the recognition and measurement issues in a longer-term project. However, we are not convinced that the proposed Statement strikes the right balance between benefits and costs. We urge the FASB to consult with preparers and legal specialists to more thoroughly evaluate the direct and indirect costs of providing the proposed disclosures.

Some companies would incur substantial direct costs to comply with the requirements of the proposed Statement. For example, entities with large numbers of lawsuits would need to establish and maintain new information systems to collect and report all of the data to be disclosed. And because the progress of lawsuits changes frequently, this information would need to be updated and maintained constantly, which would be expensive and time-consuming for some companies (especially for interim periods, as discussed in the proposed Statement). Furthermore, entities might incur additional fees and costs associated with the work of outside counsel and auditors in preparing and corroborating the information. We remain unconvinced that many of the proposed disclosures, such as (1) claim amounts, (2) an entity's estimate of its maximum exposure to loss, or (3) certain remote loss contingencies, would provide useful information to investors and warrant the additional costs for preparers.

In addition, the proposed disclosures could result in substantial indirect costs to a company and its investors if they were to negatively affect an entity's ability to defend itself in litigation and settlement negotiations. While the proposed Statement contains an exemption from disclosing prejudicial information, that exemption is subject to strict conditions and does not extend to disclosure about, for example, the entity's estimate of the maximum exposure to loss if there is no claim amount. The FASB should consult with legal specialists to determine whether preparing, providing, or auditing the proposed disclosures could cause harm to an entity's defense. For example, we would be concerned if audit testing of the use of the prejudicial exemption or the assumptions underlying other disclosures could result in a loss of client-attorney privilege.

Question 2: Do you agree with the Board's decision to include within the scope of this proposed Statement obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations, which are currently subject to the provisions of Statement 5? Why or why not?

Member of
Deloitte Touche Tohmatsu

August 7, 2008
Appendix A - Page 2
File Reference No. 1600-100

We agree that these obligations should be included in the proposed Statement. We suggest that the FASB also consider this issue in the context of pension plan disclosures.

Question 3: Should an entity be required to provide disclosures about loss contingencies, regardless of the likelihood of loss, if the resolution of the contingencies is expected to occur within one year of the date of the financial statements and the loss contingencies could have a severe impact upon the operations of the entity? Why or why not?

While we understand that some type of qualitative disclosure may be warranted about certain loss contingencies that could have a severe impact in the near term, we are concerned that the proposed quantitative disclosures have limited usefulness, could be misleading, and may unnecessarily alarm some financial statement users. In addition, we are concerned that preparers will find it difficult to determine whether a contingency is expected to be resolved within one year

We do not support the proposed requirement for an entity to disclose a claim amount for loss contingencies when the loss has only a remote likelihood of occurring. In many cases, the claim amount bears little, if any, relation to the ultimate outcome and is likely to be of very limited usefulness in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies. This is particularly true for cases that have only a remote likelihood of succeeding.

We do not support the proposed requirement that, when there is no claim amount, an entity must disclose an estimate of the maximum exposure to loss and its assumptions in arriving at that estimate. In many circumstances, it will be difficult for preparers to develop reliable estimates of their maximum exposure to loss, even if they engage outside specialists. Estimates of the maximum exposure to loss can be highly subjective and difficult to verify objectively. Moreover, we question why a defendant should be required to estimate the maximum exposure to loss and describe its assumptions in estimating that amount if the plaintiff has not quantified the amount of its claim.

In addition, we urge the FASB to consult with legal specialists to determine whether the disclosure could harm an entity's defense. The ABA Statement of Policy states, "Lawyers should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission."

To avoid disclosure of loss contingencies when there is no practical likelihood of the loss occurring, but when its occurrence could have a severe impact, the FASB should consider including additional criteria, such as whether:

- Information about the loss contingency is provided internally to key management personnel such as the entity's board of directors or chief executive officer.

August 7, 2008
Appendix A - Page 3
File Reference No. 1600-100

- The contingency "is likely to have" a severe impact if it were to occur (rather than "could have" a severe impact if it were to occur).

Question 4: Paragraph 10 of Statement 5 requires entities to "give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." One of financial statement users' most significant concerns about disclosures under Statement 5's requirements is that the disclosures rarely include quantitative information. Rather, entities often state that the possible loss cannot be estimated. The Board decided to require entities to disclose the amount of the claim or assessment against the entity, or, if there is no claim or assessment amount, the entity's best estimate of the maximum possible exposure to loss. Additionally, entities would be permitted, but not required, to disclose the possible loss or range of loss if they believe the amount of the claim or assessment is not representative of the entity's actual exposure.

> *a. Do you believe that this change would result in an improvement in the reporting of quantitative information about loss contingencies? Why or why not?*

We believe that even though disclosure of the claim amount may be verified objectively and not be prejudicial, the FASB should consider further whether this information is helpful to financial statement users. Specifically, the claim amount (1) often bears little relation to the ultimate outcome, (2) may increase or decrease repeatedly over time, and (3) is a number for which a plaintiff has minimal accountability. Such amounts are often inflated for sensational or tactical purposes.

Other than when the amount can be reasonably estimated, we are not convinced that disclosure of an estimate of the maximum exposure to loss will be helpful to users of financial statements. Estimating the maximum exposure to loss will often be subjective and depend on non-economic factors that are difficult to quantify. In addition, the maximum exposure to loss may be boundless because of the unpredictability of the legal process. Different methods for estimating loss contingencies also may hinder the comparability of financial statement disclosures. The FASB should consult legal specialists to determine whether the methods used are sufficiently consistent to meet the expectations of users regarding the comparability of financial statement presentation by issuers.

Moreover, obtaining audit evidence to support the estimate will often be difficult, and disclosure of this amount and the assumptions used in arriving at the estimate may be frequently viewed by entities as prejudicial. We question why a defendant should be required to disclose its estimate of the maximum exposure to loss if the plaintiff has been unwilling or unable to quantify its claim.

> *b. Do you believe that disclosing the possible loss or range of loss should be required, rather than optional, if an entity believes the amount of the claim or assessment or its best estimate of the maximum possible exposure to loss is not representative of the entity's actual exposure? Why or why not?*

August 7, 2008
Appendix A - Page 4
File Reference No. 1600-100

We agree with the FASB's proposal that disclosing the possible loss or range of loss should be optional. Although there are not often established methods for determining the best estimate of loss or range of loss and such an estimate is likely to be highly subjective, this disclosure would be more useful than the other proposed quantitative disclosures.

However, obtaining audit evidence to support the amounts will be challenging. The ABA Statement of Policy states that "the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss . . . only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight."

> *c. If you disagree with the proposed requirements, what quantitative disclosures do you believe would best fulfill users' needs for quantitative information and at the same time not reveal significant information that may be prejudicial to an entity's position in a dispute?*

We recommend that the FASB limit any quantitative disclosure requirements to amounts that can be reasonably estimated.

To address the issues regarding an auditor's ability to obtain evidence in auditing some of the proposed disclosures, the FASB may also wish to consider whether enhanced quantitative disclosures about loss contingencies could be more appropriately furnished outside the audited financial statements and footnotes. For example, the SEC could amend its MD&A requirements to enhance current disclosures about loss contingencies.

Question 5: If a loss contingency does not have a specific claim amount, will an entity be able to provide a reliable estimate of the maximum exposure to loss (as required by paragraph 7(a)) that is meaningful to users? Why or why not?

We believe that an entity often will not be able to provide a reliable estimate of the maximum exposure to loss that is meaningful to users. See our response to Question 4 above.

Question 6: Financial statement users suggested that the Board require disclosure of settlement offers made between counterparties in a dispute. The Board decided not to require that disclosure because often those offers expire quickly and may not reflect the status of negotiations only a short time later. Should disclosure of the amount of settlement offers made by either party be required? Why or why not?

We agree that for the reasons provided in the question, disclosure of settlement offers should not be required.

August 7, 2008
Appendix A - Page 5
File Reference No. 1600-100

Question 7: Will the tabular reconciliation of recognized loss contingencies, provided on an aggregated basis, provide useful information about loss contingencies for assessing future cash flows and understanding changes in the amounts recognized in the financial statements? Why or why not?

We agree that, except when it could be prejudicial, the proposed disclosure of a reconciliation of aggregate changes in loss contingencies that have already been recognized in the financial statements is useful. This reconciliation may provide information to users of financial statements about management's use of estimates in determining amounts accrued for loss contingencies. However, the proposed requirement to provide a qualitative description of the significant activity in the reconciliation may often prove to be prejudicial.

Question 8: This proposed Statement includes a limited exemption from disclosing prejudicial information. Do you agree that such an exemption should be provided? Why or why not?

We agree that an exemption from disclosing prejudicial information should be provided. However, we expect that auditing these types of assertions may prove difficult because of attorney-client privilege (as discussed in the body of this comment letter). In addition, although the proposed Statement suggests that use of this exemption would be rare, we believe that companies and their attorneys will frequently view certain types of disclosures as prejudicial, such as the entity's best estimate of the maximum exposure to loss, the most likely outcome, and the significant assumptions used in estimating quantitative information.

The proposed Statement is unclear about what constitutes "prejudicial" and how a company would go about making such an assessment. The FASB should provide more guidance about this and consult with preparers, attorneys, and users about what components make up this determination and what the appropriate disclosures should be regarding the prejudicial exemption.

Question 9: If you agree with providing a prejudicial exemption, do you agree with the two-step approach in paragraph 11? Why or why not? If not, what approach would you recommend and why?

We believe that the proposed Statement should not presume that disclosure of information required by paragraph 7, when aggregated at a higher level, or of the tabular reconciliation, would be prejudicial only in "rare" instances. For example, companies with only one major dispute may frequently need to invoke the prejudicial exemption. In addition, we do not agree with the FASB's proposal that an entity should not be permitted to use the prejudicial exemption to forego disclosing an estimate of the maximum exposure to loss (in the absence of a claim amount) or the potential impact on the outcome. We believe that if such information is prejudicial, an entity should not be required to disclose it.

August 7, 2008
Appendix A - Page 6
File Reference No. 1600-100

We believe that in certain circumstances, aggregation under the two-step approach may be helpful. However, the FASB should provide more guidance on how to apply this approach (e.g., by adding illustrative examples of the aggregation process).

Question 10: The International Accounting Standards Board (IASB) continues to deliberate changes to IAS 37, Provisions, Contingent Liabilities and Contingent Assets, but has not yet reconsidered the disclosure requirements. The existing disclosure requirements of IAS 37 include a prejudicial exemption with language indicating that the circumstances under which that exemption may be exercised are expected to be extremely rare. This proposed Statement includes language indicating that the circumstances under which the prejudicial exemption may be exercised are expected to be rare (instead of extremely rare). Do you agree with the Board's decision and, if so, why? If not, what do you recommend as an alternative and why?

See our response to Question 8 above.

Question 11: Do you agree with the description of prejudicial information as information whose "disclosure . . . could affect, to the entity's detriment, the outcome of the contingency itself"? If not, how would you describe or define prejudicial information and why?

We believe that the FASB should consult with legal specialists to determine whether this is an appropriate description of prejudicial information.

Question 12: Do you believe it is operational for entities to disclose all of the proposed requirements for interim and annual reporting periods? Should the tabular reconciliation be required only annually? Why or why not?

We believe that the tabular reconciliation should be required only on an annual basis. If there are significant changes to the year-end estimates, public companies are already required under SEC regulations to disclose these on an interim basis.

Question 13: Do you believe other information about loss contingencies should be disclosed that would not be required by this proposed Statement? If so, what other information would you require?

We have not identified any other information about loss contingencies that we believe should be disclosed.

Question 14: Do you believe it is operational for entities to implement the proposed Statement in fiscal years ending after December 15, 2008? Why or why not?

We believe that the proposed effective date is too aggressive. As noted in the body of this comment letter, we believe that an appropriately revised ABA Statement of Policy should be in place before the FASB proceeds with the proposed disclosures that rely on legal judgments. In addition, implementation of the proposed Statement may prove challenging for companies

August 7, 2008
Appendix A - Page 7
File Reference No. 1600-100

with a large portfolio of cases. Such companies may need to incur substantial costs to establish information systems to collect the required information and obtain attorney opinions needed to prepare and audit the information.

Another concern is how the gathering, processing, and reporting of these increased disclosures would be covered under an entity's internal control over financial reporting. We expect this would take a significant amount of time and effort for some companies to implement because they would need to make changes to their existing process and controls to comply with the proposed Statement.

In addition, the effective dates of the proposed Statement and Statement 141(R) conflict. Although the proposed Statement includes an amendment to Statement 141(R), the proposed Statement would be effective before companies are required to implement Statement 141(R). This means that the proposed Statement would apply to loss contingencies in the scope of Statement 141(R) before Statement 141(R) itself becomes effective. The FASB should address this inconsistency.

LETTER OF COMMENT NO. 51

7 August 2008

Mr. Robert Herz
Chair, Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116
USA

Re: File Reference: Exposure Draft *Disclosure of Certain Loss Contingencies an amendment of FASB Statements No. 5 and 141(R)*

Dear Mr. Herz:

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC),[2] appreciates the opportunity to comment on the Financial Accounting Standards Board (FASB) Exposure Draft, *Disclosure of Certain Loss Contingencies an amendment of FASB Statements No. 5 and 141(R)* (ED).

The CFA Institute Centre represents the views of investment professionals, particularly the CFA Institute membership, which includes portfolio managers, investment analysts, and advisors worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA

434 951 5499
434 951 5262
info@cfainstitute.org
www.cfainstitute.org

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 2

General Comments

The ultimate objective of the wealth-generation process is to generate cash. Thus, it is critically important for investors to understand how companies generate cash and the risks associated with the nature, amount, and timing of future cash flows. To meet this objective, investors must be provided with transparent and accessible information related to loss contingencies to incorporate into their analyses and judgments. The need for adequate disclosures is even more critical given the dominant characteristic (i.e., uncertainty) of contingencies. Most sophisticated users of financial information realize that measuring contingencies involves making assumptions in order to estimate the future cash flows required to settle a given contingency. In other words, they expect the measurement of contingencies to change from one reporting period to the next until cash flows and other facts are certain. Transparent disclosures regarding loss contingencies provide information that is essential to an investor's understanding of these risks and uncertainties.

Investors have long expressed the concern that disclosures required by FASB Statement No. 5, *Accounting for Contingencies,* do not provide sufficient and transparent information in a timely manner to enable investors to assess the nature, likelihood, timing, and amount of future cash flows related to loss contingencies. The disclosures provided by the ED would enhance the ability of investors to make such assessments, which are essential to their analysis and use of the information contained in the financial statements.

Survey Results Regarding Cash Flows and Footnote Disclosures

In a CFA Institute corporate disclosure survey conducted in 2007, ninety-seven percent of the 406 respondents indicated that information about a company's capacity to generate future cash flows was important to their analysis or investment decision-making process. Respondents were also asked to rate both the importance and quality of note disclosures regarding contractual or future commitments for outflows of cash. On a five-point scale, the respondents rated the importance of such disclosures at 4.3 and their quality at only 3.1[3]. This indicates a problematic gap between the importance respondents place on note disclosures and the quality they actually experience.

Further, regarding contingencies and exposures to risks, the results of corporate disclosure surveys of CFA Institute members conducted in 2007, 2003, and 1999, identified deficiencies in financial reporting of both quantitative and qualitative information. While respondents rated

[3] Importance scale: 1= not important to 5=very important; Quality scale: 1=not useful and/or not provided to 5=very useful. The ratings shown represent the weighted average mean based on the total responses for each question and/or specific item set within a given question. If respondents selected "no opinion" or did not make a selection, this response or lack thereof is not included in the total responses used to calculate the mean rating.

