# 611 – Navigating the Thorny Pathe of Post-Anderson Audit

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# Faculty Biographies

## Alberto Gonzalez-Pita

J. Alberto Gonzalez-Pita is the executive vice president and general counsel of Tyson Foods, Inc., in Springdale, Arkansas, where he is responsible for overseeing the company's legal, ethics, compliance, and internal audit departments. Tyson Foods, a Fortune 100 company, is the world's leading processor and marketer of chicken, beef, and pork, generating over $25 billion in revenues from 300 facilities and offices in 26 states and 20 countries.

Mr. Gonzalez-Pita has legal experience in a wide range of areas including mergers and acquisitions, regulatory, compliance, human resources, and litigation. He came to Tyson Foods from BellSouth Corporation where, as a board elected officer, he served as general counsel and vice president- international legal, regulatory, and external affairs of BellSouth International. He was previously an executive partner at the Miami office of White & Case and, prior to that, was in private practice with several different law firms.

He has been an ACC member and on ACC's Board of Directors. He serves as chair of the ACC Board's Advocacy Committee, which directs the association's activities as a public policy advocate on behalf of its members' interests. He previously served as co-chair of the International Bar Association's corporate counsel committee, co-chair of The Conference Board's council of senior international attorneys and as a trustee of St. Thomas University School of Law.

Mr. Gonzalez-Pita holds a holds a bachelor's from the University of Miami and a law degree from Boston University Law School.

## Robert Kueppers

Robert J. Kueppers is deputy chief executive officer of Deloitte & Touche USA LLP in New York City. In this capacity he works closely with the CEO of Deloitte & Touche USA LLP and provides direction for ethics and compliance processes, as well as regulatory and public policy matters. He is also a vice chairman of Deloitte & Touche USA LLP.

Mr. Kueppers previously served as the senior technical partner with Deloitte & Touche LLP in its national office in Wilton, Connecticut and was national managing partner—risk, professional, and regulatory matters. Prior to that, Mr. Kueppers was in charge of the professional practice group, served as the national director of SEC services, and served as the national director of independence. Mr. Kueppers was the chief financial officer of an SEC-reporting manufacturing company in New York. He also served as a partner in the New York and national offices of Deloitte & Touche. Prior to that Mr. Kueppers was a professional accounting fellow in the office of the chief accountant at the SEC in Washington, DC. Accounting fellows work extensively with registrants and their accountants on unique accounting issues, are involved in SEC rulemaking projects, and participate in the oversight of the accounting profession. Mr. Kueppers began his career with Deloitte & Touche in Minneapolis.

Mr. Kueppers is active in issues affecting the profession on behalf of the firm. He is presently the chairman of the executive committee of the American Institute of Certified Public Accountants' (AICPA) Center for Public Company Audit Firms. He is a past member of the AICPA's SEC practice section executive committee, the professional ethics executive committee, and the SEC regulations committee. Mr. Kueppers is also president of the SEC Historical Society in Washington, DC and a member of the Public Company Accounting Oversight Board's standing advisory group.

Mr. Kueppers is a graduate of the University of Minnesota.

## Carol Petren

Carol Ann Petren is executive vice president and general counsel of CIGNA Corporation and is responsible for the company's legal and public affairs activities.

Prior to joining CIGNA, Ms. Petren served as senior vice president and deputy general counsel of MCI, responsible for litigation, domestic and international regulatory matters, employment law, government affairs, and compliance. Before MCI, Ms. Petren served as deputy general counsel at Sears, Roebuck and Co., following litigation defense practice with law firms in Washington, DC. Earlier in her career, she served as a prosecutor in Jackson County, Missouri., as assistant U.S. attorney for the Western District of Missouri and as counsel to the U.S. House of Representatives' committee on standards of official conduct.

Ms. Petren is a magna cum laude graduate of Boston College and received her J.D. and L.L.M. degrees from the University Of Missouri School Of Law.

## Thomas J. Sabitino

Thomas J. Sabatino Jr. is executive vice president and general counsel of Schering-Plough Corporation, a global science-based health care company with leading prescription, consumer and animal health products located in Kenilworth, New Jersey. Through internal research and collaborations with partners, Schering-Plough discovers, develops, manufactures and markets advanced drug therapies to meet important medical needs. Schering-Plough's vision is to earn the trust of the physicians, patients and customers served by its more than 30,000 people around the world. 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, community affairs, 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, he 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. After that he left Baxter to join Secure Medical, Inc., Mundelein, Illinois as president and chief executive officer. Later, he was named associate general counsel for American Medical International Inc., Dallas, Texas, and then became vice president and general counsel. American Medical International later merged with National Medical Enterprises to become Tenet Healthcare Corporation. Mr. Sabatino left Tenet to rejoin Baxter as associate general counsel. He was later named general counsel and then 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 B.A. degree, cum laude, from Wesleyan University and a J.D. degree from the University of Pennsylvania Law School.

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## ACC'S ANNUAL MEETING 2007
## SESSION 611: Navigating the Thorny Path of Post-Andersen Audit Procedures

**October 30, 2007; 2:30-4:00 p.m.**
**Hyatt Regency Chicago**

### Program Description

ACC's focus on privilege protection led us to look into the evolving (devolving?) relationship between lawyers and auditors for the company, but what we found takes us far beyond problems that arise in the context of auditor access to confidential or privileged files: additional dissatisfactions permeate the relationship. This program will present the results of ACC's Blue Ribbon Panel on Improving the Working Relationship Between Lawyers and Auditors Serving the Corporate Client (more on this below) and propose ideas to help facilitate the important work that lawyers and auditors should be working together to accomplish. We'll look at privilege protection, contract terms, indemnification/liability assumptions, investigation techniques, and more.

### ACC's Blue Ribbon Panel on Improving the Working Relationship Between Lawyers and Auditors Serving the Corporate Client

ACC is examining the changing relationship between lawyers and auditors in the post-Andersen world. Legal leaders tell us that problems are on the rise, undermining crucial aspects of the working relationship, from retention standards, to assumption of liability, to document review and investigation procedures, to privilege/confidentiality erosion, to PCAOB standards, to changing expectations about how both lawyers and auditors best serve the company client and its stakeholders.

Our Blue Ribbon Panel brings together a group of top-level practitioners from a variety of industries and backgrounds in both accounting and corporate legal practice, to analyze the problems, propose possible improvements and solutions, and issue a findings and recommendations report. Highlights of the Report will be discussed as part of this session.

### Session Materials

Attached are select background resources relating to the session topic. Session participants will also receive a copy of the above Blue Ribbon Panel Report which will be fresh off the printer and provided onsite. For those viewing these materials electronically, this Report should be posted to our website by late October.

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## Resource Bibliography
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**Below is a sampling of resource materials pertaining to the 2007 ACC Annual Meeting Session 611 and available for further reference at www.acc.com/vl.**

### ACC Blue Ribbon Panel Discussion Materials

**ACC Outline of Issues**

**Issue Sheets: Records Retention; Indemnification/Limited Liability; Internal Investigations; Privilege Concerns; Relationship Issues: the PCAOB Rules' Impact**

### ACC CLO ThinkTank Materials

**Executive Report- CLO's Role in Financial Compliance & Relationships with Auditors**
http://www.acc.com/protected/clo/financialcompliance.pdf

### Additional ACC Articles; White Papers

**Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud (ACC Docket 2006)**
http://acc.com/protected/pubs/docket/nd06/house.pdf

**Managing an Internal Fraud Investigation and Prosecution (ACC Docket 2007)**
http://acc.com/resource/v8313

**Recent Trends in Internal Investigations**
http://acc.com/resource/v8312

**Providing In-House Legal Support to the CFO & Finance Function (ACC Leading Practice Profile 2004)**
http://acc.com/resource/v5902

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What to do When the Whistle Blows: Do's and Don'ts of Internal Investigations (ACC Docket 2004)
http://acc.com/protected/pubs/docket/may04/whistle.pdf

Helping the Audit Committee Manage its Relationship with the Outside Auditor (ACC Docket 2004)
http://acc.com/protected/pubs/docket/may04/tools.pdf

Responding to Auditor Requests (ACC Docket 2005)
http://acc.com/protected/pubs/docket/jun05/toolkit.pdf

Indemnification and Insurance Coverage for In-House Lawyers (ACC Leading Practice Profile 2004)
http://acc.com/resource/v6300

Audit Letters in the Wake of Sarbanes-Oxley (ACC Docket 2003)
http://acc.com/resource/v6300

### Additional Select Resources of Interest

*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), David M. Brodsky, Pamela S. Palmer & Robert J. Malionek
http://www.acc.com/public/article/attyclient/debate.pdf

ABA Task Force on Attorney-Client Privilege: Task Force Report Recommendation to the ABA House of Deletgates on Audit Issues as Adopted (August 2006)

*New PCAOB Auditing Standard on Internal Control Over Financial Reporting,* KPMG (May 2007)

AS3 (PCAOB Release No. 2004-006, June 9, 2004)

*Audit Documentation: It's a Whole New World,* CPA Journal (June 2005)

*The Compliance Imperative: Managing Record Retention in a Rapidly Changing Regulatory Environment,* DM Review (June 2005)

Record Retention and the Paperless Office, The Risk Management Resource (AICPA, Spring 2005)

*Tips for the Sarbanes-Oxley Learning Curve,* Journal of Accountancy (June 2004)

PCAOB Standing Advisory Group Meeting, Emerging Issue- The Effects of Independence of Indemnification, Limitation of Liability and Other Litigation-Related Clauses in Audit Engagement Letters (February 9, 2006)

PCAOB Rule 3600T, Interim Independence Standards (May 12, 2006)

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

*Understanding the Role of The Auditor in Defending Auditor Liability Cases,* Foley Hoag LLP on behalfof The American Law Institite- American Bar Association Course of Study (May 3-4, 2007)

Laurie Sablak, *Cover Me,* Corporate Counsel (January 2004)

Eriq Gardner, *Naked as a Jaybird,* Corporate Counsel (September 2003)

John F. Savarese, "Strategies For Conducting Internal Investigations," Practicing Law Institute: Corporate Compliance Institute (March-June 2005)

Andrew Longsterth, "Double Agent," The American Lawyer (February 1, 2005)

Interview with Neil Goldenberg "Corporate Counsels' Role in Internal controls- The Auditors' Perspective," The Metropolitan Corporate Counsel (January 2005)

Michael R. Young, "Eighteen Safeguards To corporate Self-Investigation," The Metropolitan Corporate Counsel (December 2004)

Stanley Keller (member of the ABA Task Force on Attorney-Client Privilege), "Proposed Approach to Addressing Audit-Related Matters," draft position paper submitted to the Task Force (June 15, 2007)

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)

Byron Eagan, "Communicating with Auditors After the Sarbanes-Oxley Act" 41 FALL Tex.J. Bus. L. 131 (2005)

Sue Reisenger, "Texas Case Raises Galvanizing Isseu for GCs: Auditor Privilege," Law.com's In-House Counsel (June 2006)

AS2 (PCAOB Release No. 2004-001, March 9 2004)

AS5 (PCAOB Release No. 2007-005, May 24, 2007)

*Exploring PCAOB Auditing Standard 2: Audits of Internal Controls,* CPA Journal (May 2005)

*Ding Dong, AS5 is Dead,* CFO.com (May 24, 2007)

*New AS5 More in Line With SEC Guidance,* Compliance Week (June 20, 2007)

*Fears, Hopes for Audits Done Under AS5,* Compliance Week (June 20, 2007)

*The Top 10 List for Implementing AS5,* Compliance Week (June 20, 2007)

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**PCAOB Release- Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (PCAOB Release No. 2004-001, March 9, 2004)**

**Outline of AICPA's Statement on Auditing Standards, No. 99: Consideration of Fraud In a Financial Statement Audit (2003)**

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# ACC's 2007 Blue Ribbon Panel on Improving the Working Relationship Between Lawyers and Auditors Serving the Corporate Client

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## OUTLINE OF ISSUES

**Topic # 1:** **Records retention policies and their impact on the working relationship between auditors and company lawyers**

**CORPORATE POLICIES AND AUDITORS' NEEDS REGARDING RECORDS RETENTION**

Corporate executives, corporate legal departments and auditors approach records retention policies with different and sometime competing interests. For example, in-house counsel often are most interested in setting up centralized corporate records retention policies with potential litigation issues in mind; corporate managers want document policies that allow for efficient knowledge management, limited storage problems and expense, as well as maximum autonomy for individual record managers who need information; and auditors are most interested in their ability to conduct an audit with easy and complete accessibility of accurate corporate records. These different perspectives can lead to disagreements between the parties as to the best policies and practices governing both the scope or length of records retention and how information is stored, secured, and retrievable.

1. **In-house counsel's role in shaping management's corporate records retention policy**

    a. What role do corporate legal departments play in shaping a corporate records policy or a retention schedule? What role do corporate legal departments play in shaping a corporate policy with respect to preserving electronic material? How much consideration is given to the requirements auditors face in shaping a corporate records policy?

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**b.** What role do corporate legal departments play in preventing any violations of sections 802 and 1102 of the Act? How have sections 802 and 1102 changed corporations' records retention policies? Do responses to auditors' document requests ever raise concerns under section 802 or 1102?

**c.** With respect to these issues: What are the various approaches that different corporate legal departments have adopted? How common is each of these approaches? What are best practices for corporate legal departments? What are the pros and cons of corporate legal departments 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?

**2. The relationship between in-house counsel and auditors with respect to records retention**

**a.** Are companies' records retention policies and schedules consistent with the auditor's needs and requirements? If not, in what ways? How do accountants manage audits with a client whose corporate records retention policy may not permit the accountants to sufficiently satisfy requirements imposed by the Act?

**b.** What role does the corporate legal department play when auditors request access to information subject to attorney-client privilege or work product protections? How are these requests handled?

**c.** Do auditors request documents not retained by corporations? Do they request information that is not easily or conveniently retrievable? If so, are there easily implemented archiving or retrieval processes or procedures that would help solve these problems? What role does the legal department play in addressing auditors' requests for documents that have not been retained or that are not retrievable in a convenient or reasonable fashion?

**d.** 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 replicable best practices we can identify? What are the pros and cons of corporate legal departments and audit firms taking an active role in preparing document management systems with these goals in mind? What problems or other issues may arise as a result of this focus on retrieval for audit purposes?


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**Topic # 2:** **<u>Liability and indemnification in the audit context, and their impact on the working relationship between lawyers and auditors</u>**

**A. AUDITORS' ENGAGEMENT LETTERS**

Drafting the terms of auditor engagement letters and of any indemnification clauses they might contain raises legal issues that fall within in-house counsel's area of expertise. Issues that can affect the relationship between in-house counsel and auditors include both the extent of in-house counsel's influence over the terms of engagement letters and any divergence between in-house counsel and auditors as to what these terms should be.

**1. In-house counsel's role in negotiating the terms of an auditor's engagement letter**

**a.** What role does the corporate legal department play in negotiating the terms of the auditor's engagement letter? How has the role of the corporate legal department changed since the Act was enacted, if at all, with respect to the engagement letter process?

**b.** What are the major terms, conditions, or other issues most difficult to negotiate between corporate legal departments and auditors when drafting the engagement letter? How commonly do they arise?

**c.** 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?

**2. Inclusion of auditor indemnification and/or limited liability clauses**

**a.** How often do auditors wish to include an indemnification or limited liability clause in the engagement letter? How is this typically handled by corporate legal departments?

**b.** What types of limited liability or indemnification provisions are most commonly sought? Do auditors and corporate legal departments attempt to limit auditors' liability in any ways other than through inclusion of clauses in engagement letters?

**c.** What are the problems that arise when these clauses are negotiated?


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**d.** 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?

**3. Impact of conflicting views of desirability and permissibility of these clauses**

**a.** What role do corporate legal departments play in interpreting the impact that different indemnification/limited liability clauses might have on auditor independence? What standards or guidelines do corporate legal departments follow? What impact do the AICPA and the FFIEC interpretations and advisories have on corporate legal departments?

**b.** How do auditors interpret the impact that different indemnification/limited liability clauses might have on auditor independence? What standards do auditors follow?

**c.** To what extent do the differences in opinions issued by professional organizations with respect to the relationship between indemnification/limited liability clauses and auditor independence impact the engagement letter process?

**d.** What issues arise as a result of the conflicting views regarding these clauses?

**e.** 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?

**4. Other issues arising beyond indemnification/liability in the retention context?**

**B. INDEMNIFICATION OR LIMITS ON LIABILITY FOR IN-HOUSE COUNSEL**

The corporate accounting scandals earlier this decade have spawned a flurry of complex laws, regulations, and standards. Given the consequences that non-compliance can have for the very existence of the corporation, in-house counsel are exposed to increased


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personal risk of liability. Management of this risk could have an impact on the working relationship between in-house counsel and auditors.

**1. In-house counsel's changing role and the challenges in finding optimal protection**

**a.** How do companies seek protection for in-house counsel given their expanded role in matters relating to audits? What are the principal problems and challenges when seeking greater protection from such liability? What have companies been doing to address these concerns?

**b.** How has Sarbox Section 307, and its counterpart attorney-conduct rules in other jurisdictions beyond the US, impacted legal departments with respect to liability issues?

**c.** How do the issues arising from protection from such liability impact the role of the in-house counsel with respect to audits?

**d.** 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?

**2. Relationship with auditors given in-house counsel's focus on personal liability concerns and professional protection**

**a.** How has seeking protection or insurance for in-house counsel impacted the relationship between corporate legal departments and auditors?

**b.** Does insufficient or unsatisfactory protection or insurance for in-house counsel impact the working relationship between the legal department and auditors?

**c.** 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?


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**Topic # 3:** **Internal investigations and their impact on auditor/lawyer working relationships**

**A. AUDITORS' OBLIGATIONS TO NOTIFY CLIENTS OF POTENTIALLY ILLEGAL ACTS**

Section 10A of the 1934 Securities Exchange Act, added by the Sarbanes-Oxley 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.

**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 a role in that process? Is this a cause of tension between in-house counsel and auditors? If so, what are practical recommendations to improve the resulting report or process?

**B. LAWYERS' OBLIGATIONS TO INVESTIGATE, REMEDY AND REPORT ON ALLEGATIONS OF WRONGDOING**

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; the SEC codified these requirements in 17 CFR Part 205. The professional codes of conduct of every US states' bar have similar requirements in their version of ABA Model Rule 1.13, which therefore makes such responsibility a lawyer requirement regardless of whether the client is a public or private company/entity. Similar obligations exist in the ethical and exchange rules of Canada, Europe, many Pacific Rim, and other large and highly-regulated jurisdictions. While these requirements suggest that lawyers have obligations to report and remedy wrongdoing when their client is an entity, they do not suggest how privilege is to be maintained if the assumption is that such investigations will be subject to review by those outside the circle of privilege protection. Further, privilege standards and applicability to in-house counsel work varies by jurisdiction – a small but significant number of jurisdictions (beyond the US and Canada) do not recognize privilege as applying to in-house counsel / client relationships. And corporate attorney-client privilege is under attack by those who would investigate wrongdoing in the prosecutorial, enforcement and plaintiff's bar community.


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**1.** How do these issues and the general momentum toward corporate "transparency" affect the lawyer/auditor relationship and what is reasonable for lawyers to withhold from production to auditors based on privilege protection concerns?

**C. CORPORATE POLICIES WITH RESPECT TO INTERNAL INVESTIGATIONS**

Internal investigations are relevant to in-house counsel because they involve potentially unlawful activity and are relevant to auditors because fraud and other unlawful conduct can impact the accuracy of an audit. Challenges may arise with respect to corporate policies regarding the detection, management, and reporting of internal investigations because there is a natural tension between auditors' desire for complete transparency and in-house counsel's desire to preserve confidentiality and attorney-client privilege.

**1.** 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?

**2.** What triggers internal investigations? How do corporations staff, structure, and manage internal investigations? How do corporations document internal investigations? Are oral reports ever used in lieu of written reports? Are auditors aware how their clients manage internal investigations?

**3.** 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?

**4.** 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?

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


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

**7.** Have auditors' requests for documents generated in the course of internal investigations changed corporate policies with respect to the detection, management, and reporting of these investigations?

**8.** 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?

**Topic # 4: Non-internal investigation attorney-client privilege issues in the audit context**

**PRIVILEGE ISSUES IN CONNECTION WITH 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. The conduct of audits in both categories can affect the relationship between auditors and in-house counsel because auditors may request documents potentially covered by attorney-client privilege or the attorney work product doctrine. While each type of audit may give rise to distinct issues and the regulatory frameworks applying to each are not identical, they are addressed together below because the questions they raise overlap substantially.

**1. Auditors' requests for documents**

**a.** 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


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- 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

**b.** What types of materials do auditors request from corporate legal departments with respect to each subject matter when performing audits of internal controls over financial reporting? Do corporate legal departments and auditors negotiate the terms of auditors' requests in advance (*e.g.* at the time of the engagement)?

**c.** What proportion of the requested documents and information is confidential? What proportion of the requested documents and information is covered by attorney-client privilege or the attorney work product doctrine?

**d.** 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?

**2. Corporate legal departments' responses to auditors' requests for potentially privileged documents**

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

**b.** Do corporate legal departments and auditors negotiate the terms of responses to auditors' requests in advance (*e.g.* at the time of the engagement)? Do corporate legal departments insist on the inclusion in auditor engagement letters of standard terms requiring the auditors to preserve confidentiality of information received and notify company of any requests for such information by third party?

**c.** 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)?

**d.** What has been the impact on corporate legal departments of Section 303 of the Sarbanes-Oxley Act and SEC Rule 13b2-2 (having the effect of making in-house counsel, among others, liable for misleading an auditor if counsel should have known that doing so could result in rendering the corporation's financial statements materially misleading)?

**e.** What has been the impact on corporate legal departments of the SEC regulations implementing Section 307 of the Sarbanes-Oxley Act (potentially leading to the creation of internal investigations documents that may be requested by auditors)?


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**f.** What has been the impact on corporate legal departments of Section 404 and the PCAOB Auditing Standards and rules?

**g.** What is the prevailing view as to whether and to what extent the ABA-AICPA Treaty remains alive and relevant? Do auditors and corporate legal departments views differ on this issue?

**h.** Do corporate legal departments work with auditors to identify what information they really need in order to find a way to provide it without giving access to confidential information, privileged materials, and attorney work product?

**i.** Do corporate legal departments give auditors the same information they would give to the Board's audit committee?

**j.** Do corporate legal departments allow auditors to review quarterly litigation summaries prepared for management?

**k.** Do corporate legal departments ever suggest that auditors hire outside counsel to advise them on the appropriateness of the corporate legal department's representations to the auditors, as an alternative to providing the auditors with privileged documents and/or work product?

**l.** When responding to auditors' requests, do corporate legal departments handle materials subject to attorney-client privileged differently from materials subject to work product protections?

**m.** How do corporate legal departments and auditors address the fact that not all states recognize the existence of a privilege covering accountant-client communications?

**n.** 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?


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**Topic # 5: <u>Evolving standards of care to meet new PCAOB rules and their impact on the working relationship between lawyers and auditors</u>**

**A. MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROLS AND AUDITORS' DUTY TO ATTEST TO, AND REPORT ON THIS ASSESSMENT**

Before they attest to management's assessment, auditors may wish to have access to the advice and documents provided by in-house and outside counsel to management. In-house counsel, however, may be reluctant to meet such requests to the extent they involve information subject to attorney-client privilege and work product protections. In addition, in some instances in-house counsel may be actively involved in the evaluation of internal controls in a management (rather than a legal) capacity, may be tasked with supporting and responding to the Board's audit committee, or may be working under the direction of internal audit or compliance leaders outside of the law department. For all of these reasons, management's assessment of the effectiveness of internal controls may be touched by in-house counsel, and thus requires auditors working with these issues to interact with lawyers serving the company in a variety of capacities.

**1. In-house counsel's involvement in management's assessment**

**a.** Do corporate legal departments play a role in establishing the framework under which management is required to base its assessment of the effectiveness of the companies' internal controls over financial reporting pursuant to AS2?

**b.** Is it common for companies' in-house lawyers to be involved in the actual evaluation by management of the effectiveness of internal controls?

**c.** Do corporate legal departments provide management with evidence and documents in support of this evaluation?

**d.** What is the role of the corporate legal department in drafting/reviewing management's assessment of the effectiveness of the company's internal controls over financial reporting, to be included in the company's annual report? What is the role of the corporate legal department in drafting/reviewing management's quarterly certifications under section 302 of the Sarbanes-Oxley Act?

**e.** With respect to these issues: What are the various approaches that different corporate legal departments have adopted? How common is each of these approaches? What are best practices for corporate legal departments? What are the pros and cons of corporate legal departments 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?


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**2. Communications between in-house counsel and auditors regarding management's assessment**

**a.** Is management's assessment and the subsequent report of the auditor on management's assessment the subject of communications between the company's in-house lawyers and its auditors? If so, are communications written? Oral? When and how often do they take place?

**b.** To the extent corporate legal departments provide management with evidence and documents in support of its evaluation of the company's internal controls over financial reporting, do auditors typically request that the legal department share any such documents or evidence with them? How are such requests addressed, particularly when they pertain to privileged material or attorney work product?

**c.** What is the role of the corporate legal department in drafting/reviewing the written representations that an auditor is required to obtain from management pursuant to AS2?

**d.** AS2 requires the auditor to communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit, prior to the issuance of the auditor's report on internal controls over financial reporting. What is in-house counsel's role, if any, in reviewing and responding to such communications?

**e.** 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?

**B. RELATIONSHIP BETWEEN AUDITORS AND IN-HOUSE COUNSEL IN THE CONTEXT OF AN AUDIT OF INTERNAL CONTROLS OVER FINANCIAL REPORTING**

An audit of internal controls over financial reporting consists of six stages (identified below). At each of these stages, auditors may direct certain inquiries to in-house counsel or request access to privileged materials or attorney work product. Auditors also may rely to some extent on work performed by counsel related to internal controls. Each of these issues may affect the working relationship between auditors and in-house counsel.

**1. Shifting nature of the relationship over the different steps of the audit process**


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**a.** What is the nature of the relationship between in-house counsel and auditors at the various stages of the auditors' mission? What problems or other issues may arise in the relationship between auditors and in-house counsel in these various areas?

- Stage 1: Planning the engagement. Among other things, AS2 states that when planning the audit of internal controls over financial reporting, the auditor should evaluate how "legal or regulatory matters of which the company is aware" will affect the auditor's procedures. What obligations do corporate legal departments have to identify such legal or regulatory matters? What obligations are there to share evaluations of such legal or regulatory matters? Do these obligations change depending upon the auditor's conduct (*e.g.*, if the auditor makes a formal request)?
- Stage 2: Evaluating management's assessment process. For example, AS2 requires the auditor to evaluate whether management's documentation provides reasonable support for its assessment. Does this include documents subject to attorney-client privilege or work product protections?
- Stage 3: Obtaining an understanding of internal controls over financial reporting AS2 states that the auditor should obtain an understanding of the design of specific controls by applying procedures that include, *inter alia*, making inquiries of appropriate company personnel and inspections of company documents. Does this include inquiries of in-house counsel? Are in-house lawyers present when inquiries are made of other personnel? Should in-house lawyers give guidance to other personnel on how to respond? Do these inspections cover documents subject to attorney-client privilege or work product protections?
- Stage 4: Testing and evaluating design effectiveness of internal controls over financial reporting. Procedures the auditor performs to test and evaluate design effectiveness include making inquiries of appropriate company personnel and inspections of company documents. The questions arising in this stage are the same as those arising in Stage 3.
- Stage 5: Testing and evaluating operating effectiveness of internal controls over financial reporting. This stage raises the same issues as Stage 4.
- Stage 6: Forming an opinion on the effectiveness of internal controls over financial reporting. AS2 states that when forming an opinion on internal controls over financial reporting, the auditor should evaluate all evidence obtained from all sources. Does this include inquiries of in-house counsel or inspections of documents subject to attorney-client privilege or work product protections?

