702 - Working with Outside Auditors

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Prior to joining Wind River, Ms. Shih was an attorney in the technology transactions practice group at Cooley Godward Kronish LLP in San Francisco, and also was an attorney in the corporate securities and technologies practice group at Pillsbury Winthrop Shaw Pittman LLP in San Francisco.

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Paul Swegle

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Mr. Swegle started his career in the securities and exchange commission's division of enforcement, during which he served two appointments as a special assistant United States attorney. He then transferred to the securities and exchange commission's division of corporation finance and later became director, law, of Plum Creek Timber, Inc.

Mr. Swegle recently completed a one year term on the Washington State Bar Association's rules of professional conduct committee. He is a founding member of the ACC's financial services committee and serves as chairperson of that committee's privacy and security subcommittee. He also serves on the executive committee of the corporate law department section of the Washington State Bar Association.

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The Association of Corporate Counsel

presents

"WORKING WITH OUTSIDE AUDITORS"

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1. Introduction

A. What Do Outside Auditors Do?

Although there are many types of audits, the most common and arguably most important is the "financial audit." The auditor's primary objective in a financial audit is to express an opinion on the fairness, in all material respects, of the presentation of a company's financial statements in conformity with generally accepted accounting principles. While each financial audit is tailored to the circumstances of the particular company, auditors will generally focus on critical accounting controls, books and records, processes and systems for entering data into those books and records, accounting and valuation methods used by the company, and other more specific issues such as tax matters, benefit plans, loss contingencies, related-party transactions, etc.

In their efforts to understand and to test accounting systems and data, auditors will meet regularly with company employees. As discussed below, they will also usually seek one or more meetings with in-house counsel to ask about specific risks or contingencies, to ask questions designed to uncover risks related to internal or external fraud, and to probe other matters they feel may be within the knowledge or responsibility of in-house counsel.

After completing an audit, auditors will issue their opinion and their auditor's report to the company's audit committee. The auditors will state whether, their opinion, the company's financial statements present fairly the financial position, results of operations, and changes in financial position for the year-ended in conformity with GAAP. There are four "types" of audit opinions: unqualified, qualified, adverse, and disclaimer. Only an unqualified opinion represents a clean bill of health for the company and/or its financials.

B. Who is in Charge?

The cooperative feel of most audits is somewhat illusory. Auditors are typically engaged by a board's audit committee through an "engagement letter" that sets forth how the audit will be conducted, the roles of the auditors and of management respectively, the auditor's reporting relationship directly with the audit committee, and the auditor's "deliverables". Among other things, the auditors will specify the level and nature of cooperation expected from management, including, implicitly, from in-house counsel, and potential consequences in the event such cooperation is not forthcoming – i.e., delay of the audit report, modification of audit procedures outlined in the engagement letter, or termination of the audit engagement.

Although retained by the company, the auditors' special role and need for professional independence places them in the driver's seat. Management can discuss and even diplomatically debate issues related to the audit, but there is a fine line in that relationship that management must be careful not to cross, lest the auditors feel they lack the ability to do their work professionally and independently. Disagreements with management often find their way into the auditor's report. As a practical matter, changing auditors, whether due to disagreements or not, is generally avoided due to the reporting obligations and negative inferences that can be triggered. The result is that management is usually deferential to the auditors, even when they believe the auditors have incorrectly analyzed a particular issue or are otherwise taking an unreasonable position.

C. What is In-house Counsel's Role?

In-house counsel need to understand the processes and dynamics described above and what is expected of them both professionally and as members of management. Although in-house accounting and finance personnel are more involved in the audit process, in-house counsel also interact with auditors in a variety of contexts during an audit. This presentation discusses some of those interactions, ideas for managing them successfully, and other audit-related issues relevant to in-house counsel.

2. Privilege and the ABA Treaty.

A. Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (the "ABA Treaty")

i. The ABA Treaty, adopted in 1975-76, attempted to balance the interests of the auditors in obtaining necessary disclosures and representations regarding the fair and accurate presentation of financial statements of a company against the public policy interest of protecting the attorney-client privilege so as not to hamper the ability of clients to seek legal counsel when necessary.

ii. The rational behind the ABA Treaty is that while the capital markets rely on public confidence in financial statements and, while auditors need to establish policies and procedures to ensure this, these procedures cannot and should not "intrude upon the confidentiality of the lawyer-client relationship in order to command such confidence".

iii. From the perspective of in-house lawyers, the ABA Treaty is the only definitive statement dealing with the privilege issue in the audit context.