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 3

highly the importance of disclosures for contingencies and risks in all three surveys, they assigned a lower rating to the quality of the information they received.

The following tables provide a snapshot of survey results:

Importance	Survey Year		
	2007	2003	1999
Contingencies related to litigation and potential exposure	4.0	4.1	n/a
Risks and exposures to risks (e.g., business, financial and market risk factors)	4.1	4.1	3.9

Quality	Survey Year		
	2007	2003	1999
Contingencies related to litigation and potential exposure	3.1	2.8	n/a
Risks and exposures to risks (e.g., business, financial and market risk factors)	3.1	2.8	3.0

The gaps in information quality as noted by these results clearly indicate the need to improve the disclosure about the nature, timing and magnitude of potential claims on an enterprise's assets and cash flows. We strongly support many of the FASB proposals and feel that they offer meaningful improvement in the disclosures required by investors.

Recognition and Measurement

Although disclosures are not a substitute for recognition and measurement, they are essential to enrich an investor's understanding of the financial statements. The role of disclosure is to provide a comprehensive explanation of events or transactions that have been recognized. These disclosures should have the same qualitative characteristics as the elements in the financial statements (including understandability, completeness, relevance, and comparability). To the greatest extent possible, these written disclosures should pertain to the individual characteristics and circumstances of the entity and avoid routine, legal boilerplate.

We encourage the FASB to address as soon as possible recognition and measurement issues currently under consideration. In particular, we stress the importance of establishing a sound definition of a liability, broadly defined as a present obligation of (or claim against) an entity.

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 4

In more detail, as described in our *Comprehensive Business Reporting Model*, a liability exists when[4]:

a. The entity is obligated to act or perform in a certain way (or refrain from acting or performing).
b. The obligation exists at the financial statement date.
c. The obligation is economic—it is an obligation to provide economic resources to others or to stand ready to do so.

We elaborate on our views in response to specific questions in the remainder of this letter.

Responses to Specific Questions

Question 1. Will the proposed Statement meet the project's objective of providing enhanced disclosures about loss contingencies so that the benefits of those disclosures justify the incremental costs? Why or why not?

What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?

Disclosures are essential to an investor's understanding and analysis of the financial statements. The enhanced disclosures proposed by the FASB will add significantly to the overall understanding of risks and uncertainties related to loss contingencies. These disclosures, provided they contain both sufficient qualitative and quantitative information, will close the gaps in information referenced previously in our general remarks.

We believe that the following disclosures proposed by the FASB provide meaningful information required by investors to fully understand the risks associated with loss contingencies:

- A description of the contingency, how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution;

- A description of the factors that are likely to affect the ultimate outcome of the contingency, along with their potential effect on the outcome;

- A qualitative assessment of the most likely outcome;

[4] CFA Institute, *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, July 2007, page 15. The full report can be found at: www.cfapubs.org/doi/abs/10.2469/ccb.v2007.n6.4818

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 5

- The significant assumptions made, in estimating the amounts disclosed and in assessing the most likely outcome; and

- A quantitative and qualitative description of any related insurance and indemnity arrangements.

Furthermore, requiring disclosure—even if the likelihood of the loss is deemed remote—when a contingency (1) is expected to be resolved in the "near term" and (2) could have a severe impact on the entity's financial position, cash flows, or results of operations, is important information for investors as well. In such circumstances, disclosure about the sources of liquidity that would be available to the entity to meet contingencies meeting the above criteria would be useful.

Minimal extra costs should be incurred to report the information in accordance with the new requirements since the data should be readily accessible and part of the entity's existing risk management practice.

Question 2. Do you agree with the Board's decision to include within the scope of this proposed Statement obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations, which are currently subject to the provisions of Statement 5? Why or why not?

Yes, we agree with the Board's decision to include obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations. Subjecting these obligations to the same requirements as other loss contingencies will provide additional meaningful information to investors. Given the lack of meaningful disclosure requirements about multiemployer plans, financial statement users currently have no information about the financial impacts of possible withdrawal.

Question 3. Should an entity be required to provide disclosures about loss contingencies, regardless of the likelihood of loss, if the resolution of the contingencies is expected to occur within one year of the date of the financial statements and the loss contingencies could have a severe impact upon the operations of the entity? Why or why not?

Yes, we agree that an entity should disclose a loss contingency—regardless of the likelihood of loss—if it is expected to be resolved in the near term and the contingency could have a severe impact on the entity's financial position, cash flows, or results of operations. Disclosing near-term contingencies that could have a financially significant disruptive effect on the normal functioning of an entity is an important disclosure. Complete, transparent disclosures relating to these events will enable investors to make appropriate independent judgments either to include or exclude these contingencies from their analysis, as they deem appropriate.

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 6

Question 4. Paragraph 10 of Statement 5 requires entities to "give an estimate of the possible loss or range of loss or state that such an estimate cannot be made."

One of financial statement users' most significant concerns about disclosures under Statement 5's requirements is that the disclosures rarely include quantitative information. Rather, entities often state that the possible loss cannot be estimated. The Board decided to require entities to disclose the amount of the claim or assessment against the entity, or, if there is no claim or assessment amount, the entity's best estimate of the maximum possible exposure to loss. Additionally, entities would be permitted, but not required, to disclose the possible loss or range of loss if they believe the amount of the claim or assessment is not representative of the entity's actual exposure.

a. Do you believe that this change would result in an improvement in the reporting of quantitative information about loss contingencies? Why or why not?

b. Do you believe that disclosing the possible loss or range of loss should be required, rather than optional, if an entity believes the amount of the claim or assessment or its best estimate of the maximum possible exposure to loss is not representative of the entity's actual exposure? Why or why not?

c. If you disagree with the proposed requirements, what quantitative disclosures do you believe would best fulfill users' needs for quantitative information and at the same time not reveal significant information that may be prejudicial to an entity's position in a dispute?

We agree that this provision is an improvement to the existing disclosure requirements. In practice, many entities often claim that a "reasonable estimate" cannot be made and, therefore do not disclose the information. By requiring an entity to disclose the claim or assessment (or if there is no such amount, the entity's best estimate of the maximum possible exposure to loss), an investor will be able to better assess the risks and financial statement effects of such claims or assessments. This information should be supplemented by sufficient information as to the nature of the events and circumstances of the loss contingency.

Furthermore, we believe that an entity should be *required* to disclose the possible range of loss if it believes the amount of the claim or assessment is not representative of its best estimate of the maximum exposure to loss. It is our experience that if an entity has an option to disclose it will choose not to do so.

These requirements would provide investors with information regarding a range of possible outcomes, instead of the current boilerplate disclosures that have no information content.

Ultimately, investors are interested in whether the existence of loss contingencies may have large, medium or small effects on an entity's results of operations, financial position and cash flows (liquidity) and whether those contingencies will require a fast, medium or slow use of

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 7

liquidity. Thus, we support qualitative or quantitative disclosures that provide help investors estimate reasonably the potential range and patterns of cash outflows that may be required to settle loss contingencies.

Question 5. If a loss contingency does not have a specific claim amount, will an entity be able to provide a reliable estimate of the maximum exposure to loss (as required by paragraph 7(a)) that is meaningful to users? Why or why not?

We believe that an entity will be able to reasonably estimate its maximum exposure to loss based on its internal assessment of the merits of claim and potential damages using the facts and circumstances known to it at the time it prepares its financial statements. It is our view that if the entity provides a reasonable estimate of the claim accompanied by the critical assumptions used to develop its estimate, this will enable investors to make appropriate adjustments to the information as they deem appropriate. If an entity is unable to make a reasonable assessment of the claim amount, its reasons for failing to do so should be clearly disclosed.

Question 6. Financial statement users suggested that the Board require disclosure of settlement offers made between counterparties in a dispute. The Board decided not to require that disclosure because often those offers expire quickly and may not reflect the status of negotiations only a short time later. Should disclosure of the amount of settlement offers made by either party be required? Why or why not?

Settlement offers should be disclosed along with sufficient qualitative information to fully understand the nature of the offer. We believe that an entity should evaluate its exposure to loss and determine the potential damages or claims based on the current facts and circumstances as part of effective risk management. If the situation is in a discovery stage or still developing whereby more information will likely be presented, then those facts should be disclosed.

While settlement offers may expire quickly, they can still provide reasonable quantitative information regarding the exposure. Moreover, investors will be informed about whether such offers are considered reasonable by management and how such offers are being evaluated. Investors are in the best position to determine what information is relevant to their analysis and therefore should be given the fullest information possible—including settlement offers—and allowed to select their information and adjust accordingly.

Question 7. Will the tabular reconciliation of recognized loss contingencies, provided on an aggregated basis, provide useful information about loss contingencies for assessing future cash flows and understanding changes in the amounts recognized in the financial statements? Why or why not?

We strongly prefer a tabular reconciliation that provides greater transparency regarding the effects of contingencies on the financial statements. Tables can be an efficient and effective means of communicating information.

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 8

The following information proposed by the Board would be very helpful to an investor's assessment of the amounts recognized in the statement of financial position and how such amounts may affect the amount, nature and timing of cash flows:

a. Increases for loss contingencies recognized during the period;
b. Increases resulting from changes in estimates of the amounts of loss contingencies previously recognized;
c. Increases for recognized loss contingencies of subsidiaries acquired or newly consolidated;
d. Increases (decreases) resulting from changes in foreign currency rates used to translate the recognized amounts stated in currencies other than the reporting currency;
e. Decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized;
f. Decreases resulting from cash payments (or other forms of settlement) for loss contingencies;
g. Decreases resulting from deconsolidation or sale of subsidiaries.

We urge the Board to require that the components of the reconciliation be presented on a gross basis, and not netted. Specifically, increases from changes in estimates in amounts of loss contingencies should be reported separately from decreases in estimates; increases from new subsidiaries should be reported separately from decreases due to deconsolidation; and so forth. Having the information reported on a gross basis provides at least an initial basis to inquire of management as to the nature of and reason for potentially material refinements in estimates that would be obscured if those amounts were netted.

We stress that in addition to the specific reconciliation requirements, an entity should provide a qualitative description of the significant activity in the reconciliation.

Question 8. This proposed Statement includes a limited exemption from disclosing prejudicial information. Do you agree that such an exemption should be provided? Why or why not?

We agree that a limited exemption from disclosing prejudicial information should be granted in certain circumstances. However, we would advocate that such an exemption be used in *extremely rare* situations rather than in merely *rare* situations. As we stated to the International Accounting Standards Committee[5]:

> "...Users need more disclosures in cases where the quality of the accounting measurement is not ensured. However, we also understand that in extremely rare

[5] Comment Letter to International Accounting Standards Committee, *Proposed International Accounting Standard, Provisions, Contingent Liabilities and Contingent Assets (E59)*, 7 January 1998. View the full letter at www.cfainstitute.org/centre/topics/comment/1998/e59.html

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 9

> circumstances (i.e., litigation), extensive disclosure may be prejudicial to the interests of the enterprise. In those cases, we agree that the amount of the provision need not be disclosed as long as facts and circumstances are sufficiently disclosed so that users understand the nature of the provision and its likely consequences for the enterprise."

We understand that there is a certain amount of opposition to the proposed changes with respect to loss contingencies related to litigation. In particular, there is the belief that any incremental disclosures, other than a description of the legal action, could potentially be useful to a plaintiff.[6] It is purported that the expanded disclosure would make it difficult for a preparer to avoid disclosures that would, or could, be prejudicial and that litigation be removed from the scope of the project and the current requirements of FAS 5 remain in effect. However, we disagree with this notion and feel that informative disclosures when properly crafted could fulfill investors' need for the information and still protect the company from disclosing prejudicial information.

We propose consideration of the following disclosures which should not prove prejudicial to the merits of the litigation:

- The reason why the company is the subject of litigation;
- The amount of damages being sought by the plaintiff (all publicly available information in the court filings);
- The company's response to the complaint, including a description of the defense and why the company is using that defense.

Disclosure of this information will enable existing and potential investors to better assess the risks associated with their investment.

Question 9. If you agree with providing a prejudicial exemption, do you agree with the two-step approach in paragraph 11? Why or why not? If not, what approach would you recommend and why?

We agree that the two-step approach of first aggregating information at a higher level and then by nature of the contingency enables preparers to disclose information without allowing a counterparty to take advantage of the information to the detriment of the entity. This disclosure should be disaggregated to the lowest level possible so as not to disclose sensitive information specific to the case. The highest aggregation point should be at the business segment level, otherwise the benefit of the disclosure is minimized. We are concerned that preparers may have a tendency to over-aggregate and thus significantly reduce the usefulness of the information provided.

[6] Letter to Robert H. Herz, Chairman, Financial Accounting Standards Board, 17April 2008, Re: *Disclosures about Loss Contingencies-Potential Amendment of FAS 5*, Financial Executives International.

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 10

Question 10. The International Accounting Standards Board (IASB) continues to deliberate changes to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* but has not yet reconsidered the disclosure requirements. The existing disclosure requirements of IAS 37 include a prejudicial exemption with language indicating that the circumstances under which that exemption may be exercised are expected to be *extremely rare.* This proposed Statement includes language indicating that the circumstances under which the prejudicial exemption may be exercised are expected to be *rare* (instead of *extremely rare*). Do you agree with the Board's decision and, if so, why? If not, what do you recommend as an alternative and why?

We support using the term *extremely rare* to describe circumstances under which the prejudicial exemption may be exercised. We anticipate that those cases will be so infrequent as to become virtually non-existent, but in such extremely rare cases the exemption should still be available. Furthermore, using a definition that is consistent with IAS 37 *"Provisions, Contingent Liabilities and Contingent Assets"* is in keeping with the move toward convergence of financial accounting standards.

Question 11. Do you agree with the description of *prejudicial information* as information whose "disclosure . . . could affect, to the entity's detriment, the outcome of the contingency itself"? If not, how would you describe or define *prejudicial information* and why?

Yes, we agree that the description of prejudicial information as proposed by the Board is appropriate.

Question 12. Do you believe it is operational for entities to disclose all of the proposed requirements for interim and annual reporting periods? Should the tabular reconciliation be required only annually? Why or why not?

We believe that it is operational for entities to disclose all of the proposed information in both the interim and annual periods, including tabular reconciliation with each. Investors require information on a timely basis and the receipt of disclosure relating to loss contingencies is important information to receive in both interim and annual reporting periods.

Tracking this activity on an on-going basis should be built into the entity's risk management practice and, therefore, this information should be readily available.

Question 13. Do you believe other information about loss contingencies should be disclosed that would not be required by this proposed Statement? If so, what other information would you require?

The ED appears to capture much of the needed disclosure. We reiterate that the principles of transparency, consistency, and completeness, along with an intention to communicate clearly, must form the basis for disclosure elements wherever they are found. Preparers should be

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 11

required to follow these principles when identifying any other information regarding contingencies they deem important to investors. It is critical that the relevant facts, once identified, should be disclosed in as clear and transparent a manner as reasonably possible.

We offer the following additional observation that we believe would simplify and streamline the information about loss contingencies included in financial reports:

There is a large amount of detailed disclosure provided about loss contingencies in the financial reports of companies that file periodic reports with the SEC. This information can be found under "Notes to Financial Statements," "Management's Discussion & Analysis" and "Legal Proceedings." We recommend that the FASB work with the staff of SEC to develop a more streamlined approach to the disclosure about loss contingencies in such periodic reports without compromising or diminishing the goal of full disclosure. For example, the use of a tabular presentation would be useful to summarize such data as: the nature of each kind of loss contingency, the number of lawsuits, plaintiffs, and class actions, and the amounts of expenses related to such contingencies recognized in the financial statements.