**b.** 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


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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?

**2. Use and reliance by auditors on the work product of counsel and other auditors**

**a.** AS2 states that in all audits of internal controls, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. The auditor may, however, use the work of others. To what extent do auditors rely on work performed by in-house and/or outside counsel?

**b.** 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?

## C. FOCUS ON FRAUD DETECTION

Fraud, like any unlawful activity affecting the corporate client, is naturally a matter of great importance to in-house counsel. Fraud is also a critical issue for auditors, especially given the fraud detection responsibilities vested in them by the PCAOB Standards. Therefore, it is relevant to discuss the working relationship between auditors and in-house counsel in the context of fraud detection.

**1. Responsibility for fraud prevention, deterrence and detection within the company**

**a.** Do corporate legal departments play a role in the design of programs and controls to prevent, deter, and detect fraud? Do corporate legal departments play a role in the implementing these programs?

**b.** Many larger companies typically have compliance officers who may or may not report through the legal department? How is the manner in which compliance and internal audit concerns are organized of concern to the lawyer/auditor relationship? How frequently do in-house counsel double as compliance officers? How do the roles of a compliance department and legal department differ? Does having in-house counsel play multiple roles in counseling the client, creating/managing/measuring the effectiveness of compliance efforts, and then


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advising on remedial measures and investigations in the event of compliance failures create the potential for conflicts of interest?

**c.** With respect to these issues: What are the various approaches that different corporate legal departments have adopted? How common is each of these approaches? What are best practices for corporate legal departments? What are the pros and cons of corporate legal departments 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?

**2. Auditors' responsibility in detecting fraud**

**a.** What type of information and documents do auditors typically request from the corporate legal department in connection with their efforts to detect fraud?

**b.** How are such requests addressed by corporate legal departments, particularly when they pertain to privileged material or attorney work product?

**c.** 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?

## D. IMPACT OF THE NEW PCAOB RULES

The issue for discussion is the extent AS5 can lead to an improved relationship between auditors and in-house counsel.

**1. Potential beneficial effects of AS5**

**a.** 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


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- 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)

**b.** Can these changes relieve some of the strain on the relationship between in-house counsel and auditors? If so, in what ways?

**2. Potential adverse effects of AS5**

**a.** 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?

**b.** Does the adoption of AS5 only three years after the adoption of AS2 create legal uncertainty?

**3. Related regulatory action**

**a.** On May 23, 2007, the SEC announced new interpretive guidance and adopted rules regarding compliance with Section 404 of the Sarbanes-Oxley Act. Will this SEC action affect the relationship between in-house counsel and auditors now that AS5 is in force? If so, how?

**b.** On May 17, 2007, the Department of the Treasury announced the creation of an Advisory Committee on the Auditing Profession. Is the work of this advisory committee likely to address any aspect of the relationship between in-house counsel and auditors now that AS5 is in force? If so, which ones?

**c.** Are there additional areas in which action by the PCAOB, SEC, or Treasury Department could further improve the relationship between in-house counsel and auditors?


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**Topic # 1: Records retention policies and their impact on the working relationship between auditors and company lawyers**

*Background*

The Sarbanes-Oxley Act imposes new duties with respect to document and records retention on both public corporations and auditors. The Act's focus on records retention includes both direct criminal penalties (Sections 802 and 1102) and audit documentation standards (Section 103).

In a widely reported case, the Supreme Court reversed Arthur Andersen's conviction for evidence tampering because the Court believed that the evidence tampering statute before them required the government to prove conscious wrongdoing. Subsequent enactment of Sections 802 and 1102 of the Sarbanes-Oxley Act, however, has amended the evidence tampering statute at issue in *Arthur Andersen v. U.S.* in such a way that can be interpreted to require a lesser *mens rea* (*i.e.*, criminal intent or mindset) for a conviction to be obtained under the statute in question. Specifically, pursuant to Section 802 individuals face a penalty of up to 20 years imprisonment as well as a fine for knowingly altering, destroying, mutilating, concealing, covering up, falsifying, or making a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the proper administration of any matter. Section 1102 imposes similar punishment for corruptly altering, destroying, mutilating, or concealing a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding.

With respect to audit documentation standards, Section 103 of the Act authorizes the PCAOB to adopt records retention standards for documents used in performing audits. Effective since October 2004, the PCAOB's Auditing Standard No. 3, *Auditing Documentation* ("AS3") establishes general requirements for documentation the auditor should prepare and retain in connection with audits of financial statements, internal control over financial reporting, and a review of interim financial information. The requirements AS3 imposes on auditors include obtaining and preserving documentation to demonstrate that the engagement complied with PCAOB standards, supporting the basis for the auditor's conclusions concerning every relevant financial statement assertion, and demonstrating that the underlying accounting records reconcile with the financial statements. Not surprisingly, since the new requirements went into effect, corporations are facing increased requests from auditors regarding access to both a wider range of corporate documents and more of them.

*Potential Issues For Further Discussion*

**CORPORATE POLICIES AND AUDITORS' NEEDS REGARDING RECORDS RETENTION**

Corporate executives, corporate legal departments and auditors approach records retention policies with different and sometime competing interests. For example, in-house counsel often are most interested in setting up centralized corporate records retention policies with potential litigation issues in mind; corporate managers want document policies that allow for efficient knowledge management, limited storage problems and expense, as well as maximum autonomy for individual record managers who need information; and auditors are most interested in their ability to conduct an audit with easy and complete accessibility of accurate corporate records. These different perspectives can lead to disagreements between the parties as to the best policies and practices governing both the scope or length of records retention and how information is stored, secured, and retrievable.

1. **In-house counsel's role in shaping management's corporate records retention policy**

   **a.** What role do corporate legal departments play in shaping a corporate records policy or a retention schedule? What role do corporate legal departments play in shaping a corporate policy with respect to preserving electronic material? How much consideration is given to the requirements auditors face in shaping a corporate records policy?

   **b.** What role do corporate legal departments play in preventing any violations of sections 802 and 1102 of the Act? How have sections 802 and 1102 changed corporations' records retention policies? Do responses to auditors' document requests ever raise concerns under section 802 or 1102?

   **c.** With respect to these issues: What are the various approaches that different corporate legal departments have adopted? How common is each of these approaches? What are best practices for corporate legal departments? What are the pros and cons of corporate legal departments 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?

2. **The relationship between in-house counsel and auditors with respect to records retention**

   **a.** Are companies' records retention policies and schedules consistent with the auditor's needs and requirements? If not, in what ways? How do accountants



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manage audits with a client whose corporate records retention policy may not permit the accountants to sufficiently satisfy requirements imposed by the Act?

   **b.** What role does the corporate legal department play when auditors request access to information subject to attorney-client privilege or work product protections? How are these requests handled?

   **c.** Do auditors request documents not retained by corporations? Do they request information that is not easily or conveniently retrievable? If so, are there easily implemented archiving or retrieval processes or procedures that would help solve these problems? What role does the legal department play in addressing auditors' requests for documents that have not been retained or that are not retrievable in a convenient or reasonable fashion?

   **d.** 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 replicable best practices we can identify? What are the pros and cons of corporate legal departments and audit firms taking an active role in preparing document management systems with these goals in mind? What problems or other issues may arise as a result of this focus on retrieval for audit purposes?

*Background Materials*


1. AS3 (PCAOB Release No. 2004-006, June 9, 2004)
2. *Audit Documentation: It's a Whole New World*, CPA Journal (June 2005)
3. *The Compliance Imperative: Managing Record Retention in a Rapidly Changing Regulatory Environment*, DM Review (June 2005)
4. *Record Retention and the Paperless Office*, The Risk Management Resource (AICPA) (Spring 2005).
5. *Tips for the Sarbanes-Oxley Learning Curve*, Journal of Accountancy (June 2004).




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# ACC's 2007 Blue Ribbon Panel on Improving the Working Relationship Between Lawyers and Auditors Serving the Corporate Client

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**Topic # 2: Liability and indemnification in the audit context, and their impact on the working relationship between lawyers and auditors**

*Background*

One area of intense focus in the audit context is the desirability and propriety of including indemnification clauses or limited liability clauses in auditors' engagement letters. The key issue is whether or not inclusion of these clauses impairs auditor independence.

Examples of clauses that may appear in engagement letters include the following:

- Auditor indemnified against claims based on auditor's negligence
- Auditor indemnified against claims based on knowing misrepresentation by audit client's management
- Auditor indemnified against claims based on audit client's negligence
- Auditor's liability limited to the amount of fees paid
- Limitation of period during which audit client could otherwise file claim
- Limitation on audit client's right to assign or transfer claim
- Exclusion of punitive damages
- Unsuccessful party to pay adversary's legal fees
- Auditor's liability limited to the amount of losses occurring during periods audited

The SEC, through its auditor independence requirements, has placed certain constraints on indemnification and limited liability clauses in engagement letters. Some U.S. states also have legislated limitations on such clauses. In addition, the Federal Financial Institutions Examination Council ("FFIEC") has issued guidance for financial institutions with respect to limitation of liability provisions in external audit engagement letters. Such auditor indemnification questions are rising with increasing frequency in other jurisdictions, as well.

A related issue regarding liability in the audit context is the legal exposure faced by in-house counsel. Because in-house counsel are now named as individual defendants in an increasing number of shareholder suits and government enforcement actions, there is new focus on the coverage (or lack thereof) afforded them by Directors and Officers ("D&O") liability insurance and Employed Lawyers professional liability insurance.



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*Potential Issues for Further Discussion*

## A. AUDITORS' ENGAGEMENT LETTERS

Drafting the terms of auditor engagement letters and of any indemnification clauses they might contain raises legal issues that fall within in-house counsel's area of expertise. Issues that can affect the relationship between in-house counsel and auditors include both the extent of in-house counsel's influence over the terms of engagement letters and any divergence between in-house counsel and auditors as to what these terms should be.

**1. In-house counsel's role in negotiating the terms of an auditor's engagement letter**

a. What role does the corporate legal department play in negotiating the terms of the auditor's engagement letter? How has the role of the corporate legal department changed since the Act was enacted, if at all, with respect to the engagement letter process?

b. What are the major terms, conditions, or other issues most difficult to negotiate between corporate legal departments and auditors when drafting the engagement letter? How commonly do they arise?

c. 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?

**2. Inclusion of auditor indemnification and/or limited liability clauses**

a. How often do auditors wish to include an indemnification or limited liability clause in the engagement letter? How is this typically handled by corporate legal departments?

b. What types of limited liability or indemnification provisions are most commonly sought? Do auditors and corporate legal departments attempt to limit auditors' liability in any ways other than through inclusion of clauses in engagement letters?

c. What are the problems that arise when these clauses are negotiated?

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d. 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?

**3. Impact of conflicting views of desirability and permissibility of these clauses**

a. What role do corporate legal departments play in interpreting the impact that different indemnification/limited liability clauses might have on auditor independence? What standards or guidelines do corporate legal departments follow? What impact do the AICPA and the FFIEC interpretations and advisories have on corporate legal departments?

b. How do auditors interpret the impact that different indemnification/limited liability clauses might have on auditor independence? What standards do auditors follow?

c. To what extent do the differences in opinions issued by professional organizations with respect to the relationship between indemnification/limited liability clauses and auditor independence impact the engagement letter process?

d. What issues arise as a result of the conflicting views regarding these clauses?

e. 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?

**4. Other issues arising beyond indemnification/liability in the retention context?**

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**B. INDEMNIFICATION OR LIMITS ON LIABILITY FOR IN-HOUSE COUNSEL**

The corporate accounting scandals earlier this decade have spawned a flurry of complex laws, regulations, and standards. Given the consequences that non-compliance can have for the very existence of the corporation, in-house counsel are exposed to increased personal risk of liability. Management of this risk could have an impact on the working relationship between in-house counsel and auditors.

**1. In-house counsel's changing role and the challenges in finding optimal protection**

a. How do companies seek protection for in-house counsel given their expanded role in matters relating to audits? What are the principal problems and challenges when seeking greater protection from such liability? What have companies been doing to address these concerns?

b. How has Sarbox Section 307, and its counterpart attorney-conduct rules in other jurisdictions beyond the US, impacted legal departments with respect to liability issues?

c. How do the issues arising from protection from such liability impact the role of the in-house counsel with respect to audits?

d. 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?

**2. Relationship with auditors given in-house counsel's focus on personal liability concerns and professional protection**

a. How has seeking protection or insurance for in-house counsel impacted the relationship between corporate legal departments and auditors?

b. Does insufficient or unsatisfactory protection or insurance for in-house counsel impact the working relationship between the legal department and auditors?

c. With respect to these issues: What are the various approaches that different corporate legal departments and audit firms have adopted? How common is each

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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?

*Background Materials*

1. PCAOB Standing Advisory Group Meeting, Emerging Issue – The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters (February 9, 2006).
2. PCAOB, Rule 3600T, Interim Independence Standards (May 12, 2006).
3. Robert J. Kueppers, *Addressing Auditor/Client Disputes in Engagement Letters: Cause for Concern or Much Ado About Nothing?*, Directors Monthly (October 2006).
4. "Understanding The Role of The Auditor in Defending Auditor Liability Cases," Foley Hoag LLP on behalf of The American Law Institute – American Bar Association Course of Study (May 3-4, 2007).
5. Laurie J. Sablak, *Cover Me*, Corporate Counsel (January 2004).
6. Eriq Gardner, *Naked As A Jaybird*, Corporate Counsel (September 2003).
7. "Indemnification and insurance coverage for in-house lawyers: What companies are doing," ACC (January 2004).



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## ACC's 2007 Blue Ribbon Panel on Improving the Working Relationship Between Lawyers and Auditors Serving the Corporate Client

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**Topic # 3: Internal investigations and their impact on auditor/lawyer working relationships**

*Background*

The Sarbanes-Oxley Act and similar corporate responsibility legislation regulating public company practices in other jurisdictions requires corporate management to assume more accountability and responsibility for internal fraud and other unlawful conduct. As a result, the number of "formal" internal investigations is increasing, complete with privileged documentation of investigations and findings. Sarbanes-Oxley also specifically requires companies 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." Accordingly, auditors are partially responsible for detecting and reporting suspicious financial activities and are thus under pressure to seek more information and demand documentation regarding the investigation and resolution of any possible wrongdoing from corporations. Attorneys conducting these investigations usually wish to keep their findings confidential under attorney-client privilege and work product protections. And an increasing number of investigations are either conducted or conducted in part under the supervision of the company's Chief Compliance Officer (CCO) or an internal audit function which is separate from the legal function, but which uses company lawyers or outside counsel to help conduct their work.

*Potential Issues For Further Discussion*

**A. AUDITORS' OBLIGATIONS TO NOTIFY CLIENTS OF POTENTIALLY ILLEGAL ACTS**

Section 10A of the 1934 Securities Exchange Act, added by the Sarbanes-Oxley 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.

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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 a role in that process? Is this a cause of tension between in-house counsel and auditors? If so, what are practical recommendations to improve the resulting report or process?

**B. LAWYERS' OBLIGATIONS TO INVESTIGATE, REMEDY AND REPORT ON ALLEGATIONS OF WRONGDOING**

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; the SEC codified these requirements in 17 CFR Part 205. The professional codes of conduct of every US states' bar have similar requirements in their version of ABA Model Rule 1.13, which therefore makes such responsibility a lawyer requirement regardless of whether the client is a public or private company/entity. Similar obligations exist in the ethical and exchange rules of Canada, Europe, many Pacific Rim, and other large and highly-regulated jurisdictions. While these requirements suggest that lawyers have obligations to report and remedy wrongdoing when their client is an entity, they do not suggest how privilege is to be maintained if the assumption is that such investigations will be subject to review by those outside the circle of privilege protection. Further, privilege standards and applicability to in-house counsel work varies by jurisdiction – a small but significant number of jurisdictions (beyond the US and Canada) do not recognize privilege as applying to in-house counsel / client relationships. And corporate attorney-client privilege is under attack by those who would investigate wrongdoing in the prosecutorial, enforcement and plaintiff's bar community.

1. How do these issues and the general momentum toward corporate "transparency" affect the lawyer/auditor relationship and what is reasonable for lawyers to withhold from production to auditors based on privilege protection concerns?

**B. CORPORATE POLICIES WITH RESPECT TO INTERNAL INVESTIGATIONS**

Internal investigations are relevant to in-house counsel because they involve potentially unlawful activity and are relevant to auditors because fraud and other unlawful conduct can impact the accuracy of an audit. Challenges may arise with respect to corporate policies regarding the detection, management, and reporting of internal investigations because there is a natural tension between auditors' desire for complete transparency and in-house counsel's desire to preserve confidentiality and attorney-client privilege.


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1. 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?

2. What triggers internal investigations? How do corporations staff, structure, and manage internal investigations? How do corporations document internal investigations? Are oral reports ever used in lieu of written reports? Are auditors aware how their clients manage internal investigations?

3. 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?

4. 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?

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

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

7. Have auditors' requests for documents generated in the course of internal investigations changed corporate policies with respect to the detection, management, and reporting of these investigations?

8. 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?


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## ACC's 2007 Blue Ribbon Panel on Improving the Working Relationship between Lawyers and Auditors Serving the Corporate Client

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**Topic # 4:** **Non-internal investigation attorney-client privilege issues in the audit context**

*Background*

A company's financial health can be significantly affected by items such as tax contingencies and litigation reserves. Therefore, the process of conducting an audit, by its very nature, requires auditors to consider legal issues. The most critical information regarding such legal issues, however, often is subject to attorney-client privilege and work product protections – while many companies would not be concerned to share these privileged materials with auditors, increasing (and indeed the majority of circuits') precedents suggest that material provided to auditors is material whose confidentiality has been waived: and waived to one is waived to all, including regulators and prosecutors, plaintiffs on the other side of law suits, and shareholder activists. At the same time, the heightened scrutiny auditors face when vouching for companies' financial statements and internal controls over financial reporting requires them to be increasingly vigilant in requesting access to privileged materials or attorney work product. Surveys show that the scope of requests and the volume of material sought by auditors has increased since the passage of the Sarbanes-Oxley Act.

Some of the statutory provisions, regulations and standards that have created the most debate on the issue of attorney-client privilege are the following:

- Section 303 of the Sarbanes-Oxley Act. This provides, *inter alia*, that is 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. This section 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 its agent. To satisfy their obligations under these provisions, corporate legal departments perform internal investigations that result in privileged communications within the corporation. Auditors often request access to these communications.

- Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit. This statement issued by the 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 1934. This section 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." It also requires auditors to report evidence of such illegal acts not only to management but also to the SEC if management fails to remedy the situation. 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.

*Potential Issues For Further Discussion*

**PRIVILEGE ISSUES IN CONNECTION WITH 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. The conduct of audits in both categories can affect the relationship between auditors and in-house counsel because auditors may request documents potentially covered by attorney-client privilege or the attorney work product doctrine. While each type of audit may give rise to distinct issues and the regulatory frameworks applying to each are not identical, they are addressed together below because the questions they raise overlap substantially.

**1. Auditors' requests for documents**

**a.** 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



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- 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

**b.** What types of materials do auditors request from corporate legal departments with respect to each subject matter when performing audits of internal controls over financial reporting? Do corporate legal departments and auditors negotiate the terms of auditors' requests in advance (*e.g.* at the time of the engagement)?

**c.** What proportion of the requested documents and information is confidential? What proportion of the requested documents and information is covered by attorney-client privilege or the attorney work product doctrine?

**d.** 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?

**2. Corporate legal departments' responses to auditors' requests for potentially privileged documents**

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

**b.** Do corporate legal departments and auditors negotiate the terms of responses to auditors' requests in advance (*e.g.* at the time of the engagement)? Do corporate legal departments insist on the inclusion in auditor engagement letters of standard terms requiring the auditors to preserve confidentiality of information received and notify company of any requests for such information by third party?

**c.** 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)?

**d.** What has been the impact on corporate legal departments of Section 303 of the Sarbanes-Oxley Act and SEC Rule 13b2-2 (having the effect of making in-house counsel, among others, liable for misleading an auditor if counsel should have known that doing so could result in rendering the corporation's financial statements materially misleading)?

**e.** What has been the impact on corporate legal departments of the SEC regulations implementing Section 307 of the Sarbanes-Oxley Act (potentially leading to the creation of internal investigations documents that may be requested by auditors)?



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f. What has been the impact on corporate legal departments of Section 404 and the PCAOB Auditing Standards and rules?

g. What is the prevailing view as to whether and to what extent the ABA-AICPA Treaty remains alive and relevant? Do auditors and corporate legal departments views differ on this issue?

h. Do corporate legal departments work with auditors to identify what information they really need in order to find a way to provide it without giving access to confidential information, privileged materials, and attorney work product?

i. Do corporate legal departments give auditors the same information they would give to the Board's audit committee?

j. Do corporate legal departments allow auditors to review quarterly litigation summaries prepared for management?

k. Do corporate legal departments ever suggest that auditors hire outside counsel to advise them on the appropriateness of the corporate legal department's representations to the auditors, as an alternative to providing the auditors with privileged documents and/or work product?

l. When responding to auditors' requests, do corporate legal departments handle materials subject to attorney-client privileged differently from materials subject to work product protections?

m. How do corporate legal departments and auditors address the fact that not all states recognize the existence of a privilege covering accountant-client communications?

n. 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?

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# ACC's 2007 Blue Ribbon Panel on Improving the Working Relationship Between Lawyers and Auditors Serving the Corporate Client

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**Topic # 5:** **Evolving standards of care to meet new PCAOB rules and their impact on the working relationship between lawyers and auditors**

*Background*

The Sarbanes-Oxley Act and similar corporate responsibility regulations in a number of jurisdictions have increased auditors' responsibilities in the performance of audits of public companies and places auditor decisions to certify a company's books and performance under heightened scrutiny. Notably, the Sarbox created the Public Company Accounting Oversight Board ("PCAOB") which it entrusted with the task of registering, inspecting, investigating, and disciplining auditors. The PCAOB is also required by section 103 of the Act to adopt auditing, quality control, and independence standards and rules to be followed by auditors. While the PCAOB's rules only "regulate" public company audit standards, most auditing firms would agree that they consider these standards as the appropriate level of scrutiny applicable to all of their audit clients, even those in the private company or non-profit entity realm.

Since 2003, the PCAOB adopted five Auditing Standards and related rules (hereinafter, these standards and rules are referred to collectively as the "PCAOB rules"). The following is a brief summary of these 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.



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- 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 auditors criticize the PCAOB rules for being excessively strict and considerably burdensome to comply with, while large public companies complain that the resulting increase in the scope and depth of audits has substantially inflated associated costs. Private companies, non-profits, and smaller entities without the resources to meet these standards of behavior suggest that already thin margins are consumed in a disproportionate manner when complying with higher audit standards and scrutiny. Moreover, during the first few years of the PCAOB's existence, it openly stated its intention to use its disciplinary powers aggressively, especially wherever the Board saw evidence that an auditor failed to detect violations of the law, in general, and fraud, in particular. In order to avoid disciplinary sanctions, auditors now request more transparency from the companies they audit and demand access to more documents than ever. In particular, there is evidence of a significant increase in requests from auditors for documents that may be covered by attorney-client privilege or the attorney work product doctrine. This can create friction between auditors and in-house counsel, the latter being highly reluctant to share privileged material or work product with a third party because such an act typically would waive these protections.

In addition, Section 404 of the Sarbanes-Oxley Act requires auditors to attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. Because in-house counsel often double as compliance officers or work closely with them, internal controls audits entail a thorough review of structures that have sometimes been designed and implemented, at least in part, by in-house counsel. This also can lead to differences of opinion and occasional tension between in-house counsel and auditors.

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It should be noted, however, that the SEC recent approval of AS5 may help reduce some of the existing tension between auditors and in-house lawyers' respective positions. In particular, by allowing auditors to devote less attention to low risk areas and scale their audit according to the size and complexity of the company, AS5 may reduce some of the pressure auditors have felt and could, in turn, limit their requests for access to privileged documents or attorney work product.

*Potential Issues for Further Discussion*

**A. MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROLS AND AUDITORS' DUTY TO ATTEST TO, AND REPORT ON THIS ASSESSMENT**

Before they attest to management's assessment, auditors may wish to have access to the advice and documents provided by in-house and outside counsel to management. In-house counsel, however, may be reluctant to meet such requests to the extent they involve information subject to attorney-client privilege and work product protections. In addition, in some instances in-house counsel may be actively involved in the evaluation of internal controls in a management (rather than a legal) capacity, may be tasked with supporting and responding to the Board's audit committee, or may be working under the direction of internal audit or compliance leaders outside of the law department. For all of these reasons, management's assessment of the effectiveness of internal controls may be touched by in-house counsel, and thus requires auditors working with these issues to interact with lawyers serving the company in a variety of capacities.

1. **In-house counsel's involvement in management's assessment**

   a. Do corporate legal departments play a role in establishing the framework under which management is required to base its assessment of the effectiveness of the companies' internal controls over financial reporting pursuant to AS2?

   b. Is it common for companies' in-house lawyers to be involved in the actual evaluation by management of the effectiveness of internal controls?

   c. Do corporate legal departments provide management with evidence and documents in support of this evaluation?

   d. What is the role of the corporate legal department in drafting/reviewing management's assessment of the effectiveness of the company's internal controls over financial reporting, to be included in the company's annual report? What is the role of the corporate legal department in drafting/reviewing management's quarterly certifications under section 302 of the Sarbanes-Oxley Act?



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   e. With respect to these issues: What are the various approaches that different corporate legal departments have adopted? How common is each of these approaches? What are best practices for corporate legal departments? What are the pros and cons of corporate legal departments 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?

2. **Communications between in-house counsel and auditors regarding management's assessment**

   a. Is management's assessment and the subsequent report of the auditor on management's assessment the subject of communications between the company's in-house lawyers and its auditors? If so, are communications written? Oral? When and how often do they take place?

   b. To the extent corporate legal departments provide management with evidence and documents in support of its evaluation of the company's internal controls over financial reporting, do auditors typically request that the legal department share any such documents or evidence with them? How are such requests addressed, particularly when they pertain to privileged material or attorney work product?

   c. What is the role of the corporate legal department in drafting/reviewing the written representations that an auditor is required to obtain from management pursuant to AS2?

   d. AS2 requires the auditor to communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit, prior to the issuance of the auditor's report on internal controls over financial reporting. What is in-house counsel's role, if any, in reviewing and responding to such communications?

   e. 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?



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**B. RELATIONSHIP BETWEEN AUDITORS AND IN-HOUSE COUNSEL IN THE CONTEXT OF AN AUDIT OF INTERNAL CONTROLS OVER FINANCIAL REPORTING**

An audit of internal controls over financial reporting consists of six stages (identified below). At each of these stages, auditors may direct certain inquiries to in-house counsel or request access to privileged materials or attorney work product. Auditors also may rely to some extent on work performed by counsel related to internal controls. Each of these issues may affect the working relationship between auditors and in-house counsel.

1. **Shifting nature of the relationship over the different steps of the audit process**

   a. What is the nature of the relationship between in-house counsel and auditors at the various stages of the auditors' mission? What problems or other issues may arise in the relationship between auditors and in-house counsel in these various areas?

   - Stage 1: Planning the engagement. Among other things, AS2 states that when planning the audit of internal controls over financial reporting, the auditor should evaluate how "legal or regulatory matters of which the company is aware" will affect the auditor's procedures. What obligations do corporate legal departments have to identify such legal or regulatory matters? What obligations are there to share evaluations of such legal or regulatory matters? Do these obligations change depending upon the auditor's conduct (*e.g.*, if the auditor makes a formal request)?
   - Stage 2: Evaluating management's assessment process. For example, AS2 requires the auditor to evaluate whether management's documentation provides reasonable support for its assessment. Does this include documents subject to attorney-client privilege or work product protections?
   - Stage 3: Obtaining an understanding of internal controls over financial reporting AS2 states that the auditor should obtain an understanding of the design of specific controls by applying procedures that include, *inter alia*, making inquiries of appropriate company personnel and inspections of company documents. Does this include inquiries of in-house counsel? Are in-house lawyers present when inquiries are made of other personnel? Should in-house lawyers give guidance to other personnel on how to respond? Do these inspections cover documents subject to attorney-client privilege or work product protections?
   - Stage 4: Testing and evaluating design effectiveness of internal controls over financial reporting. Procedures the auditor performs to test and evaluate design effectiveness include making inquiries of appropriate company personnel and inspections of company documents. The questions arising in this stage are the same as those arising in Stage 3.