B. Where Are We Today?

i. Is the ABA Treaty still applicable?

(a) Response letters from outside counsel continue to follow the general direction proposed by the ABA Treaty.

(b) Under the ABA Treaty, the form of letter submitted by general counsel in connection with an audit was limited by the general carve-outs. This carve-out is no longer commonly used.

(c) However, existing case law and the changing practical landscape in which public companies operate have made the treaty obsolete in certain circumstances.

(I) Recent scandals have left the appearance that auditors were "in bed" with management in perpetrating fraud upon shareholders.
(II) As a result, auditors have taken a more conservative approach and are often no longer willing to rely on the statements of in-house counsel or finance thus requiring more supporting documentation for the audit.
(III) Auditors are being perceived as "gatekeepers" much in the way that in-house legal departments are.

ii. As a Result:

(a) The scope of "rep letters" given by companies to their auditors has expanded; and

(b) The amount of documentation required by auditors has increased such that it impinges on matters that are subject to privilege claims.

C. What Can be Done to Address This?

i. In 2004, the ABA Task Force on Attorney-Client Privilege tried to reconcile the ABA Treaty with current practice. In doing so, the Task Force pointed to some specific areas where the PCAOB, SEC and AICPA should provide clarification to discourage the request by auditors for privileged communications.

(a) <u>Tax Advice and Opinions</u> – AICPA standards provide that if a client's tax accrual is based upon an opinion of counsel, the auditor

should obtain the opinion regardless of attorney-client privilege issues. Some auditors have interpreted this to mean that it is mandatory that they have copies of all advice or opinions from outside tax advisors.

(b) Litigation Reserves – the scope of documents requested should only cover factual information relevant to determining the amount of the reserve. The auditor should also be provided with confirmation if requested that the amount of the reserve is consistent with the advice received from counsel.

(c) Environmental Contingencies/Conditional Asset Retirement – documentation from counsel on these matters (such as whether environmental laws require remediation or taking an asset out of service) should only be necessary where the client justifies its position based on the opinion of counsel.

(d) Internal Investigations – Auditors can be provided with factual information that is not protected by privilege. They should not have access to notes prepared by counsel, legal assessments or legal advice provided in connection with the internal investigation.

ii. The Task Force recommended clarifying that audit documentation and audit work papers more correctly refer to documentation "to preserve evidence of the work done by auditors rather than to preserve the work of others that may have been used by the audited company but are not appropriately considered to be 'corroborating information'".

C. What Should Auditors be Given? What Steps Should In-house Counsel Take?

i. Auditors Should be Given:

(a) Audit response letters from outside counsel. The scope of these letters has not changed.

(b) A representation letter from the company's general counsel regarding any other existing litigation, which specifically refers to the ABA treaty:

"This response is limited by, and in accordance with, the 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…" see sample letters appended to the ABA Treaty for full text.

(c) Access to minutes of disclosure committee meetings.

(d) Access to summaries of disclosure controls and internal controls responses and certifications.

ii. In-house Counsel Should:

(a) Ensure that the representative from finance who is in-charge of the audit is aware of, and adequately educated about, the attorney-client privilege issues raised by auditors' requests for privileged documents;

(b) Review and revise as necessary representations letters provided by the company; and

(c) Review audit response letters submitted by outside counsel.

3. The Ever-Growing Representation Letter

A. Best Practices. A Representation Letter is a letter from management to the auditor stating that the financial statements are fairly presented. It is addressed to the independent auditor, dated as of the date of the auditor's report, and signed by members of management whom the auditor believes are responsible for and knowledgeable about the matters covered - usually the chief executive officer and the chief financial officer.

i. Who Should Review?

(a) A rep letter is a "legal" document in that it allocates liability, yet typically it is neither drafted nor reviewed by lawyers.

(b) Letters should be reviewed by the person in the finance department in charge of interfacing with the auditors during the audit and by the CFO.

(c) Letters should also be reviewed by the in-house legal department as well as the general counsel.

ii. Good contract drafting techniques should be used when drafting or providing comments on a representation letter, including the following.