Question 14. Do you believe it is operational for entities to implement the proposed Statement in fiscal years ending after December 15, 2008? Why or why not?

We believe that entities should have disclosure information readily available to allow for the implementation of the proposed standard in fiscal years ending after December 15, 2008. Gathering, analyzing, and tracking information with regard to loss contingencies is a best practice for entities with a good risk management process.

In closing, we would like to reiterate our general support of the overall direction the FASB is taking to strengthen disclosures relating to loss contingencies. We feel that investors should be fully informed about all contingencies and risks when they arise.

We appreciate the opportunity to provide comments to the FASB and its staff regarding Exposure Draft *Disclosure of Certain Loss Contingencies an amendment of FASB Statements No. 5 and 141(R).* If you or your staff should have questions or seek further elaboration of our views, please contact Matthew Waldron, at 434.951.5321 or matthew.waldron@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht	*/s/ Gerald I. White*
Kurt N. Schacht, CFA Managing Director	Gerald I. White, CFA Chair, Corporate Disclosure Policy Council

Re: ED "Disclosure of Certain Loss Contingencies"

7 August 2008
Page 12

cc: Jeffrey D. Diermeier, CFA, President and CEO, CFA Institute
Ray DeAngelo, Managing Director, Member and Society Division, CFA Institute
Corporate Disclosure Policy Council

NO. 1600-100 | JUNE 5, 2008

Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Disclosure of Certain Loss Contingencies

an amendment of FASB Statements No. 5 and 141(R)

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. 1600-100

Comment Deadline: August 8, 2008

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be **received** in writing by August 8, 2008. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1600-100. Those without email may send their comments to the "Technical Director—File Reference No. 1600-100" at the address at the bottom of this page. Responses should **not** be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and will be included in the project's public record.

Any individual or organization may obtain one copy of this Exposure Draft without charge until August 8, 2008, on written request only. **Please ask for our Product Code No. E195.** For information on applicable prices for additional copies and copies requested after August 8, 2008, contact:

Order Department
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Copyright © 2008 by Financial Accounting Standards Board. All rights reserved. Permission is granted to make copies of this work provided that such copies are for personal or intraorganizational use only and are not sold or disseminated and provided further that each copy bears the following credit line: "Copyright © 2008 by Financial Accounting Standards Board. All rights reserved. Used by permission."

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

Notice for Recipients of This Proposed FASB Statement

This proposed Statement would replace and enhance the disclosure requirements in FASB Statement No. 5, *Accounting for Contingencies,* for loss contingencies that are recognized as liabilities in a statement of financial position and for unrecognized loss contingencies that would be recognized as liabilities if the criteria for recognition in paragraph 8 of Statement 5 were met. It would not change the disclosure requirements for loss contingencies that are (or would be) recognized as asset impairments. This proposed Statement also would apply to loss contingencies recognized in a business combination accounted for under FASB Statement No. 141 (revised 2007), *Business Combinations.*

Effective Date and Transition

The disclosures about loss contingencies required by this proposed Statement would be effective for annual financial statements issued for fiscal years ending after December 15, 2008, and interim and annual periods in subsequent fiscal years.

Request for Comments

The Board invites individuals and organizations to send written comments on all matters in this proposed Statement, particularly on the questions listed below. Respondents need not comment on each issue and are encouraged to comment on additional matters they believe should be brought to the Board's attention. Comments are requested from those who agree with the provisions of this proposed Statement as well as from those who do not. Comments are most helpful if they identify the issues to which they relate and clearly explain the reasons for the positions taken. Those who disagree with provisions of this proposed Statement are asked to describe their suggested alternatives, supported by specific reasoning. Respondents must submit comments in writing by August 8, 2008.

The Board requests that constituents provide comments on the following questions:

1. Will the proposed Statement meet the project's objective of providing enhanced disclosures about loss contingencies so that the benefits of those disclosures justify the incremental costs? Why or why not? What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?
2. Do you agree with the Board's decision to include within the scope of this proposed Statement obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations, which are currently subject to the provisions of Statement 5? Why or why not?
3. Should an entity be required to provide disclosures about loss contingencies, regardless of the likelihood of loss, if the resolution of the contingencies is

expected to occur within one year of the date of the financial statements and the loss contingencies could have a severe impact upon the operations of the entity? Why or why not?

4. Paragraph 10 of Statement 5 requires entities to "give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." One of financial statement users' most significant concerns about disclosures under Statement 5's requirements is that the disclosures rarely include quantitative information. Rather, entities often state that the possible loss cannot be estimated. The Board decided to require entities to disclose the amount of the claim or assessment against the entity, or, if there is no claim or assessment amount, the entity's best estimate of the maximum possible exposure to loss. Additionally, entities would be permitted, but not required, to disclose the possible loss or range of loss if they believe the amount of the claim or assessment is not representative of the entity's actual exposure.
    a. Do you believe that this change would result in an improvement in the reporting of quantitative information about loss contingencies? Why or why not?
    b. Do you believe that disclosing the possible loss or range of loss should be required, rather than optional, if an entity believes the amount of the claim or assessment or its best estimate of the maximum possible exposure to loss is not representative of the entity's actual exposure? Why or why not?
    c. If you disagree with the proposed requirements, what quantitative disclosures do you believe would best fulfill users' needs for quantitative information and at the same time not reveal significant information that may be prejudicial to an entity's position in a dispute?
5. If a loss contingency does not have a specific claim amount, will an entity be able to provide a reliable estimate of the maximum exposure to loss (as required by paragraph 7(a)) that is meaningful to users? Why or why not?
6. Financial statement users suggested that the Board require disclosure of settlement offers made between counterparties in a dispute. The Board decided not to require that disclosure because often those offers expire quickly and may not reflect the status of negotiations only a short time later. Should disclosure of the amount of settlement offers made by either party be required? Why or why not?
7. Will the tabular reconciliation of recognized loss contingencies, provided on an aggregated basis, provide useful information about loss contingencies for assessing future cash flows and understanding changes in the amounts recognized in the financial statements? Why or why not?
8. This proposed Statement includes a limited exemption from disclosing prejudicial information. Do you agree that such an exemption should be provided? Why or why not?
9. If you agree with providing a prejudicial exemption, do you agree with the two-step approach in paragraph 11? Why or why not? If not, what approach would you recommend and why?

10. The International Accounting Standards Board (IASB) continues to deliberate changes to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* but has not yet reconsidered the disclosure requirements. The existing disclosure requirements of IAS 37 include a prejudicial exemption with language indicating that the circumstances under which that exemption may be exercised are expected to be *extremely rare*. This proposed Statement includes language indicating that the circumstances under which the prejudicial exemption may be exercised are expected to be *rare* (instead of *extremely rare*). Do you agree with the Board's decision and, if so, why? If not, what do you recommend as an alternative and why?
11. Do you agree with the description of *prejudicial information* as information whose "disclosure . . . could affect, to the entity's detriment, the outcome of the contingency itself"? If not, how would you describe or define *prejudicial information* and why?
12. Do you believe it is operational for entities to disclose all of the proposed requirements for interim and annual reporting periods? Should the tabular reconciliation be required only annually? Why or why not?
13. Do you believe other information about loss contingencies should be disclosed that would not be required by this proposed Statement? If so, what other information would you require?
14. Do you believe it is operational for entities to implement the proposed Statement in fiscal years ending after December 15, 2008? Why or why not?

Public Roundtable Meeting

The Board plans to hold one or more public roundtable meetings on this Exposure Draft. The purpose of roundtable meetings is to listen to the views of, and obtain information from, interested constituents about the Exposure Draft. The Board plans to seek participants for the meetings that represent a wide variety of constituents, including investors, preparers of financial statements, auditors, and others to ensure that it receives broad input. Any individual or organization desiring to participate must notify the FASB by sending an email to director@fasb.org by July 25, 2008, and submit their comments on the Exposure Draft in writing by August 8, 2008. Roundtable meetings can accommodate a limited number of participants. Depending on the number of responses received, the Board may not be able to accommodate all requests to participate.

Field Testing Volunteers

The Board also is soliciting entities that would be willing to participate with the staff, on a confidential basis, in field testing the provisions of this proposed Statement. The purpose of the field tests is to assess the workability of the proposed guidance and evaluate the cost and benefits of the proposed change. Those interested parties can contact David B. Elsbree, Jr., practice fellow, at 203-956-3453 or dbelsbree@fasb.org.

Summary

Why Is the FASB Issuing This Proposed Statement and When Is It Effective?

Investors and other users of financial information have expressed concerns that disclosures about loss contingencies under the existing guidance in FASB Statement No. 5, *Accounting for Contingencies*, do not provide adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies. This proposed Statement would expand disclosures about certain loss contingencies in the scope of Statement 5 or FASB Statement No. 141 (revised 2007), *Business Combinations*. This proposed Statement would require expanded disclosures for those loss contingencies unless certain criteria are met. This proposed Statement would be effective for fiscal years ending after December 15, 2008, and interim and annual periods in subsequent fiscal years.

What Is the Scope of This Proposed Statement?

This proposed Statement would apply to all loss contingencies that are within the scope of either Statement 5 or Statement 141(R) except for the following:

a. Loss contingencies that are (or would be) recognized as asset impairments in a statement of financial position. Such loss contingencies would continue to be disclosed in accordance with Statement 5. Creditors would continue to disclose information about impaired loans in accordance with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.
b. Guarantees within the scope of the disclosure requirements in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, including guarantees that are recognized either initially or subsequently based on the Statement 5 accounting guidance.
c. Liabilities for unpaid claim costs related to insurance contracts or reinsurance contracts of an insurance entity or a reinsurance entity within the scope of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, or No. 163, *Accounting for Financial Guarantee Insurance Contracts*.
d. Liabilities for insurance-related assessments within the scope of AICPA Statement of Position 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*.
e. Liabilities for employment-related costs, including pensions and other postemployment benefits. However, obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations would be disclosed in accordance with this Statement.

How Will This Proposed Statement Improve Current Accounting Practice?

This proposed Statement would enhance disclosures about loss contingencies that are (or would be) recognized as liabilities in a statement of financial position. Specifically, this proposed Statement would (a) expand the population of loss contingencies that are required to be disclosed, (b) require disclosure of specific quantitative and qualitative information about those loss contingencies, (c) require a tabular reconciliation of recognized loss contingencies to enhance financial statement transparency, and (d) provide an exemption from disclosing certain required information if disclosing that information would be prejudicial to an entity's position in a dispute. The Board believes that these enhanced disclosure requirements will significantly improve the overall quality of disclosures about loss contingencies by providing financial statement users with important information.

How Does This Proposed Statement Relate to International Convergence?

The disclosures that would be required by this proposed Statement are similar, but not identical, to those required by IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. This proposed Statement would require disclosures about a broader population of contingencies than required by IAS 37. Specifically, this proposed Statement would require disclosures about loss contingencies, regardless of the likelihood of loss, if the contingencies are expected to be resolved in the near term and if the contingencies could have a severe impact on the entity's financial position, cash flows, or results of operations. IAS 37 does not require disclosures for remote loss contingencies regardless of the expected timing of resolution or potential severity of the contingency. The IASB currently is deliberating changes to IAS 37 but has not yet considered its disclosure requirements. The IASB is expected to evaluate the disclosure requirements in this proposed Statement when it reconsiders the IAS 37 disclosure requirements, which will provide a potential convergence opportunity.

Proposed Statement of Financial Accounting Standards

Disclosure of Certain Loss Contingencies

an amendment of FASB Statements No. 5 and 141(R)

June 5, 2008

CONTENTS

Paragraph Numbers

Objective 1–2
Standards of Financial Accounting and Reporting:
Scope 3
Disclosures 4–11
Tabular Reconciliation of Recognized Loss Contingencies 8–9
Subsequent Events 10
Exemption from Disclosing Prejudicial Information 11
Effective Date and Transition 12
Appendix A: Background Information and Basis for Conclusions A1–A37
Appendix B: Amendments to FASB Pronouncements and
Other Authoritative Literature B1–B15

Proposed Statement of Financial Accounting Standards

Disclosure of Certain Loss Contingencies

an amendment of FASB Statements No. 5 and 141(R)

June 5, 2008

OBJECTIVE

1. FASB Statement No. 141 (revised 2007), *Business Combinations,* establishes the accounting and reporting for gain and loss contingencies recognized in a business combination. FASB Statement No. 5, *Accounting for Contingencies,* establishes the accounting and reporting for all other gain and loss contingencies. The objective of this Statement is to improve the disclosures about certain loss contingencies by amending Statements 5 and 141(R). This Statement does not change the recognition and measurement guidance for loss contingencies contained in those Statements.

2. The term *loss contingency,* as defined in Statement 5, includes losses that may result from the loss or impairment of an asset or the incurrence of a liability. This Statement replaces the disclosure requirements in Statement 5 for loss contingencies that are recognized as liabilities in a statement of financial position and for unrecognized loss contingencies that would be recognized as liabilities if the criteria for recognition in paragraph 8 of Statement 5 were met. Loss contingencies that are (or would be) recognized as asset impairments should continue to be disclosed in accordance with Statement 5. This Statement also amends Statement 141(R) to require the disclosures included in this Statement for loss contingencies recognized in a business combination.

All paragraphs in this Statement have equal authority.
Paragraphs in **bold** set out the main principles.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

3. This Statement applies to all loss contingencies that are within the scope of either Statement 5 or Statement 141(R), except for the following:

a. **Loss contingencies that are (or would be) recognized as asset impairments in a statement of financial position. Such loss contingencies shall continue to be disclosed in accordance with Statement 5. Creditors shall continue to disclose information about impaired loans in accordance with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan.***
b. **Guarantees within the scope of the disclosure requirements of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* including guarantees that are recognized either initially or subsequently based on the Statement 5 accounting guidance.**
c. **Liabilities for unpaid claim costs related to insurance contracts or reinsurance contracts of an insurance entity or a reinsurance entity within the scope of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* or No. 163, *Accounting for Financial Guarantee Insurance Contracts.***
d. **Liabilities for insurance-related assessments within the scope of AICPA Statement of Position 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments.***
e. **Liabilities for employment-related costs, including pensions and other postemployment benefits. However, obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations shall be disclosed in accordance with this Statement.**

Disclosures

4. An entity shall provide disclosures to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies that are (or would be) recognized as liabilities in a statement of financial position. Those disclosures shall include information about the risks those loss contingencies pose to the entity and their potential and actual effects on the entity's financial position, cash flows, and results of operations.

5. An entity shall disclose all loss contingencies within the scope of this Statement, except as follows (or as required by paragraph 6):

a. Disclosure is not required for a loss contingency for which the entity has made an assessment and determined that the likelihood of a loss is remote.
b. Disclosure is not required for a loss contingency involving an unasserted claim or assessment in which there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, unless:
   (1) It is probable that a claim will be asserted; and
   (2) The likelihood of a loss, if the claim or assessment were to be asserted, is more than remote.

6. Notwithstanding the guidance in paragraph 5, an entity shall disclose a loss contingency, or a combination of loss contingencies, regardless of the likelihood of loss, if both:

a. The contingency or contingencies are expected to be resolved in the near term;[1] and
b. The contingency or contingencies could have a severe impact[2] on the entity's financial position, cash flows, or results of operations.

7. An entity shall disclose the following information about loss contingencies required to be disclosed under paragraph 5 or 6:

a. Quantitative information about the entity's exposure to loss from the contingency (including any amounts already recognized in the financial statements but excluding potential recoveries disclosed under paragraph 7(c)), as follows:
   (1) The amount of the claim or assessment against the entity (including damages, such as treble or punitive damages), if applicable
   (2) If there is no claim or assessment amount, the entity's best estimate of the maximum exposure to loss.