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   - Stage 5: Testing and evaluating operating effectiveness of internal controls over financial reporting. This stage raises the same issues as Stage 4.
   - Stage 6: Forming an opinion on the effectiveness of internal controls over financial reporting. AS2 states that when forming an opinion on internal controls over financial reporting, the auditor should evaluate all evidence obtained from all sources. Does this include inquiries of in-house counsel or inspections of documents subject to attorney-client privilege or work product protections?

   b. 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?

2. **Use and reliance by auditors on the work product of counsel and other auditors**

   a. AS2 states that in all audits of internal controls, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. The auditor may, however, use the work of others. To what extent do auditors rely on work performed by in-house and/or outside counsel?

   b. 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?

**C. FOCUS ON FRAUD DETECTION**

Fraud, like any unlawful activity affecting the corporate client, is naturally a matter of great importance to in-house counsel. Fraud is also a critical issue for auditors, especially given the fraud detection responsibilities vested in them by the PCAOB Standards. Therefore, it is relevant to discuss the working relationship between auditors and in-house counsel in the context of fraud detection.

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1. **Responsibility for fraud prevention, deterrence and detection within the company**

   a. Do corporate legal departments play a role in the design of programs and controls to prevent, deter, and detect fraud? Do corporate legal departments play a role in the implementing these programs?

   b. Many larger companies typically have compliance officers who may or may not report through the legal department? How is the manner in which compliance and internal audit concerns are organized of concern to the lawyer/auditor relationship? How frequently do in-house counsel double as compliance officers? How do the roles of a compliance department and legal department differ? Does having in-house counsel play multiple roles in counseling the client, creating/managing/measuring the effectiveness of compliance efforts, and then advising on remedial measures and investigations in the event of compliance failures create the potential for conflicts of interest?

   c. With respect to these issues: What are the various approaches that different corporate legal departments have adopted? How common is each of these approaches? What are best practices for corporate legal departments? What are the pros and cons of corporate legal departments 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?

2. **Auditors' responsibility in detecting fraud**

   a. What type of information and documents do auditors typically request from the corporate legal department in connection with their efforts to detect fraud?

   b. How are such requests addressed by corporate legal departments, particularly when they pertain to privileged material or attorney work product?

   c. 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?

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**D. IMPACT OF THE NEW PCAOB RULES**

The issue for discussion is the extent AS5 can lead to an improved relationship between auditors and in-house counsel.

1. **Potential beneficial effects of AS5**

   a. 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)

   b. Can these changes relieve some of the strain on the relationship between in-house counsel and auditors? If so, in what ways?

2. **Potential adverse effects of AS5**

   a. 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?

   b. Does the adoption of AS5 only three years after the adoption of AS2 create legal uncertainty?

3. **Related regulatory action**

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**a.** On May 23, 2007, the SEC announced new interpretive guidance and adopted rules regarding compliance with Section 404 of the Sarbanes-Oxley Act. Will this SEC action affect the relationship between in-house counsel and auditors now that AS5 is in force? If so, how?

**b.** On May 17, 2007, the Department of the Treasury announced the creation of an Advisory Committee on the Auditing Profession. Is the work of this advisory committee likely to address any aspect of the relationship between in-house counsel and auditors now that AS5 is in force? If so, which ones?

**c.** Are there additional areas in which action by the PCAOB, SEC, or Treasury Department could further improve the relationship between in-house counsel and auditors?

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# Tools You Can Use

By Michael D. Cahn
and Michael J. Scanlon

IT SEEMS INNOCENT ENOUGH—one of your company's subsidiaries in Indonesia has been outsourcing its bookkeeping for the past few years. No problem, right? But then you learn that the same firm that has been providing these bookkeeping services is an affiliate of your outside auditor. The antennae start to go up. You wonder: Is this an auditor independence problem? Does the outside auditor know about this potential conflict? Should the audit committee get involved in this situation? Assuming there is an independence concern, what are the consequences and how can you remedy the situation?

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Resolving questions concerning the outside auditor's independence has always been an important part of the audit process, but until recently it might have been seen as somewhat routine. However, developments over the past few years—in particular, the passage of the Sarbanes-Oxley Act of 2002—have made the issue of auditor independence a primary concern for audit committees and company management. Because the Act makes the audit committee "directly responsible" for the appointment, compensation and oversight of the outside auditor, the audit committee must play a more active role than ever in overseeing a company's relationship with its outside auditor.[1]

In-house counsel can also play a crucial role in assisting the audit committee in this task. As a starting point, you should ensure that the audit committee understands the auditor independence rules, including the requirements for audit committee pre-approval of services to be provided by the auditor. Imparting this understanding is no easy task given the complexity of the auditor independence rules as applied in today's complex business environment. But this may not be enough. It also is imperative that you help ensure that the individuals who will have frequent interaction with the auditor—such as your chief financial officer and controller—also fully understand the auditor independence rules and the consequences that will result if the auditor's independence is deemed impaired. Achieving that level of understanding is a daunting task, but one for which you can provide significant assistance.

### AUDITOR INDEPENDENCE BEFORE AND AFTER SARBANES-OXLEY

Many people share the common misperception that the auditor independence rules came of age with the passage of the Sarbanes-Oxley Act. While Sarbanes-Oxley affected some important changes to these rules, the guidelines governing an auditor's relationship with its client evolved well before the Act's passage. For decades, the Securities and Exchange Commission (SEC) has required that all audited financial statements included in annual reports or registration statements filed by public companies be audited by independent auditors. The criteria for determining the independence of auditors developed over the years in informal fashion, with the SEC staff issuing non-binding guidance from time to time in the form of no-action letters or interpretive releases. However, in 2000, after a sometimes contentious rulemaking process, the SEC issued a comprehensive set of rules governing auditor independence. These rules were modified and expanded in 2003 with a further round of SEC rulemaking that was mandated by Sarbanes-Oxley; as a result, the independence rules that are in effect today are largely a combination of the 2000 and 2003 rules.[2]

The SEC's current rules governing auditor independence include both general and specific criteria for assessing an auditor's independence. Starting with the general standard, an auditor will not be recognized as independent "if the accountant is not, or a reasonable investor knowing all the relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement."[3] This general standard dictates that the auditor must be independent in fact and appearance, and lays the foundation for the specific categories of relationships that are further proscribed by the rules. The general standard also applies in circumstances that are not expressly covered by any of the rules addressing the specific categories of relationships. Consequently, even though the rules may not appear to cover your particular situation, you must consider how the general standard might apply before concluding that your auditor's independence will not be deemed impaired.[4]

Prior to 2000, the SEC's auditor independence rules were uniquely focused on this general standard. While one could turn to various resources in the pre-2000 era to analyze the manner in which the SEC would apply the general set of criteria in any given situation, the analysis of such issues was based more on lore than law. To infuse this critical analysis with a greater level of certainty, the SEC formally identified specific categories of prohibited relationships as part of the 2000 and 2003 auditor independence rulemaking process.[5] These specific standards govern the following types of relationships between the outside auditor and the audit client: (1) financial relationships, (2) employment relationships, (3) business relationships, and (4) the provision of non-audit services by the outside auditor to the audit client.

THE RULES ON FINANCIAL RELATIONSHIPS IMPOSE LIMITATIONS ON DIRECT AND MATERIALLY INDIRECT INVESTMENTS, INVESTMENTS IN COMMON WITH AUDIT CLIENTS, BROKER-DEALER RELATIONSHIPS, DEBTOR-CREDITOR RELATIONSHIPS, AND INSURANCE PRODUCTS ISSUED BY CLIENTS.

The rules also identify numerous sub-categories of relationships within each of the broader categories that may be deemed to impair independence. In considering the relationships identified in these subcategories, you always should bear in mind that the rule's use of the term "audit client" includes all affiliates of the audit client, which generally means any entity that controls, is controlled by, or is under common control with, your company.[6] Thus, when evaluating whether the rules apply to a particular situation, you should consider the relationships between your company and the auditor, as well as the relationships between your auditor and subsidiaries, equity investments (including joint ventures), and other controlled entities. Similarly, the definition of "audit firm" in the SEC's rules includes not just the firm that is actually auditing your company but also associated entities of that firm, which might operate under different names in various countries.[7]

#### Financial Relationships

The rules on financial relationships impose limitations on direct and materially indirect investments, investments in common with audit clients, broker-dealer relationships, debtor-creditor relationships, and insurance products issued by clients.[8] For example, under the SEC's auditor independence rules, your audit firm and its accountants clearly cannot hold direct investments—stocks, bonds, notes, options, or other securities—in your company during the period of the audit engagement. Your auditor's independence may also be deemed to be impaired if the audit firm makes an investment in your company through an intermediary under its control.

#### Employment Relationships

The rules also prohibit employment of current professional personnel of an outside auditor from being employed by the audit client or serving on the audit client's board of directors. This prohibition may seem obvious enough, but situations may inadvertently arise that implicate this rule. For example, let's say that a senior financial officer at one of your subsidiaries in Malaysia resigns during a critical financial reporting period, and local management of your subsidiary asks a senior accountant from your auditor's affiliate in Kuala Lumpur to temporarily perform the manager's duties until the press of work subsides. This may sound innocent enough, but you now have a significant auditor independence situation on your hands.

Similarly, the auditor's independence could be deemed impaired if a close family member of a partner or a professional employee of the auditor serves in an accounting role or financial reporting oversight role (a position where he or she has influence over the content of your accounting records).[9] In addition, as part of Sarbanes-Oxley, Congress expanded the conflict of interest principles governing employment by former audit firm personnel, providing that independence will be impaired unless there is a one-year cooling off period before a member of the audit engagement team can begin working with the client in certain key financial positions.[10] The "one-year" cooling-off period is somewhat of a misnomer, however, because the rules adopted by the SEC to implement this provision can extend the cooling-off period to up to 23 months, depending on when

the individual left the audit firm and whether he or she was working at the firm at the time the firm commenced its audit procedures for your current audit.[11]

**Business Relationships**

The auditor independence rules also severely restrict the extent to which your company is permitted to enter into business relationships with its auditor. Specifically, an auditor's independence will be deemed impaired when the auditor has a direct or material indirect business relationship with an audit client.[12] This aspect of the rules is sometimes difficult to apply in practice given the rule's subjective construction of what constitutes a material indirect business relationship. As a general matter, however, you should be alert to the potential for an independence violation when you see that your company is being asked to provide a product or service to your auditor that you know to be material either to the auditor or to your company.

Joint business ventures and prime/subcontractor relationships between an auditor and your company also are off limits under this provision of the auditor independence rule. Despite the apparent breadth of its prohibitions, the rule is not intended to limit ordinary course transactions.[13] For example, if your company is selling off-the-shelf software to numerous customers, you would be permitted to sell the same product to your auditor—unless the auditor is materially reliant on the software, in which case further consideration would need to be given to whether the sale would present an independence problem.

**Non-Audit Services**

The portion of the auditor independence rules that has received the most attention since the passage of Sarbanes-Oxley pertains to restrictions on an auditor's ability to provide non-audit services to its client. Most of these scope of service restrictions, however, had already been implemented by the SEC as part of its 2000 rulemaking. The provisions include restrictions on the several types of non-audit services (*see* "Don't Go There," this page, for a complete list). Congress affirmed the restrictions on these services when it passed the Sarbanes-Oxley Act, and merely added expert services to the list of prohibited engagements.[13] In addition, Congress authorized the Public Company Accounting Oversight Board (PCAOB) to supplement the proscriptions on non-audit services.[14] Importantly, Sarbanes-Oxley clarified that audit firms may continue to provide tax services to their clients, although some qualifications to this principle that have been articulated by the SEC. (See "A Tax Service by Any Other Name . . . ," next page, for a discussion of these limitations.)

## Don't Go There

### Restrictions on Non-Audit Services

The SEC's auditor independence rules set forth 10 particular non-audit services that will be deemed to impair the auditor's independence. Although the rules governing these restricted services are not absolute in all cases (for example, some of the restrictions include an exception if it is reasonable to conclude that the results of these services will not be subject to audit procedures during a financial statement audit), the circumstances where these types of services can be provided by your outside auditor are very limited. Thus, your company should refrain from engaging the independent auditor to perform the following services, unless it is clear that the circumstances would permit such an engagement:

- Bookkeeping or other services related to your accounting records or financial statements,
- Financial information systems design and implementation,
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports,
- Actuarial services,
- Internal audit outsourcing services,
- Management functions, including acting (temporarily or permanently) as a director, officer or employee of your company or performing any decision-making, supervisory or ongoing monitoring function for a company,
- Human resources functions,
- Broker-dealer, investment adviser or investment banking services,
- Legal services, *i.e.*, services that could be provided only by someone qualified to practice law in the jurisdiction in which the service is provided, and
- Expert services unrelated to the audit, including the provision of an expert opinion or other expert service. (In legal proceedings, however, the independent accountant is permitted to provide factual accounts of work performed and can explain positions taken during the performance of any services provided for your company.)

When formulating rules implementing the auditor independence provisions of Sarbanes-Oxley, in 2003, the SEC modified some of the exceptions to the scope of service restrictions. For example, the rules eliminated an exception that allowed bookkeeping services if the services were provided in an emergency situation. On the other hand, the SEC's rules now allow an auditor to provide bookkeeping, appraisal or valuation services, actuarial services, and internal audit services, when "it is reasonable to conclude that the results of these services will not be subject to audit procedures" during a financial statement audit.[15] In these situations, the SEC has indicated that it is comfortable with the auditor providing the otherwise prohibited service because the auditor will not be auditing its own work.[16]

Another important exception set forth in the rules allows audit firms to evaluate the internal control systems of their audit clients for purposes of recommending changes to these systems and processes. This is a significant development because under Section 404 of Sarbanes-Oxley, your auditor must attest to management's evaluation of your company's internal control over financial reporting. By allowing the auditor to evaluate these internal controls in advance of the attestation and recommend changes where appropriate, this exception should minimize the number of instances in which a company is surprised by an adverse attestation report from the auditor. Your auditor, however, still cannot design or implement your internal accounting systems or risk management controls because these services would be deemed to impair independence.

## Tackling an Expanded Pre-Approval Role

The Sarbanes-Oxley Act's most important modification to the auditor independence regime is the enhancement of the audit committee's role in overseeing and monitoring the auditor's independence. Prior to Sarbanes-Oxley, the audit committee was responsible for evaluating the outside auditor's independence in view of the services provided by the auditor.[17] With the passage of Sarbanes-Oxley, Congress considerably expanded this responsibility by making the audit committee "directly responsible" for the appointment, compensation, and oversight of the outside auditor. Congress also made one element of this oversight responsibility more concrete by requiring that the audit committee pre-approve the audit and all non-audit services provided by the outside auditor.[18]

Obviously, understanding the scope of the auditor independence rules is critical for all persons involved in the audit process. As in-house counsel, you can assist the audit committee in this task by imparting your understanding of the applicable regulations when an auditor independence issue arises. A firm grasp of the auditor independence rules also ensures a smooth execution of the pre-approval process, and will enable you actively to assist your audit committee in developing a sensible and practical pre-approval strategy for the committee.

Before engaging the auditor to perform audit or non-audit services, the audit committee now must pre-approve the provision of those services. Previously, no such affirmative oversight steps were required.[19] This rule means exactly what it says—the approval must be obtained *before* the auditor is engaged for the service; subsequent ratification is not sufficient.[20] The audit committee can

## A Tax Service by any Other Name . . .

The Sarbanes-Oxley Act provides that an accounting firm does not impair its independence by providing tax services that are pre-approved by the audit committee. In its release adopting auditor independence rules under Sarbanes-Oxley, the SEC reiterated its own position that an accounting firm can continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients without impairing its independence. However, the release warns that merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence. In particular, the release notes that an accountant's independence could be deemed to be impaired if the accountant is retained to structure a transaction initially recommended by the accountant—the sole purpose of which is tax avoidance and the tax treatment may not be supported by the Internal Revenue Code and related regulations.

implement a pre-approval process in one of two ways: by expressly pre-approving the specific engagement at an in-person or telephone meeting of the committee, or by establishing pre-approval policies and procedures that set forth the manner in which specific services are approved and in some instances, the manner in which certain categories of services are pre-approved. Many large corporations favor the latter option because it affords the audit committee greater flexibility in pre-approving outside auditor services.

**CRAFTING AN ACCEPTABLE PRE-APPROVAL POLICY FOR YOUR AUDIT COMMITTEE IS NOT AS SIMPLE A TASK AS YOU MIGHT EXPECT. NOT ONLY MUST A POLICY ADDRESS THE SEC'S PRE-APPROVAL RULES, BUT IT MUST ALSO COMPORT WITH INFORMAL GUIDANCE ISSUED BY THE SEC STAFF.**

**The Pre-Approval Three-Step**

Crafting an acceptable pre-approval policy for your audit committee is not as simple a task as you might expect. Not only must a policy address the SEC's pre-approval rules, but it must also comport with informal guidance issued by the SEC staff.

Fundamentally, a pre-approval policy must satisfy three basic requirements: (1) the policy must be detailed as to the particular services to be provided by the outside auditor; (2) the policy must evidence that the audit committee is informed of each service that is being pre-approved, and; (3) the policy cannot delegate the audit committee's responsibilities to management.[21]

**Detailing the Service**

When crafting a pre-approval policy, you should describe the services that are being pre-approved under the policy with as much detail as possible. One fairly common practice that audit committees already employ to satisfy this requirement is to attach an appendix to the policy specifying the services that are being pre-approved. In the appendix, services should be broken into categories—audit, audit-related, tax, and other services—and should be accompanied by a specific description of the services that the auditor will provide. For example, if the audit committee is seeking pre-approval for a service that falls under the audit-related category, such as audits of your company's employee benefit plans, it is helpful to specify the actual plans that will be audited. Similarly, if the appendix includes a category for tax compliance services, you should consider including as much detail as possible regarding the type of tax compliance services—*e.g.*, state tax filing services, expatriate tax services, or VAT tax services—rather than simply including it as a line item designated as "tax compliance" services. These recommendations are based on indications from the SEC staff that a pre-approval policy will not be viewed as acceptable if the policy provides for what the SEC views as broad, categorical approvals, such as "tax compliance" services.[22]

As a means of providing the appropriate level of detail in the policy and demonstrating effective oversight of the outside auditor, many audit committees are drafting pre-approval policies that include the terms of engagement and the fee thresholds for the various types of services for which pre-approval is being sought. While the fee threshold cannot be the only basis used to pre-approve services, it is acceptable and useful to have fee thresholds that correspond to the different services. In addition, to avoid perpetual pre-approval, most policies provide that the pre-approval granted under the policy will extend for a period of one year, unless otherwise indicated. While it is not always easy to draft a policy that is sufficiently detailed, there is a simple rule of thumb: Read the description of the service in the policy, and ask yourself whether management would need to make a judgment call regarding whether an engagement falls within the pre-approved category. If this judgment call has to be made, then—according to the SEC staff—the policy may not be sufficiently detailed as to the particular services provided.[23] In such a case, the audit committee would need to pre-approve the specific engagement.

**Keeping the Audit Committee Informed**

By including a sufficient level of detail regarding a particular service, you will also help to ensure that the policy satisfies the second pre-approval policy requirement—keeping the audit committee



informed about the particular services to be provided by the auditor. The SEC staff has stated that when seeking pre-approval of services that are listed in a policy, it is appropriate to provide the audit committee with detailed back-up documentation regarding the specific services that are to be provided.[24] It is not exactly clear what the SEC staff has in mind when it refers to such documentation, but it might, for instance, include a detailed description of the particular work to be done, supplemented by materials such as draft engagement letters and existing summaries or outlines for the planned projects. To keep the audit committee informed, the policy can also include a provision that the audit committee will be presented with materials at its regularly scheduled meetings that provide an update on the status of pre-approved services and fees charged for those services.

**IF YOUR COMPANY HAS NUMEROUS SUBSIDIARIES AND/OR JOINT VENTURES, YOU SHOULD BE THINKING ABOUT WHETHER OR NOT THE PROVISION OF SERVICES TO THESE AFFILIATES BY THE AUDITOR WOULD IMPLICATE THE PRE-APPROVAL REQUIREMENTS.**

**Restriction on Delegation to Management**

The third pre-approval policy requirement is that the policy not delegate responsibilities to management. To satisfy this requirement, many audit committees draft pre-approval policies that contain a specific disclaimer that the audit committee is not delegating any of this pre-approval responsibility to management. The audit committee also may wish to provide that all engagements of the auditor be subject to formal engagement letters and that, in instances where the audit committee has pre-approved the service but has not itself executed the engagement letter, only certain company officers, such as the CFO or Controller, will have the authority to execute such engagement letters. This limited delegation of authority to your CFO or Controller should provide that all proposed engagements of the auditor will be approved by one of those officers or some other gatekeeper designated by the audit committee to execute such letters. Upon receiving a request for a specific engagement, this designated officer should determine if the engagement already has been pre-approved by the audit committee. If it has not, then the officer must seek pre-approval from the audit committee before the auditor can be engaged. Because the audit committee cannot delegate its pre-approval authority to management, this officer must present the engagement to the audit committee if there is any question as to whether the engagement is authorized.

**Going Beyond Pre-Approval Basics**

In addition to incorporating the SEC's three basic requirements into the audit committee's pre-approval policy, there are several other steps that you should consider. For example, if you want to build additional flexibility into the policy, include a provision that allows the audit committee to delegate specific pre-approval authority to one or more members of the audit committee. Under the SEC rules, if this delegation option is elected, the member or members approving the specific engagement must then report on this action at the next audit committee meeting.

Similarly, if your company has numerous subsidiaries and/or joint ventures, you should be thinking about whether or not the provision of services to these affiliates by the auditor would implicate the pre-approval requirements, and, if so, how the services that are intended to be provided to these affiliates should be pre-approved. In other words, what do you know about the services to be provided? And, what should the audit committee know about these services? Your knowledge of the auditor independence rules will be particularly helpful in these situations as you learn about the services and consider whether there are or may be any issues surrounding the services that could implicate the auditor independence rules.

Additionally, consider whether your pre-approval policy should cover audit services provided to an affiliate by an audit firm that is not associated with your principal outside auditor. Pre-approval for such services is not required under the auditor independence rules, but section 301 of Sarbanes-Oxley does mandate that the audit committee is

responsible for the "appointment, compensation, and oversight of the work of any *registered public accounting firm* employed by the issuer . . . for the purpose of preparing or issuing an audit report or related work."[25] Thus, for example, as expressed in recent guidance from the SEC staff, if a subsidiary of your company in another country uses an audit firm that is not affiliated with your principal outside auditor to provide statutory audit services, and that firm is registered with the Public Company According Oversight Board (PCAOB), your audit committee should be approving the appointment of that firm to provide audit services to the subsidiary.[26] As noted by the SEC staff, however, failure of the audit committee to pre-approve audit services provided by another audit firm will not affect the independence of the principal auditor.[27]

**IN THE EVENT AN AUDITOR INDEPENDENCE SITUATION ARISES, YOU SHOULD BE PREPARED TO PLAY A CRITICAL ROLE IN MANAGING THE SITUATION. THE MOST IMPORTANT STEP IN THIS PROCESS IS TO ESTABLISH AND MAINTAIN COMMUNICATION.**

You also can aid the audit committee in its oversight of the outside auditor by communicating with the outside auditor before final adoption of the pre-approval policy. Any concerns voiced by the auditor regarding the policy can be discussed with the audit committee at that time and any changes, if merited, can be made. Once the audit committee is satisfied with the policy, the audit committee must formally adopt it; separate board approval of the policy is not required.

It is important to note that your work is not done when the policy is adopted. You should pay particular attention to the manner in which the policy is being implemented over the next few years in order to identify ways to improve and enhance the policy, both from the perspective of the audit committee and management. In addition to monitoring whether the policy is providing a useful and efficient oversight tool, you also should work with the audit committee, management, and the outside auditor to monitor adherence to the standards set forth in the policy.

### NAVIGATING INDEPENDENCE CONCERNS

Some events are just beyond your control. No matter how clear your understanding of the auditor independence rules and how effective the audit committee's oversight of the relationship with the outside auditor has been (including through application of the pre-approval policy), you may still have to confront a potential auditor independence issue. This is particularly true given the complexity of both the auditor independence rules and today's business environments. In addition, it is not inconceivable that auditor independence issues could arise as a result of the PCAOB audit firm inspection process, as this supervisory body examines the manner in which firms are providing non-audit services to audit clients.

In the event an auditor independence situation arises, you should be prepared to play a critical role in managing the situation. The most important step in this process is to establish and maintain communication—with your audit committee, with management, and with the auditor—to achieve a satisfactory outcome.

When an auditor independence issue first arises, you must develop the facts quickly. The best way to do this is to work closely with your CFO, Controller and their staffs to mitigate any existing problems and to head off similar issues that might be unfolding. You also should ask the outside auditor to develop its analysis regarding the situation as quickly as possible. When communicating this request to the auditor, you should advise the auditor that it might be asked to present its analysis to the audit committee. If, after gathering the facts, you determine that the issue appears of significant magnitude, you may want to engage outside counsel to investigate the situation or suggest that the audit committee do so.

If an interpretive issue regarding application of the rules remains outstanding once you have ascertained all the facts, it is worth bearing in mind that the SEC staff has indicated that it is willing to consult on auditor independence issues.[28] Thus, it



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- *The Rise and Fall of Enron: Principles for Director Focus,* available at ACCA Online[SM] at http://www.acca.com/legres/enron/NACDENRON.pdf.
- *Summary and Analysis of Sarbanes-Oxley Act,* available at ACCA Online[SM] at http://www.acca.com/legres/enron/sarbanes_oxley_act.pdf.
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- *Congress' Conference Report on Sarbanes-Oxley*, at www.senate.gov/~banking/docs/reports/reports.htm.
- Sarbanes-Oxley Act of 2002, available at http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf.
- U.S. Securities & Exchange Commission ("SEC") page about its Sarbanes-Oxley rulemaking, at www.sec.gov/news/press/2002-128.htm.
- Marian Exall and John D. Capers, Jr., "Audit Committees Under the Sarbanes-Oxley Act: Establishing the New Complaint Procedures," *ACC Docket* 21, no. 1 (January 2003), available at ACCA Online[SM] at http://www.acca.com/protected/pubs/docket/ja03/audit.pdf.
- Peter Loughran, James Scoville and Erin Callahan, "Corporate Governance and Directors' Duties: United States, GLOBAL COUNSEL CORPORATE GOVERNANCE HANDBOOK, 2003," available on PLC Law Department at www.practicallaw.com/A27021.

**ON PAPER:**

- JOHN K. VILLA, CORPORATE COUNSEL GUIDELINES (ACCA and West 1999, with annual updates).

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may be appropriate to have your outside counsel or your outside auditor approach the SEC staff on a "no-names" basis regarding the relevant matter to obtain a preliminary opinion on the issue at hand. Regardless of how you proceed, all involved need to work quickly and in a coordinated fashion to determine whether you, the auditor, or most importantly, the audit committee believes that an auditor independence issue exists. Efficient coordination and communication among you, the audit committee, the auditor, and the respective counsel are at a premium in these situations.