(a) All representations should be limited to the financial statements being audited and the footnotes thereto.

(b) The letter should state that the representations contained in the letter are true and correct to the best of the Company's knowledge and belief as of the date of the letter.

(c) Duplicative disclosure should be avoided.

(I) Example 1- often representations regarding compliance with laws in the case of a representation letter relating to an employee benefit plan will be discussed under the heading "Management's Responsibility, Contingent Liabilities" and under the heading "Other Plan Matters".

(II) Example 2 - noting both under the heading "Minutes and Contracts" and in other sections that all contracts, written or oral, have been provided.

(d) Clean up potentially inconsistent language.

(I) Example – "We have disclosed to you all allegations of financial improprieties, including fraud or suspected fraud." The next sentence said, "We have no knowledge of any fraud or suspected fraud…" Either there was fraud or allegations of fraud that were disclosed to the auditors or the company has no knowledge of any fraud or suspected fraud – both statements cannot be true!

(e) Avoid generic catch-all phrases such as "we have given you all documents that you may need in connection with the audit" or "we have provided you with all information that you need in connection with the audit."

(f) Letters should be organized such that matters are dealt with in an organized, sequential manner and under the correct headings.

(I) For example, although there will likely be a section in the letter dealing with internal controls during the period covered by the report, changes in internal controls after the period covered by the report should be addressed under the "subsequent events" heading.

4. FAS 5 Basics – Accounting for Contingencies

A. Understanding the Terminology and Implications of FAS 5.

i. Amounts deemed "loss contingencies" may need to be accrued by a charge to income and/or disclosed.

ii. A loss contingency is defined under FAS 5 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."

iii. The likelihood of a particular contingency materializing ranges from "probable to remote." FAS defines *probable, reasonably possible* and *remote* 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.

iv. FAS 5 gives the following examples of loss contingencies:

(a) Collectibility of receivables.
(b) Obligations related to product warranties and product defects.
(c) Risk of loss or damage of… property by fire, explosion, or other hazards.
(d) Threat of expropriation of assets.
(e) Pending or threatened litigation.
(f) Actual or possible claims and assessments.
(g) Risk of loss from catastrophes assumed by property and casualty insurance companies….
(h) Guarantees of indebtedness of others.
(i) Obligations of commercial banks under "standby letters of credit."
(j) Agreements to repurchase receivables… that have been sold.

v. Accrual and Disclosure of Loss Contingencies. It is not the general counsel's job or any other in-house lawyer's job to determine the applicability of FAS 5 to a particular matter. Those are decisions for the chief financial officer, likely made in consultation with the controller, CEO, general counsel, and perhaps the audit committee. Close decisions on significant matters are often discussed, if not vigorously debated, with the company's outside auditors.

(a) Notwithstanding in-house counsel's peripheral involvement in FAS 5 decisions, in-house counsel must understand the operation of FAS 5 in order to:

(I) be alert for matters to be highlighted for consideration by the CFO and others under FAS 5;

(II) participate competently when asked to give a legal assessment on matters being vetted under FAS 5; and

(III) where appropriate, to know how and when to raise questions and/or to escalate matters where the requirements of FAS 5 might otherwise be disregarded, thus causing a misstatement in company financials.

(b) Accrual. Paragraph 8 of FAS 5 states that:

"An estimated loss from a contingency… shall be accrued by a charge to income if *both* of the following conditions are met:

a. Information available prior to the 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.

b. The amount of loss can be reasonably estimated."

(c) Disclosure. Paragraph 9 of FAS 5 states that:

"Disclosure of the nature of an accrual 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."

Paragraph 10 goes on to say regarding disclosure:

"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 probability that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall given an estimate of the possible loss or range of loss or state that such an estimate cannot be made…."

vi. Examples. Appendix A to FAS 5 gives a series of examples regarding, among other things, collectibility of receivables, obligations related to product warranties and product defects, risk of loss or damage of enterprise property, and litigation, claims, and assessments. Although all of the examples provide insights for assessing the treatment of contingencies, the following excerpts from the examples under *Litigation, Claims, and Assessments* are particularly informative:

(a) FAS 5, Paragraph 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… 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."

(b) FAS 5, Paragraph 34 provides useful guidance on timing issues related to accrual and or disclosure of litigation or other claims.