   An entity also may disclose its best estimate of the possible loss or range of loss if it believes that the amount of the claim or assessment or the maximum exposure to loss is not representative of the entity's actual exposure.
b. Qualitative information about the contingency sufficient to enable users to understand the risks posed to the entity. This information shall include, at a minimum, a description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution;

---

[1]The term *near term* means a period of time not to exceed one year from the date of the financial statements. [AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*]
[2]The term *severe impact* means a significant financially disruptive effect on the normal functioning of an entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe effect on (disrupt) the entity itself. The concept of severe impact, however, includes matters that are less than catastrophic. Matters that are catastrophic include, for example, those that would result in bankruptcy. [SOP 94-6]

a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome; the entity's qualitative assessment of the most likely outcome of the contingency; and significant assumptions made by the entity in estimating the amounts disclosed in paragraph 7(a) and in assessing the most likely outcome.

c. A qualitative and quantitative description of the terms of relevant insurance or indemnification arrangements that could lead to a recovery of some or all of the possible loss, including any caps, limitations, or deductibles that could affect the amount of recovery.

The disclosures required by this paragraph may be aggregated by the nature of the loss contingency (for example, product liability or antitrust matters).

Tabular Reconciliation of Recognized Loss Contingencies

8. For each period for which a statement of income is presented, an entity shall provide a reconciliation, in tabular format, of the total amount recognized in the aggregate for loss contingencies in its statement of financial position at the beginning and end of the period. Amounts recognized for loss contingencies that are accounted for in accordance with Statement 141(R) shall be shown separately from amounts for loss contingencies that are accounted for in accordance with Statement 5. The reconciliation shall include at a minimum:

a. Increases for loss contingencies recognized during the period
b. Increases resulting from changes in estimates of the amounts of loss contingencies previously recognized
c. Decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized
d. Decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

An entity shall provide a qualitative description of the significant activity in the reconciliation and shall disclose the line items in the statement of financial position in which recognized loss contingencies are included. All loss contingencies recognized in a business combination shall be included in the reconciliation. However, other loss contingencies whose underlying cause and ultimate settlement occur in the same period shall be excluded from the reconciliation.

9. An entity also shall disclose the total amount of recoveries from insurance or indemnification arrangements recognized in each statement of financial position and statement of income presented that are related to the loss contingencies included in the tabular reconciliation required by paragraph 8.

Subsequent Events

10. After the date of an entity's financial statements but before those financial statements are issued, information may become available indicating that a liability was

incurred after the date of the financial statements or that it is more than remote that a liability was incurred after that date. In those situations, an entity shall provide the disclosures required in paragraph 7. In the case of a loss arising after the date of the financial statements in which the amount of the liability incurred can be reasonably estimated, an entity may supplement the historical financial statements by disclosing pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a statement of financial position only, in columnar form on the face of the historical financial statements.

Exemption from Disclosing Prejudicial Information

11. For certain contingencies, such as pending or threatened litigation, disclosure of certain information about the contingency may be prejudicial to an entity's position (that is, disclosure of the information could affect, to the entity's detriment, the outcome of the contingency itself). In those circumstances, an entity may aggregate the disclosures required by paragraph 7 at a level higher than by the nature of the contingency such that disclosure of the information is not prejudicial. In those rare[3] instances in which the disclosure of the information required by paragraph 7, when aggregated at a level higher than by the nature of the contingency, or of the tabular reconciliation would be prejudicial (for example, if an entity is involved in only one legal dispute), the entity may forgo disclosing only the information that would be prejudicial to the entity's position. In those circumstances, an entity shall disclose the fact that, and the reason why, the information has not been disclosed. In no circumstance may an entity forgo disclosing the amount of the claim or assessment against the entity (or, if there is no claim amount, an estimate of the entity's maximum exposure to loss); providing a description of the loss contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; and providing a description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact on the outcome.

EFFECTIVE DATE AND TRANSITION

12. This Statement shall be effective for annual financial statements issued for fiscal years ending after December 15, 2008, and interim and annual periods in subsequent fiscal years. A tabular reconciliation of recognized loss contingencies is not required for earlier periods that are provided for comparative purposes.

The provisions of this Statement need not be applied to immaterial items.

[3]The term *rare* is not intended to mean *never*. The example provided is not intended to represent the only circumstance in which a disclosure might be sufficiently prejudicial as to warrant omission of that disclosure. All of the facts and circumstances must be considered and significant judgment must be applied to determine in what circumstances disclosures might be prejudicial.

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

	Paragraph Numbers
Introduction	A1
Background Information	A2–A4
Scope	A5–A10
Business Combinations	A6
Guarantees	A7
Insurance	A8–A9
Multiemployer Plans	A10
Disclosure Principle	A11
Disclosure Threshold	A12–A14
Unasserted Claims and Assessments	A14
Disclosure of the Claim Amount or the Maximum Exposure to Loss	A15–A16
Qualitative Nature of Loss Contingencies	A17–A18
Recoveries	A19
Aggregation of Disclosures about Loss Contingencies	A20
Tabular Reconciliation	A21–A24
Prejudicial Exemption	A25–A29
Effective Date and Transition	A30
Similarities and Differences with International Accounting Standards	A31–A33
Benefits and Costs	A34–A37

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this proposed Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

A2. In September 2007, the Board added a project to its agenda on the accounting for certain nonfinancial liabilities and contingencies, including contingencies under FASB Statement No. 5, *Accounting for Contingencies*. The Board decided to conduct this project in two phases: a short-term phase to amend and enhance the disclosure requirements for Statement 5 loss contingencies and a long-term phase to comprehensively reconsider the recognition and measurement guidance for certain nonfinancial liabilities.

A3. The short-term phase of the project was undertaken to address constituents' concerns that the disclosures about certain loss contingencies under existing guidance do not provide sufficient information in a timely manner to assist users in assessing the likelihood, timing, and amounts of cash flows associated with loss contingencies. The loss contingencies affected are those that are (or would be, if the criteria in paragraph 8 of Statement 5 were met) recognized as liabilities in a statement of financial position that do not have other applicable disclosure guidance, such as liabilities arising from litigation. The following are the primary criticisms of disclosures about such loss contingencies that are addressed in this project:

a. The initial disclosure of specific information about a loss contingency often does not occur until a material accrual is recognized for that loss contingency.
b. The *at least reasonably possible* threshold for disclosing loss contingencies has not resulted in the disclosure of the full population of an entity's existing loss contingencies that would be of interest to financial statement users.
c. The option to state that "an estimate of the possible loss or range of loss cannot be made" is exercised with such frequency by financial statement preparers that users often have no basis for assessing an entity's possible future cash flows associated with loss contingencies.
d. The amounts recognized in the financial statements related to loss contingencies are not transparent to users.

A4. To address these concerns, this proposed Statement expands the disclosures about certain loss contingencies by replacing the disclosure requirements of Statement 5 for

those loss contingencies with the new, enhanced disclosure requirements in this proposed Statement.

Scope

A5. Loss contingencies that are recognized as asset impairments in a statement of financial position, such as allowances for uncollectible accounts receivable and impairments of loans, are outside the scope of this proposed Statement and, therefore, would continue to be subject to the existing disclosure requirements of Statement 5. The Board has a separate project on its agenda to consider disclosures related to allowances for credit losses associated with finance receivables.

Business Combinations

A6. Loss contingencies assumed in a business combination in accordance with FASB Statement No. 141 (revised 2007), *Business Combinations,* are within the scope of this proposed Statement. The Board reasoned that those loss contingencies have a similar economic nature to loss contingencies arising from the normal operations of the entity and, thus, also should be subject to the disclosure requirements of this proposed Statement. However, because loss contingencies recognized under Statement 141(R) have a different measurement attribute than those recognized under Statement 5, the Board decided that these amounts would be shown separately in the tabular reconciliation required by paragraph 8 of this proposed Statement.

Guarantees

A7. The Board considered whether guarantees within the scope of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* should be included in the scope of this proposed Statement. The Board determined that because of the nature of guarantees, separate disclosure requirements were needed that reflect the specific recognition and measurement guidance to which they are subject in Interpretation 45. The Board also noted that including guarantees in the tabular reconciliation required by this proposed Statement would result in additional complexity because of the various subsequent measurement methods used for guarantees. As a result, the Board decided to exclude all guarantees within the scope of Interpretation 45 from the scope of this proposed Statement. This exclusion would include guarantees for which the subsequent recognition and measurement of a guarantee within the scope of Interpretation 45 are based on the Statement 5 criteria. For those guarantees, the Board concluded that the associated liability is still within the scope of Interpretation 45 and should follow the disclosure requirements of that Interpretation.

Insurance

A8. The Board does not intend to change the accounting and disclosure requirements for insurance and reinsurance entities in this project. Accordingly, liabilities for unpaid claim costs related to insurance contracts or reinsurance contracts of an insurance entity or a

reinsurance entity are outside the scope of this proposed Statement. However, the existing disclosure requirements of Statement 5 apply in certain circumstances, as required by AICPA Statement of Position 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*. This Statement amends that SOP to include within its body the existing Statement 5 disclosure requirements. Similarly, liabilities for insurance-related assessments also are outside the project's scope; thus, AICPA Statement of Position 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments,* also is being amended to reflect the existing Statement 5 disclosure requirements, rather than the requirements in this proposed Statement.

A9. Loss contingencies of insurance and reinsurance entities that are unrelated to insurance or reinsurance contracts are within the scope of Statement 5; therefore, the disclosure requirements of this proposed Statement would apply to those contingencies. Additionally, loss contingencies that are self-insured are in the scope of Statement 5 and, therefore, also would be in the scope of this proposed Statement.

Multiemployer Plans

A10. The Board noted that under the existing accounting model for multiemployer plans, obligations that may result from withdrawal from a multiemployer plan represent loss contingencies that are within the scope of Statement 5. The Board decided that those loss contingencies also are in the scope of this proposed Statement.

Disclosure Principle

A11. The Board agreed to include a disclosure principle to communicate the objective of the disclosure requirements. By including an objective, an entity could better understand what information about loss contingencies should be included in the notes to the financial statements. The disclosure principle is based on paragraph 37 of FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* which states that "financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (footnote reference omitted). To meet this objective, the principle requires that an entity also provide a discussion of the risks associated with loss contingencies and their actual and potential effects on the entity's financial position, cash flows, and results of operations.

Disclosure Threshold

A12. Financial statement users have stated that, on balance, the *at least reasonably possible* threshold in Statement 5 results in delayed disclosure of relevant information about loss contingencies. The disclosure threshold in this proposed Statement would expand the population of loss contingencies that are required to be disclosed, resulting in more timely disclosure of loss contingencies for financial statement users. The Board decided that this proposed Statement should require disclosures of the entire population of loss contingencies except those contingencies that meet certain narrow criteria. Disclosure would not be required for a loss contingency for which the entity has made an

assessment and determined that the likelihood of a loss is remote, except as discussed in paragraph A13. The Board wanted this proposed Statement to emphasize that an entity should make an assessment of the likelihood of loss for its population of loss contingencies each reporting period. Additionally, the Board believes that if an entity is unable to assert that the likelihood of loss is remote, it should disclose the contingency.

A13. The Board also decided to require disclosure of loss contingencies if the contingencies are expected to be resolved in the *near term* and if the contingencies could have a *severe impact* on the entity (as those terms are defined in AICPA Statement of Position 94-6, *Disclosures of Certain Significant Risks and Uncertainties*), without regard to the likelihood of loss. The Board agreed that users should be aware of all loss contingencies with the potential to have a significantly disruptive effect on the financial health or operations of an entity within one year. Initially, the Board considered requiring disclosure of all loss contingencies that could have a severe impact on the entity, without regard to the expected timing of resolution. However, the Board decided to narrow this requirement because it believes that disclosure of all contingencies that could severely affect the entity would result in disclosure of a significant amount of information that would not be cost-beneficial.

Unasserted Claims and Assessments

A14. The Board decided to substantially retain existing language from Statement 5 about unasserted claims or assessments against an entity. This language states that disclosure of a loss contingency related to an unasserted claim or assessment is not necessary unless it is probable that a claim or assessment will be asserted and the likelihood of loss, if the claim or assessment were to be asserted, is more than remote. The Board believes that unasserted claims and assessments represent a unique set of loss contingencies for which specific guidance is necessary.

Disclosure of the Claim Amount or the Maximum Exposure to Loss

A15. To enhance the quantitative disclosure requirements, the Board decided to require disclosure of the amount of the claim or assessment against an entity, or an entity's best estimate of the maximum exposure to loss if there is no claim or assessment amount. The Board decided that disclosing the claim or assessment amount would provide relevant information about the maximum potential for loss, even if it is unlikely that a loss would ever be realized in this amount. The amount of the claim is an objective amount that often can be determined by reference to court documents, which are publicly available. Therefore, it is not prejudicial to disclose this amount. Furthermore, if the entity believes that the amount of the claim or maximum exposure is not representative of the entity's actual exposure to loss, it may explain why it is unlikely that the amount would ever be incurred and what a more reasonable range of the possible loss would be. Therefore, additional disclosure of the entity's best estimate of the possible loss, or range of loss, is permitted, but not required, by this proposed Statement.

A16. The Board decided not to retain the disclosure exemption that if an amount cannot be reasonably estimated, an entity would not have to provide an amount in the disclosure

but, instead, would provide the reasons why an estimate cannot be made. Financial statement users indicated that this exemption in Statement 5 is used with such regularity that rarely does any quantitative information accompany loss contingency disclosures. They prefer to have a highly uncertain estimate supplemented with a qualitative description than no quantification of a potential loss as commonly occurs in existing practice.

Qualitative Nature of Loss Contingencies

A17. Under this proposed Statement, the required disclosures include a description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution. The Board believes that an entity generally includes much of this information when describing the nature of the contingency under the existing Statement 5 requirements.

A18. This proposed Statement also requires disclosure of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome, a qualitative assessment of the most likely outcome of the contingency, and any assumptions made in estimating the amounts in the quantitative disclosures and in assessing the most likely outcome. The Board decided that this information would provide users with data to perform analysis and better understand the potential future cash flows of the entity. In particular, disclosure of the factors that are likely to affect the ultimate outcome and their potential effects will assist users in making their own assessments about the likelihood of future events related to the loss contingency as well as the potential cash flows related to those future events.

Recoveries

A19. FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* specifies the criteria that must be met in order to offset an asset and a liability in a statement of financial position. The Board believes it would be unusual for those criteria to be met in the case of a possible recovery from an insurance, indemnification, or other similar arrangement related to a loss contingency primarily because there is usually more than one counterparty involved. Accordingly, loss contingencies and their related recoveries usually must be presented separately in a statement of financial position at their gross amounts. Consistent with this presentation, the Board decided that the quantitative disclosures required by paragraph 7 and the amounts in the tabular reconciliation required by paragraph 8 of this proposed Statement should exclude the effect of possible recoveries from insurance, indemnifications, or other similar arrangements. The Board decided that information about these arrangements and any amounts recognized in the statement of position should be disclosed separately.

Aggregation of Disclosures about Loss Contingencies

A20. To simplify the disclosure presentation and reduce the possibility of disclosing prejudicial information, the Board decided that the qualitative and quantitative disclosures required by paragraph 7 may be aggregated by the nature of the contingency. The Board

appropriate to exercise this exemption is a matter of significant judgment that depends on the facts and circumstances.

Effective Date and Transition

A30. The Board decided that this proposed Statement should be effective for annual financial statements issued for fiscal years ending after December 15, 2008, and for interim and annual financial statements thereafter. The Board believes it is important that enhanced disclosures be available to financial statement users as soon as practicable. The Board also believes that most of the information required by this proposed Statement is already available and that collecting those data from various locations in year-end reporting packages should be feasible for entities whose fiscal year ends on December 31, 2008. The Board also decided that the tabular reconciliation should not be required for earlier periods that are presented for comparative purposes, because of concerns that it may be impracticable for entities to gather the necessary information.