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In addition, when faced with an independence issue, you must be prepared to apprise your audit committee of the potential penalties and implications in the event that an auditor independence violation is found. The consequences of such a violation can be extraordinarily serious. The independent auditor's opinion on your company's financial statements, or consent to use such opinion, must be included in your annual report on Form 10-K and in any registration statement, and the independent auditor also must review all unaudited financial statements included in your interim reports filed on Form 10-Q. Thus, if your current auditor's independence is deemed to be impaired under the SEC's rules, you must move very quickly, and at considerable expense, either to resolve the independence issue with the SEC or to retain a new audit firm. This may cause the filing of your periodic reports or registrations statements to be delayed. Even more troubling is the potential that your past SEC filings could be in jeopardy if it turns out that your auditor was not independent at the time of those filings. This unfortunate turn of events could result in a series of tribulations, including potential SEC enforcement action. In view of the potentially severe consequences that could flow from an auditor independence violation, the value in taking the preventive steps and identifying a strategy for addressing a genuine auditor independence issue is of the utmost importance.

Some audit committees may feel overwhelmed by the scope and depth of their additional responsibilities, including those associated with the regulation of auditor independence issues. In-house counsel can take important steps to assist audit committees in managing their burdens in relation to the auditor independence rules and in managing their relationship with the outside auditor. These steps include explaining the auditor independence rules to the audit committee, assisting the audit committee in establishing effective compliance procedures, and being prepared in advance with a strategy in the event an auditor independence issue arises. ■

NOTES

1. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §301; Exchange Act Rule 10A-3(b)(2). While the SEC's auditor independence rules apply to public companies and the application of these rules are most relevant to in-house counsel at public companies, there is a movement afoot in several states to adopt state-specific "Sarbanes-Oxley"-like legislation, which could very well impact the manner in which private companies are forced to view the auditor independence rules.
2. The auditor independence rules as modified in 2000 and 2003 are codified in Rule 2-01 of Regulation S-X.
3. 17 C.F.R. § 210.2-01(b).
4. There is also a preliminary note to the SEC's auditor independence rules to be aware of. The note sets forth four principles the SEC suggests you should consider when evaluating auditor independence issues. There is a popular misconception that these principles are part of the rules; for example, it is often stated that the auditor cannot perform "advocacy services" for the audit client. But, while there is a restriction on legal services, there is no express prohibition on "advocacy" services per se. Taking these four principles to their logical conclusions, however, it would be difficult to see when an audit firm could provide services to a client in any given situation. Partially in view of concerns about the overbreadth of the principles in application, the SEC elected not to codify them in the rules. While the principles may provide useful guidance in some situations, they are difficult to apply in practice.
5. 17 C.F.R. § 210.2-01(c).
6. 17 C.F.R. § 210.2-01(f)(4).
7. 17 C.F.R. § 210.2-01(f)(1).
8. 17 C.F.R. § 210.2-01(c)(1).
9. 17 C.F.R. §§ 210.2-01(c)(2) and 2-01(f)(3) (defining "accounting role or financial reporting oversight role").
10. *See* Sarbanes-Oxley Act of 2002, § 206.
11. 17 C.F.R. § 210.2-01(c)(2)(B)(iii).
12. 17 C.F.R. § 210.2-01(c)(4).
13. *See* 65 Fed. Reg. 76008, 76043 (Dec. 5, 2003).
14. *See* Sarbanes-Oxley Act of 2002, § 201.
15. *See* Sarbanes-Oxley Act of 2002, § 201(a). Any additional limitation on non-audit services proposed by the PCAOB will be subject to notice and comment rulemaking and approval by the SEC.
16. *See* 17 C.F.R. §§ 210.2-01(c)(4) (i), (iii), (iv) and (v).
17. *See* 68 Fed. Reg. 6006, 6012 (Feb. 5, 2003).
18. *See* Item 9(e)(4) of Schedule 14A (superceded) (previously requiring the audit committee to state in its report whether it has considered if the provision of non-audit services provided by the outside auditor is compatible with maintaining the auditor's independence).
19. *See* Sarbanes-Oxley Act of 2002, §§ 201, 202.
20. *Id.*
21. The pre-approval requirement includes a narrow exception, providing that a waiver from the pre-approval requirement is permissible where the services: (1) do not in the aggregate account for more than five percent of total revenues paid by the audit client to the auditor in the fiscal year in which the services were performed; (2) were not recognized as non-audit services at the time of the engagement; and (3) are promptly brought to the attention of the audit committee and approved prior to completion of the audit by the audit committee. *See* 17 C.F.R. § 210.2-01(c)(7)(i)(C).
22. 17 C.F.R. § 210.2-01 (c)(7)(i)(B).
23. *See* U.S. Securities and Exchange Commission, Office of Chief Accountant: *Application of the January 2003 Rules on Auditor Independence, Frequently Asked Questions* (Office of Chief Accountant FAQ) (August 13, 2003).
24. *Id.*
25. *Id.* at FAQ 24.
26. Sarbanes-Oxley Act of 2002, § 301 (emphasis added).
27. *See* Office of Chief Accountant FAQs, at FAQ 21.28. Because the audit committee's obligation to oversee the hiring of registered public accounting firms arises under Section 301 of Sarbanes-Oxley, which mandates the national exchanges to adopt listing standards that comply the requirements of this provision, it is conceivable that the failure of the audit committee to pre-approve audit services provided by another registered public accounting firm could affect your company's compliance with applicable listing standards. Currently, however, neither the NYSE or NASDAQ listing standards provide any guidance indicating that this would be the case.
29. *See* 68 Fed. Reg. at 6015 (encouraging, in the context of the legal services prohibition, that accounting firms consult with the staff where certain independence issues arise). The SEC rules also include an exemption from independence violations where the parties did not know of the circumstances giving rise to the lack of independence; the independence impairing event was corrected as promptly as possible after the firm became aware of it; and the firm has a quality control system in place that satisfies certain criteria. *See* 17 C.F.R. § 210.2-01(d).

# 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
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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

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"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, 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.



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**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.



The Association of Corporate Counsel's Board of Directors endorsed the following position paper on October 24, 2004.

# 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

**Presented by**
**Latham & Watkins LLP**
**on behalf of**
**The Corporate Counsel Consortium**

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## I. INTRODUCTION

This paper addresses an emerging problem of vital public interest identified by a broad consortium of public companies.[1] The role of independent auditors in detecting financial statement fraud within public companies continues to receive enhanced scrutiny, and companies are expected both to implement controls for dealing with alleged fraud internally and to provide their auditors with detailed information on a wide range of corporate issues, even where such information may include attorney-client privileged communications or work product. Companies involve legal counsel, both external and internal, for all manner of inquiries and advice, from conducting comprehensive investigations of alleged fraud to inquiring about employment problems, answering questions about whistleblower letters, advising the Board on their duties in connection with an acquisition, or establishing the bases for tax positions. Views and advice on these and a myriad of other daily issues are now routinely being asked for by auditors to buttress their reliance on management representations. However, providing access to auditors to such privileged information causes companies to risk the waiver of privileges and, as a result, provides almost automatic access in civil lawsuits to adversaries lying in wait.

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 an expectation that counsel's work and advice may be exposed to adversaries, then companies may well be deterred from seeking the advice of counsel regarding the best way to comply with the law, or deterred from conducting thorough internal investigations of potentially illegal conduct with the goal of taking remedial action.

That good corporate governance and full cooperation in the audit process would lead to this result is incongruous and a matter of serious concern. It is also, we believe, unnecessary; we will, therefore, propose a solution to this growing problem at the conclusion of this paper.

This paper proceeds from the propositions that auditors must continue to be provided with as much information as they deem necessary to perform their important public functions 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 attorney work product. Thus, this paper discusses these two vital public interests – the public company audit function and protection of the attorney work product doctrine and attorney-client privilege – as well as their intersection. While auditors have historically planned and performed their audits in such a manner that they can obtain reasonable assurance that a company's financial statements are not materially misstated due to the existence of corporate fraud – and auditors continue to do so – recent developments in federal law and policy have focused attention on strengthening the

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[1] The General Counsel Working Group, convened by The Association of the Bar of the City of New York, 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 retained to prepare a White Paper on the issues, as well as make recommendations to the appropriate regulatory and governmental entities to help resolve the problems identified.

auditors' vigilance. Sparked by the corporate scandals of 2001-2002, legislation, regulations of the Securities & Exchange Commission ("SEC") and standards and rules of the Public Company Accounting Oversight Board ("PCAOB") have impacted how generally accepted auditing standards ("GAAS") are applied and have increased scrutiny on auditors' procedures to verify company positions and representations.

The same developments in law and policy and the same corporate scandals are causing companies to step up their own efforts to maintain and bolster effective internal procedures for the conduct of their businesses so as to detect and respond to allegations of inappropriate conduct, wrongdoing, or even 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, all the time generating work product and communicating advice and results to the companies – in seeming confidence. Once auditors perform their planned procedures, and seek and then obtain access to the company's privileged information regarding a variety of circumstances and issues, companies are increasingly losing any expectation that this information will remain confidential. Instead, companies now must *expect* that this sensitive information will find its way into the hands of litigation adversaries – merely because the company consulted with its attorneys, then cooperated with its independent auditors.

It is our perception that recent events have brought about a subtle but important change in how auditors carry out their responsibilities regarding public company oversight.[2] The PCAOB's and the SEC's roles overseeing auditors' compliance with GAAS in the detection of fraud and public companies' compliance with securities laws have been strengthened. The auditors' role in performing procedures regarding the fair presentation of a company's financial statements has been spotlighted. It is the companies, however, that are charged with developing proper internal controls and cooperating with their auditors in the first instance. And yet, their reward may be vast exposure to civil litigations. As recognized whenever the attorney-client privilege and work product doctrine are debated, the kind of advertent, inadvertent, and sometimes virtually compelled privilege waivers that companies are facing now serves to deny companies the effective assistance of counsel. While one public policy is being strengthened, one, therefore, is being weakened. The societal detriment caused by imprudent and unnecessary waivers of the privileges associated with the advice and involvement of counsel – a problem which has been highlighted by the shift in policy currently being experienced in the regulations surrounding Corporate America – is well-documented, and is discussed in this paper.

The waiver problem is very real. Judicial development in the law governing waiver of privileges is, at best, mixed, thus affording no assurance to companies that privileged information disclosed to auditors will remain protected from adversaries. The solution is not – and we emphasize that it is not the purpose of this White Paper to seek – that auditors back off from obtaining clarification or substantiation of facts from their corporate clients. Rather, the

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[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).





solution – as has already been recognized with regard to the SEC and the PCAOB – must be legislative protection of the privileges, recognizing that it is just as important for companies to furnish necessary information to their auditors while protecting it from disclosure to their adversaries as it is for auditors to seek what they need to fulfill their role as "gatekeepers."

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

Whether or not the current political climate and regulatory developments constitute what could be considered *changes* to GAAS with respect to the detection of fraud – in other words, whether auditors are expected to apply more stringent standards to uncover corporate fraud, or whether there is simply greater public and government oversight of long standing auditing standards – is debatable. Whatever the impetus, however, the consortium of public companies whose concerns prompted this paper cite a sharp increase in requests from independent auditors not simply for relevant factual information from the company, but also for *privileged* information, either as conditions of engagement or as requirements for completion of financial statement audits and reviews.

Given the regulatory trends discussed above, this 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 support of audits of litigation loss and tax contingency accruals 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*.[4]

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*."[5]

On August 26, 2004, in fact, the PCAOB released limited inspection reports on each of the four major accounting firms.[6] The Board "cheerfully admit[ted] it is being harsh" in acknowledging that the reports appear to be "laden with criticism" and "an unflinching candour

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[3] *See* Appendix A for a comprehensive analysis of the audit standards designed to detect fraud and the recent legislative and regulatory initiatives in this regard.

[4] 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).

[5] *See id*. (emphasis added).

[6] Each of the four 2003 Limited Inspection Reports issued by the PCAOB are available at http://www.pacobus.org/Inspections.

with firms about the points on which we see a need for improvement."[7] Among its limited inspection reports, the PCAOB criticized two firms for not having adequate support in one audit for contingent liabilities under FAS 5, including the analysis of counsel.[8]

As members of the Corporate Counsel Consortium have reported, a company's privileged information and the work product of its attorneys are increasingly being requested by auditors under various circumstances. Auditors are requiring clients to provide detailed information or open their files regarding whistleblower allegations, investigations and outcomes. For example, in connection with their obligation under Section 10A of the Exchange Act to follow "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,"[9] 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 issuer and ultimately satisfy itself that the company has appropriately remediated the matter. 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. Thus, the information required by auditors frequently includes privileged attorney-client communications and work product.

Similarly, pursuant to Section 307 of the Sarbanes-Oxley Act (by which Congress directed the SEC to set forth "minimum standards of professional conduct for attorneys appearing and practicing before the Commission") and the SEC's implementing regulations which 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," corporate counsel is required – much like auditors under Section 10A – to report evidence of misconduct up the corporate ladder and to satisfy itself

[7] *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 of provisions for tax reserves and valuation allowances. *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; KPMG Report, *supra*, at 23, n.4.

[8] PCAOB, Report on 2003 Limited Inspection of Deloitte & Touche LLP (Aug. 26, 2004) at 19-20, *available at* http://www.pcaobus.org/documents/Inspections/2004/Public_Reports/Deloitte_Touche.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.

[9] 15 U.S.C. § 78j-1. Section 10A is modeled after the predecessor of SAS 82, a GAAS requirement 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." AICPA, Auditing Standard Board, Statement on Auditing Standards No. 82: Consideration of Fraud in a Financial Statement Audit (codified in AICPA Professional Standards, AU § 316). Section 10A imposes 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.



that the company has taken appropriate remedial action.[10] The Section 307 structure, therefore, also spawns internal investigations which generate attorney-client privileged communications and attorney work product. Auditors are requiring public company clients to disclose this internal investigation information, including whether corporate legal counsel has advised the company of evidence of any material violations of the law in the first place.

Such internal investigations frequently are undertaken by companies and their legal counsel, whether or not there is a parallel SEC investigation or proceeding. Indeed, companies' roles in establishing the primary controls to detect and respond to allegations of fraud – through their audit committees – has grown considerably under the Sarbanes-Oxley Act. Pursuant to the Act, 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."[11] 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 are conducted pursuant to these procedures routinely in response to all disputes, whether or not litigation is involved, and attorney work product is generated as a result.

Auditors may require public company clients to disclose legal advice and analyses concerning other specific issues that could impact the financial statements of the company. As part of an audit of the company's financial statement assertions regarding tax assets, liabilities and contingency reserves, auditors frequently require companies to provide legal advice, analyses and judgments provided to the company concerning the potential tax consequences of transactions.[12] In addition, as part of their audit inquiry into company loss contingencies pursuant to FAS 5, auditors ask that corporate legal counsel disclose their judgments and supporting information regarding potential outcome, range of loss and other issues resulting from litigation, claims and assessments against the company.

While in light of Mr. Taub's comments and the criticisms levied in the PCAOB's limited inspection reports, as discussed above, auditors may conclude that it would be imprudent in this climate *not* to demand expansive access to a company's litigation files in these and other situations, this is neither entirely new nor *per se* inappropriate. Certainly, this paper takes the position that the audit process has long been set up such that public companies have been giving their auditors access to the information that the auditors need – including sensitive information – to conduct their audits. The public interest in continuing and strengthening this system, in which auditors have access to all information required to conduct a proper audit, including inquiries

[10] 17 C.F.R. Part 205.

[11] The Sarbanes-Oxley Act of 2002, Section 301, 15 U.S.C. § 78j-1.

[12] Indeed, pursuant to an auditor's obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS provides 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 this issues. *Id.*

into corporate fraud, is laudable and undeniable. In other words, barring some notable exceptions, this is how the audit system has worked and should continue to work. And the exceptions should be, and are being, corrected. Fixing the problems which led to those exceptions, however, need not come at the expense of other public interests that are just as important.

When companies are required to provide their independent auditors with attorney work product and privileged communications, the waiver problem is squarely presented. The question then becomes 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[13]

A legal system that fails to assure public companies the protection of the attorney-client privilege and work product protection denies those companies the effective assistance of counsel when potentially illegal corporate behavior is discovered.[14] 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."[15]

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.[16]

13 See Appendix B for a comprehensive analysis of the historical significance of the attorney-client privilege and work-product doctrine.

14 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.

15 *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.

16 *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 additon, the Antitrust Law Section's paper, discussed *supra*, makes the point that companies that cannot protect



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 comprehensive information that they need to conduct proper audits. In 1975, the audit and legal professions debated the issue[17] and reached an accord[18] – or "Treaty," as it is sometimes called – regarding the waiver problem arising when auditors ask their clients for privileged information related to the judgments of company counsel regarding loss contingencies for litigation, claims and assessments.[19] 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.[20] In 1977, the AICPA affirmed this

privileged information from litigation adversaries 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.

17 Law review articles at the time discuss the tensions that led to it, 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.

18 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.

19 The accord 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.

20 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.

protection and limitation regarding auditor access to confidential information and work product maintained by the client.[21]

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.[22]

Thus, while it is the auditors who require access to such attorney-client information – as part of their job of performing audits – they recognized the importance of the privileges enough to agree to a "Treaty" insisting that the public interest in protecting these privileges be upheld.

The SEC is also on record promoting work product protection for the internal investigation files of a public company's counsel.[23] The SEC recently argued in one case, *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, the SEC argued that such production "should not result in waiver of work-product

[21] *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 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)

[22] ABA Statement of Policy, Preamble (emphasis added).

[23] 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.



protection because preserving work-product protection is in the public interest. . . ."[24] 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 hands of its 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."[25]

The same policies underlie public companies' disclosure of work product to their auditors. Disclosure of such material may be part of an effective and comprehensive audit, but it would be *unfair* for companies to be exposed to a waiver of their privileges as to their adversaries – who stand ready to use this sensitive information to file civil lawsuits and obtain an immediate advantage over the companies in litigation – simply because the companies maintain effective internal controls for responding to allegations of wrongdoing and cooperating with their auditors. This is the waiver problem, and it is growing.

## IV. THE WAIVER PROBLEM

While it may be true that 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. This renewed focus has led to increased government scrutiny of auditors and, as reported by many public companies, increased requirements by auditors for confidential information 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 public policies, may – simply because a company establishes prompt, effective controls for responding appropriately to allegations of wrongdoing – be sacrificed to civil litigation adversaries for the mere reason that the corporation and their auditors are doing their jobs.

[24] *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.

[25] *Id.* 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; 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.

A. **CASE LAW REGARDING WAIVERS OF PRIVILEGES BASED UPON DISCLOSURE TO AUDITORS**[26]

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.[27] Indeed, the case law has been neither favorable nor consistent with respect to the protection of confidential information disclosed by clients to auditors.

With respect to the attorney-client privilege, courts generally hold that disclosure of attorney-client communications to auditors, as independent third parties, constitutes a waiver.[28] Courts in some states, however – those states which, through legislation or otherwise, have created an accountant-client privilege – reach the opposition conclusion regarding the disclosure of attorney-client communications to auditors.[29]

Regarding the work product doctrine, there is even less consistency among courts. Some courts considering the discoverability of attorney work product disclosed by a company to its auditors hold that most such work product was prepared in the ordinary course of business, not "in anticipation of litigation or for trial," which is the language used to describe the work product protection in Federal Rule of Civil Procedure 26(b)(3), and thus that, because the work product doctrine never applied, it is discoverable. Other courts hold that such work product is not discoverable because it does not constitute relevant evidence in a litigation. One court decided that the company's disclosure waives the protection of the work product doctrine

26 *See* Appendix C for a comprehensive analysis of the case law regarding waivers of the attorney-client privilege and work product protection based upon a company's disclosure to its auditors.

27 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 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.

28 *See*, *e.g.*, *Gutter v. E.I. Dupont De Nemours and Co.*, 1998 WL 2017926, at *3 (S.D. Fla. May 18, 1998); *In re Pfizer Inc. Securities Litig.*, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993).

29 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. *See* Appendix C for further analysis.



because there are no "common interests" between an auditor and the client; other courts disagree.[30] Many courts employ still other – and vastly different – lines of reasoning. 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 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 completely 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."[31]

Unfortunately, the uncertainty has only grown with the onset of the post-Sarbanes-Oxley Act world. To the extent that some courts *have* protected privileged information disclosed to auditors from discovery by third-party adversaries, as outlined on Appendix C, the lynchpin has been the auditors' professional obligation to maintain the information in confidence.[32] 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."[33] 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."[34] 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.[35] The expectation of confidentiality safeguards in the audit system has been key to those decisions denying waivers by a company's cooperation with its auditors.[36]

30 *Compare Medinol, Ltd. v. Boston Scientific Group*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002) *with In re Pfizer*, 1993 WL 561125, at *6; and Appendix C for further analysis of the cases.

31 *Upjohn*, 449 U.S. at 392.

32 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.

33 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.")

34 *Id.*

35 ABA Statement of Policy, par. 7.

36 Confidentiality agreements have, therefore, 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*

Under the Sarbanes-Oxley Act, however, the PCAOB – not the AICPA – is charged with establishing standards for auditing, attestation, quality control, ethics and independence with respect to public company audits, subject to SEC approval.[37] In April 2003, the PCAOB adopted interim, transitional standards in each of these areas which generally directed public company auditors to continue to comply with AICPA standards. The interim *ethics* standards selectively identify only certain rules of the AICPA Code of Professional Conduct for adoption – *not* including Rule 301.[38] While auditors should abide by Rule 301 as members of the AICPA, the rule has been given no force by the 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 attested to by the fact that legislative efforts have been made 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 ability to be effective. 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 questions of 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

*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))).

37 The Sarbanes-Oxley Act, Section 103, 15 U.S.C. § 7214.

38 *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.





to waive attorney-client privileges and work product protections.[39] 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.[40] 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 another government agency constitutes a full waiver of all privileges and protections that otherwise might have applied against any other adversaries.[41]

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."[42] Members of Congress responded with H.R. 2179, introduced on May 21, 2003, which, as currently drafted, proposes an amendment to the 1934 Securities & 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*

39 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.

40 *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).

41 *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).

42 U.S. Securities and Exchange Commission, 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, at p. 45.

> *than the Commission or the appropriate regulatory agency to which the document or information is provided.*[43]

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:

> [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 …*[44]

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."[45] This provision has been implemented in the PCAOB's Ethics Code and Rules.[46]

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43 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).

44 The Sarbanes-Oxley Act, Section 105(b)(5)(A), 15 U.S.C. § 7215(b)(5)(A) (emphasis added).

45 *Id*. Section 105(b)(5)(B), 15 U.S.C. § 7215(b)(5)(B).

46 *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").



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.[47] 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.

## 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.[48]

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 full and complete audit cooperation by laying the groundwork for their litigation adversaries to obtain sensitive and otherwise appropriately-privileged information. Under prevailing legal doctrine, the courts do

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47 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).

48 ABA Statement of Policy, Preamble.

not provide assurance that disclosure of privileged information to auditors will not result in such waivers as to others.

This result is untenable and, we submit, unnecessary. Instead, we offer a proposal for resolving the tension between cooperation with auditors and protecting appropriate privileges:

> The SEC and PCAOB, joined by the corporate counsel community and the principal auditors of the vast majority of U.S. public companies, should propose and support federal legislation, modeled on H.R. 2179, that would permit companies to provide privileged and attorney work product information 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.





**APPENDIX A**

**"DETECTING" CORPORATE FRAUD: AUDIT STANDARDS, LEGISLATION AND RECENT REGULATORY INITIATIVES**

Generally acceptable auditing standards have long recognized that auditors have particular responsibilities with respect to the discovery of corporate fraud during an audit. 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" about whether the financial statements are free of material misstatement, whether caused by error or fraud.[49] In October 2002, the Auditing Standards Board issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.*[50] SAS No. 99 establishes standards for auditors to fulfill that responsibility as it relates to fraud in an audit of financial statements conducted in accordance with GAAS.

SAS 99, consistent with its predecessor, 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 in 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 exist and should be communicated to the company or its audit committee.[51] 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.[52]

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

[50] SAS No. 99 superseded SAS No. 82, also entitled, *Consideration of Fraud in a Financial Statement Audit*. 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.

[51] SAS 99, ¶¶ 5, 12, 31, 80.

[52] *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

While GAAS, therefore, has outlined the obligations of auditors to obtain reasonable assurance that a company's financial statements are free of material misstatement due to error or fraud, several recent developments have focused heightened attention on the function of the auditor in the discovery of public company fraud. 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.

This renewed emphasis is apparent through legislative and regulatory creations. For example, Section 10A of the 1934 Securities & Exchange Act,[53] which was added by the Private Securities Litigation Reform Act of 1995 ("Reform Act"), requires auditors to employ procedures, in accordance with GAAS, designed to provide "reasonable assurance of detecting illegal acts" that would have a material effect on the financial statements. Like SAS 82, auditors are required 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.[54] 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.

The public interest focus on the public company audit function has also been mirrored by the SEC in its recent initiatives to enforce federal securities laws. 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.[55]

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 that "it is not appropriate for the auditor to rely solely on such legal opinion" in conducting the audit regarding these issues).

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

[54] 15 U.S.C. § 78j-1.





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.[56] The SEC's review, presented in a January 2003 report to Congress (the "704 Report"), showed that of 515 enforcement actions in total, 18 actions were filed against audit firms and 89 against individual auditors.[57] 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."[58] 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."[59]

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.[60] Recent

[55] 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.)

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

[57] 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.

[58] *Id.* at 3.

[59] *Id.* at 40.

[60] 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

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," the change in the Enforcement Division's approach regarding "deficient audits" by focusing now on firm responsibility for those audits and 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 gatekeeping role.[61] 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.

Finally, the PCAOB, established by the Sarbanes-Oxley Act, has been given a public mandate to inspect, investigate and discipline auditors conducting public company audits.[62] 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.[63] He said:

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 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).

[61] 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).

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

[63] GAAS expressly recognizes that a properly performed and executed audit may fail to detect fraud. SAS 82, *Consideration of Fraud in a Financial Statement Audit*, explains how fraud is less likely to be detected when it involves concealment and collusion: "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.





> 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.[64]

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 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.[65] The PCAOB has stated that inspections will assess compliance at all levels – *i.e.*, actions, omissions, policies and behavior patterns "from the senior partners to the line accountants."[66] The inspections will allow the PCAOB, in its own words, to "apply pressure to improve a firm's audit practices."[67]

The recent wave of scrutiny on auditors' detection of fraud has also extended to the companies themselves. It has always been the obligation of a company, of course, to cooperate fully with its 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. Reaffirming 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.[68] 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. . . ."[69]

[64] *The Enforcer*, CFO.com (Aug. 2, 2004) (emphasis added).

[65] 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.

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

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

[68] 17 C.F.R. § 240.13b2-2.

[69] *Id.* at § 240.13b2-2(a) & (b).

By both design and effect, these regulatory developments – Section 10A, SEC enforcement and PCAOB inspections and rule-making – have led in recent years to a framework for enhanced government oversight of audited financial statement disclosure and auditors. These exemplify the strong public interest in preserving and strengthening the audit function. They also may reflect why auditors are perceived by their corporate clients to be seeking more privileged and work product protected materials than what appears to have been the case in years past.





## APPENDIX B

### 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."[70] 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."[71]

The strongest criticism of the attorney-client privilege – and, indeed, of any evidentiary privilege – is that, in court 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 specific cases."[72] As the Supreme Court has held, this social good appropriately extends to corporations as well as to individuals.[73]

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."[74] 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.'"[75] 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

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70 *Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981).

71 *Id.*

72 *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.").

73 *Upjohn*, 449 U.S. at 389-90.

74 *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)).

75 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).

wits borrowed from the adversary."[76] 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 will, not surprisingly, be reluctant to seek legal assistance at all.

Protection of 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."[77] 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. And it is because of this underlying rationale that work product protection may not – unlike the attorney-client privilege – be waived by mere disclosure to a third party, "but rather only if a disclosure runs counter to the principles embodied by the adversary system."[78] Protecting work product from adversaries is the policy goal of the doctrine; it is grounded on sheer fairness. 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 that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means"[79] – 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, are using 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 learn about 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. They 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

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[76] *Hickman v. Taylor*, 329 U.S. 495, 516 (1946) (Jackson, J., concurring).