(c) Paragraph 36: "If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of… financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition of 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 and views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of… management on 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)…."

(d) Paragraph 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…. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of the loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10…."

5. Auditors and the Disclosure Committee

A. Legal Basis for Disclosure Committees

i. '34 Act and SOX. The function of the disclosure committee is to help reporting companies fulfill their legal obligations to maintain disclosure controls and procedures under Rules 13a-15 and 15d-15 of the '34 Act. In addition, since Section 302 of SOX requires reporting company CEOs and CFOs to make certifications with respect to these controls, the disclosure committee provides assurance to the reporting company CEO and CFO when signing their certifications.

ii. SEC Guidance. However, there is no legal requirement to establish a disclosure committee. Neither Sarbanes-Oxley, nor the SEC in its implementing rules, impose such a requirement. But, the SEC does recommend that reporting companies establish a disclosure committee to consider the materiality of information and to determine a company's disclosure obligations on a timely basis and whether changes in the company's operations have been addressed by appropriate changes in procedures. As a result of SOX and the SEC recommendation, it's best practice for reporting companies to have a disclosure committee. Although not all companies do have one, generally the larger the company, the more likely it is to have a disclosure committee.

B. Role, Responsibilities and Members of the Disclosure Committee

i. Responsibilities. Many disclosure committees have a charter that specifically sets forth the role of the committee. In addition to consideration of the materiality of information and determination of disclosure obligations, other responsibilities may include: (a) outlining process for reviewing financial disclosures, (b) directing and overseeing the executive certification process and (c) emphasizing the review and evaluation of back-up sub-certifications. The committee also may analyze the nature of any miscommunications, roadblocks or inefficiencies in the disclosure process and considers how best to remedy these deficiencies.

ii Members of the Committee. Insiders with high visibility into the internal operations of the company are important constituents in identifying disclosure issues. Common members are: Controller or principal accounting officer, General Counsel, Chief Operating Officer, Internal Audit Director, CFO and CEO. Others that may be involved are the Chief Investor Relations Officer, Treasurer, CIO and Chief Risk Officer.

C. Role of Auditors

i. Role of Outside Advisors. It is up to company management to maintain disclosure controls and procedures, and to determine what disclosures are appropriate for the company. Also, the disclosure committee discussions and responsibilities are broader than the specific issues for which external auditors need be involved. For this reason, outside auditors (and outside advisors generally) should not be standing members of the disclosure committee. Instead, auditors should be consulted on particular issues that may surface during the disclosure committee meetings, and also should be consulted with generally on an ongoing basis to keep current on "best practices" and approach to disclosure generally.

ii. Role of In-House Counsel in Working with Auditors. In-house counsel should assist in identifying issues that may warrant disclosure, and should coordinate with the finance team to address such issues with the outside auditors. In addition, in-house counsel should help to shape the timing and process of the disclosure committee activities and review process for financial disclosures, including the determination of when and how to loop in the external auditors. In-house counsel should also be responsible for drafting the minutes of the committee meetings, and any other documentation or record keeping of diligence efforts or otherwise. Due to the privilege issues discussed previously, legal counsel should be sensitive when drafting materials and providing information to auditors of the risk of loss of privilege.

6. Avoiding Surprises

A. Communication. Regular communication between auditors and in-house attorneys can help reduce the risk of unwelcome surprises.

i. The audit committee and/or the auditors should make clear to management that, within proper boundaries that protect attorney-client privilege, the auditors should have free access to in-house counsel and in-house counsel to the auditors.

ii. The annual cycle of audit committee meetings where auditors are present and on-site audit planning sessions, interim audit activities and year-end audit activities normally provide plenty of face-to-face opportunities for communication between in-house counsel and the auditors. Some matters, like those listed below, however, may warrant a timely call or other communication with the auditors.

B. No Surprises. Auditors can better serve clients when they are timely informed of such things as regulatory examinations and communications, significant litigation developments, anticipated debt or equity offerings, potential changes to employee benefit plans, "whistleblower" communications, possible fraud or illegal acts on the part of management or employees, etc. When in-house counsel become aware of such matters, they should ensure that the info is timely presented to the auditors, either directly or through accounting department channels.