Similarities and Differences with International Accounting Standards

A31. Deliberations continue in the International Accounting Standards Board's (IASB's) project to reconsider IAS 37; however, those deliberations have not progressed to the point of reconsidering the disclosure requirements of IAS 37. The Exposure Draft issued by the IASB in June 2005 included disclosure requirements that are largely consistent with the existing disclosure requirements of IAS 37. Those requirements are similar to the disclosures included in this proposed Statement. The IASB is expected to evaluate the disclosure requirements in this proposed Statement when it reconsiders the IAS 37 disclosure requirements, which will provide a potential convergence opportunity. Similarly, the FASB expects to consider the IASB's decisions on recognition and measurement when it deliberates those issues in the long-term phase of this project.

A32. IAS 37 requires disclosure of the carrying amount of provisions at the beginning and end of the period as well as changes during the period. This requirement is largely consistent with the tabular reconciliation of recognized loss contingencies in this proposed Statement. Under IAS 37, separate disclosure is required for additional provisions, amounts incurred against provisions, and unused amounts reversed during the period. Increases during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate also are required to be disclosed. This proposed Statement does not require that last disclosure because contingencies usually are not measured at a discounted amount under Statement 5.

A33. This proposed Statement would require disclosures about a broader population of contingencies than required by IAS 37. Specifically, this proposed Statement would require disclosures about loss contingencies, regardless of the likelihood of loss, if the contingencies are expected to be resolved in the near term and if the contingencies could have a severe impact on the entity's financial position, cash flows, or results of operations. IAS 37 does not require disclosures for remote loss contingencies regardless of the expected timing of resolution or potential severity of the contingency.

Benefits and Costs

A34. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Current and potential investors, creditors, donors, and other users of financial information benefit from the improvements in financial reporting, while the costs to implement a new standard are borne primarily by current investors. The Board's assessment of the costs and benefits of issuing an accounting standard is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement an accounting standard or to quantify the value of improved information in financial statements.

A35. The Board's assessment of this proposed Statement's benefits and costs is based on discussions with preparers, auditors, regulators, and users of financial statements. The Board considered the incremental costs of providing the additional disclosure requirements, particularly the tabular reconciliation of recognized loss contingencies, and concluded that those costs do not outweigh the benefits of improved information about loss contingencies.

A36. The Board recognizes that the effort for gathering the necessary data to provide the disclosures required in this proposed Statement may be significant for some entities and that the review and audit procedures of such disclosures may require additional effort. Notwithstanding the above additional costs, these disclosures were developed with the goal of providing users of financial statements with pertinent information about potential cash flow requirements of an entity. Furthermore, the Board believes that many entities already have the information necessary to fulfill these disclosure requirements and that including the information should not require substantial additional cost or effort. The Board plans to conduct field testing of these disclosure requirements before issuing a final Statement to better assess the relative costs and benefits of the disclosures that would be required.

A37. The Board believes that this proposed Statement requires disclosures that provide more specific information about loss contingencies. This will enable users to make a more informed assessment of the likelihood, timing, and amount of future cash flows. Discussions with users and regulators, as well as the Board's research, indicated that the recognition or derecognition of a loss contingency, or a change in the estimate of a loss contingency, can have a significant impact on an entity's financial statements. Therefore, the Board concluded that the benefits of the disclosures in this proposed Statement outweigh the costs.

Appendix B

AMENDMENTS TO FASB PRONOUNCEMENTS AND OTHER AUTHORITATIVE LITERATURE

B1. FASB Statement No. 5, *Accounting for Contingencies,* is amended as follows: [Added text is underlined and deleted text is ~~struck out~~.]

a. Paragraph 7A, as added:

> The accounting requirements in t~~T~~his Statement do~~does~~ not apply to contingent gains or losses that are recognized at the acquisition date in a business combination. FASB Statement No. 141 (revised 2007), *Business Combinations,* provides the subsequent accounting ~~and disclosure~~ requirements for both contingent gains ~~or~~ and contingent losses recognized as part of a business combination. The accounting requirements in t~~T~~his Statement does, however, apply to contingent gains or losses that were acquired or assumed in a business combination but that were not recognized at the acquisition date because they did not meet the recognition threshold in Statement 141(R) at that date.

b. Paragraphs 7B and 7C are added as follows:

> 7B. The disclosure requirements in paragraphs 9–11 of this Statement apply to loss contingencies that are (or would be, if the recognition criteria in paragraph 8 of this Statement were met) recognized as asset impairments in a statement of financial position. Loss contingencies that are (or would be) recognized as liabilities shall be disclosed in accordance with FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies.*
>
> 7C. Gain contingencies accounted for in accordance with this Statement shall be disclosed in accordance with paragraph 17 of this Statement. Gain contingencies accounted for in accordance with Statement 141(R) shall be disclosed in accordance with that Statement.

c. Paragraphs 9–11 and the related heading and footnotes 5 and 6:

> **Disclosure of Loss Contingencies That Are (or Would Be) Recognized as Asset Impairments**
>
> 9. Disclosure of the nature of an asset impairment recognized ~~accrual~~[5] ~~made~~ pursuant to the provisions of paragraph 8, and in some circumstances the amount of that impairment~~accrued~~, may be necessary for the financial statements not to be misleading.
>
> 10. If no asset impairment ~~accrual~~ is recognized ~~made~~ for a loss contingency because one or both of the conditions in paragraph 8 are not

> indicate that it is *probable* that an asset had been impaired ~~or a liability had been incurred~~ at the date of the financial statements.

d. Paragraph 12:

> ~~Certain loss contingencies are presently being disclosed in financial statements even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee, normally with a right to proceed against an outside party in the event that the guarantor is called upon to satisfy the guarantee. Examples include (a) guarantees of indebtedness of others, (b) obligations of commercial banks under "standby letters of credit," and (c) guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned. The Board concludes that disclosure of those loss contingencies, and others that in substance have the same characteristic, shall be continued. The disclosure shall include the nature and amount of the guarantee. Consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.~~

e. Paragraph 25:

> If, based on available information, it is probable that customers will make claims under warranties relating to goods or services that have been sold, the condition in paragraph 8(a) is met at the date of an enterprise's financial statements because it is probable that a liability has been incurred. Satisfaction of the condition in paragraph 8(b) will normally depend on the experience of an enterprise or other information. In the case of an enterprise that has no experience of its own, reference to the experience of other enterprises in the same business may be appropriate. Inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims (i.e., failure to satisfy the condition in paragraph 8(b)) precludes accrual and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded prior to expiration of the warranty period or until sufficient experience has been gained to permit a reasonable estimate of the obligation; in addition, the disclosures called for by paragraphs 13–16 ~~10~~ of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* ~~this Statement~~ should be made.

f. Paragraph 34:

> As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose

underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by Statement 16x~~paragraph 11~~.

g. Paragraphs 37 and 38 and 39, as amended:

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by Statement 16x~~paragraph 10 of this Statement~~.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual ~~or disclosure~~ would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate~~, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10~~. Disclosures shall be made in accordance with Statement 16x.

39. As a condition for accrual of a loss contingency, paragraph 8(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying

met, or if an exposure to loss exists in excess of the amount recognized ~~accrued~~ pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired ~~or a liability was incurred~~ after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired ~~or a liability was incurred~~ after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements~~ or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements~~. In none of the cases cited in this paragraph was an asset impaired ~~or a liability incurred~~ at the date of the financial statements, and the condition for recognition ~~accrual~~ in paragraph 8(a) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of the asset impairment ~~or liability incurrence~~ can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a statement of financial position ~~balance sheet~~ only, in columnar form on the face of the historical financial statements.

~~[5]Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of *Accounting Terminology Bulletin No. 1*, "Review and Resume").~~

[6]For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not

Prejudicial Exemption

A25. This proposed Statement provides a limited disclosure exemption for instances in which an entity concludes that disclosing quantitative or qualitative information about a loss contingency as required by this proposed Statement, either separately or aggregated by the nature of the contingency, would be prejudicial to its position in a dispute (that is, disclosure of the information could affect, to the entity's detriment, the outcome of the contingency itself).

A26. Financial statement users generally opposed providing any exemption from disclosing prejudicial information. They stated their concern that preparers would use such an exemption excessively, resulting in no significant improvement in the quality of disclosures about loss contingencies. Financial statement preparers, on the other hand, raised concerns about being required to disclose information that would be harmful to the entity and its shareholders, who represent a significant financial statement user constituency.

A27. The Board considered those concerns and decided to include an exemption from the disclosure requirements that would strike a balance between the interest of both users and preparers. Specifically, the Board considered under what conditions such an exemption would be allowed and also considered the information that an entity would still be required to disclose if the criteria for the exemption were met. The Board decided on a two-step approach for entities to follow. In the first step, entities would be allowed to aggregate information about loss contingencies at a higher level than by the nature of the contingency. The Board believes that this step will enable preparers to disclose information that is valuable to users without enabling the counterparty in a dispute to take advantage of the information to the detriment of the entity, because the information could not be linked to its specific case. In the second step, if disclosure of the information would still be prejudicial even when aggregated at this higher level, an entity would be allowed to forgo disclosing only the information that would be prejudicial.

A28. The Board noted that a prejudicial exemption already exists under International Financial Reporting Standards. The Board considered whether to include language from paragraph 92 of IAS 37 indicating that the circumstances under which that exemption may be exercised are expected to be *extremely rare*. Some Board members felt that including this language was appropriate, as they expect the ability to first aggregate disclosures at a higher level will reduce the frequency with which a prejudicial exemption would need to be utilized. Those Board members also were sensitive to the broad concern of financial statement users that providing the exemption would result in a lack of transparency about loss contingencies (a situation that users assert exists currently).

A29. A majority of Board members, however, expressed concern about how the words *extremely rare* may be interpreted in practice. Consequently, the Board agreed that the circumstances under which a prejudicial exemption would be exercisable should be characterized as *rare* rather than *extremely rare*. The Board decided to include language clarifying that *rare* is not intended to mean *never* and that the determination of when it is

believes that many financial statement preparers already aggregate their disclosures about loss contingencies in a meaningful way. Therefore, this option is not likely to result in a significant change to current practice.

Tabular Reconciliation

A21. To provide more transparency about the effects of loss contingencies on the financial statements, the Board decided to include a requirement for a tabular reconciliation for recognized loss contingencies in this proposed Statement. The Board believes that a tabular reconciliation will provide users with valuable information about significant and sensitive estimates and changes in those estimates that are subject to significant measurement judgment.

A22. The Board is aware of the concerns of financial statement preparers that information about recognized loss contingencies could be used against them in legal disputes. To address those concerns, the Board decided to allow amounts recognized for all loss contingencies to be aggregated. The Board believes that disaggregating the information in the tabular reconciliation would not incrementally improve a user's ability to predict future cash flows and may provide excess information that is not cost-beneficial. Additionally, the Board decided that the tabular reconciliation would be subject to the exemption from disclosing prejudicial information.

A23. The Board considered whether the tabular reconciliation should be required for annual periods only or for both interim and annual periods. Some Board members expressed concerns about the amount of effort required for preparers to collect and auditors to review this information in the short time available for performing these activities between the end of an interim period and the quarterly filing deadline for SEC registrants. However, a majority of Board members supported requiring the tabular reconciliation in both interim and annual financial statements because financial statement users generally consider interim information to be as important as annual information. Therefore, it is important to provide information about the effect of recognized loss contingencies on the financial statements on an interim and annual basis.

A24. The Board decided that loss contingencies whose underlying cause and ultimate settlement occur in the same period should be excluded from the tabular reconciliation. The Board reasoned that the short period of time involved in those circumstances raises questions about whether the item meets the definition of a contingency. Additionally, the Board noted that for those items, the loss is recognized in the same period as cash is paid or other assets transferred. Therefore, there is no effect on the financial statements across reporting periods, and including those items would not fulfill the purpose of the tabular reconciliation. The Board noted that, in contrast, loss contingencies initially recognized in a business combination are not recognized in earnings. The Board concluded that it was important to include those loss contingencies in the tabular reconciliation because they result in payments of cash, transfers of assets, or recognition of income for which no corresponding loss was recognized at the time of initial recognition.

the condition in paragraph 8(a)), but the range of possible loss is wide. For example, an enterprise may be litigating a dispute with another party. In preparation for the trial, it may determine that, based on recent developments involving one aspect of the litigation, it is probable that it will have to pay $2 million to settle the litigation. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay an additional $8 million over and above the $2 million. In that case, paragraph 8 requires accrual of the $2 million if that is considered a reasonable estimate of the loss. Additionally, disclosures shall be made in accordance with Statement 16x~~Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that the additional amounts will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the $2 million that was accrued~~.

B2. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* is amended as follows:

a. Paragraph 26:

> A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables pursuant to the provisions of paragraph 18. ~~If required by paragraphs 9–13 of *FASB Statement No. 5*, a~~A debtor shall also disclose in those financial statements total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

B3. FASB Statement No. 87, *Employers' Accounting for Pensions,* is amended as follows:

a. Paragraph 70:

> In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of its unfunded benefit obligations. ~~If w~~Withdrawal under circumstances that would give rise to an obligation shall be accounted for in accordance with ~~is either probable or reasonably possible, the provisions of~~ FASB Statement No. 5, *Accounting for Contingencies*, and shall be disclosed in accordance with FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies* ~~shall apply~~. Paragraph 7 of Statement 5 is amended to delete the references to accounting for pension cost and Opinion 8.

B4. FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits,* is amended as follows:

a. Footnote 13 to paragraph C26:

> Paragraph 70 of Statement 87 states, in part: "In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of its unfunded benefit obligations. ~~If w~~Withdrawal under circumstances that would give rise to an obligation shall be accounted for in accordance with ~~is either probable or reasonably possible, the provisions of~~ FASB Statement No. 5, *Accounting for Contingencies*, and shall be disclosed in accordance with FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies* ~~shall apply~~."

B5. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* is amended as follows:

a. Paragraph 83:

> In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is ~~either~~ probable ~~or reasonably possible~~ that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the accounting guidance in ~~provisions of~~ FASB Statement No. 5, *Accounting for Contingencies*. Disclosure shall be made in accordance with FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies.*

B6. FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits,* is amended as follows:

a. Paragraph 13:

> In some situations, withdrawal from a multiemployer plan may result in an employer having an obligation to the plan for a portion of the unfunded benefit obligation of the pension plans and other postretirement benefit plans. ~~If w~~Withdrawal under circumstances that would give rise to an obligation shall be accounted for in accordance with ~~is either probable or reasonably possible, the provisions of~~ FASB Statement No. 5, *Accounting for Contingencies,* and shall be disclosed in accordance with FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies* ~~shall apply~~ (Statement 87, paragraph 70). If it is more than remote~~either probable or reasonably possible~~ that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds

necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the accounting guidance in~~provisions of~~ Statement 5 and the disclosure guidance in Statement 16x (Statement 106, paragraph 83).

B7. FASB Statement No. 141 (revised 2007), *Business Combinations,* is amended as follows:

a. Paragraph 68(j):

For assets ~~and liabilities~~ arising from gain contingencies:

(1) The amounts recognized at the acquisition date or an explanation of why no amount was recognized (paragraph 24)
(2) The nature of recognized and unrecognized gain contingencies
(3) An estimate of the range of outcomes (undiscounted) for gain contingencies (recognized and unrecognized) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated.