[77] Fed. R. Civ. P. 26(b)(3).

[78] *Philippines v. Westinghouse Elec. Corp.*, 132 F.R.D. 384, 389 (D.N.J. 1990).

[79] Fed. R. Civ. P. 26(b)(3).



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."[80]

The application of the work product doctrine 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 these categories of materials. The distinction is an important one that is well-accepted in the law.[81]

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[80] 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.

[81] *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 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.").

APPENDIX C

**SURVEY OF CASE LAW REGARDING WAIVER OF ATTORNEY-CLIENT PRIVILEGE AND WORK-PRODUCT PROTECTION BASED UPON DISCLOSURE TO AUDITORS**

Attorney-Client Privilege

Courts generally hold that disclosure of attorney-client communications to auditors waives the attorney-client privilege.[82] 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.[83]

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.[84] In every other jurisdiction, including all federal courts, the common law rule applies that communications between outside auditors and clients are not privileged.[85]

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82 *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").

83 *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.

84 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.

85 *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").





Work Product Doctrine

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.[86]

In another line of authority, courts have held that any evaluation of litigation risk and loss exposure prepared in response to an audit inquiry does 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."[87] This line of authority, however, is older, has attracted no recent followers and reflects a minority view.

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.[88] These authorities reject the earlier,

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86 In the following cases, courts rejected attempts by client adversaries to discover documents created by counsel and provided to auditors, including audit-inquiry responses concerning assessment of pending and potential litigation. *See 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).

87 *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 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").

88 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

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.[89]

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.[90] These courts acknowledge that, unlike the attorney-client privilege, which protects the confidentiality of the communication, work-product protection is

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").

89 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.

90 *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").





"intended only to prevent disclosure to the opposing counsel and his client" – so, it is not necessarily waived by disclosure to other third-parties.[91] 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.[92]

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.[93]

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.[94]

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

91 *Tronitech, Inc.*, 108 F.R.D. at 657.

92 *In re Raytheon*, 218 F.R.D. at 359.

93 *See* cases cited in note 86, *supra*.

94 214 F.R.D. at 116-17 (emphasis added).

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.[95]

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.[96] Since the auditor-client relationship does not fit neatly into this analytical box, the *Medinol* court found a waiver. 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.[97]

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 case law is not uniform and some courts would hold that disclosure constitutes a waiver. Companies, therefore, have no guarantee that courts will protect the work product generated from internal investigations from waiver as to adversaries if these materials are disclosed to auditors. This uncertainty undermines the purpose of the privileges: 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."[98]

95 *Id.* at 116 (quoting *Arthur Young & Co.*, 465 U.S. at 817-818).

96 *See, e.g., Stix Prods. Inc. v. United Merch. and Mfrs., Inc.*, 47 F.R.D. 334, 338 (S.D.N.Y. 1969).

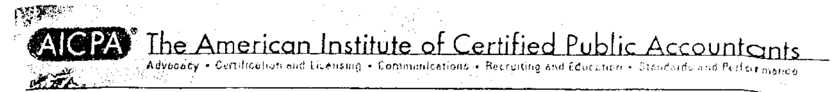
97 Although the Massachusetts District Court in *In re Raytheon*, citing *Medinol*, noted that "the existence of common interests" was relevant to whether disclosure to auditors created a waiver, the court also found that "there is no evidence that materials disclosed to an independent auditor are likely 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).

98 *Upjohn*, 449 U.S. at 392.












## Record Retention and the Paperless Office

After much hype and anticipation, the age of the paperless office is here. Most CPA firms today use technology to render client services, communicate internally and externally, and manage and store business data. But are you aware of the potential risks associated with creating, maintaining, and destroying electronic documents? To protect yourself and your firm, it's important to understand the technology you use, to establish and update guidelines for the use of electronic communications, and to implement appropriate controls over the record retention processes your firm employs.

### Common Electronic Communication Methods

Some of the tools commonly used by CPA firms include

- ***Telephones***
  Generally speaking, telephone conversations are not saved electronically on computer storage devices; however, they can be recorded. Federal law (The Electronic Communications Privacy Act) permits recording if at least one party to the call has given consent, but state law varies. Most states allow recording provided that at least one party to the conversation consents to the recording, but some states require the consent of both parties prior to recording. Before recording or retaining a copy of any telephone conversation, be sure to consult with your attorney regarding applicable state laws. Voicemail is another popular workplace technology. CPAs use both firm and client voicemail systems to send and receive information relevant to client engagements. Relying on voicemail as documented evidence in rendering client services is not recommended. Voicemail is a handy means of exchanging information quickly, but it is not particularly secure. Notwithstanding the client's implied consent to be recorded by leaving a voicemail message, the possible application of federal and state privacy laws, along with a CPA's duty to maintain client confidentiality under the AICPA Code of Professional Conduct and state board of accountancy regulations, suggest that using voicemail as a means of document storage and retrieval is ill-advised. After listening to a voicemail from a client, delete it promptly, and verify the information via a follow-up telephone conversation or written communication with the client.

- ***E-mail***
  E-mail is the communication tool of choice in many CPA firms, and it is used extensively in client communications. Like all other computer data, e-mails are subject to discovery. Accordingly, CPA firms should have an e-mail usage policy in place. The policy should be simple, clear, and define the circumstances under which e-mail use is or is not authorized. Additionally, the policy should include guidelines on deleting or retaining e-mails at the time they are sent or received, depending on the nature of the e-mail.

  Once an e-mail is created and sent, it continues to exist on both the sender's and recipient's computers and servers due to backup mechanisms. E-mails should be retained in accordance with the CPA firm's general document retention policy, and there should be a control in place to monitor compliance with the policy. Consult with your information technology specialist on the use of e-mail "shredding" software, which actually overwrites data to render it unreadable. Such software should comply with Department of Defense standard DoD 5220.22-M, which is the industry standard for this type of software.

- ***Instant Messaging (IM) Applications***
IM applications enable instant communication. However, IM is not a secure method of communicating confidential information, and it leaves an electronic data trail on the computers and backup storage systems involved. Like all other data that exists on firm computers and backup systems, this information is subject to discovery for production in professional malpractice lawsuits. Additionally, because IM is used as a conversation tool and an alternative to the telephone, users often do not consider the content of their messages prior to sending them.

  Additionally, it is difficult to monitor the ongoing use of IM. For these reasons, from a risk management perspective, IM is not recommended for use within CPA firms and should not be employed to retain and store information relevant to client engagements.

**Electronic Documents**
CPA firms use a variety of software applications to create documents. All applications should record when and by whom the document was created, when it was changed, and who changed it. Users should recognize that because these documents are often critical to a CPA's working paper files, it is important to preserve evidence of this information. Duplicate or superseded electronic documents should be deleted at the conclusion of each client service. To do so, consult with your information technology specialist regarding backup systems and document disposal.

**Document Imaging and Storage Systems**
The marketplace offers a variety of document imaging and storage systems designed to assist CPA firms in managing electronic documents. Some systems include off-site data storage or storage via the Internet using a third-party service provider. Others are scanning and storage devices, or network appliances designed to allow firms to store and retrieve all types of documents.

Regardless of the technology used, document imaging systems should feature a password-protected design that authenticates the date and time a document is imaged and indicates the person who executes the imaging. If your firm is already using such a system, it is important to conduct regular training classes and monitor compliance with your firm's policy on system use and record retention. If you are considering purchasing a system, investigate the following:

- Cost
- Design
- Ease of use
- Background, experience, and continued viability of the vendor
- System and off-site security
- References from other CPA firms that are using the system

**Paperless Working Papers**
Paperless applications are widely used for preparing tax returns, performing bookkeeping and audit services, and generating client financial statements. Each application is generally designed to stand alone and allow CPA firms to retain both client data and working papers electronically. Historically, there has been much consolidation within this part of the software application industry, and products are often superseded. From a document retention perspective, it is critical that each application be saved in a secure environment so that data saved in accordance with a firm's document retention policy can always be retrieved, even if the software provider is no longer in business.

Most CPA firms use multiple software applications and may use more than one





storage and backup method as well. Additionally, new applications are constantly being integrated into the practice. Firm management, regardless of whether the firm is a sole practitioner or has multiple offices, must catalog the various software applications and storage systems in use. Consider requirements to retain working papers by reviewing the regulations of the U.S. Treasury Department, state departments of revenue and other state and federal agencies, as well as state board of accountancy rules and regulations applicable to client industries (including the industries of former clients).

The use of electronic documents can significantly affect document storage and retrieval. That's why it's important to consult with an information technology specialist to determine if your firm's existing record retention policy must be updated to include specific guidance about the use of electronic communications and the retention, storage, retrieval, and destruction of electronic documents. In the long run, this not only aids firms in maintaining documents that may be needed to assist clients or defend malpractice claims, but also allows firms to maximize the use of their existing systems.

For more information about document retention, consult the practice management guide ***Retaining Engagement Records and Responding to Requests for Records: A Guide for CPA Firms,*** available exclusively to AICPA Professional Liability Insurance Program policyholders at no charge in the Policyholder Resource Center of the AICPA Insurance Programs website at www.cpai.com.

**Protect Your Firm (Executive Summary):**
There are legal liability issues associated with creating, maintaining, and destroying electronic documents. To protect yourself and your firm:

- Understand the technology you use.
- Establish guidelines for the use of electronic communications, and monitor compliance.
- Implement appropriate controls over the record retention processes your firm employs.
- Consult with an information technology specialist about updating your firm's existing record retention policy to include specific guidance about the use of electronic communications.

January 2005
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**Additional Resources**

*Document Retention in the Electronic Workplace*, by Michael R. Overly and Chanley T. Howell, Pike & Fischer, Inc., 2001

http://www.willyancey.com/electronic_evidence.htm#Email (a web page containing a useful list of links to articles and other materials about Electronic Evidence and Records Retention, maintained by Will Yancey, PhD., CPA)

"A Paperless Success Story," by Sarah Phelan, *Journal of*

*Accountancy*, October 2003

Guide to Paperless CPA Firm Administration, by Tom C Davis and Roman H Kepczyk, available at www.accountingweb.com

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Appendix 1 – Auditing Standard No. 3

June 9, 2004
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

# Auditing Standard No. 3 –

# *AUDIT DOCUMENTATION*

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Public Company Accounting Oversight Board

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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

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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

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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,

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

[1/] See paragraph 12 of this standard for a description of significant findings or issues.

[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*.

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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
- 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.

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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:

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- 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.

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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

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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.

[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

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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 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

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[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.

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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]

### 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 [the later of November 15, 2004, or 30 days after the date of approval of this standard by the SEC]. 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.

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[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 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.)

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AUDITING STANDARD No. 5 –

AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS

AND RELATED INDEPENDENCE RULE AND CONFORMING AMENDMENTS

PCAOB Release No. 2007-005
May 24, 2007

PCAOB Rulemaking
Docket Matter No. 021

Summary: After public comment, the Public Company Accounting Oversight Board is adopting Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, as well as an independence rule and conforming amendments to the Board's auditing standards.

Board Contact: Sharon Virag, Associate Chief Auditor (202/207-9164)

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## 1. Introduction

In 2002, Congress passed the Sarbanes-Oxley Act (the "Act"), which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Public Company Accounting Oversight Board ("PCAOB" or "Board"), to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2").[1] The

[1] See PCAOB Release No. 2004-001 (March 9, 2004).

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Securities and Exchange Commission ("Commission" or "SEC") approved Auditing Standard No. 2 on June 17, 2004.[2]

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

As a result of this monitoring, two basic propositions emerged.[3] First, the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2.[4] On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would replace Auditing Standard No. 2. The Board also proposed a related auditing standard, *Considering and Using the Work of Others in an*

[2] See Securities Exchange Act Release No. 49884 (June 17, 2004).

[3] See Proposed Auditing Standard: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007 (Dec. 19, 2006).

[4] See PCAOB Press Release, "Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements" (May 17, 2006). The other aspects of the plan are: (1) reinforcing auditor efficiency through PCAOB inspections; (2) developing or facilitating development of implementation guidance for auditors of smaller public companies; and (3) continuing PCAOB Forums on Auditing in the Small Business Environment.

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*Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and conforming amendments to its auditing standards.[5/]

The Board issued these proposals with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In formulating these proposals, the Board re-evaluated every significant aspect of Auditing Standard No. 2.

The Board received 175 comment letters on its proposals. The Board also discussed the proposals with its Standing Advisory Group on February 22, 2007.[6/] A large majority of commenters were generally supportive of the Board's proposals, particularly the top-down, risk-based approach and focus on the most important matters. Based on the comments received, the Board believes that the proposal achieves, in large part, the objectives the Board set out when deciding to amend Auditing Standard No. 2. Many commenters also offered suggestions to improve the final standard, which the Board has carefully analyzed.

In considering the comments received and formulating a final standard, the Board closely coordinated its work with the SEC, which proposed guidance for management on evaluating internal control at the same time that the Board issued its proposals.[7/] In addition to its role in implementing Section 404(a) of the Act, the SEC

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[5/] See Proposed Auditing Standard: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Other Proposals*, PCAOB Release No. 2006-007 (Dec. 19, 2006).

[6/] A transcript of the portion of the meeting that related to the proposals and an archived web cast of the entire meeting are available on the Board's Web site at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2007/02-22/SAG_Transcript.pdf.

[7/] See Securities Exchange Act Release No. 54976 (Dec. 20, 2006).

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must approve new PCAOB auditing standards before they can become effective.[8/] On April 4, 2007, the Commission held a public meeting to discuss the Board's proposals and the coordination of those proposals with the Commission's proposed management guidance. At the meeting, the SEC staff provided the Commission its analysis of the public comments on the PCAOB's proposal and the proposed management guidance. The Commission endorsed the recommendations of its staff and directed its staff to focus its remaining work in four areas:

- "Aligning the PCAOB's new auditing standard ... with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions, and terms";
- "Scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies";
- "Encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment"; and
- "Following a principles-based approach to determining when and to what extent the auditor can use the work of others."[9/]

After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board has decided to adopt the revised standard on auditing internal control as Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("Auditing Standard No. 5"), to supersede Auditing Standard No. 2. The Board has also decided to adopt the independence rule and conforming amendments to the auditing standards.[10/]

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[8/] See Section 107 of the Act.

[9/] See SEC Press Release, "SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'" (Apr. 4, 2007).

[10/] As discussed below, the Board has determined not to adopt the proposed auditing standard on considering and using the work of others.

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2. **Notable Areas of Change in the Final Standard**

As stated above, the Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach. This section describes the areas of change to the proposals that are most notable. Appendix 4 contains additional discussion of comments received on the proposals and the Board's response.

A. **Alignment with management guidance**

On December 20, 2006, the SEC issued proposed guidance to help management evaluate internal control for purposes of its annual assessment. In formulating a new standard on auditing internal control, the Board sought to describe an audit process that would be coordinated with management's evaluation process. Many commenters suggested, however, that the SEC's management guidance and the Board's standard should be more closely aligned.

After considering the comments in this area, the Board has decided to make changes that will improve the coordination between the SEC's management guidance and the Board's standard. In doing so, the Board has been mindful of the inherent differences in the roles of management and the auditor. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to evaluate internal control and the sufficiency of the evidence it needs for its annual assessment. Management also should be able to rely on self-assessment and, more generally, the monitoring component of internal control, provided the monitoring component is properly designed and operates effectively.

The auditor is required to provide an independent opinion on the effectiveness of the company's internal control over financial reporting. The auditor does not have the familiarity with the company's controls that management has and does not interact with or observe these controls with the same frequency as management. Therefore, the auditor cannot obtain sufficient evidence to support an opinion on the effectiveness of internal control based solely on observation of or interaction with the company's controls. Rather, the auditor needs to perform procedures such as inquiry, observation, and inspection of documents, or walkthroughs, which consist of a combination of those procedures, in order to fully understand and identify the likely sources of potential misstatements, while management might be aware of those risk areas on an on-going basis.

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The Board believes, however, that the general concepts necessary to an understanding of internal control should be described in the same way in the Board's standard and in the SEC's guidance. Accordingly, the Board has decided to use the same definition of material weakness in its standard that the SEC uses in its final management guidance and related rules. In addition, the Board is adopting the definition of significant deficiencies that the SEC has proposed. The final standard and final management guidance also describe the same indicators of a material weakness. In addition, as described more fully below, the final standard on auditing internal control uses the term "entity-level controls" instead of "company-level controls," which was used in the proposed standard, in order to use the same term as the SEC uses in its final management guidance.[11] Auditing Standard No. 5's discussion of the effect of these controls is also consistent with the discussion of the same topic in the SEC's final guidance.

B. **The top-down approach**

The proposed standard on auditing internal control was structured around the top-down approach to identifying the most important controls to test. This approach follows the same principles that apply to the financial statement audit -- the auditor determines the areas of focus through the identification of significant accounts and disclosures and relevant assertions. Under the proposed standard, the auditor would specifically identify major classes of transactions and significant processes before identifying the controls to test.

In response to comments about the level of detail in the requirements of the proposed standard, the Board has reconsidered whether the final standard should include the identification of major classes of transactions and significant processes as a specifically required step in the top-down approach. As a practical matter, the auditor will generally need to understand the company's processes to appropriately identify the correct controls to test. The Board believes, however, that specific requirements directing the auditor how to obtain that understanding are unnecessary and could contribute to a "checklist approach" to compliance, particularly for auditors who have a long-standing familiarity with the company. Accordingly, the Board has removed the requirements to identify major classes of transactions and significant processes from

[11] These terms were used interchangeably in the proposed standard and SEC's proposed management guidance and, for these purposes, they mean the same thing. See Securities Exchange Act Release No. 54976 (Dec. 20, 2006), at 12 fn. 29.

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the final standard. While this should allow auditors to apply more professional judgment as they work through the top-down approach, the end point is the same as in the proposed standard – the requirement to test those controls that address the assessed risk of misstatement to each relevant assertion.[12]

C. Emphasis on fraud controls

The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Commenters suggested that the placement of the discussion, or the lack of specificity regarding the controls that should be deemed fraud controls, failed to properly emphasize these controls or provide auditors with sufficient direction on how to test fraud controls. In response, the Board has made several changes in the final standard.

First, the discussion of fraud risk and anti-fraud controls has been moved closer to the beginning of the standard to emphasize to auditors the relative importance of these matters in assessing risk throughout the top-down approach.[13] Incorporating the auditor's fraud risk assessment – required in the financial statement audit – into the auditor's planning process for the audit of internal control should promote audit quality as well as better integration. While internal control cannot provide absolute assurance that fraud will be prevented or detected, these controls should help to reduce instances of fraud, and, therefore, a concerted focus on fraud controls in the internal control audit should enhance investor protection. Second, management fraud has also been identified in the final standard as an area of higher risk; accordingly, the auditor should focus more of his or her attention on this area.[14] Finally, the standard, as adopted, provides additional guidance on the types of controls that might address fraud risk.[15]

[12] See paragraph 21.

[13] See paragraphs 14 and 15.

[14] See paragraph 11.

[15] See paragraph 14.

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D. Entity-level controls

The proposed standard on auditing internal control emphasized entity-level controls because of their importance both to the auditor's ability to appropriately tailor the audit through a top-down approach – specifically by identifying and testing the most important controls – and to effective internal control. Additionally, the proposed standard emphasized that these controls might, depending on the circumstances, allow the auditor to reduce the testing of controls at the process level. Commenters suggested that the proposed standard did not provide enough direction on how entity-level controls can significantly reduce testing, and some suggested that controls that operate at the level of precision necessary to do so are uncommon. Many commenters suggested incorporating in the final standard the discussion of direct versus indirect entity-level controls that was included in the SEC's proposed management guidance.

The Board continues to believe that entity-level controls, depending on how they are designed and operate, can reduce the testing of other controls related to a relevant assertion. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level controls provide some assurance so that the testing of other controls related to that assertion can be reduced. In response to comments and in order to clarify these concepts, the Board included in the final standard a discussion of three broad categories of entity-level controls, which vary in nature and precision, along with an explanation of how each category might have a different effect on the performance of tests of other controls.[16]

The final standard explains that some controls, such as certain control environment controls, have an important, but indirect effect, on the likelihood that a misstatement 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.

The final standard explains that other entity-level controls may not operate at the level of precision necessary to eliminate the need for testing of other controls, but can reduce the required level of testing of other controls, sometimes substantially. This is

[16] See paragraph 23. The Board believes that expertise of auditors and companies in the area of entity-level controls will continue to evolve. For example, the Committee of Sponsoring Organizations of the Treadway Commission has begun a project on the monitoring component of internal control that may provide some guidance in this area.

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because the auditor obtains some of the supporting evidence related to a control from an entity-level control and the remaining necessary evidence from the testing of the control at the process level. Controls that monitor the operation of other controls are the best example of these types of controls. These monitoring controls help provide assurance that the controls that address a particular risk are effective and, therefore, they can provide some evidence about the effectiveness of those lower-level controls, reducing the testing of those controls that otherwise would be necessary.

Lastly, the final standard explains that some entity-level controls might operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of misstatement to a relevant assertion. If a control sufficiently addresses the risk in this manner, the auditor does not need to test other controls related to that risk.

E. **Walkthroughs**

The proposed standard on auditing internal control would have required auditors to perform a walkthrough of each significant process each year. This proposed requirement represented a change from Auditing Standard No. 2, which required a walkthrough of each major class of transactions within a significant process. Commenters were split on the question of whether the re-calibration from major class of transactions to significant process in the proposed standard would result in a reduction of effort. Some issuers and auditors suggested that walkthroughs are already being performed on significant processes, while other issuers and auditors commented that this proposed requirement would make a difference. A few commenters suggested that a walkthrough of each significant process was insufficient and would negatively affect audit quality, but many others stated that walkthroughs should not be required at all.

In evaluating these comments, the Board focused principally on the objectives it believes are achieved through a properly performed walkthrough. The Board firmly believes that those objectives should be met for the auditor to verify that he or she has a sufficient understanding of the points within the processes where misstatements could occur and to properly identify the controls to test.[17] Procedures that fulfill those objectives also play an important role in the evaluation of the effectiveness of the design of the controls. The Board believes that, in some instances, the requirement to perform a walkthrough may have overshadowed the objectives it was meant to achieve. This may have resulted in some walkthroughs being performed to meet the requirement but failing to achieve the intended purpose.

[17] See paragraph 34, which describes these objectives.

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The final standard, therefore, focuses specifically on achieving certain important objectives, and the performance requirement is based on fulfilling those objectives as they relate to the understanding of likely sources of misstatement and the selection of controls to test.[18] While a walkthrough will frequently be the best way of attaining these goals, the auditor's focus should be on the objectives, not on the mechanics of the walkthrough. In some cases, other procedures may be equally or more effective means of achieving them.

F. **Evaluation and communication of deficiencies**

The proposed standard on auditing internal control required the auditor to evaluate the severity of identified control deficiencies to determine whether they are significant deficiencies or material weaknesses. It then required the auditor to communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The proposed standard defined "significant deficiency" as "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected." The term "significant misstatement" was defined, in turn, to mean "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Commenters generally supported the proposed definition of the term "significant misstatement," though some were concerned that it was too subjective. Other commenters questioned whether the standard should include a definition of significant deficiency and a requirement to communicate significant deficiencies to the audit committee. At least one commenter suggested that the term be removed from the standard.

After considering these comments, the Board has determined to make changes to the definition of significant deficiency and related requirements.[19] The Board

[18] See paragraph 34.

[19] The Board also made minor changes to the definition of material weakness in order to use the same definition in the SEC's management guidance and related rule. In the final standard, material weakness is defined as "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."

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continues to believe that the standard should require auditors to provide relevant information about important control deficiencies – even those less severe than a material weakness – to management and to the audit committee. The final standard, therefore, requires the auditor to consider and communicate any identified significant deficiencies to the audit committee. In order to emphasize that the auditor need not scope the audit to identify all significant deficiencies, however, the Board placed these provisions in the section of the final standard that describes communications requirements.[20]

The relatively minor changes that the Board made to the definition of significant deficiency are also intended to focus the auditor on the communication requirement and away from scoping issues. The final definition is based on the proposed definition of "significant misstatement," which commenters generally supported, and is aligned with the SEC's proposed definition of the same term. Under the final standard, 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."

G. Scaling the audit

The proposed standard on auditing internal control indicated that a company's size and complexity are important considerations and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls. The proposed standard included a section on scaling the audit for smaller, less complex companies and would have required auditors to evaluate and document the effect of the company's size and complexity on the audit. This documentation requirement applied to audits of companies of all sizes. The proposed standard also included a list of the attributes of smaller, less complex companies and a description of how the auditor might tailor his or her procedures when these attributes

[20] See paragraph 80. The final standard also includes the proposed requirement for the auditor to communicate, in writing, to management, all deficiencies in internal control identified during the audit and inform the audit committee when such a communication has been made, and the proposed requirement to inform, when applicable, the board of directors of the auditor's conclusion that the audit committee's oversight is ineffective. See paragraphs 79 and 81. Some commenters believed that the requirement to communicate all identified deficiencies to management would result in an unnecessary administrative exercise. The Board continues to believe, however, that auditors should provide information about identified control deficiencies to management.

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are present. In general, commenters were supportive of the proposed standard's general approach to scalability, but had several recommendations for change.

Some commenters suggested that scalability should not be covered as a stand-alone discussion applicable only to smaller companies and that other companies, regardless of size, might have areas that are less complex. The Board agrees that the direction on scaling will be most effective if it is a natural extension of the risk-based approach and applicable to all companies. Consequently, the Board shortened the separate section on "scaling the audit," and incorporated a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs describe how to tailor the audit to the particular circumstances of a smaller, less complex company or unit. The Board also retained the list of attributes of smaller, less complex companies and acknowledged that, even within larger companies, some business units or processes may be less complex than others. Discussion of these attributes has been incorporated in the section on the auditor's planning procedures in the final standard.[21] As described in the proposing release, the provisions on scalability in the final standard will form the basis for guidance on auditing internal control in smaller companies to be issued this year.

Several commenters, mostly auditors, suggested that the performance requirements that applied to all companies, including large, complex companies, would lead to unnecessary and costly documentation requirements. These commenters were particularly concerned about the requirement to document the effects of size and complexity on all aspects of the audit, even if a particular engagement could not be tailored as a result of these factors. After considering these comments, the Board agreed that this documentation requirement is not necessary to promote audit quality and, therefore, has not included it in the final standard.

H. Use of the work of others in an integrated audit

At the time the Board proposed Auditing Standard No. 5 for public comment, the Board also proposed an auditing standard entitled *Considering and Using the Work of Others in an Audit* that would have superseded the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replaced the direction on using the work of others in an audit of internal control in Auditing Standard No. 2. As discussed in the proposing release, the Board had several objectives in proposing this standard. The first was to better integrate the financial statement audit and the audit of internal control by having

[21] See paragraph 9.

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only one framework for using the work of others in both audits. Additionally, the Board wanted to encourage auditors to use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons. Among other things, under the proposed standard, auditors would have been able to use the work of sufficiently competent and objective company personnel – not just internal auditors – and third parties working under the direction of management or the audit committee for purposes of the financial statement audit as well as the audit of internal control.

The Board received numerous comments on the proposed standard on using the work of others. Commenters generally indicated support for a single framework regarding the auditor's use of the work of others in an integrated audit. Some, however, suggested retaining existing AU sec. 322 as the basis for that single framework. They expressed the view that the objective of removing barriers to integration and using the work of others to the fullest extent appropriate could be achieved by retaining AU sec. 322 and going forward with the proposed removal of the "principal evidence" provision. At the same time, some other commenters suggested that the proposed standard did not go far enough in encouraging auditors to use the work of others.