C. Trust and Confidence. Open communication and timely information regarding potentially important issues or developments enhance the auditor's trust and confidence in in-house counsel. That trust and confidence will help shape a positive view of the company's overall controls and top-down integrity, which, in turn, will enable the auditors to focus on higher-value issues and processes of greater benefit to the company, management and shareholders.

7. Special Audits

A. Working with Other Auditors

i. Auditor Independence.

(a) SOX; SEC and PCAOB. In 2002 SOX established rules promoting the ethics and independence of registered public accounting firms that audit financial statements of U.S. public companies. The SEC subsequently implemented auditor independence rules to clarify the non-audit services that a company's auditors can perform. In addition, SOX also prohibits any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible. The SEC announced final rules approving additional PCAOB ethics and independence rules.

(b) Consistent with SOX, the SEC rules prohibit the following non-audit services, subject to various exceptions and qualifications as described below: (i) bookkeeping or other services related to the accounting records or financial statements of the audit client; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker or dealer, investment adviser, or investment banking services; (viii) legal services; and (ix) expert services unrelated to the audit; and (x) specified types of tax services.

(c) Companies may work with other external auditors in a number of these areas, including: M&A diligence review, internal audit outsourcing services (including SOX analysis from management perspective), tax advice, and other audit services.

ii. Special Committee of the Board.

(a) If the Board forms an independent committee to review or investigate a matter, the Board or the committee may choose to retain outside advisors that may include outside legal counsel, auditors, or other third parties.

(b) Companies may work with other external auditors in this way in a number of areas, such as in conjunction with litigation counsel for a stock option review or special litigation review.

iii. Role of In-House Counsel.

(a) Assist in the coordination and supervision of the work of auditors. Educate other internal organizations as to what topics require legal review and involvement.

(b) Consider whether to engage the external auditor through the legal department, to have them working under Legal's direction and control.

(c) Consider the potential loss of attorney-client privilege in materials you provide.

(d) Understand the role of the auditor in independent investigations. The company's legal department may be the key point of interface for requests for information and coordination. However, in these instances internal personnel may not have visibility into the findings or conclusions of auditors or other outside advisors.

(e) Develop a process to work with board committees. Work with the board committee to deal with the scope of work requested of outside advisors. Clarify up-front how and when outside advisors and board members will update company management. Ascertain whether in-house counsel can be present at meetings of the board committee and their outside advisors. Discuss with board members their expectations regarding process for payment of fees and review of itemized billing reports.

(f) Assist with coordination of involvement between these project auditors and the company's registered, independent auditor.

8. Law Firm Letters/Audit Inquiry Letters

A. The AICPA Codification of Statements on Auditing Standards provides the following guidance regarding when and to whom audit inquiry letters should be sent:

> "Audit inquiry letters should be sent to those lawyers, [who] may be either inside or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation, claims and assessments. If inside counsel is handling litigation, claims and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside and outside lawyers have been involved in the matters, but inside counsel has assumed primary responsibility for the matters, inside counsel's evaluation may well be considered adequate. However, there may be circumstances where litigation, claims and assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers' response that they have not formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation, even though inside counsel may have primary responsibility."

B. Work with the Auditors.

i. Absent any guidance, auditors will err on the conservative side and will require that most or all of a company's outside firms respond to audit inquiry letters. This results in unnecessarily large bills for the company, as each firm will charge the company for its efforts in reviewing files and conducting other internal processes necessary to respond to the letters. It will also result in wasted time, effort and expense for the auditors, who will be forced to wade through and decipher immaterial responses.

ii. The best approach is to prepare for the auditors a short summary of the nature of the work performed by each firm, accompanied by supporting invoices covering six to twelve months and in-house counsel's suggestion as to which firms have worked on matters that would be of greatest interest to the auditors. The auditors should be discouraged from sending letters to firms working exclusively on <u>immaterial</u> matters such as the following:

(a) routine contracts or leases;
(b) minor litigation;
(c) routine trademark or copyright matters;
(d) routine employment law or benefits counseling;
(e) routine regulatory counseling;
(f) routine corporate governance matters;
(g) other proactive counseling not involving any threat or claim.

iii. If the auditors are initially concerned about this approach, the audit senior or audit partner can be brought into the discussion and will usually see its merit.

iv. In-house counsel should follow-up to ensure that the law firms timely respond to the auditors. This will further increase support for in-house counsel's involvement in the guiding the process.