An acquirer may aggregate disclosures for assets ~~and liabilities~~ arising from gain contingencies that are similar in nature.

b. Paragraph 68(jj) is added as follows:

For liabilities arising from loss contingencies:

(1) The amounts recognized at the acquisition date or an explanation of why no amount was recognized (paragraph 24)
(2) The disclosures required by FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies*.

c. Paragraph 72(c):

For each reporting period after the acquisition date until the acquirer collects, sells, or otherwise loses the right to recognized assets arising from gain contingencies~~, or the acquirer settles recognized liabilities or its obligation to settle them is cancelled or expires~~:

(1) Any changes in the recognized amounts of assets ~~and liabilities~~ arising from gain contingencies and the reasons for those changes
(2) Any changes in the range of outcomes (undiscounted) for both recognized and unrecognized assets ~~and liabilities~~ arising from gain contingencies and the reasons for those changes.

d. Paragraph 72(cc) is added as follows:

For each reporting period after the acquisition date until the acquirer settles recognized liabilities or its obligation to settle them is cancelled or expires, the disclosures required by Statement 16x.

B8. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* is amended as follows:

a. Paragraphs 3–7:

3. When condition (a) in paragraph 8 is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, condition (b) in paragraph 8 is met and an amount shall be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.[1] If the loss is recognized as an asset impairment in the statement of financial position, the disclosures in paragraphs 9 and 10 of Statement 5 are required. If the loss is recognized as a liability in the statement of financial position, disclosure should be made in accordance with FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies*.~~In addition, paragraph 9 of the Statement may require disclosure of the nature and, in some circumstances, the amount accrued, and paragraph 10 requires disclosure of the nature of the contingency and the additional exposure to loss if there is at least a reasonable possibility of loss in excess of the amount accrued.~~

4. As an example, assume that an enterprise is involved in litigation at the close of its fiscal year ending December 31, 1976, and information available indicates that an unfavorable outcome is probable. Subsequently, after a trial on the issues, a verdict unfavorable to the enterprise is handed down, but the amount of damages remains unresolved at the time the financial statements are issued. Although the enterprise is unable to estimate the exact amount of loss, its reasonable estimate at the time is that the judgment will be for not less than $3 million or more than $9 million. No amount in that range appears at the time to be a better estimate than any other amount. *FASB Statement No. 5* requires accrual of the $3 million at December 31, 1976, and the disclosures in Statement 16x are required~~disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $6 million, and possibly disclosure of the amount of the accrual~~.

5. The same answer would result under the example in paragraph 4 above if it is probable that a verdict will be unfavorable even though the trial has not been completed before the financial statements are issued. In that situation, condition (a) in paragraph 8 would be met because information available to the enterprise indicates that an unfavorable verdict is probable. An assessment that the range of loss is between $3 million and $9 million would meet condition (b) in paragraph 8. If no single amount in that range is a better estimate than any other amount, *FASB Statement No. 5* requires an accrual of $3 million at December 31, 1976, and the disclosures in Statement 16x are required~~disclosure of the nature of the contingency and~~

~~the exposure to an additional amount of loss of up to $6 million, and possibly disclosure of the amount of the accrual~~. Note, however, that if the enterprise had assessed the verdict differently (e.g., that an unfavorable verdict was *not* probable but was only reasonably possible), condition (a) in paragraph 8 would not have been met and no amount of loss would be accrued but the disclosures in Statement 16x would still be required~~nature of the contingency and any amount of loss that is reasonably possible would be disclosed~~.

6. Assume that in the examples given in paragraphs 4 and 5 above condition (a) in paragraph 8 has been met and a reasonable estimate of loss is a range between $3 million and $9 million but a loss of $4 million is a better estimate than any other amount in that range. In that situation, *FASB Statement No. 5* requires accrual of $4 million, and the disclosures in Statement 16x are required~~disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $5 million, and possibly disclosure of the amount of the accrual~~.

~~7. As a further example, assume that at December 31, 1976 an enterprise has an investment of $1,000,000 in the securities of another enterprise that has declared bankruptcy, and there is no quoted market price for the securities. Condition (a) in paragraph 8 has been met because information available indicates that the value of the investment has been impaired, and a reasonable estimate of loss is a range between $300,000 and $600,000. No amount of loss in that range appears at the time to be a better estimate of loss than any other amount. *FASB Statement No. 5* requires accrual of the $300,000 loss at December 31, 1976, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $300,000, and possibly disclosure of the amount of the accrual.~~

B9. EITF Issue No. 03-8, "Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity," is amended as follows:

a. Paragraph 26:

The Task Force discussed what disclosures would be appropriate when an enterprise changes from occurrence-based insurance to claims-made insurance or elects to significantly reduce or eliminate its insurance coverage. Members of the Task Force noted that paragraph 10 of Statement 5 requires disclosure if it is at least reasonably possible that a loss has been incurred. That paragraph also discusses disclosure with respect to unasserted claims. Statement 16x, which is effective for annual financial statements issued for fiscal years ending after December 15, 2008, and interim and annual periods in subsequent fiscal years, replaces the disclosure requirements in Statement 5 for loss contingencies that are (or would be, if the recognition criteria were met) recognized as liabilities in a statement of financial position. Upon adoption of Statement 16x, an entity should disclose loss contingencies, whether insured or uninsured, in accordance with that Statement, rather than in accordance with Statement 5. [Note: See STATUS section.]

b. Paragraph 30:

~~No further EITF discussion is planned.~~ Statement 16x, which is effective for annual financial statements issued for fiscal years ending after December 15, 200x, and interim and annual periods in subsequent fiscal years, replaces the disclosure requirements in Statement 5 for loss contingencies that are (or would be, if the recognition criteria were met) recognized as liabilities in a statement of financial position. Issue 5 addresses the disclosures that should be made by an entity that changes from occurrence-based to claims-made insurance or that elects to significantly reduce or eliminate its insurance coverage. Upon adoption of Statement 16x, an entity should disclose loss contingencies, whether insured or uninsured, in accordance with that Statement, rather than in accordance with Statement 5.

c. Paragraph 31 is added as follows:

No further EITF discussion is planned.

B10. AICPA Audit and Accounting Guide, *Federal Government Contractors,* is amended as follows:

a. Paragraph 3.43:

The rights of the contracting parties in a default termination of a fixed-price contract differ significantly from those in a convenience termination; consequently, the accounting must reflect these differences. Accordingly, contractors should record, in addition to normal contract liabilities, those liabilities arising from a default termination (for example, damages, excess reprocurement costs, and progress payments to be repaid). Termination for default may result in a reduction of previously recorded earnings. In such cases, adjustments of prior-period amounts are not appropriate. Instead, the resulting income effect should be included in the loss on termination of the contract in the current period as a change in an accounting estimate in conformity with FASB Statement No. 154. If material in amount, such loss should be reported as a separate item in the income statement or otherwise disclosed in the notes to the financial statements in conformity with FASB Statement No. ~~5~~16x, *Disclosure of Certain Loss Contingencies*.

b. Paragraph 3.44:

Generally, the effect of a contract termination should be reflected in the financial statements of the contractor in the period in which the termination occurs, or earlier if the termination is a subsequent event occurring prior to issuance of the financial statements and attributable to conditions that

existed at the date of the balance sheet. However, if sufficient information is not available to predict the effect of a very recent termination, then the best information available should be disclosed in the notes to financial statements in conformity with FASB Statement No. ~~5~~16x.

c. Paragraph 3.46:

Significant uncertainties may exist about the recoverability of costs in a termination claim, particularly in cases of termination for default. Such termination may create additional uncertainties regarding possible liabilities for damages or excess reprocurement costs. ~~As required by paragraphs 8 through 10 of FASB Statement No. 5, a~~A determination should be made about the probability that a loss has been incurred and whether an amount can be estimated. Based on this determination, such liabilities should be recorded as required by paragraph 8 of FASB Statement No. 5 and ~~or~~ disclosed in accordance with FASB Statement 16x.

d. Paragraph 3.87:

Defective pricing. As discussed in Chapter 2, the Truth in Negotiations Act permits the government to make contract price reductions if a contractor fails to submit certified accurate, current, and complete cost or pricing data before award of certain negotiated contracts or contract amendments. When defective pricing exists, contract prices, including profit or fee, may be adjusted, and disclosure should be made if the amounts are material. Instances may occur when defective pricing may be alleged by the government but disputed by the contractor. In these cases, consideration of the circumstances (including consultation with legal counsel) and judgment is required. If the potential amounts involved are material, disclosure in the notes to financial statements should be made in accordance with FASB Statement No. ~~5~~16x.

B11. AICPA Statement of Position 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code,* is amended as follows:

a. Paragraph .24:

Prepetition liabilities, including claims that become known after a petition is filed, should be reported on the basis of the expected amount of the allowed claims in accordance with FASB Statement No. 5, *Accounting for Contingencies*, as opposed to the amounts for which those allowed claims may be settled. Claims not subject to reasonable estimation should be disclosed in the notes to the financial statements based on the provisions of FASB Statement No. ~~5~~16x, *Disclosure of Certain Loss Contingencies*. Once these claims satisfy the accrual provisions of FASB Statement No. 5, they should be recorded in the accounts in accordance with the first sentence of this paragraph.

B12. AICPA Statement of Position 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises,* is amended as follows:

a. Paragraph .12:

If an insurance enterprise has recognized a liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities (such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures), disclosure of the nature of the liability recognized, and in some circumstances the amount recognized, may be necessary so the financial statements are not misleading. If no liability has been recognized, or if an exposure to loss exists in excess of the amount recognized, disclosure of the contingent unpaid claims and claim adjustments shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingent unpaid claims or claim adjustments and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of an unasserted claim when there has been no manifestation by a potential claimant of an awareness of a possible claim unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. In addition to ~~the~~ these disclosures and those required by ~~FASB Statement No. 5 and~~ other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities~~, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures~~.

b. Paragraph .15, subparagraph A-4:

The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph .12 of this SOP to disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under paragraph .12 of this SOP, ~~FASB Statement No. 5, FASB Interpretation 14, *Reasonable Estimation of the Amount of a Loss,*~~ AICPA SOP 94-6, and SEC requirements.)

[For ease of use, the note, which is unaffected by this Statement, has been omitted.]

B13. AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* is amended as follows:

a. Paragraph .05:

> The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies,* FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies,* and, for public business enterprises, FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise.*[*] The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

b. Paragraph .12:

> Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9 through 11~~12~~, and 17b, and footnote 6 of FASB Statement No. 5, and paragraphs 4 through 11 of FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies,* specify disclosures to be made about contingencies[6] that exist at the date of the financial statements. The disclosure requirements ~~of paragraphs 9 through 12~~ of Statement No. 5 and Statement No. 16x are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss.* In addition to disclosures required by FASB Statement No. 5, FASB Statement No. 16x, and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below.

c. Paragraph .14:

> The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible[8] that a change in the estimate will occur in the near term.[9] ~~If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.~~ Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

d. Paragraph .16:

> This SOP's disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5 or FASB Statement No. 16x; rather, the disclosures required under this SOP supplement the disclosures required under those Statements~~Statement No. 5~~ as follows:
>
> - If an estimate (including estimates that involve contingencies recognized in accordance with ~~covered by~~ FASB Statement No. 5 or disclosed in accordance with either FASB Statement No. 5 or FASB Statement No. 16x) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.
> - An estimate that does not involve a contingency covered by Statement No. 5 or Statement No. 16x, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

e. The note under the heading "Certain Significant Estimates" in paragraph .27 (between subparagraphs A-10 and A-11) of Appendix A:

> *Note: Some of the following disclosures contain certain information that is already required to be disclosed under FASB Statement No. 5 and FASB Statement No. 16x; in those cases, the following disclosures illustrate that the FASB Statement No. 5 and FASB Statement No. 16x disclosure requirements are supplemented by an indication that it is at least reasonably possible that a change in an estimate will occur in the near term. They are not intended to illustrate all of the disclosure requirements of FASB Statement No. 5 and FASB Statement No. 16x. Others may not be covered by FASB Statement No. 5 or FASB Statement No. 16x.*

f. Paragraph .28, subparagraph B-23:

> FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows:
>
> > ~~If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or *if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.*[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. [Emphasis added.] [FASB Statement No. 5, paragraph 10]~~

~~Footnote 6 to Statement No. 5 states:~~

> ~~For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset has been impaired or a liability had been incurred at the date of the financial statements. [Emphasis in original.]~~

~~FASB Statement No. 5 defines loss contingencies as:~~

> ~~an existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. [paragraph 1]~~

~~The recognition and disclosure requirements of Statement No. 5 are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. This SOP does not change the requirements of FASB Statement No. 5 or FASB Interpretation No. 14; the requirements of this SOP supplement those requirements. For example, i~~If a loss contingency meets the criteria for disclosure under ~~both~~ either Statement No. 5 or Statement No. 16x and paragraph .13 of this SOP, this SOP requires disclosure that it is at least reasonably possible that future events confirming the fact of the loss or the change in the estimated amount of the loss will occur in the near term.

B14. AICPA Statement of Position 96-1, *Environmental Remediation Liabilities*, is amended as follows:

a. Paragraph .123:

> Two kinds of costs that may be involved in environmental remediation situations are not discussed in this chapter. These costs—natural resource damages and toxic torts—are identified in paragraphs .21 and .48 through .50 in chapter 2 of this SOP. Concepts and practices with respect to natural resource damages are still evolving, and third-party suits are too case-specific for general guidance. The accounting guidance with respect to litigation [FASB Statement No. 5, especially paragraphs 33 through 39, and FASB Statement No. 16x, *Disclosure of Certain Loss Contingencies*] should be considered in accounting for and the disclosure of such costs.

b. Paragraphs .155 and .156:

> .155 FASB Statement No. ~~5~~16x provides the primary guidance applicable to disclosures of environmental remediation loss contingencies. ~~Paragraphs 9 and 10 of FASB Statement No. 5 state:~~
>
> > ~~9. Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 8 [of Statement No. 5], and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.~~
> >
> > ~~10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. [*footnotes omitted*]~~
>
> .156 The disclosure requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* also apply to environmental remediation liabilities. SOP 94-6, paragraphs 12 through 14 state in part:
>
> > 12. In addition to disclosures required by FASB Statement No. 5, FASB Statement No. 16x, and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or disclosure of gain or loss contingencies, as described below.
> >
> > 13. Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:
> >
> > - It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
> > - The effect of the change would be material to the financial statements.