After considering these comments, the Board continues to believe that a single framework for the auditor's use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits. At the same time, the Board agreed with those commenters who suggested that better integration of the audits could be achieved without replacing the existing auditing standard. The Board therefore has decided to retain AU sec. 322 for both audits and incorporate language into Auditing Standard No. 5 that establishes these integration concepts rather than adopt the proposed standard on considering and using the work of others.

Consistent with the proposal, however, Auditing Standard No. 5 allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls and eliminates the principal evidence provision. Recognizing that issuers might employ personnel other than internal auditors to perform activities relevant to management's assessment of internal control over financial reporting, the final standard allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee.[22]

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[22] See paragraph 17.

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In line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others depends, in part, on the risk associated with the control being tested. As the risk decreases, so does the need for the auditor to perform the work him or herself. The impact of the work of others on the auditor's work also depends on the relationship between the risk and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases as well.[23] Likewise, in higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

Finally, the Board understands that some of the work performed by others for the purposes of management's assessment of internal controls can be relevant to the audit of financial statements. Therefore, in an integrated audit, the final standard allows the auditor to use the work of these sufficiently competent and objective others – not just internal auditors – to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial statements.[24] The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.

**3. Rule 3525 – Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting**

The Board also proposed a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related non-audit services. As proposed, the rule required a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to: describe, in writing, to the audit committee the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. Most commenters were supportive of the rule as proposed, though some offered

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[23] See paragraph 18.

[24] See paragraph 17.

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suggestions about what should be included in the required communication. After considering the comments on the proposed rule, the Board has adopted it without change.

4. **Conforming Amendments**

As part of the proposal issued for public comment, the Board proposed amendments to certain of the Board's other auditing standards. Only one comment letter specifically addressed the proposed amendments. That letter expressed support for the amendments and suggested a few additional amendments that might be necessary. The Board has considered this comment and added these additional amendments, as well as others, as necessary based on the final standard.

5. **Effective Date**

The proposing release solicited commenters' feedback on how the Board could structure the effective date of the final requirements so as to best minimize disruption to ongoing audits, but make greater flexibility available to auditors as early as possible. Most commenters on this topic suggested making the final standard on auditing internal control effective as soon as possible in order to be available for 2007 audits.

The Board agrees that the improvements in Auditing Standard No. 5 should be available as soon as possible. Accordingly, the Board has determined that Auditing Standard No. 5, Rule 3525, and the conforming amendments will be effective, subject to approval by the SEC, for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted, however, at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after SEC approval but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by this release.

Auditing Standard No. 2 will be superseded when Auditing Standard No. 5 becomes effective. Auditors who do not elect to comply with Auditing Standard No. 5 before that date (but after SEC approval) must continue to comply with Auditing Standard No. 2 until it is superseded. Such auditors should, however, apply the definition of "material weakness" contained in Auditing Standard No. 5, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in Auditing Standard No. 5 parallels the new SEC definition.

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* * *

On the 24th day of May, in the year 2007, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

May 24, 2007

APPENDIX 1 – Auditing Standard No. 5 – *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

APPENDIX 2 – Rule 3525 – *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*

APPENDIX 3 – Conforming Amendments to PCAOB Auditing Standards

APPENDIX 4 – Additional Discussion of Comments and the Board's Response

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| AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS | ) | PCAOB Release No. 2004-001<br>March 9, 2004<br><br>PCAOB Rulemaking<br>Docket Matter No. 008 |

Summary: After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This standard is the standard on attestation engagements referred to in Section 404(b) as well as Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or "the Act"). The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

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* * *

The series of business failures that began with Enron in late 2001 exposed serious weaknesses in the system of checks and balances that were intended to protect the interests of shareholders, pension beneficiaries and employees of public companies – and to protect the confidence of the American public in the stability and fairness of U.S. capital markets.

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From the boardroom to the executive suite, to the offices of accountants and lawyers, the historic gatekeepers of this confidence were found missing or, worse, complicit in the breaches of the public trust.

Congress responded to the corporate failures with the Sarbanes-Oxley Act of 2002, creating a broad, new oversight regime for auditors of public companies while prescribing specific steps to address specific failures and codifying the responsibilities of corporate executives, corporate directors, lawyers and accountants.

The merits, benefits, cost and wisdom of each of the prescriptions can and will fuel debate. But the context for the passage of the Sarbanes-Oxley Act, and the President's signing it into law on July 30, 2002, cannot be ignored: Corporate leaders and advisors failed. People lost their livelihoods and their life savings. The faith of America and the world in U.S. markets was shaken to the core.

In that context, the PCAOB adopted the standard for auditors to use when assessing whether managers of a public company have accurately reported on companies' internal controls over financial reporting.

Failures in internal control, particularly over financial reporting, were among the specific concerns addressed by Congress in the Sarbanes-Oxley Act. Congress required not just that management report on a company's internal control over financial reporting, but that auditors attest to the accuracy of management's report.

The bottom line for Congress, and for the PCAOB, is the reliability of the company's financial statements – statements relied on by shareholders, management, directors, regulators, lenders, investors and the market at large.

To achieve reliable financial statements, internal controls must be in place to see that records accurately and fairly reflect transactions in and dispositions of a company's assets; to provide assurance that the records of transactions are sufficient to prepare financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are made only as authorized by management and directors; and to make sure that steps are in place to prevent or detect theft, unauthorized use or disposition of the company's assets of a value that could have a material effect on the financial statements.

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In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it exercises adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets and the possibility of misappropriation of company assets.

The Sarbanes-Oxley Act, in Section 404, requires company management to assess and report on the company's internal control. It also requires a company's independent, outside auditors to issue an "attestation" to management's assessment – in other words, to provide shareholders and the public at large with an independent reason to rely on management's description of the company's internal control over financial reporting.

Reliable financial reporting is too important to relegate an auditor's attestation to a rubber-stamped endorsement of management's report on internal controls. As a result, the PCAOB is requiring that auditors perform an audit of internal control over financial reporting and to perform that audit in conjunction with the audit of a company's financial statements.

The one audit cannot be separated from the other. The information the auditor learns as a result of auditing the company's financial statements has a direct and important bearing on the auditor's conclusion about the effectiveness of the company's internal control over financial reporting.

Section 404 and the Board's requirements will entail extra work and, for companies, extra expense, particularly in the first year of implementation. The PCAOB will be vigilant in its inspections of accounting firms and conversations with issuers, particularly small and medium-sized companies, to see that expense isn't increased for its own sake.

The Board does not underestimate the demands this auditing standard will impose on auditors and public companies. But in the end, the Board, public companies and the accounting profession answer to the higher demand of accuracy, reliability and fairness in the financial statements that provide the basis for trust in our financial markets.

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A. <u>The Benefits of Effective Internal Control Over Financial Reporting</u>

Companies use internal controls as checks on a variety of processes, including financial reporting, operating efficiency and effectiveness, and compliance with applicable laws and regulations. The Sarbanes-Oxley Act focuses on companies' internal control over financial reporting.

Internal control over financial reporting consists of company policies and procedures that are designed and operated to provide reasonable assurance about the reliability of a company's financial reporting and its process for preparing and fairly presenting financial statements in accordance with generally accepted accounting principles. It includes policies and procedures for maintaining accounting records, authorizing receipts and disbursements, and the safeguarding of assets.

Effective internal control over financial reporting is essential for a company to effectively manage its affairs and to fulfill its obligation to its investors. A company's management, its owners – public investors – and others must be able to rely on the financial information reported by companies to make decisions.

Strong internal controls also provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that internal control reporting can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), assessments of internal controls over financial reporting should emphasize controls that prevent or detect errors as well as fraud.

Evaluating a company's internal control over financial reporting is not without cost, but it provides many far-reaching benefits. Regular assessments, and reporting on those assessments, can help management develop, maintain and improve existing internal control. Assessments can identify cost-ineffective procedures, reduce costs of processing accounting information, increase productivity of the company's financial function, and simplify financial control systems. It also may result in fewer financial statement restatements and less litigation.

The primary benefit of evaluations, however, is to provide the company, its management, its board and audit committee, and its owners and other stakeholders

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with a reasonable basis on which to rely on the company's financial reporting. The integrity of financial reporting represents the foundation upon which this country's public markets are built.

As with many endeavors, internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented. As a result, no system of internal control over financial reporting, regardless of how well it is designed and operating, can provide absolute assurance that a company's financial statements are accurate.

Nevertheless, as companies develop processes to assist management in assessing internal control and as auditors perform their evaluations, the assessment process should result in a continuous strengthening of internal control over financial reporting.

B. Basis for Internal Control Reporting and the Board's Standard

Section 404(a) of the Sarbanes-Oxley Act requires the management of a public company to assess the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year and to include in the company's annual report to shareholders management's conclusion, as a result of that assessment, about whether the company's internal control is effective. The SEC implemented Section 404(a) in a rule on June 5, 2003.[1/]

Section 404(b) of the Act requires the company's auditor to attest to and report on the assessment made by the company's management. Sections 103(a)(2)(A) and 404(b) of the Act direct the PCAOB to establish professional standards governing the independent auditor's attestation.

In April 2003, the Board adopted pre-existing professional standards as the Board's interim standards, including a standard governing an auditor's attestation on internal control. Mindful of the requirements of the Sarbanes-Oxley Act and the need to evaluate the pre-existing standard, the Board convened a public roundtable discussion

[1/] See Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

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on July 29, 2003, to discuss issues and hear views related to reporting on internal control. The participants included representatives from public companies, accounting firms, investor groups, and regulatory organizations.

As a result of comments made at the roundtable, advice from the Board's staff, and other input, the Board determined that the pre-existing standard governing an auditor's attestation on internal control was insufficient for purposes of effectively implementing the requirements of Section 404(b) of the Act and for the Board to appropriately discharge the Board's standard-setting obligations under Section 103 of the Act. In response, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled "An Audit of Internal Control over Financial Reporting in Conjunction with An Audit of Financial Statements."

The Board received 193 comment letters from a variety of interested parties, including auditors, investors, internal auditors, issuers, regulators, and others on a broad array of topics. Those comments led to changes in the proposed standard, intended to make the requirements of the standard clearer and more operational.

The Board has approved PCAOB Auditing Standard No. 2, implementing the requirements of the Sarbanes-Oxley Act and incorporating comments received.

This release summarizes the process involved in conducting an audit of internal control over financial reporting, other significant provisions of PCAOB Auditing Standard No. 2 and some of the significant considerations of the Board when it initially proposed this standard and when it evaluated the comments it received. The Board's detailed analysis of the comments received and the Board's responses are contained in Appendix E to the standard.

C. The Audit of Internal Control Over Financial Reporting

In preparing PCAOB Auditing Standard No. 2, the Board was guided by a number of broad considerations that have effect throughout the standard. Those broad considerations included: that "attestation" is insufficient to describe the process of assessing management's report on internal controls; that an audit of internal control over financial reporting must be integrated with an audit of the company's financial statements; and that the costs of the internal control audit be appropriate in

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consideration of the expected benefits to investors of improved internal control over financial reporting.

D. Attestation vs. Audit

Throughout Auditing Standard No. 2, the auditor's attestation of management's assessment of the effectiveness of internal control is referred to as the audit of internal control over financial reporting. The Board has noted, in comment letters and in other communications, that some people have drawn a distinction between an "audit" and an "attestation," suggesting that an attestation is a different type of engagement that involves a lesser amount of work than an audit. This idea is erroneous. An attestation engagement to examine management's assessment of internal control requires the same level of work as an audit of internal control over financial reporting.

The objective of an audit of internal control over financial reporting is to form an opinion "as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects."[2] Further, Section 103(a)(2)(A)(iii) of the Act requires the auditor's report to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary, among other requirements.

Importantly, the auditor's conclusion will pertain directly to whether the auditor can agree with management that internal control is effective, not just to the adequacy of management's process for determining whether internal control is effective.

An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct. The auditor needs to evaluate management's assessment process to be satisfied that management has an appropriate basis for its conclusion. The auditor, however, also needs to test the effectiveness of internal control to be satisfied that management's conclusion is correct and, therefore, fairly stated. Indeed, as the Board heard at the internal control roundtable and in comment letters, investors expect the independent auditor to test whether the company's internal control over financial reporting is effective, and Auditing Standard No. 2 requires the auditor to do so.

[2] See SEC Regulation S-X 2-02(f), 17 C.F.R. 210.2-02(f).

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E. Integrated Audit

PCAOB Auditing Standard No. 2 describes an integrated audit of the financial statements and internal control over financial reporting. Accordingly, it is an integrated standard that (1) addresses both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements and (2) refers to the attestation of management's assessment of the effectiveness of the internal control as the audit of internal control over financial reporting.

The Board decided that these audits should be integrated because the objectives of, and work involved in performing, an audit of internal control over financial reporting and an audit of the financial statements are closely related. Furthermore, Section 404(b) of the Sarbanes-Oxley Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement.

Each audit provides the auditor with information relevant to the auditor's evaluation of the results of the other audit. For example, the auditor's discovery of misstatements in the financial statements while performing financial statement auditing procedures indicates that there may be weaknesses in the company's internal control over financial reporting. Because of the significance of this interrelationship, the Board has made it clear that, to conduct and report on the results of an audit of internal control over financial reporting pursuant to Auditing Standard No. 2, the auditor also must audit the company's financial statements.

Notwithstanding the fact that the two audits are interrelated, the integrated audit results in two separate objectives: to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting and to express an opinion on whether the financial statements are fairly stated.

F. Cost

The Board is sensitive to the costs Section 404 and Auditing Standard No. 2 may impose on all companies, particularly some small and medium-sized companies. The

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Board anticipates that most companies of all sizes will experience the highest cost of complying with Section 404 during the first year of implementation.

Internal control is not "one-size-fits-all," and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company. Large, complex, multi-national companies, for example, are likely to need extensive and sophisticated internal control systems.

In smaller companies, or in companies with less complex operations, the ethical behavior and core values of a senior management group that is directly involved in daily interactions with both internal and external parties might reduce the need for elaborate internal control systems. The Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.

Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures to develop the framework. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published Internal Control – Integrated Framework. COSO's publication (also referred to simply as COSO) provides a suitable framework for purposes of management's assessment.

The directions in Auditing Standard No. 2 are based on the internal control framework established by COSO because of the frequency with which management of public companies are expected to use that framework for their assessments. Other suitable frameworks have been published in other countries and likely will be published in the future. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass all of COSO's general themes. The auditor should therefore be able to apply the concepts and guidance in Auditing Standard No. 2 in a reasonable manner if management uses a suitable framework other than COSO.

The Board believes that the special considerations for small and medium-sized companies included within COSO provide well for the auditor's use of such judgment, more so than the appendix that the Board's proposed standard originally included. For

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this reason, the proposed appendix was removed from Auditing Standard No. 2 and replaced with a direct reference to the special considerations within COSO.

The Board also was cognizant of audit costs in its consideration of the appropriate extent to which the auditor may use the work of internal auditors and others to support the auditor's opinion on internal control effectiveness. Auditing Standard No. 2 provides the auditor with significant flexibility in using the relevant work of highly competent and objective personnel, while also requiring the auditor to obtain through his or her own auditing procedures a meaningful portion of the evidence that supports the auditor's opinion. The Board believes it has achieved an appropriate balance of work between the auditor and others that will ensure a high quality audit of internal control and that have the complementary benefit of encouraging companies to invest in competent and objective internal audit functions.

G. The Audit Process

An audit of internal control over financial reporting is an extensive process involving several steps, including planning the audit, evaluating the process management used to perform its assessment of internal control effectiveness, obtaining an understanding of the internal control, evaluating the effectiveness of both the design and operation of the internal control, and forming an opinion about whether internal control over financial reporting is effective.

The auditor's objective is to express an opinion about whether management's assessment, or conclusion, on the effectiveness of internal control over financial reporting is stated fairly, in all material respects. To support his or her opinion, the auditor must obtain evidence about whether internal control over financial reporting is effective. The auditor obtains this evidence in several ways, including evaluating and testing management's assessment process; evaluating and testing work on internal control performed by others, such as internal auditors; and testing the effectiveness of the controls himself or herself.

H. Auditor Independence

The Sarbanes-Oxley Act, and the SEC rules implementing Section 404(a) of the Act, require the auditor to be independent to perform an audit of internal control over financial reporting. Under the SEC's Rule 2-01 on auditor independence, an auditor

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impairs his or her independence if the auditor audits his or her own work, including any work on designing or implementing an audit client's internal control system. PCAOB Auditing Standard No. 2 explicitly prohibits the auditor from accepting an engagement to provide an audit client with an internal control-related service that has not been specifically pre-approved by the audit committee. That is, the audit committee cannot pre-approve internal control-related services as a category, but must approve each service.

I. Key Provisions of Audit Standard No. 2

1. Evaluating Management's Assessment

The natural starting place for the audit of a company's internal control over financial reporting is management's assessment. By evaluating management's assessment, an auditor can have confidence that management has a basis for expressing its conclusion on the effectiveness of internal control. Such an evaluation also provides information that will help the auditor understand the company's internal control, helps the auditor plan the work necessary to complete the audit, and provides some of the evidence the auditor will use to support his or her opinion.

The work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. Auditing Standard No. 2 allows the auditor to use, to a reasonable degree, the work performed by others. The more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

Also, the more clearly management documents its internal control over financial reporting, the process used to assess the effectiveness of the internal control, and the results of that process, the easier it will be for the auditor to understand the internal control, confirm that understanding, evaluate management's assessment, and plan and perform the audit of internal control over financial reporting. This too should translate into reduced professional fees for the audit of internal control over financial reporting.

2. Obtaining an Understanding of Internal Control Over Financial Reporting, Including Performing Walkthroughs

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The auditor should understand how internal control over financial reporting is designed and operates to evaluate and test its effectiveness. The auditor obtains a substantial amount of this understanding when evaluating management's assessment process.

The auditor also should be satisfied, however, that the controls actually have been implemented and are operating as designed. Thus, while inquiry of company personnel and a review of management's assessment process provide the auditor with an understanding of how the system of internal control is designed and operates, they are insufficient by themselves. Other procedures are necessary for the auditor to confirm his or her understanding.

Auditing Standard No. 2 directs the auditor to confirm his or her understanding by performing procedures that include making inquiries of and observing the personnel who actually perform the controls; reviewing documents that are used in, and that result from, the application of the controls; and comparing supporting documents (for example, sales invoices, contracts, and bills of lading) to the accounting records.

The most effective means of accomplishing this objective is for the auditor to perform "walkthroughs" of the company's significant processes. To introduce a powerful efficiency, and because of the importance of several other objectives that walkthroughs accomplish, Auditing Standard No. 2 requires the auditor to perform walkthroughs in each annual audit of internal control over financial reporting.

In a walkthrough, the auditor traces a transaction from each major class of transactions from origination, through the company's accounting and information systems and financial report preparation processes, to it being reported in the company's financial statements. Walkthroughs provide the auditor with audit evidence that supports or refutes his or her understanding of the process flow of transactions, the design of controls, and whether controls are in operation. Walkthroughs also help the auditor to determine whether his or her understanding is complete and provide information necessary for the auditor to evaluate the effectiveness of the design of the internal control over financial reporting.

Because of the judgment that a walkthrough requires and the significance of the objectives that walkthroughs allow the auditor to achieve, Auditing Standard No. 2 requires the auditor to perform the walkthroughs himself or herself. In other words,

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Auditing Standard No. 2 does not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs. However, to provide additional evidence, the auditor may also review walkthroughs that have been performed and documented by others.

The walkthroughs also must be done in each annual audit of internal control over financial reporting. Important objectives of walkthroughs are to confirm that the auditor's understanding of the controls is correct and complete. Without actually "walking" transactions through the significant processes each year, there is too high a risk that changes to the processes would go undetected by the auditor.

Because of the significance of the objectives they are intended to achieve, and the judgment necessary to their effective performance, walkthroughs should be performed by appropriately experienced auditors. Inexperienced audit personnel who participate in walkthroughs should be supervised closely so that the conditions encountered in the walkthroughs are considered appropriately and that the information obtained in the walkthroughs is appropriately documented.

3. Identifying Significant Accounts and Relevant Assertions

As a part of obtaining an understanding of internal control, the auditor also determines which controls should be tested, either by the auditor, management, or others. Auditing Standard No. 2 requires that the auditor obtain evidence about the operating effectiveness of internal control over financial reporting for all relevant assertions for all significant accounts or disclosures. This requirement relies heavily on two concepts: significant account and relevant assertion.

Auditing standards implicitly recognize that some accounts are more significant than others. Auditing Standard No. 2 provides additional direction on how to determine significant accounts for purposes of the audit of internal control over financial reporting. In short, the auditor begins by performing a quantitative evaluation of accounts at the financial-statement caption or note-disclosure level. Then the auditor expands the evaluation to include qualitative factors, such as differing risks, company organization structure, and other factors, which would likely result in additional accounts being identified as significant.

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Financial statement amounts and disclosures embody financial statement assertions. Does the asset exist, or did the transaction occur? Has the company included all loans outstanding in its loans payable account? Have marketable investments been valued properly? Does the company have the rights to the accounts receivable, and are the loans payable the proper obligation of the company? Are the amounts in the financial statements appropriately presented, and is there adequate disclosure about them? Answering these questions helps the auditor to identify the relevant financial statement assertions for which the company should have controls.

Identifying "relevant" assertions is a familiar process for experienced auditors, and because of the importance relevant assertions play in the required extent of testing, Auditing Standard No. 2 provides additional direction.

Similarly, experienced auditors are familiar with identifying significant processes and major classes of transactions. Major classes of transactions are those groupings of transactions that are significant to the company's financial statements. For example, at a company for which sales may be initiated by customers through personal contract in a retail store or electronically using the Internet, these would be two major classes of transactions within the sales process (if they were both significant to the company's financial statements). Because of the importance of significant processes and major classes of transaction in the design of the auditor's procedures, Auditing Standard No. 2 provides additional direction here, too.

4. Testing and Evaluating the Effectiveness of the Design of Controls

To be effective, internal controls must be designed properly, and all the controls necessary to provide reasonable assurance about the fairness of a company's financial statements should be in place and performed by appropriately qualified people who have the authority to implement them. At some point during the internal control audit, the auditor will need to make a determination as to whether the controls would be effective if they were operated as designed, and whether all the necessary controls are in place. This is known as design effectiveness.

The procedures the auditor performs to test and evaluate design effectiveness include inquiries of company personnel, observation of internal controls, walkthroughs, and a specific evaluation of whether the controls are likely to prevent or detect financial statement misstatements if they operate as designed. Auditing Standard No. 2 adopts

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these methods of testing and evaluating design effectiveness. The last step is especially important because it calls for the auditor to apply professional judgment and knowledge of and experience with internal control over financial reporting to his or her understanding of the company's controls.

5. Testing Operating Effectiveness

Auditing Standard No. 2 requires the auditor to obtain evidence about the operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements.

For this reason, in addition to being satisfied as to the effectiveness of the design of the internal controls, the auditor performs tests of controls to obtain evidence about the operating effectiveness of the controls. These tests include a mix of inquiries of appropriate company personnel, inspection of relevant documentation, such as sales orders and invoices, observation of the controls in operation, and reperformance of the application of the control.

Auditing Standard No. 2 directs required tests of controls to "relevant assertions" rather than to "significant controls." To comply with the requirements of Auditing Standard No. 2, the auditor would apply tests to those controls that are important to fairly presenting each relevant assertion in the financial statements. It is neither necessary to test all controls nor is it necessary to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). However, the emphasis is better placed on addressing relevant assertions (because those are the points where misstatements could occur) rather than significant controls. This emphasis encourages the auditor to identify and test controls that address the primary areas where misstatements could occur, yet limits the auditor's work to the necessary controls.

Expressing the extent of testing in this manner also resolves the issue of the extent of testing from year to year (the "rotating tests of controls" issue). Auditing Standard No. 2 states that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year.

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At the Board's roundtable, public company representatives and auditors indicated that providing examples of extent-of-testing decisions would be helpful. The proposed auditing standard included several examples, which have been retained in Appendix B of Auditing Standard No. 2.

6. Timing of Testing

The Act requires management's assessment and the auditor's opinion to address whether internal control was effective as of the end of the company's most recent fiscal year, in other words, as of a point-in-time. Performing all of the testing on December 31 is neither practical nor appropriate, however. To form a basis to express an opinion about whether internal control was effective as of a point in time requires the auditor to obtain evidence that the internal control operated effectively over an appropriate period of time. Auditing Standard No. 2 recognizes this and allows the auditor to obtain evidence about operating effectiveness at different times throughout the year, provided that the auditor updates those tests or obtains other evidence that the controls still operated effectively at the end of the company's fiscal year.

7. Using the Work of Others

The auditor must consider other relevant and available information about internal control when evaluating internal control effectiveness. In this regard, Auditing Standard No. 2 requires the auditor to understand the results of procedures performed by others, for example, internal auditors, other company personnel, and third parties working under the direction of management, on internal control over financial reporting.

At a minimum, the auditor should consider the results of those tests in designing the audit approach and ultimately in forming an opinion on the effectiveness of internal control over financial reporting. To this end, Auditing Standard No. 2 requires the auditor to review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address internal controls over financial reporting and evaluate any internal control deficiencies identified in those reports.

Additionally, the auditor may use the results of testing by others to alter the nature, timing, and extent of his or her tests of controls. At the Board's roundtable and in comment letters, public companies indicated their concern that at some point, the

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Board's standard could require an excessive amount of retesting by the auditor in order to use the work of others, especially internal auditors, and would inappropriately restrict the auditor's ability to use the work of internal auditors and others.

Public companies were particularly sensitive to this issue because of its direct bearing on the cost of complying with Section 404. On the other hand, the federal bank regulators indicated that experience with the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), which requires internal control reporting similar to Section 404 of the Act, revealed instances in which the auditor used the work of internal auditors to an inappropriately high degree, where the auditor himself or herself did not perform sufficient work to provide a reasonable basis for his or her opinion.

The directions in Auditing Standard No. 2 for using the work of others are based on the same concepts as Statement on Auditing Standards ("SAS") No. 65, Auditor's Consideration of the Internal Audit Function in an Audit of the Financial Statements.[3] However, because the subject matter in an audit of internal control – the effectiveness of the controls – is different from the subject matter in an audit of financial statements – the reliability of the financial amounts and disclosures – some adaptation of SAS No. 65 was required.

The competence and objectivity factors described in SAS No. 65 were adapted to the evaluation of persons other than internal auditors, such as members of financial management, and the evaluation of the nature of the items tested by others was adapted to the context of an audit of internal control over financial reporting rather than an audit of financial statements. Additionally, Auditing Standard No. 2 creates an overall boundary on the use of the work of others in an audit of internal control over financial reporting not contained in SAS No. 65 by requiring that the auditor's own work provide the principal evidence for the audit opinion.

Auditing Standard No. 2 describes an evaluation process, focusing on the nature of the controls subject to the work of others and the competence and objectivity of the

[3] The Board adopted the generally accepted auditing standards, as described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") SAS No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. SAS No. 65 is one of those standards.

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persons who performed the work, that the auditor should use in determining the extent to which he or she may use the work of others.

For example, based on the nature of the controls in the control environment, the auditor should not use the work of others to reduce the amount of work he or she performs on the control environment. On the other hand, the auditor could use the work of others to test controls over the period-end financial reporting process. However, given the nature of these controls, the auditor would normally determine that he or she should perform more of these tests himself or herself, and that for any of the work of others the auditor used, the degree of competence and objectivity of the individuals performing the work should be high. Therefore, the auditor might use the work of internal auditors in this area to some degree but not the work of others within the company. Because of the importance of these decisions, Auditing Standard No. 2 provides additional direction.

Auditing Standard No. 2 also requires that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion. Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment as to whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work performed on pervasive controls and in areas such as the control environment than on other controls such as controls over routine, low-risk transactions. Also, the work the auditor performs in the control environment and walkthroughs provide an important part of the principal evidence the auditor needs to obtain.

These principles interact to provide the auditor with considerable flexibility in using the work of others and also prevent inappropriate over-reliance on the work of others. Although Auditing Standard No. 2 requires that the auditor reperform some of the tests performed by others in order to use their work, it does not set any specific requirement on the extent of the reperformance. For example, the standard does not require that the auditor reperform tests of controls over all significant accounts for which the auditor uses the work of others. Rather, Auditing Standard No. 2 relies on the auditor's judgment, such that the re-testing is sufficient to enable the auditor to evaluate the quality and effectiveness of the work.

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This considerable flexibility in using the work of others should translate into a strong encouragement for companies to develop high-quality internal audit, compliance, and other such functions. The more highly competent and objective these functions are, and the more thorough their testing, the more the auditor will be able to use their work.

8. Evaluating the Results of Testing

Both management and the auditor may identify deficiencies in internal control over financial reporting. A control deficiency exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Auditing Standard No. 2 requires the auditor to evaluate the severity of all identified control deficiencies because such deficiencies can have an effect on the auditor's overall conclusion about whether internal control is effective. The auditor also has a responsibility to make sure that certain parties, such as the audit committee, are aware of control deficiencies that rise to a certain level of severity.

Under Auditing Standard No. 2, a control deficiency (or a combination of internal control deficiencies) should be classified as a significant deficiency if, by itself or in combination with other control deficiencies, it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. A significant deficiency should be classified as a material weakness if, by itself or in combination with other control deficiencies, it results in more than a remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected.

The definitions of significant deficiency and material weakness focus on likelihood and magnitude as the framework for evaluating deficiencies. The Board anticipates that this framework will bring increased consistency to these evaluations yet preserve an appropriate degree of judgment. Additionally, Auditing Standard No. 2 includes examples of how these definitions would be applied in several different scenarios.

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Auditing Standard No. 2 requires the auditor to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor also is required to communicate to the company's management, in writing, all control deficiencies of which he or she is aware that have not previously been communicated in writing to management and to notify the audit committee that such communication has been made.

9. Identifying Significant Deficiencies

Auditing Standard No. 2 identifies a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists, including –

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee. Effective oversight by the company's board of directors, including its audit committee, is essential to the company's achievement of its objectives and is an integral part of a company's monitoring of internal control. In addition to requiring the audit committee to oversee the company's external financial reporting and internal control over financial reporting, the Act makes the audit committee directly responsible for the appointment, compensation, and oversight of the work of the auditor. Thus, an ineffective audit committee can have detrimental effects on the company and its internal control over financial reporting, as well as on the independent audit. Auditing Standard No. 2 requires that, as part of evaluating the control environment and monitoring components of internal control, the auditor assess the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting.

  To be sure, the company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee. Auditing Standard No. 2 does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. If the auditor concludes that oversight by the audit committee is ineffective, however, the auditor must communicate that specific significant

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deficiency, or material weakness as the case may be, in writing to the board of directors.

Normally, the auditor's interests and the audit committee's interests will be aligned: both should be interested in fairly presented financial statements, effective internal control over financial reporting, and an effective audit process. The Board recognizes that a theoretical conflict of interest results from the audit committee's responsibility to hire and fire the auditor. However, this type of conflict is one that experienced auditors are accustomed to bearing and that investors expect an auditor to address: when the auditor determines that its overseer is ineffective (which significantly impairs the effectiveness of the financial reporting process), the auditor must speak up.

- Material misstatement in the financial statements not initially identified by the company's internal controls. As previously stated, the audit of internal control over financial reporting and the audit of the company's financial statements are an integrated activity and are required by the Act to be a single engagement. The results of the work performed in a financial statement audit provide evidence to support the auditor's conclusions on the effectiveness of internal control, and vice-versa. Therefore, if the auditor discovers a material misstatement in the financial statements as a part of the audit of the financial statements, the auditor should consider whether internal control over financial reporting is effective. That the company's internal controls did not first detect the misstatement is, therefore, a strong indicator that the company's internal control over financial reporting is ineffective.

  Timing might be a concern for some issuers, particularly as it relates to making preliminary drafts of the financial statements available to the auditor. However, changes to the financial statement preparation process that increase the likelihood that the financial information is correct prior to providing it to the auditors likely will result in an improved control environment. The auditor also must exercise judgment when performing this evaluation. For example, if the auditor initially identified a material misstatement in the financial statements but, given the circumstances, determined that management would have found the misstatement on a timely basis before the financial statements were made publicly available, the auditor might appropriately determine that the circumstance was a significant deficiency but not a material weakness.

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- Significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after reasonable periods of time. Significant deficiencies in internal control that are not also determined to be material weaknesses, as defined in the proposed auditing standard, are not so severe as to require the auditor to conclude that internal control is ineffective. However, these deficiencies are, nonetheless, significant, and the auditor should expect the company to correct them. If, however, management fails to correct significant deficiencies within a reasonable period of time, that situation reflects poorly on tone-at-the-top, and directly on the control environment as a whole. Additionally, the significance of the deficiency can change over time (for example, major changes in sales volume or added complexity in sales transaction structures might increase the severity of a significant deficiency affecting sales).

10. Forming an Opinion and Reporting

Auditing Standard No. 2 permits the auditor to express an unqualified opinion if the auditor has identified no material weaknesses in internal control after having performed all of the procedures that the auditor considers necessary in the circumstances. In the event that the auditor cannot perform all of the procedures that the auditor considers necessary in the circumstances, Auditing Standard No. 2 permits the auditor to either qualify or disclaim an opinion. If an overall opinion cannot be expressed, Auditing Standard No. 2 requires the auditor to explain why.[4/]

[4/] See also SEC Regulation S-X 2-02(f), 17 C.F.R. § 212 2-02(f) ("The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and clearly state the opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects, or must include an opinion to the effect that an overall opinion cannot be expressed. If an overall opinion cannot be expressed, explain why.").

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In addition, the auditor's report is to include two opinions as a result of the audit of internal control over financial reporting: one on management's assessment and one on the effectiveness of internal control over financial reporting. The Board decided that two opinions will most clearly communicate to report readers the nature and results of the work performed and most closely track with the requirements of Sections 404 and 103 of the Act.

11. No Disclosure of Significant Deficiencies

The auditor's report must follow the same disclosure model as management's assessment. The SEC's final rules implementing Section 404(a) require management's assessment to disclose only material weaknesses, not significant deficiencies. Therefore, because management's assessment will disclose only material weaknesses, the auditor's report may disclose only material weaknesses.[5]

12. Material Weaknesses Result in Adverse Opinion on Internal Control

The previously existing attestation standard provided that when the auditor identified a material weakness in internal control, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor might qualify his or her opinion ("except for the effect of the material weakness, internal control was effective") or might express an adverse opinion ("internal control over financial reporting was not effective").

The SEC's final rules implementing Section 404(a) state that "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In other words, in such a case, management must conclude

[5] It should be noted, however, that the final rules indicated that an aggregation of significant deficiencies may constitute a material weakness in a company's internal control over financial reporting, in which case disclosure would be required. See Final Rule: Management's Reports in Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238, (June 5, 2003) [68 FR 36636].

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that internal control is not effective (i.e., a qualified or "except for" conclusion is not allowed).

Similar to the reporting of significant deficiencies, the reporting model for the auditor must follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion on the effectiveness of internal control over financial reporting must also be adverse; Auditing Standard No. 2 does not permit a qualified opinion in the event of a material weakness. However, Auditing Standard No. 2 also requires an opinion on management's assessment in every audit report.

In the event of a material weakness, the auditor could express an unqualified opinion on management's assessment, so long as management properly identified the material weakness and concluded in their assessment that internal control was not effective.

If the auditor and management disagree about whether a material weakness exists (i.e., the auditor concludes a material weakness exists but management does not and therefore makes the conclusion in its assessment that internal control is effective), then the auditor would render an adverse opinion on management's assessment.

The Board chose for the auditor's report to express two opinions in part because it would be more informative when a material weakness exists.

13. Testing Controls Intended to Prevent or Detect Fraud

Strong internal controls provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that the internal control reporting required by Section 404 can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), the auditing standard on performing the audit of internal control over financial reporting should emphasize controls that prevent or detect errors as well as fraud. For this reason, Auditing Standard No. 2 specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably possible to result in material misstatement of the financial statements.

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* * *

On the 9th day of March, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

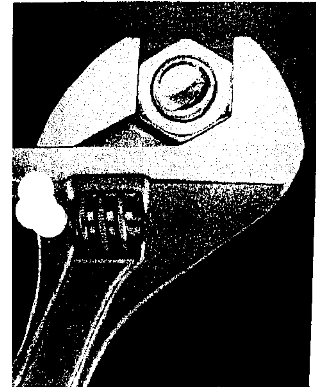
/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

March 9, 2004

APPENDIX – Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

May 2007, No. 07-16



# New PCAOB Auditing Standard on Internal Control Over Financial Reporting

The Public Company Accounting Oversight Board adopted a new auditing standard for an audit of internal control over financial reporting that is integrated with an audit of financial statements. If approved by the SEC, the new standard will supersede the Board's existing standard for these audits.[i] The Board incorporated in the new standard some elements of its proposal on considering and using the work of others, rather than issuing a separate standard as originally proposed.

This edition of *Defining Issues* explains how the new standard might affect the auditor's work in forming an opinion on internal control over financial reporting.

The new standard is designed to focus the audit of internal control on the most important matters, include only requirements necessary for an effective audit, make the audit scalable to fit the size and the complexity of any company, and simplify the requirements.

The new standard differs from last December's proposal by:

- Revising selected terms and concepts to more closely align them with SEC rules and guidance,
- Emphasizing more prominently the importance of assessing fraud risk and evaluating anti-fraud controls,
- Explaining the effect of different types of entity-level controls on selecting and testing other controls, and
- Requiring auditors to meet the objectives of a properly performed walkthrough, rather than perform walkthroughs in all cases.

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[i] PCAOB, Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, May 24, 2007 and Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, March 9, 2004, both available at www.pcaobus.org

### Matters Most Important to Internal Control

The new standard requires a top-down approach to selecting the controls to be tested. A top-down approach begins with an understanding of the risks to internal control over financial reporting. The auditor then focuses on entity-level controls, 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.

Risk assessment is central to the approach in the new standard. It includes identifying significant accounts, disclosures, and relevant assertions, selecting controls to test, and determining the evidence to gather for a given control. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends on the risk associated with the control. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

The results of the auditor's fraud-risk assessment must be taken into account when planning and performing the audit of internal control over financial reporting. The potential for management fraud is identified in the new standard as an area of higher risk that requires commensurately more attention. As part of identifying and testing entity-level controls and selecting other controls to test, the auditor is to evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and of management override of other controls. The new standard provides additional guidance on the types of controls that might address fraud risk.

> **SEC Guidance for Management**
>
> On May 23, 2007, the Securities and Exchange Commission approved interpretive guidance to help public-company managements perform assessments of internal control over financial reporting for purposes of enhancing compliance under Section 404 of the Sarbanes-Oxley Act. The new guidance is intended to focus company management on the internal controls that best protect against the risk of a material financial misstatement and to reduce unnecessary management procedures. The guidance is expected to be posted to the SEC's Web site soon.

Under a top-down, risk-based approach, the auditor should focus on the controls most important to financial reporting. The new standard identifies three broad categories of entity-level controls that vary in nature and precision and explains how each category might affect the performance of tests of other controls:

- Controls, such as control environment controls, that have an indirect effect on the likelihood that a misstatement will be prevented or detected on a timely basis might affect other controls the auditor selects for testing and the nature, timing, and extent of the procedures the auditor performs on other controls, but likely do not operate at a level of precision sufficient to eliminate the need to test other controls in their entirety.
- Controls that monitor the effectiveness of other controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would sufficiently address the assessed risk that misstatements of a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce tests of other controls.
- Controls that when operating effectively at a level of precision sufficient to adequately prevent or detect on a timely basis misstatements of one or more relevant assertions and may enable the auditor to avoid testing additional controls related to a particular risk of misstatement.

The Board recognized that the auditor generally will need to understand the company's processes to appropriately identify the correct controls to test, but the standard contains no requirement to identify major classes of transactions and significant processes.

The new standard retained the existing framework for evaluating deficiencies under which material weaknesses are identified by assessing the likelihood and magnitude of a potential misstatement. However, some definitions and concepts were clarified. A material weakness is now defined as "a deficiency, or 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." A significant deficiency is now defined as "a deficiency, or 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."

The changes made to the definition of a significant deficiency are intended to focus the auditor on the communication requirement and away from scoping issues. The term "reasonable possibility" replaces the term "more than remote likelihood" within the material weakness definition. This makes the terminology for evaluating the likelihood of a misstatement consistent with the concepts in FASB Statement No. 5, Accounting for Contingen-cies. Finally, the reference to "significant deficiency" is removed from the definition of material weakness to eliminate the inference that the auditors' procedures should be detailed enough to detect a significant deficiency.

The new standard includes a list of indicators of a material weakness. A deficiency that is not a listed indicator may be a material weakness. On the other hand, the presence of one of the indicators does not necessitate a conclusion that there is a material weakness. Because the auditor's focus is on detecting whether any material weaknesses in internal control over financial reporting exist, the new standard does not include a list of areas that ordinarily result in at least significant deficiencies in internal control over financial reporting.

The new standard also clarifies the role of materiality (including interim materiality) in the audit. Auditors are to give account-level materiality the same weight in determining the nature, timing, and extent of their procedures in an audit of internal control as would be given in a financial-statement audit. As before, the reference to interim financial statements in the definitions of material weakness relates only to the evaluation of deficiencies, not to the scope of the auditor's testing.

### Eliminating Certain Procedures

The Board evaluated the procedures required by Auditing Standard No. 2 and eliminated provisions that it concluded were not necessary to achieve the objectives of Auditing Standard No. 5. The eliminated procedures include the requirement to evaluate management's process for assessing the effectiveness of internal control. The rationale for eliminating this requirement was that in combination with the requirement to provide an opinion on management's assessment (not assessment process), it could cause confusion and lead to unnecessarily detailed testing of management's process. Under the new standard, auditors will need to obtain an understanding of management's process as a starting point in understanding a company's internal control, in assessing risk, and in determining the extent to which they will use the work of others, but the change may reduce the level of work in this area and enable improved coordination between management and auditors.

The new standard expressly permits auditors to consider the nature, timing, and extent of procedures performed in prior years, and the results of those procedures, when assessing the risk associated with a particular control. This may enable auditors to reduce tests or change their nature in areas of lower risk assessment after considering knowledge gained from audits in prior years. However, the new standard does not permit the results of procedures performed in prior years to be used in lieu of performing some procedures in the current year ("rotation of control testing").

Scoping decisions in a multi-location environment under the new standard are focused on risk rather than on coverage. The standard omits the requirement to test controls over a "large portion" of the company and directs auditors to use a risk-based approach to determine the testing strategy for multiple locations. In addition, the guidance on multi-location scoping decisions notes that auditors should vary the nature, timing, and extent of control testing at locations or business units from year to year.

The new standard removes certain barriers to using the work of other parties in the audit of internal control over financial reporting. For example, the new standard allows the auditor performing an integrated audit to use the work of others considered sufficiently competent and objective in testing controls in the control environment. The new standard also allows auditors to use direct assistance from other parties in performing walkthroughs, a change from Auditing Standard No. 2's prohibition against using others' work in performing walkthroughs.

The effect of other parties' work on the auditor's work depends on the relationship between the risk associated with the control and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases. In areas of higher risk (for example, controls that address specific fraud risks), the need for the auditor to perform his or her own work on the control increases. The Board had proposed a separate auditing standard on using others' work in an audit that would have replaced the current standard on considering the internal audit function.[2] However, the Board decided instead to retain the current standard on considering the internal audit function and incorporate additional guidance into new Auditing Standard No. 5.

[2] PCAOB, Proposed Auditing Standard, Considering and Using the Work of Others in an Audit, December 19 2006, and Interim Professional Auditing Standard, AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

The new standard's requirements contrast with Auditing Standard No. 2's requirement for a walkthrough of each major class of transactions within a significant process and with the proposed requirement to perform a walkthrough of each significant process each year. The new standard focuses the auditor on achieving specified objectives related to understanding the likely sources of potential misstatements and to selecting controls to test. It states that a walkthrough frequently will be the best way of achieving the objectives, but that in some cases, other procedures may be equally or more effective ways to achieve them.

### Scaling the Audit for Less Complex Companies

The new standard describes how to tailor the audit to the particular circumstances of less complex companies or one or more of a company's less complex business units. The Board believes that focusing on entity-level controls and relying on principles will enable the auditor to scale the audit approach to effectively and efficiently test controls at less complex companies. The new standard states that companies of different sizes and complexity might achieve control objectives differently.

The Board is planning to issue further guidance on auditing internal control in smaller and less complex companies. The guidance is being developed with assistance from a task force of auditors (including KPMG) of smaller and less complex companies, will expand on the principles in the standard, and is intended to provide practical advice about the audit of internal control in a smaller, less complex company.

### Simplifying the Requirements

The new standard is intended to simplify the requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal control over financial reporting. The objective was to achieve these three improvements in the requirements:

- Reduce the level of detail and specificity to encourage auditors to apply more professional judgment under the facts and circumstances,
- Organize the standard to better reflect the sequential flow of an audit of internal control, from planning the audit to reporting on the effectiveness of internal control, and
- Articulate the requirements in a more readable manner.

### Reporting and Communication Requirements

The auditors' report required by the new standard expresses only one opinion, an opinion on the effectiveness of the company's internal control over financial reporting. No opinion will be expressed by the auditor on whether management's assessment is fairly stated.

Auditors may disclaim an opinion on internal control over financial reporting if and when they conclude that a scope limitation would prevent them from obtaining the reasonable assurance necessary to express an opinion. In these circumstances, the auditor need not perform additional work before disclaiming an opinion.

The auditors' responsibility for communicating material weaknesses, significant deficiencies, and other deficiencies is the same as under the existing standard. Material weaknesses and significant deficiencies identified during the audit will continue to be communicated in writing to management and the audit committee, and other deficiencies identified during the audit will be communicated in writing to management.

### Nonaudit Services

The Board adopted a related new rule on auditors' responsibilities when they seek audit committee pre-approval of internal-control-related nonaudit services.[3] New Rule 3525 is intended to ensure that audit committees obtain information sufficient for them to make an informed decision on how performing internal-control-related services might affect audit independence. The new rule requires a registered public accounting firm to take the following steps:

- Describe the scope of the proposed service in writing to the audit committee,
- Discuss with the audit committee the potential effects of the proposed service on the firm's independence, and
- Document the substance of the discussion with the audit committee.

These requirements parallel auditors' responsibilities when seeking audit committee pre-approval to perform tax services for a public-company audit client.

The new rule recognizes that audit committees may pre-approve the provision by their independent auditor of each specific internal-control-related service or may pre-approve such services based on committee-approved policies and procedures.

### Effective Date

Assuming approval by the SEC, the new standard and Rule 3525 will be effective for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any point after SEC approval. Auditors who elect to comply with the new standard after SEC approval but before its effective date must at the same time comply with Rule 3525 and other PCAOB standards as amended.

Auditors who do not elect to comply with Auditing Standard No. 5 before the effective date must continue to comply with Auditing Standard No. 2 until it is superseded. Those auditors should, however, apply the definition of "material weakness" contained in the new standard, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in the new standard parallels the new SEC definition.

Readers should not treat the descriptive and summary statements above about the PCAOB's new standard and rules as a substitute for what has been adopted and approved, or for any other SEC or PCAOB requirements. When filing reports with the SEC, registrants should refer to the text of the relevant requirements, consider their particular circumstances, and consult their accounting and legal advisors.

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[3] PCAOB Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting, May 24, 2007, available at www.pcaobus.org.

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**

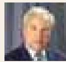
Mark was doing well in his career. He was a valued and trusted senior officer of the company, having worked his way up the corporate ladder over two decades. He now enjoyed the title of senior vice president of finance of one of the company's most profitable divisions. Sure it was a lot of responsibility,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

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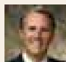

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**Initial Detection**

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.

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;

### 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*

- 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



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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).

1 AMERICAN BAR ASSOCIATION
2
3 TASK FORCE ON ATTORNEY-CLIENT PRIVILEGE
4 TENNESSEE BAR ASSOCIATION
5 SECTION OF STATE AND LOCAL GOVERNMENT LAW
6 BAR ASSOCIATION OF SAN FRANCISCO
7 SECTION OF BUSINESS LAW
8 TORT TRIAL AND INSURANCE PRACTICE SECTION
9 GENERAL PRACTICE, SOLO AND SMALL FIRM DIVISION
10 SECTION OF HEALTH LAW
11 SECTION OF LITIGATION
12 SECTION OF TAXATION
13 NEW YORK STATE BAR ASSOCIATION
14 SECTION OF LABOR AND EMPLOYMENT LAW
15 SECTION OF INDIVIDUAL RIGHTS AND RESPONSIBILITIES
16 YOUNG LAWYER FORUM DIVISION
17
18 REPORT TO THE HOUSE OF DELEGATES
19
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21 RECOMMENDATION
22
23 RESOLVED that the American Bar Association supports the preservation of the
24 attorney-client privilege and work product doctrine in connection with audits of company
25 financial statements.
26
27 FURTHER RESOLVED that the American Bar Association urges the Securities
28 and Exchange Commission, the Public Company Accounting Oversight Board, the
29 American Institute of Certified Public Accountants, the legal and accounting professions,
30 and other relevant organizations to adopt standards, policies, practices and procedures
31 and take other appropriate steps to ensure that attorney-client privilege and work product
32 protections are preserved throughout the audit process.

## REPORT

### I. BACKGROUND OF THE TASK FORCE

The American Bar Association established its Task Force on the Attorney-Client Privilege in September 2004, to evaluate issues and recommend policy related to the attorney-client privilege and work-product doctrine.[1] The Task Force has been examining current developments regarding the privilege and work-product doctrine, the circumstances in which governmental agencies and others are asserting the need for privileged and work product protected information, and the extent to which preserving the privilege and work product protections or disclosing privileged information or attorneys' litigation work product in such circumstances harms the public interest. By examining and reporting on these and related issues, the Task Force hopes to inform the public and the legal profession of the importance of the privilege and work-product doctrine, relate each of these principles to the competing demands for access to protected information, and assist the ABA in developing policies that strike the right balance given these competing demands.

The Task Force began its work by identifying a variety of contemporary contexts in which attorney-client confidentiality has come under serious pressure, in light of changes in the law and changes in institutional practices by government agencies and others. The Task Force recognized that initially it would focus on the areas that seem to be producing the greatest tensions on the privilege and work-product doctrine. In light of its charge and its determination regarding the most pressing issues, the Task Force gave notice to the professional community that it would begin by focusing its attention on two substantial practices: (1) requests by prosecutors and government regulators for the production of material protected by the attorney-client privilege and work-product doctrine, and (2) requests by auditors of public companies for the production of material protected by the attorney-client privilege and work-product doctrine.

As part of its ongoing charge, the Task Force has reviewed scholarly articles and applicable law, conducted meetings, held public hearings, and received oral and written testimony from interested persons. These meetings and hearings have produced varied views and considerable information, some of which is noted in this Report and all of which is posted on the Task Force's website, which is located at http://www.abanet.org/buslaw/attorneyclient.[2]

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1 Information about the Task Force and relevant materials assembled by it can be found on the Task Force's website, http://www.abanet.org/buslaw/attorneyclient/home.shtml.

2 The following is a list of the individuals and groups providing written or oral testimony to the Task Force on February 11, 2005. The American College of Trial Lawyers; David M. Brodsky, Corporate Counsel Consortium, Kenneth W. Gideon, ABA Section of Taxation; Steven K. Hazen, State Bar of California, Business Law Section, Corporations Committee; James W. Conrad, Jr., American Chemistry Council; Paul Rosenzweig, The Heritage Foundation, John Gamino, TXU Corporation; Ursula Weingold, University of St. Thomas School of Law (Minnesota); Brad Brian, ABA Section of Litigation, United States Chamber of Commerce, The Law Society of Upper Canada; Steven R. Schell, Black Helterling LLP; Paul Rice, American University Washington College of Law; ABA Section of State and Local Government Law; Randolph Braccialarghe, NSU Law Center; and State Bar of California, Standing Committee on Professional Responsibility & Conduct. The following is a list of the individuals and groups providing written or oral testimony to the Task Force on April 21, 2005: Stephen A. Saltzburg, The George Washington School of Law; Susan Hackett, Association of Corporate Counsel, John Beccia III, The Financial Services Roundtable; Jonathan Bach, New York Council of Defense

(footnote continued on following page)

After gathering and analyzing this information, the Task Force submitted a proposed resolution last year to the ABA House of Delegates, known as "Recommendation 111," which expresses support for the privilege and work product doctrine and opposition to governmental policies that erode these protections. The resolution, which the ABA House of Delegates approved unanimously in August 2005, states as follows:

> RESOLVED, that the American Bar Association strongly supports the preservation of the attorney-client privilege and work-product doctrine as essential to maintaining the confidential relationship between client and attorney required to encourage clients to discuss their legal matters fully and candidly with their counsel so as to (1) promote compliance with law through effective counseling, (2) ensure effective advocacy for the client, (3) ensure access to justice and (4) promote the proper and efficient functioning of the American adversary system of justice; and
>
> FURTHER RESOLVED, that the American Bar Association opposes policies, practices and procedures of governmental bodies that have the effect of eroding the attorney-client privilege and work product doctrine and favors policies, practices and procedures that recognize the value of those protections.
>
> FURTHER RESOLVED, that the American Bar Association opposes the routine practice by government officials of seeking to obtain a waiver of the attorney-client privilege or work product doctrine through the grant or denial of any benefit or advantage.

In addition to Recommendation 111, the Task Force also provided the ABA House of Delegates with a detailed Report discussing and analyzing the importance of the attorney-client privilege and the work product doctrine, as well as the various ways in which these protections have been eroded in recent years.[3] In the Report, the Task Force detailed the reasons behind the Recommendation. Among other things, the Report demonstrated the overriding public benefit resulting from preservation of client confidentiality, including in the organizational context, and the way such benefit is attained through faithful application of the attorney-client privilege and the attorney work-product doctrine. The key benefits of these protections identified in the Report can be summarized as follows:

- the protections foster the attorney-client relationship
- the protections encourage client candor

*(footnote continued from preceding page)*

Lawyers; Elizabeth J. Cabraser, Lieff, Cabraser, Heimann & Bernstein; Gerald B. Lefcourt, National Association of Criminal Defense Lawyers; Martin S. Kaufman, Atlantic Legal Foundation; W. Wayne Withers, Emerson; State Bar of California, Business Law Section, Corporations Committee; Federation of Defense & Corporate Counsel; and Section of International Law, Ad Hoc Task Force on Money Laundering and Professional Responsibilities

3 Recommendation 111 and the related Report are available on the Task Force's website at http://www.abanet.org/buslaw/attorneyclient/. The Recommendation, but not the Report, constitutes official ABA policy



- the protections foster voluntary legal compliance
- the protections promote efficiency in the legal system
- the protections enhance the constitutional right to effective assistance of counsel

While those benefits focus on the role of the attorney, the direct beneficiary is the client. Furthermore, the failure to achieve those benefits has an adverse impact on society in general and the administration of justice in particular.

Recommendation 111 is consistent with a narrower policy adopted by the ABA House of Delegates in August 2004 opposing recent amendments to the Federal Sentencing Guidelines that encourage prosecutors to pressure companies to waive their attorney-client privilege and work product protections during investigations.[4]

Since August 2005, the Task Force has continued its efforts. For example, in an effort to help implement the ABA's August 2005 recommendations, the Task Force prepared a memorandum (the "Revised Memorandum") earlier this year suggesting specific changes to the Justice Department's privilege waiver policy as stated in its 1999 "Holder Memorandum," 2003 "Thompson Memorandum," and 2005 "McCallum Memorandum." The Task Force's "Revised Memorandum" recommends that the Department's policies be modified to (1) prohibit federal prosecutors from demanding, requesting, or encouraging, directly or indirectly, that companies waive their attorney-client privilege or work product protections during investigations, (2) specify the types of factual, non-privileged information that prosecutors may request from companies during investigations as a sign of cooperation, and (3) clarify that any voluntary decision by a company to waive the attorney-client privilege and the work product doctrine shall not be considered when assessing whether the entity provided effective cooperation. Subsequently, on May 2, 2006, ABA President Michael Greco sent a letter to Attorney General Alberto Gonzales urging the Department to revise its waiver policies in accordance with the principles outlined in the Task Force's Revised Memorandum.