14. The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. ~~If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss or state that such an estimate cannot be made.~~ Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

c. Footnote 15 to paragraph .158:

Nothing in this SOP eliminates disclosures that are required by FASB Statement No. ~~5~~16x or SOP 94-6.

d. Paragraph .159:

~~Paragraphs 9 and 10 of FASB Statement No. 5 provide for disclosures related to three different aspects of loss contingencies: (a) recognized losses and reasonably possible (additional) loss exposures, (b) probable but not reasonably estimable losses, and (c) unasserted claims. Following are the disclosures that are required or encouraged by Statement No. 5, SOP 94-6, and this SOP for each aspect.~~

e. Paragraph .160 and its related footnote 16:

~~If the FASB Statement No. 5 criteria of remote, reasonably possible, and probable were mapped onto a range of likelihood of the existence of a loss spanning from zero to 100 percent, the reasonably possible portion would span a significant breadth of the range starting from remote and ending with probable. The potential outcomes of environmental remediation loss contingencies often span a range of possibilities. If a loss is deemed probable and it is reasonably estimable, it is recognized; however, beyond the recognized losses, there may be additional exposure to loss that is reasonably possible. This often happens in situations in which a range of possible outcomes is identified and, in accordance with FASB Interpretation No. 14, the entity records either a best estimate within the range or the minimum amount in the range, thus leaving unrecorded amounts of additional possible loss for the higher cost outcomes.[16] In other situations, no loss may be probable, but a loss is reasonably possible. There may also be situations where a loss is probable, but no amount that would be material to the entity is reasonably estimable (see the subsequent section entitled "Probable But Not Reasonably Estimable Losses" in paragraphs .165 through .167).~~

~~[16] When an overall liability is estimated by combining estimates of various components of the liability, additional possible losses present in the component estimates must be considered in determining an overall additional possible loss.~~

f. Paragraphs .161–.164:

.161 With respect to recorded accruals for environmental remediation loss contingencies and assets for third-party recoveries related to environmental remediation obligations, in addition to the disclosures required by FASB Statement No. 16x, financial statements should disclose ~~the following:~~

- ~~*a.* The nature of the accruals, if such disclosure is necessary for the financial statements not to be misleading, and, in situations where disclosure of the nature of the accruals is necessary, the total amount accrued for the remediation obligation, if such disclosure is also necessary for the financial statements not to be misleading~~
- ~~*b.* If any portion of the accrued obligation is discounted,~~ the undiscounted amount of the obligation and the discount rate used in the present-value determinations, if any portion of the accrued obligation is discounted
- ~~*c.* If the criteria of SOP 94-6 are met with respect to the accrued obligation or to any recognized asset for third-party recoveries, an indication that it is at least reasonably possible that a change in the estimate of the obligation or of the asset will occur in the near term~~

~~.162 With respect to reasonably possible loss contingencies, including reasonably possible loss exposures in excess of the amount accrued, financial statements should disclose the following:~~

- ~~*a.* The nature of the reasonably possible loss contingency, that is, a description of the reasonably possible remediation obligation, and an estimate of the possible loss exposure or the fact that such an estimate cannot be made~~
- ~~*b.* If the criteria of SOP 94-6 are met with respect to estimated loss (or gain) contingencies, an indication that it is at least reasonably possible that a change in the estimate will occur in the near term~~

.163 Entities also are encouraged, but not required, to disclose the following:

- *a.* The estimated time frame of disbursements for recorded amounts if expenditures are expected to continue over the long term
- *b.* The estimated time frame for realization of recognized probable recoveries, if realization is not expected in the near term
- ~~*c.* If the criteria of SOP 94-6 are met with respect to the accrued obligation, to any recognized asset for third-party recoveries, or to reasonably possible loss exposures or disclosed gain contingencies, the factors that cause the estimate to be sensitive to change~~
- ~~*d.* If an estimate of the probable or reasonably possible loss or range of loss cannot be made, the reasons why it cannot be made~~

e. If information about the~~ reasonably~~ possible loss or the recognized and additional unrecognized~~ reasonably~~ possible loss for an environmental remediation obligation related to an individual site is relevant to an understanding of the financial position, cash flows, or results of operations of the entity, the following with respect to the site:

- The total amount accrued for the site
- ~~The nature of any reasonably possible loss contingency or additional loss, and an estimate of the possible loss or the fact that an estimate cannot be made and the reasons why it cannot be made~~
- Whether other PRPs are involved and the entity's estimated share of the obligation
- ~~The status of regulatory proceedings~~
- ~~The estimated time frame for resolution of the contingency~~

~~.164 The following is an illustration of disclosure for a situation in which—~~

~~*a.* An entity is involved in a single environmental site at which a number of potential outcomes may occur.~~
~~*b.* There is a probable, reasonably estimable recovery from a third party.~~
~~*c.* The entity has accrued for the most likely outcome within a range of possible outcomes for each component.~~
~~*d.* The nature of the amounts accrued for remediation and the related probable recovery are necessary to be disclosed in order for the financial statements not to be misleading.~~
~~*e.* There is a reasonably possible loss exposure in excess of the amount accrued that is material and it is reasonably possible that a change in estimate that would be material to the financial statements will occur in the near term.~~

~~Information that is not required is italicized and enclosed in brackets.~~

~~Enterprise A has been notified by the United States Environmental Protection Agency (EPA) that it is a potentially responsible party (PRP) under Superfund legislation [*with respect to XYZ site in Sometown, USA, a disposal site previously used in its chemical-fertilizer business. The EPA has also identified ten other PRPs for XYZ. A remedial investigation and feasibility study has been completed, and the results of that study have been forwarded to the EPA. The study indicates a range of viable remedial approaches, but agreement has not yet been reached with the EPA on the final remediation approach. The PRP group has preliminarily agreed to an allocation that sets Enterprise A's share of the cost of remediating XYZ site at 6 percent.*] Enterprise A has accrued its best estimate of its obligation with respect to the site at December 31, 199X, [*which is $10 million and which is included in long-term liabilities and is expected to be disbursed over the next ten years. If certain of the PRPs are ultimately not able to fund their allocated shares or the EPA insists on a more expensive remediation approach,*] Enterprise A could incur additional obligations of up to $7 million. It is reasonably possible that Enterprise A's recorded estimate of its obligation may change in the near term.~~

~~With respect to the environmental obligation discussed above, the site was acquired in 1982, and, in connection with that acquisition, the former owner partially indemnified Enterprise A for environmental impacts occurring prior to the acquisition. [*Based on existing documentation indicating the years in which the business shipped wastes to XYZ and the terms of the indemnification in the acquisition agreement,*] Enterprise A [*believes it is probable that it will recover from the prior owners 50 percent of its allocated remediation costs for XYZ and, accordingly,*] has recorded a receivable of $5 million at December 31, 199X.~~

g. Paragraphs .166–.168:

.166 Even though an entity may not be able to establish a reasonable estimate of a material loss or a range of reasonably estimable material loss exposure that must be recorded, in many cases it can determine early in the investigation whether the costs of environmental remediation, in fact, may be material (that is, the upper end of the range of the reasonable estimate of the loss is material). If an entity's probable but not reasonably estimable environmental remediation obligations may be material, the financial statements should disclose ~~the nature of the probable contingency~~information about the loss contingency in accordance with FASB Statement No. 16x~~, that is, a description of the remediation obligation, and the fact that a reasonable estimate cannot currently be made. Entities also are encouraged, but not required, to disclose the estimated time frame for resolution of the uncertainty as to the amount of the loss.~~

~~.167 An illustration of disclosure of a probable but not yet reasonably estimable environmental remediation loss contingency follows (information that is italicized and enclosed in brackets is not required):~~

~~Enterprise A has been notified by the U.S. Environmental Protection Agency (EPA) that it is a potentially responsible party (PRP) with respect to environmental impacts [*identified at the XYZ site in Sometown, USA. Several meetings have been held with the EPA and the other identified PRPs, and a remedial investigation has recently commenced.*] Although a loss is probable, it is not possible at this time to reasonably estimate the amount of any obligation for remediation [*of XYZ site*] that would be material to Enterprise A's financial statements [*because the extent of environmental impact, allocation among the PRPs, remediation*~~

~~*alternatives (which could involve no or minimal efforts), and concurrence of the regulatory authorities have not yet advanced to the stage where a reasonable estimate of any loss that would be material to the enterprise can be made*]. [*A reasonable estimate of a material obligation, if any, is expected to be possible in 199X.*]~~

Unasserted Claims

.168 Whether notification by regulatory authorities in relation to particular environmental laws and regulations constitutes the assertion of a claim is a matter of legal determination. If an entity concludes that it has no current legal obligation to remediate a situation of probable or possible environmental impact, then in accordance with ~~paragraph 10 of~~ FASB Statement No. ~~5~~16x, no disclosure is required. Similarly, future actions of an entity, when they occur, may create a legal obligation to perform environmental remediation; however, no obligation exists currently (for example, if the obligation arises only when and if an entity ceases to operate a facility).[17] However, if an entity is required by existing laws and regulations to report the release of hazardous substances and to begin a remediation study or if assertion of a claim is deemed probable, the matter would represent a loss contingency subject to the disclosure provisions of Statement No. ~~5, paragraph 10~~16x, regardless of a lack of involvement by a regulatory agency.

h. Paragraph .171:

Financial statements may include a *contingency conclusion* that addresses the estimated total unrecognized exposure to environmental remediation and other loss contingencies. Such contingency conclusions may state, for example, that "management believes that the outcome of these uncertainties should not have (or "may have") a material adverse effect on the financial condition, cash flows, or operating results of the enterprise." Alternatively, the disclosure may indicate that the adverse effect could be material to a particular financial statement or to results and cash flows of a quarterly or annual reporting period. Although potentially useful information, these conclusions are not a substitute for the required disclosures of this SOP and of FASB Statement No. ~~5~~16x~~, such as their requirement to disclose the amounts of material reasonably possible additional losses or to state that such an estimate cannot be made~~. Also, the assertion that the outcome should not have a material adverse effect must be supportable. If the entity is unable to estimate the maximum end of the range of possible outcomes, it may be difficult to support an assertion that the outcome should not have a material adverse effect.

i. Paragraph .173, subparagraph A-5:

~~Paragraphs 9 and 10 of FASB Statement No. 5 state the following.~~

~~9. Disclosure of the nature of an accrual [*footnote omitted*] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.~~

~~10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[6] The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.~~

~~The disclosure requirements of FASB Statement No. 5 are emphasized in FASB Interpretation No. 14.~~

~~[6]For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(*a*) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(*b*)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(*a*)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements.~~

j. In paragraph .174, subparagraph B-1 of Appendix B, the following footnote is added to the end of the second paragraph after the heading ***Discussion of Case:***

[18a]The disclosure requirements of FASB Statement No. 16x apply to loss contingencies that are (or would be, if the recognition criteria were met) recognized as liabilities in a statement of financial position for annual financial statements issued for fiscal years ending after December 15, 2008, and interim and annual periods in subsequent fiscal years.

B15. AICPA Statement of Position 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments,* is amended as follows:

a. Paragraph .27:

If an entity has recognized a liability for assessments covered by this SOP, disclosure of the nature of the liability recognized, and in some circumstances the amount recognized, may be necessary for the financial statements not to be misleading. If no liability has been recognized, or if an exposure to loss exists in excess of the amount recognized, disclosure of the contingent assessment shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingent assessment and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of an unasserted assessment when there has been no manifestation by a potential claimant of an awareness of a possible assessment unless it is considered probable that an assessment will be asserted and there is a reasonable possibility that the outcome will be unfavorable. ~~FASB Statement No. 5, FASB Interpretation No. 14, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* address disclosures related to loss contingencies. That guidance~~The guidance in SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* also is applicable to assessments covered by this SOP. Additionally, if amounts have been discounted, the entity should disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity should disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

Top Ten Reasons Corporate Counsel Should Be On Alert to the FASB's Proposed Amendments to FAS 5, *Accounting for Contingencies*

The Financial Accounting Standards Board (FASB) released a June 5, 2008 Exposure Draft of proposed amendments to their disclosure requirements in FASB Statements No. 5, *Accounting for Contingencies,* and 141(R). If adopted, these amendments would be effective for annual financial statements issued for fiscal years ending after December 15, 2008, and interim and annual periods thereafter. The greatly enhanced loss contingency reporting requirements, as proposed, call for companies to disclose substantially more information on their litigation loss contingencies, and will create serious issues for companies if passed. ACC is mounting a campaign of interested companies and will be filing comments protesting these proposals (due August 8, 2008). If you'd like to sign your company on, contact ACC's General Counsel, Susan Hackett at hackett@acc.com.

Additional documents, including the FASB's proposals, are online at: http://www.acc.com/php/cms/index.php?id=84

Outlined below are the top ten reasons corporate counsel should be extremely concerned and advising the company's CFO/CEO about the dangers these proposals present.

1. These proposals are a solution in pursuit of a problem.

The current standards aren't broken, and there is no evidence that current disclosure requirements are insufficient or harming market transparency. Adopting significant new and ill-advised proposals without evidence that changes are either necessary or likely to improve disclosures is folly.

2. Heightened disclosure requirements will create unprecedented waivers of the company's attorney/client privilege and work product rights.

Because the proposed amendments will require clients to produce more sensitive and speculative information about possible losses related to litigation, and require earlier production of loss analyses than currently required (namely, before an exposure is well documented or quantified by "facts" as opposed to by an attorney's initial evaluation of possible liability or harm), reporting will likely increase the risk of waiver of privilege and have related punitive effects. These required "qualitative" disclosures will broadly communicate the company's litigation assessments that previously were carefully guarded in adversarial proceedings. Additionally, independent auditors may seek more detail from counsel to test the estimates and disclosures reported, adding to the risk of privilege waiver to auditors.

3. Deeper disclosures of attorney-client privileged assessments will coerce undesirable outcomes in matters on which companies are only asked to report.

The proposed amendments' requirements to provide qualitative assessments of likely outcomes, timing of resolution, and the company's assumptions on loss amounts "give away the store" to any interested adversaries, providing invaluable detail about the company's litigation strategies and settlement coercion-points. The result would be a perverse twist on the FASB's stated desire to disclose more accurate and timely information about loss contingencies: companies' litigation counsel would likely become more circumspect about providing their clients with legal assessments and detailed contingency analyses to assist in their decision-making in order to avoid unnecessary disclosure or liability.

4. Will disclosures themselves be used as admissible evidence in future proceedings on the underlying matters? We hope not, but …

Reporting requirements, as amended, call for qualitative and quantitative assessments of litigation, including most likely outcomes and estimates of exposure to any litigation in which the chance of loss is more than "remote." These assessments could end up as exhibits in court, with the potential to affect settlement discussions or other possible outcomes.

5. The company would have to report its maximum potential exposure in any adversarial proceeding if the claimant has not been willing or able to quantify it.

Proposed FAS 5's quantitative assessments require a company to provide its "best estimate of the maximum exposure to loss" if a claimant has given "no claim or assessment amount," again providing claimants with information that could drive the outcome of the case with no further work.

6. Requirements to more fully report and assess (four times a year) the status of open litigation will be harmful to investors.

FASB's objective to improve reporting for the benefit of financial statement users, in this case, could hurt the very people it tries to help. Litigation strategies can frequently involve taking a loss in a lower court to position a company for better outcome on appeal, or to preserve rights for appeal, or any number of other courses of action that would not be apparent to anyone but those closest to the proceedings or trained attorneys. Therefore, investors' decisions based on the proposed disclosures could be based on an incomplete understanding of the situation and inappropriately suggest to the markets that which is not what the company wishes to signal.

7. Reporting under the proposed rules would extend to matters in which likelihood of loss is considered "remote."

These unlikely losses would have to be reported if they are "expected to be resolved in the near term" (*i.e.*, within one year) and may cause "severe impact" (*i.e.*, a "significant financially disruptive effect" on the company's "normal functioning"). The threshold for "severe impact" is higher than the current "material" standard ("important enough to influence a user's decisions"), so that's a relief, but the imposition of rules that require any reporting on "remote" matters that implicate anything less than bankruptcy is both burdensome and dangerous – by definition, it's ill-quantified or less than likely. And if you don't report on something remote that you didn't see as entailing severe impact, you will be subject to the great unwritten rule of second guessing with 20/20 hindsight.

8. The frequency and level of detail for the new disclosures, as proposed, will be unduly cumbersome.

The new reporting requirements create the need for more disclosures, and significantly more detail. Quantitative disclosures include the amount of the claim or assessment (including applicable damages, such as punitive or treble), or, of course, if no amount is claimed, the company's "best estimate of the maximum exposure to loss." Qualitative disclosures must include a litany of facts and assessments about the contingency. Additionally, companies must now also include quantitative and qualitative assessment of relevant insurance and indemnification arrangements.

9. FASB's treatment of prejudicial information is insufficient.

Though FASB attempts to mitigate the potential for release of prejudicial information under the proposed amendments, the solution falls short of preventing disclosures to third parties. FASB would allow, in "rare instances," a company to "forgo disclosing prejudicial information," although the company would still be required to provide the amount of the claim and would have to prove that disclosure would broadcast prejudicial information. Thus, potential adversaries will have sufficient information to link the disclosure to a case or subset of cases. The protections offered under these provisions create an inappropriately unavailable threshold by limiting this safe harbor to "rare" cases.

10. Disclosures based on estimates and assumptions that later prove incorrect can, in turn, become sources for additional litigation.

The nature of litigation makes it nearly impossible to predict with much certainty any outcome. Sometimes litigation is not even founded on a factual dispute, but is raised for the specter of publicity, increased negotiating leverage on other matters, business competition or politics, coercion by a plaintiff's group, etc., thus further complicating accurate analysis. Incorrect disclosures and assessments could provide litigants with future arguments that they relied on disclosures which later turned out to be inaccurate.

***And one more for good measure*: if adopted in the US by the FASB, the International Accounting Standards Board (IASB) may also adopt these disclosure requirements for their international standards, which are becoming the increasing norm for global businesses.**

According to FASB's introductory summary, the IASB is expected to evaluate the disclosure requirements in these proposed amendments when it reconsiders the IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* disclosure requirements, further complicating matters.

As noted, ACC is pursuing a coordinated response to these proposed amendments and welcomes any input you may have. We will prepare comments and testify, and have retained John Villa of Williams & Connolly and Daniel Fischel, former Dean of The University of Chicago Law School and currently a professor (and world recognized commentator on financial disclosure issues) at Northwestern Law School and the Kellogg School of Management. The FASB filing deadline is August 8, 2008, so we would appreciate any comments you have by the end of July. For more information or to share your views, please contact Susan Hackett, ACC's General Counsel (hackett@acc.com) or JD White, ACC's Advocacy Manager (white@acc.com).

NEWS RELEASE

CONTACT:

Joel Allegretti
Director – Media Relations
212-596-6111
jallegretti@aicpa.org

Shirley Twillman
Senior Manager – Media Relations
202-434-9220
stwillman@aicpa.org

AICPA STATEMENT ON SEC ROADMAP FOR IFRS

Washington, DC (August 27, 2008) - The Securities and Exchange Commission's roadmap for the adoption of International Financial Reporting Standards (IFRS) marks an important stage in what the American Institute of Certified Public Accountants believes will be the eventual move from U.S. Generally Accepted Accounting Principles to international accounting standards for public companies.

"The AICPA supports one set of high-quality global accounting standards for public companies," said Barry Melancon, AICPA president and CEO. "We believe the capital markets ultimately will insist on IFRS for public companies. Today's action by the SEC continues a robust and thoughtful debate that is critical as the transition occurs."

The Institute believes the following are key steps, among others, for a smooth transition:

- ongoing collaboration between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board to achieve convergence;
- preparation for the shift to IFRS-based reporting using eXtensible Business Reporting Language (XBRL).

"A critical initial step is the development of a project plan that directs all components of the financial reporting system toward achieving the milestones laid out by the SEC," said Arleen Thomas, AICPA senior vice president – member competency and development. "The AICPA will work closely with the FASB, the IASB and the International Accounting Standards Committee Foundation to help bring these milestones to fruition. We are working with our members, both preparers and auditors, on IFRS to help them prepare for what's ahead."

In May 2008, the AICPA created www.ifrs.com to serve as a resource for IFRS-related publications, articles, conferences, educational courses, videos and links to additional sources of information. The site includes materials for auditors, financial managers, boards of directors and audit committees, and investors.

-more-

AICPA STATEMENT ON SEC ROADMAP FOR IFRS -Page 2 of 2

The SEC is proposing that IFRS reporting begin with 2014 filings if the interim milestones are met. That timeline is consistent with a 2008 AICPA survey showing that a majority of members polled believe it will take three to five years to prepare for IFRS: 34 percent said they would need three years, and 31 percent said it would take four or five years.

About the AICPA

The American Institute of Certified Public Accountants (www.aicpa.org) is the national, professional association of CPAs, with more than 350,000 CPA members in business and industry, public practice, government, education, student affiliates, and international associates. It sets ethical standards for the profession and U.S. auditing standards for audits of private companies, non-profit organizations, federal, state and local governments. It develops and grades the Uniform CPA Examination.

The AICPA maintains offices in New York, Washington, D.C., Durham, N.C., Ewing, N.J., and Lewisville, TX.

Media representatives are invited to visit the AICPA Online Media Center at www.aicpa.org/mediacenter.

###

U.S. Securities and Exchange Commission

SEC Proposes Roadmap Toward Global Accounting Standards to Help Investors Compare Financial Information More Easily

FOR IMMEDIATE RELEASE
2008-184
Video: Open Meeting

Chairman Cox discusses giving investors greater comparability and greater confidence in the transparency of financial reporting worldwide.

Washington, D.C., Aug. 27, 2008 — The Securities and Exchange Commission today voted to publish for public comment a proposed Roadmap that could lead to the use of International Financial Reporting Standards (IFRS) by U.S. issuers beginning in 2014. Currently, U.S. issuers use U.S. Generally Accepted Accounting Principles (U.S. GAAP). The Commission would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multi-year plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the Commission.

The increasing integration of the world's capital markets, which has resulted in two-thirds of U.S. investors owning securities issued by foreign companies that report their financial information using IFRS, has made the establishment of a single set of high quality accounting standards a matter of growing importance. A common accounting language around the world could give investors greater comparability and greater confidence in the transparency of financial reporting worldwide.

"An international language of disclosure and transparency is a goal worth pursuing on behalf of investors who seek comparable financial information to make well-informed investment decisions," said SEC Chairman Christopher Cox. "The increasing worldwide acceptance of financial reporting using IFRS, and U.S. investors' increasing ownership of securities issued by foreign companies that report financial information using IFRS, have led the Commission to propose this cautious and careful plan. Clearly setting out the SEC's direction well in advance, as well as the conditions that must be met, will help fulfill our mission of protecting investors and facilitating capital formation."

Chairman Cox noted that since March 2007, the Commission and staff have held three roundtables to examine IFRS, including one earlier this month regarding the performance of IFRS and U.S. GAAP during the subprime crisis. Almost one year ago,

the Commission issued a concept release on allowing U.S. issuers to prepare financial statements using IFRS.

Today, more than 100 countries around the world, including all of Europe, currently require or permit IFRS reporting. Approximately 85 of those countries require IFRS reporting for all domestic, listed companies.

Public comment on the SEC's proposing release should be received by the Commission no later than 60 days after its publication in the Federal Register.

* * *

The full text of the SEC's proposing release will be posted to the SEC Web site as soon as possible.

# # #

http://www.sec.gov/news/press/2008/2008-184.htm

U.S. Securities and Exchange Commission

Speech by SEC Chairman: Proposing a Roadmap Toward IFRS

by

Chairman Christopher Cox

U.S. Securities and Exchange Commission

Open Meeting
Washington, D.C.
August 27, 2008

The fourth item on our agenda today is the proposal of a Roadmap for U.S. participation in the development of truly global and high quality accounting standards.

One of the proposals we just adopted earlier during this meeting requires that foreign companies make disclosures to U.S. investors in English. That is both a necessary and an important step, because despite the relatively widespread use of English and a few other more common languages, even in the 21st century the world is still a very multilingual place. Today, the top 10 languages in the world by number of speakers are Mandarin Chinese; English; Hindustani; Spanish; Arabic; Russian; Portuguese; German; French; and Japanese. And every one of these languages is spoken by over 100 million people. It may be a very long time indeed before the world's 6.5 billion people can all speak in the same tongue.

Fortunately, we won't have to wait nearly as long for the language of business and finance to converge. One of the more revolutionary developments in the world's capital markets is the remarkably quickening pace of acceptance of a true *lingua franca* for accounting.

The world's capital markets have long searched for a single set of high quality accounting standards that could be used anywhere on earth. An international language of disclosure and transparency would significantly improve investor confidence in global capital markets. Investors could more easily compare issuers' disclosures, regardless of what country or jurisdiction they came from. They could more easily weigh investment opportunities in their own countries against competing opportunities in other markets. And a single set of high-quality standards would be a great boon to emerging markets, because investors could have greater confidence in the transparency of financial reporting.

Today, all of Europe and nearly 100 countries around the world require or permit the use of IFRS, and many more are on the verge of doing so. And yet the increased use of IFRS around the world is a fairly recent phenomenon. The majority of companies that are currently reporting financial results based on IFRS have only been doing so for a few years. This relatively limited history is an important reason that the U.S. needs to continue to support the work of the International Accounting Standards Board, and the foundation that oversees it — the International Accounting Standards Committee Foundation. In order for IFRS to fulfill the promise it holds to be a uniter

of the world's capital markets and a powerful tool for investors everywhere, there are a handful of principles that are critical to its success. The Roadmap we are proposing today is aimed in significant part at seeing to it that these principles are applied.

The first key success factor for IFRS is that the standards be crafted in the interest of investors. That has to be their overarching purpose.

The second is that the standard setting process be transparent. That is essential not only to maintain investor confidence, but to ensure the integrity and quality of the standards.

The third is that the standard setter must be independent. That means independent from special pleaders, from the political process, from favored industries or industry players, and from national or regional biases.

Fourth, the standard setter must be accountable. This means ensuring that IFRS actually meet the needs of investors and other stakeholders, and that they are updated in a timely way.

And fifth and finally, it is vitally important that all of the stakeholders themselves participate in the standard setting process in order to ensure the continued success of IFRS.

This focus on the investor's interest in global comparability also underlies the Roadmap's support for eXtensible Business Reporting Language in IFRS reports. In the same way that IFRS might someday soon make financial statements understandable to investors anywhere on earth, the 30 different spoken languages that will someday soon be embedded in XBRL data tags attached to public company financial statements could let any investor read an IFRS financial statement from any country in his or her own native language.

The IASC Foundation is explicitly dedicated to the development, in the public interest, of a single set of high-quality, understandable and enforceable accounting standards. This public interest mandate is documented in the IASC Foundation Constitution. Further, all Trustees must formally commit to acting in the public interest. In order to enhance their public interest focus and this institutional framework, the IASC Foundation has embraced a new monitoring group as part of its 2008 Constitution review. The purpose of this new group is to ensure the accountability of the global standard setter to national authorities charged with protecting the capital markets and the public interest. This arrangement is designed to preserve the independence of the IASB while enhancing the accountability of the IASC Foundation to national authorities. Both of these mutually reinforcing objectives will serve the interests of investors.

The United States' participation in the development of global accounting standards goes back many years. In 2002, Section 108(d) of the Sarbanes-Oxley Act of 2002 required the SEC to conduct a study and report to Congress on the adoption of a principles-based accounting system. And in July 2003, the Commission submitted the report to the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives.

The report noted, among many findings, that global accounting standardization would produce a myriad of benefits, including:

- Greater comparability for investors across firms and industries globally
- More efficient allocation of scarce capital among investment alternatives
- Lower costs of capital, since global accounting standards would eliminate the duplicative cost of preparing two sets of financial statements and make it easier for companies to access capital in more markets

This study concluded that the adoption of objectives-oriented, principles-based accounting standards in the United States would be consistent with the vision of reform that was the basis for the Sarbanes-Oxley Act.

Much has been accomplished since that report was completed in 2003. Above all, we have seen the emergence of IFRS as a high quality, increasingly globally accepted set of financial standards. Over 100 countries and all of Europe currently require or permit IFRS reporting, with approximately 85 of those countries requiring IFRS reporting for all domestic, listed companies. The market capitalization of exchanges within those 85 countries requiring IFRS represented approximately 35 percent of global market capitalization as of the end of July. That number exceeds the 28 percent share of global market capitalization held by United States exchanges. And the share of global market capitalization represented by IFRS markets will grow still larger with the inclusion of the additional countries that have decided to adopt IFRS by 2011.

U.S. investors keep buying securities issued by foreign companies that report their financial information using IFRS. Today, two-thirds of U.S. investors own securities of foreign companies. Given the fact that IFRS financial information is reported in home country filings well before they're filed with the Commission, U.S. investors and market participants have been analyzing and evaluating foreign companies listed here on the basis of only IFRS financial information for over two years.

These two facts — the increasing worldwide acceptance of financial reporting using IFRS and U.S. investors' increasing ownership of securities issued by foreign companies that report their financial information using IFRS — make it plain that if we do nothing and simply let these trends develop, with each passing year comparability and transparency decreases for U.S. investors and U.S. issuers. To help fulfill its statutory missions of protecting investors and facilitating capital formation, the Commission is duty bound to determine what role IFRS should play in U.S. capital markets — including whether it should be available for use by U.S. public companies.

Any proposed consideration of the potential required use of IFRS must start with the belief that IFRS, increasingly recognized throughout the world as a set of high quality globally accepted accounting standards, has the potential to best provide the common language on which companies can report and investors can compare financial information. From that belief, the real work begins.

Since March 2007, the Commission and the staff have held three roundtables on IFRS. We began with a "Roadmap" roundtable in March 2007 and earlier this month held our most recent roundtable — this one regarding the performance of IFRS and US GAAP during the subprime crisis. Almost one year ago, the Commission issued a concept release on allowing U.S. issuers to prepare financial statements using IFRS. Against this backdrop — and with the learning from those roundtables firmly in mind — the staff is today recommending that the Commission adopt a proposing release that describes a proposed Roadmap that could lead to the mandatory use of IFRS by U.S. issuers beginning in 2014 if the Commission believes it to be in the public interest and consistent with the protection of investors.

The proposed Roadmap is cautious and careful. It is a proposed multi-year plan that sets forth both the basis for considering the use of IFRS by U.S. issuers, and several milestones which if achieved could lead to the use of IFRS by U.S. issuers.

A common language of mutual understanding is vitally important to commercial integration among the world's cultures and nations. Global markets cannot achieve their full potential without that common language. A global set of high quality

accounting standards would be an international language of disclosure, transparency, and comparability. It is a goal worth pursuing and that is why we are here today.
I would like to thank John White, our Director of the Division of Corporation Finance, and Conrad Hewitt, our Chief Accountant, as well as their staffs, for their excellent work in preparing this proposal. In particular, I want to thank Wayne Carnall, Paul Dudek, Craig Olinger, and Michael Coco in our Division of Corporation Finance, and Liza McAndrew-Moberg, Paul Beswick, Julie Erhardt, and Jeff Minton in our Chief Accountant's Office for their work. Also, I want to thank Jim Overdahl and his outstanding staff in the Office of Economic Analysis for their inspired work in developing key parts of the Roadmap. And I would be remiss if I did not note the tremendous amount of work our Office of the Chief Accountant and the Division of Corporation Finance performed in preparing not only this release, but also completing the roundtables and the concept release. Finally, I would like to thank our Office of General Counsel for its expert assistance to John, Con, and their staffs. Finally, I thank our other Commissioners and their counsels for their work. I will now turn it over to John White and his staff to provide us with the details of the proposed Roadmap.

http://www.sec.gov/news/speech/2008/spch082708cc_ifrs.htm

Important Links for Additional Information

Association of Corporate Counsel
http://www.acc.com/

Center for Audit Quality
http://www.thecaq.org/

American Bar Association
http://www.abanet.org/

Association of Independent Certified Public Accountants
http://www.aicpa.org/

Financial Accounting Standards Board
http://www.fasb.org/

U. S. Securities and Exchange Commission
http://www.sec.gov/

Public Company Accounting Oversight Board
http://www.pcaobus.org/

International Financial Accounting Standards
http://www.ifrs.com/

International Accounting Standards Board
http://www.iasb.org/Home.htm