The Task Force expects to continue its work to develop specific measures in furtherance of the resolutions adopted by the ABA House of Delegates in August 2005. Discussions are underway with representatives of various regulators, which will help guide the Task Force in determining potential solutions to the issues. It has been very gratifying to see lawyers from corporations, the private sector and government all working together in a constructive manner on these critical issues for our justice system.

4 In August 2004, the ABA adopted Recommendation 303, supporting five specific changes to the then-proposed amendments to the Federal Sentencing Guidelines for Organizations, including amending the Commentary to Section 8C2 5 to state affirmatively that waiver of attorney-client and work product protections "should not be a factor in determining whether a sentencing reduction is warranted for cooperation with the government." Recommendation 303 and the related Report are available at http://www abanet.org/poladv/report303 pdf. The Recommendation, but not the Report, constitutes official ABA policy. After receiving extensive written comments and testimony from the ABA, other organizations, and numerous former senior Justice Department officials, the Sentencing Commission voted unanimously on April 5, 2006, to reverse the 2004 privilege waiver amendment to the Sentencing Guidelines. Unless Congress acts to modify or reverse the change, it will become effective on November 1, 2006.

II. NEED FOR ABA POLICY ON THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT DOCTRINE IN THE AUDIT CONTEXT

The policy adopted by the ABA in August 2005 that is contained in Recommendation 111 focused mainly on the need to preserve attorney-client privilege and work product protections in the context of federal law enforcement and prosecution, with special emphasis on the practice of certain federal agencies requiring companies to waive these protections during investigations. The policy did not directly address the status of the attorney-client privilege in the audit area. In fact, Section VIII of the Report accompanying Recommendation 111 specifically stated that the Task Force had not yet gathered sufficient information to make recommendations to the House of Delegates in the audit area and would seek to do so in the future. For these reasons, the Task Force believes it is both appropriate and necessary for the ABA to adopt a new resolution that directly addresses erosion of the privilege and the work product doctrine in the context of audits of financial statements. Unless the ABA adopts such a policy, it will be unable to effectively pursue its dialogue and advocacy efforts with federal regulators and the accounting profession.

The current proposed Recommendation and Report were prepared by the Task Force to address issues surrounding the tension between preservation of the fundamental protections of the attorney-client privilege and work product doctrine and the need for reliable financial reporting and effective audits.[5] The goal of the ABA should be to balance and reconcile these important competing public policies with a view to maintaining these fundamental protections while enabling effective audits of company financial statements. We believe this can be accomplished by defining auditing standards that identify information auditors need to obtain and retain for purposes of the audit in a manner that is entirely consistent with preserving these protections.

The importance of preserving attorney-client privilege and work product protections in the organizational context, as fundamental to our democratic values and system of justice, has been historically recognized in the accounting literature as part of generally accepted auditing standards. The ABA remains staunchly committed to preserving these fundamental values because they help protect the confidentiality of the attorney-client relationship and the essential candor of communications between client and counsel that are dependent on confidentiality. It is this confidentiality and the resulting candor of communications that permit lawyers to play a crucial role in encouraging legal compliance. The Task Force also is sensitive to the need for auditors to receive the information they reasonably need to conduct an effective audit and provide the reliable and transparent financial reporting upon which the credibility of our financial markets is based. This Report seeks to identify ways in which both goals might be achieved. It does so by identifying the information that we believe may properly be required in connection with an audit without undermining attorney-client and work product protections. It also addresses issues surrounding the extent to which information provided as part of the audit might be protected from further disclosure should that be considered a desirable outcome.

5 Not all members of the Task Force endorse every view expressed in this Report, but the Report taken as a whole reflects a consensus of the members of the Task Force. The views expressed in this Report have not been approved by the House of Delegates or Board of Governors of the American Bar Association and, accordingly, should not be considered as representing the policy of the American Bar Association.



In furtherance of the foregoing objectives, the Task Force believes that it is advantageous for the ABA to adopt current policy that expresses its support for the preservation of the attorney-client privilege and work product doctrine in the audit context and encourages relevant regulatory and industry groups to take steps to ensure that these protections are preserved throughout the audit process. Accordingly, it is submitting the Recommendation and providing this Report to amplify the reasons for the Recommendation and actions the Task Force could take to implement it in cooperation with regulatory authorities and industry groups.

III. EXISTING ABA POLICY ON AUDIT DISCLOSURES

During the period 1975-76, the ABA and the American Institute of Certified Public Accountants ("AICPA") adopted a policy endorsing a "Statement of Policy" regarding the appropriate scope of the lawyer's response to the auditor's request for certain privileged materials during the course of audits, including requests for disclosure of "contingent liabilities" that would violate the attorney-client privilege.[6] This policy, which is commonly referred to as the "Treaty," strikes a delicate balance between preserving the benefits arising from attorney-client and work product protections and other potentially competing policy considerations. Preserving this balance has been a hallmark of the interaction between the legal and accounting professions for over 30 years, and rationale for the Treaty remain valid today.

The Preamble to the Treaty explains these important policy considerations in pertinent part as follows:

> 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.
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> * * * * *

6 American Bar Association "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests," approved by the ABA Board of Governors in December, 1975, confirmed by the Board of Directors of the American Institute of Certified Public Accountants ("AICPA") in January, 1976, ratified by the ABA House of Delegates in August 1976, and incorporated by the AICPA in March 1977 into its "Standards of Fieldwork" as Exhibit II of AU Section 337 ("Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments") simultaneously with issuance of AU Section 9337 (Interpretations of Section 337). These standards and related interpretations have been adopted as interim auditing standards for public companies by the PCAOB in Rule 3200T. As noted below, there has been only one modification of these interpretations as it relates to tax opinions, and then the modification was carefully limited. A copy of the ABA/AICPA policy adopted in 1975-76 is available on the ABA Task Force's website at http://www.abanet.org/buslaw/attorneyclient/policies/aicpa.pdf.

It is also recognized that our legal, political and economic systems depend to an important extent on public confidence in published financial statements. 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.[7]

## IV. AUDITING PRACTICES AFFECTING THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT DOCTRINE

The collapse of Enron in late 2001 and the disclosure of other corporate and financial irregularities in early 2002 led to enactment of the Sarbanes-Oxley Act of 2002 ("SOX"). Shortly thereafter, the government caused an indictment to be filed against Arthur Andersen, a prominent accounting firm, in connection with the Enron matter and that firm ultimately ceased providing professional services. SOX created the PCAOB and charged it with authority, among other things, to inspect the performance of auditors and issue reports on those inspections. At the same time, civil liability claims against auditing firms and resulting settlements and judgments have continued to escalate. The combination of these factors has had a direct impact on the relationship between corporations and their auditors and, in turn, on the attorney-client relationship and related protections in a number of ways regularly identified by corporations and their internal and external counsel, including the following:

- auditor requests for a much broader range of documents in the possession of the audited company, often in the view of the client with limited relevance of the requested documents to the audit;
- auditor requests for documents covered by the protections notwithstanding other possible sources of the relevant information or other potential ways of satisfying audit needs;
- departures from the Treaty and an increase in non-standard requests;
- expansive treatment of documents in the files of an audited company as being "audit documentation"/"work papers" even though it is not clear that they actually document the audit process; and
- efforts to review protected materials not necessary for the audit of the financial statements in order to provide the internal controls certification required under SOX Section 404.

7 Preamble to ABA "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests"



Auditors have sometimes pointed to the regulatory requirements of the PCAOB and the SEC as justification for these actions. In the view of many knowledgeable observers, this claimed justification is unwarranted.

## V. EXAMPLES OF POTENTIAL IMPLEMENTATION ACTIONS

The Task Force believes that adoption of the Recommendation as official policy of the ABA will facilitate efforts of the Task Force to initiate dialogues with appropriate regulatory authorities, including the SEC, the PCAOB and the AICPA, as well as with representatives of the accounting profession with a goal of resolving the issues associated with preservation of the protections in the audit context.

In the Task Force's view, these regulatory authorities could substantially alleviate those issues by making clear what information auditors need, and more importantly do not need, for the proper conduct of the audit. This clarification would reaffirm the importance of the fundamental policy of preserving attorney-client privilege and work product protections as a priority and outline carefully the information that can properly be sought and still be consistent with preservation of these protections. The clarification could consist of both general principles, such as reaffirmation of the primacy of the protections, and specific guidance. We identify several areas in this Section of the Report to illustrate how this might work, beginning with one that auditing standards have already addressed and can serve as a model if properly applied. These are provided solely as examples and not as positions adopted by the Task Force, much less recommended for adoption as specific policies of the ABA.[8]

The Task Force begins with the position, supported by several existing ABA policies, that preservation of the protections is vitally important. Thus, the circumstances for permitting information to be obtained that might implicate the attorney-client privilege or work product protections should be strictly limited to those where it is clearly necessary for purposes of the audit and not those where it merely would be convenient or would provide additional confirmation or comfort. In general terms, those circumstances should be limited to factual information that is not available from other sources or, solely when relied on by the client to justify its financial reporting position, applicable legal advice and opinions.

### A. Tax Advice and Opinions

AICPA Standard of Field Work AU Section 9326.22 specifies that "*[i]f* the client's support for the tax accrual of matters affecting it, including tax contingencies, is based upon an opinion issued by an outside advisor with respect to a potentially material matter, the auditor *should* obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege."[9] In contrast to this measured approach, some accounting firms are reported to take the position that *all advice or opinions* received by the entity from outside tax advisors regarding the entity's tax accounts or matters affecting such accounts or the related

8 If adopted, only the Recommendation supported by this Report, not the Report itself and thus not the examples provided, will constitute official ABA policy.

9 Emphasis added. AU Section 9326 provides interpretations (in Q&A format) of AICPA AU 326. *See* note 18 and related text.

financial statements disclosures should be reviewed and retained. As a result, in the view of many, these accounting firms are requesting protected information unnecessarily. At least one accounting firm justifies its position on the grounds that use of the word "should" in the quoted text "is to be interpreted consistently with its use in [PCAOB] Rule 3101," and that "it is mandatory that we obtain copies of opinions or advice provided by our client's outside tax advisors." Another firm justifies the position as required by AU Section 339 dealing with audit documentation.

In our judgment, that position is not supported by AU Section 9326.22 because it ignores its predicate condition that, before the opinion should be sought, the company must base its support for its tax position upon the opinion of counsel. It is only when the company seeks to justify its tax position on counsel's opinion that the standard calls for the auditor to have access to the opinion. Furthermore, the conclusion reached from use of the word "should" is not necessarily supported by Rule 3101, which actually provides that use of the word "should" means that the auditor must follow the procedure "*unless* the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objective of the standard."[10] Indeed, AU Section 9326.22 specifically provides that the "audit documentation" retained by the auditor "should include *either* the actual advice or opinions rendered by an outside advisor, *or other sufficient documentation or abstracts supporting both the transaction or facts addressed, as well as the analysis and conclusions reached by the client and advisor.*"[11] The interpretation goes on to state that "it may be possible to accept a client's analysis summarizing an outside adviser's opinion, but the client's analysis must provide sufficient competent evidential matter for the auditor to formulate his or her conclusion."[12] The term "evidential matter" refers to "underlying accounting data and all corroborating information available to the auditor."[13] The justification based on audit documentation is discussed further below in Section E.

Thus, in the area of tax advice and opinions of counsel, auditor's requests should be limited to those circumstances in which the opinion or advice is asserted by the company as the basis for its tax position. In most circumstances, however, we believe it will be possible for the company to produce materials satisfying audit requirements that disclose the factual and legal bases for the tax position taken by the company without the need for inquiry by the auditor into the advice or opinion of counsel.[14]

10 Rule 3101(A)(2).

11 Emphasis added

12 *Id*

13 AU Section 326.15.

14 Tax advice and tax opinions inherently involve legal analysis and determinations intended to be covered by the protections. These protections are essential to permit taxpayers to receive effective tax advice and to have the benefits of an adversarial system in controversies with the government. Moreover, tax matters are uniquely within the expertise of accounting firms, thus reducing their need to obtain protected analyses of counsel



B. **Litigation Reserves**

Litigation reserves represent the client's quantification for financial reporting purposes of its loss contingencies. The quantification may be based upon a number of factors, one of which may be advice or assessments from counsel. Loss contingencies are the subject matter of the Treaty, which addresses the information counsel is to provide to the auditor in a manner that does not impair the attorney-client privilege and work product protections. This carefully constructed framework should not be undermined by the auditor's seeking from the client protected information that, in conformity with the Treaty, is *not* to be obtained from counsel.

An exception to this principle could be made, similar to the tax opinion situation, if the client seeks to support its litigation reserve by reference to the opinion or assessment of counsel. That situation is not inconsistent with preserving the protections because, as has been recognized in other contexts, the client cannot both assert reliance on the advice of counsel and seek to protect that advice from disclosure.

It is important that all parties involved in the audit process recognize that factual information relevant to determining the proper amount of the reserve is not the subject of the protections and therefore should not be withheld by the company from its auditor, even if the factual information was compiled by counsel.

Furthermore, an auditor in appropriate circumstances may, if necessary, seek confirmation from the client that the client's position on the litigation reserve is not inconsistent with the advice of its counsel.

Under these procedures, we believe that auditors can effectively audit client litigation reserves without encroaching on the protections.

C. **Environmental Contingencies/Conditional Asset Retirement**

Environmental contingencies, including those involving the future obligation to retire assets covered by FAS No. 143 and Interpretation No. 47, may involve considerations similar to those with respect to tax matters. Questions relating to the proper accounting for environmental contingencies can involve legal determinations, such as whether environmental laws require remediation or taking an asset out of service and the expected timing of such actions.

Consistent with the treatment of tax opinions, counsel's assessment of these matters would properly be sought by the auditor only if the client justifies its position on the contingency by use of counsel's advice. Other sources of confirmation, such as engineering analysis and the like, may be available to support the position. Also, factual information, such as environmental, as opposed to legal, assessments should be available to the auditor. As with other situations, the auditor may seek confirmation from the client that its position is not inconsistent with the advice of counsel.

D. **Internal Investigations**

Internal investigations provide special problems, in part because of the responsibilities imposed on the auditor under Section 10A of the Exchange Act and in part because of the

potential relevance to the adequacy of the client's internal controls. However, procedures among companies, counsel and auditors have evolved that enable the auditor to obtain the information it needs for verification while preserving the attorney-client privilege and work product protections. For example, auditors can be provided with summaries of the factual information that has been developed, including access to transcripts of interviews that are not otherwise protected. We do not believe, however, that the auditor should have access to the investigating counsel's notes of interviews, legal assessments or legal advice to the client. The requirement by auditors that any of those materials generated by counsel be shared with it would unnecessarily impede the ability of counsel fully to investigate, report and advise the corporate client and potentially would interfere with and weaken the ability of corporations to engage in self-policing. Instead, we suggest that the auditor can rely on investigating counsel's provision of non-protected materials and its assurance, as contemplated by the Treaty, that counsel fulfills its professional responsibility in advising the client with respect to its disclosure obligations.

We believe that recognition of these procedures in auditing standards would (i) provide comfort to the auditor that it is following proper procedures, (ii) confirm to users of financial statements that following these procedures does not constitute inadequate auditing, and (iii) assist companies in resisting unnecessary requests that could impair the protections and undermine the ability to conduct effective internal investigations.

### E. Clarification of "Audit Documentation"

For the most part, issues concerning the attorney-client privilege and work product protections arise in audit-related matters in the context of furnishing documents to the auditor. Those documents might include letters, e-mails, faxes, legal opinions, and the like.

The PCAOB adopted Auditing Standard No. 3, "Audit Documentation," to address documentation requirements.[15] It subsequently adopted Rule 3101, providing definitions of certain terms used in Auditing Standard No. 3 and other auditing and related professional practice standards.[16] As the Board indicated in its press release announcing Auditing Standard No. 3, its principal objective was to require "that auditors document procedures performed, evidence obtained, and conclusions reached."[17] Unfortunately, some have interpreted Auditing Standard No. 3 to establish new substantive documentation requirements. The PCAOB should clarify that Auditing Standard No. 3 does not establish the information required for an audit, but rather addresses the need to document the audit process and preserve that documentation, in part to support the PCAOB's inspection process of audit work.

In this connection, documents evidencing advice of counsel to the audited company would not themselves appear to constitute "procedures performed, evidence obtained, and conclusions reached" by the auditor merely because they exist and may be used by the client in

15 Public Company Accounting Oversight Board Bylaws and Rules -- Standards -- AS No. 3, as approved in SEC Release No. 34-50253; File No. PCALB-2004-05, August 25, 2004.

16 Public Company Accounting Oversight Board Bylaws and Rules -- Professional Standard, as approved pursuant to SEC Release No. 34-50031, File No. Board-2004-06, September 8, 2004.

17 Board Release No. 2004-006, at p. 4.



connection with the preparation of, as opposed to support for, its financial statements. Rather, the documents appear only to constitute "evidence obtained" to support the audit and, therefore, would be limited only to those appropriately obtained by the auditor as an integral part of the audit.

AICPA Standard of Field Work AU Section 326, Evidential Matter provides that "evidential matter supporting the financial statements consists of the underlying *accounting data* and all corroborating information *available* to the auditor."[18] In auditing literature, "audit documentation" is also frequently referred to as "audit work papers." The "evidence obtained" thus does not appear to include documents prepared by others that might be used by the company in connection with presenting the components of the financial statement unless it was needed by the auditor as "corroborating information." The PCAOB could appropriately clarify that the purpose of audit standards with respect to "audit documentation"/"audit work papers" is to preserve evidence of work done by the 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."

### F. Confirmation of Continued Application of the Treaty

The Treaty has worked well for 30 years as a practical approach to preserving attorney-client privilege and work product protections in the context of communications between lawyers and auditors of companies. At the same time, the Treaty makes clear that it does not eliminate the professional responsibility of lawyers to advise their clients with respect to the client's disclosure obligations, which responsibility encompasses the client's disclosure to its auditors and through them to the investing public. This underpinning of the Treaty is even more valid today in the wake of SOX and the SEC's rules governing attorney professional conduct than it was when the Treaty was adopted. As such, the Treaty and the interpretations relating to it are key elements in recognizing the fundamental importance of the protections.

Because of the importance of the protections as a fundamental public policy matter, the PCAOB could issue a statement confirming the integrity and continuing application of the Treaty, including clarification that nothing contained in Auditing Standard No. 3 or Rule 3101 is intended to negate the provisions of the Treaty. The PCAOB also could issue a statement explicitly reaffirming that the principles of confidentiality recognized in the AICPA interpretations that have been adopted by the PCAOB as interim auditing standards are fundamental values entitled to respect.

### G. Auditor Safe Harbor

Many have pointed to excessive exposure to extensive civil liability as a prime source of auditor requests for information beyond that necessary for the audit and as a significant impediment to restoring the proper balance in audit procedures to recognize the overriding importance of the attorney-client privilege and work product protections.

18 AU Section 326, issued August 1980, at par. 5.

The SEC's Advisory Committee on Smaller Public Companies in its final report dated April 23, 2006[19] noted the impact on smaller public companies of the diminished use of professional judgment by auditors due in part to fear of second-guessing by regulators and litigants. To combat this, it recommended development of a safe harbor protocol for accounting for transactions that would protect well-intentioned preparers of financial statements from regulatory or legal action when the process is appropriately followed and results in an accounting conclusion that has a reasonable basis.

The Task Force supports continued attention to this issue and a detailed examination of whether it would be appropriate to develop such a safe harbor as a means of enabling auditors to follow auditing procedures that recognize the overriding importance of the protections with confidence that their doing so will not be second guessed.

## VI. CONFIDENTIALITY OF DISCLOSED INFORMATION

The foregoing approaches would define the limited circumstance under which information implicating the attorney-client privilege and work product protections could be requested by the auditor. That definition is essential to preserving the protections as historically recognized in the auditing standards. A separate question is the extent to which this information, as well as other information that a company may choose to share with the auditors in connection with the audit, will be protected from being accessible by third parties, such as governmental agencies and civil litigants, as a result of that disclosure.

Existing legal principles protect information disclosed to another party as attorney work product if there is a common legal interest between the parties.[20] There has been a difference among the courts in whether to recognize the company and the auditors as having a common legal interest so as to protect information shared by the company with its auditors in connection with the audit.[21] The argument for finding a common interest is stated by the court in *Merrill Lynch* as follows:

> [A]ny tension between an auditor and a corporation that arises from the auditor's need to scrutinize and investigate a corporation's records and book-keeping practices simply is not the equivalent of an adversarial relationship contemplated by the work product doctrine. Nor should it be. A business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud. Indeed, this is precisely the type of limited alliance that courts should encourage. For example, here Merrill Lynch complied with Deloitte & Touche's request for copies of the internal investigation

19 Available at www.sec.gov/info/smallbns/acspc.shtml.

20 Another possible basis for protection, on which there is unsettled and conflicting authority, is "limited or selective waiver," especially when information is provided under a confidentiality agreement. For a discussion of these concepts, see Paper prepared by Latham & Watkins LLP on behalf of The Corporate Counsel Consortium (Dec. 22, 2004), available on the Task Force's website (*see* note 1).

21 Compare, e.g., *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (SDNY 2002), with *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (SDNY 2004).



> reports so that the auditors could further assess Merrill Lynch's internal controls, both to inform its audit work and to notify the corporation if there was a deficiency.

*Merrill Lynch* at 448. The court further stated regarding an auditor's involvement with a company's internal investigation:

> [T]he aim should be for corporations to share information with their auditors to facilitate a meaningful review and, ultimately, the availability of more accurate information for the investing public. It is also important to encourage complete disclosure between a company and its auditor, so that auditors are not inadvertently shielded from complete frankness by corporate management, so that they can later claim that they had no knowledge of alleged malfeasance.

*Id.* at 449. It also noted that to find the auditor to be an adversary and thus for there to be a waiver of the work product protection "could very well discourage corporations from conducting a critical self-analysis and sharing the fruits of such an inquiry with the appropriate actors." *Id.*

The argument against finding a common interest, as stated by the court in *Medinol*, is primarily based upon the auditor assuming a public responsibility in providing an independent opinion on the fairness of the company's financial reports and thus not necessarily having interests that are aligned with those of the company.[22] The court also noted that the "common interest" protection normally applied only in the context of sharing work product in connection with litigation.

If there is to be reliable protection in place for information shared by a company with its auditors in connection with an audit, the differences among the courts would need to be resolved because "an uncertain privilege . . . is little better than no privilege at all."[23] The Task Force is not recommending at this time that the ABA take a position on the common interest issue. However, the Task Force believes that it would be useful for the SEC, the PCAOB, the AICPA and the accounting profession to examine whether those uncertainties should be eliminated in the audit context and ways in which that might be done while still maintaining the privilege and work product protections.

## VII. CONCLUSION

For the reasons set forth in this Report, the Task Force respectfully requests the ABA House of Delegates to adopt the proposed resolutions included in the Recommendation.

Respectfully submitted,

R. William Ide, III, Chair
ABA Task Force on Attorney-Client Privilege

22 *See United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

23 *See Upjohn Co. v. U.S.*, 449 U.S. 383, 393 (1981).

## STANDING ADVISORY GROUP MEETING

**EMERGING ISSUE – THE EFFECTS ON INDEPENDENCE OF INDEMNIFICATION, LIMITATION OF LIABILITY, AND OTHER LITIGATION-RELATED CLAUSES IN AUDIT ENGAGEMENT LETTERS**

**FEBRUARY 9, 2006**

### Introduction

The Standing Advisory Group ("SAG") will discuss the possible effects of the inclusion of indemnification, limitation of liability, and other litigation-related clauses (collectively referred to as "litigation-related clauses") in audit engagement letters. The discussion will focus on how these clauses relate to the independence and objectivity of the auditor. This briefing paper provides background information about the existing independence guidance, new proposals currently under consideration by other standards-setting bodies, and the types of litigation-related clauses that currently are used.

### Background

Audit engagement letters sometimes include provisions that seek to manage the external auditor's liability risk in an audit in various ways, including, in some cases, express limitations on liability. As used in this paper, an indemnification clause is an agreement in which the audit client agrees to compensate the auditor for any losses resulting from litigation arising out of the engagement, including losses to third parties such as investors. Other limitations on liability may protect the auditor only from liability to the audit client, or only against certain kinds of damages. For example, an engagement letter might cap the auditor's liability to the client at the amount of audit fees that the client paid. Such a provision would not limit any exposure that the auditor

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

might have to third parties.[1/] Other litigation-related clauses do not limit the amount of the auditor's liability but impose other requirements in the event of litigation. For example, an engagement letter might require the client to bring any actions within a set time period, or prevent the client from transferring a claim to another party.

A registered public accounting firm must be independent of its audit client to perform an audit of an issuer. The Securities and Exchange Commission's ("SEC") Codification of Financial Reporting Polices provides that auditor independence is impaired "[w]hen an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission . . ."[2/] The codification explains that this type of indemnification clause removes or greatly weakens "one of the major stimuli" to the auditor's objective and unbiased consideration of the problems encountered in a particular engagement. The SEC staff reiterated this position in Frequently Asked Questions and further noted that "including in engagement letters a clause that a registrant would release, indemnify, or hold [the auditor] harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence."[3/]

Conversely, Ethics Ruling Number 94 under Rule 101 of the American Institute of Certified Public Accountants' ("AICPA") Code of Professional Conduct, which is included in the Board's interim independence standards,[4/] states that the auditor's

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[1/] Limitation of liability and other agreements between the auditor and the audit client might, however, bind anyone who brings an action on behalf of the client, including shareholders in a derivative action (but not a class action) or a trustee appointed for the client in bankruptcy, for example.

[2/] Securities and Exchange Commission ("SEC") "Codification of Financial Reporting Policies," section 602.02.f.i. (See Appendix A of this briefing paper.)

[3/] SEC, Office of the Chief Accountant, *Application of the Commission's Rules on Auditor Independence Frequently Asked Questions*, Other Matters – Question 4 (December 13, 2004). (See Appendix A of this briefing paper for the specific question and answer.)

[4/] The Board adopted as its interim independence standards (See PCAOB Rule 3600T) the American Institute of Certified Public Accountants ("AICPA") Code of

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independence is not impaired if the engagement letter includes "a clause that provides that the client would release, indemnify, defend, and hold the member . . . harmless from any liability and costs resulting from knowing misrepresentations by management.[5/] Auditors must, of course, comply with the SEC's auditor independence requirements as well as those of the Board in an audit of a public company. Because SEC independence requirements prohibit indemnification agreements in audit engagement letters, Ethics Ruling Number 94 has no practical effect with respect to audits of public companies.[6/]

Additionally, Ethics Ruling Number 95 under Rule 101 of the AICPA Code of Professional Conduct, which is included in the Board's interim independence standards, states that independence would not be impaired if the auditor and the audit client agreed to alternative dispute resolution ("ADR") to resolve disputes relating to past services.[7/]

**Current Developments**

Many of the litigation-related clauses in use today are not specifically addressed by the existing regulatory framework governing auditor independence. In 2005, two different standards-setting bodies issued proposals seeking comment regarding

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Professional Conduct Rule 101 and Rule 191, related interpretations and rulings, as they existed on April 16, 2003, to the extent not superseded or amended by the Board.

5/ AICPA Code of Professional Conduct, ET sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity,* "Ethics Ruling No. 94, Indemnification Clause in Engagement Letters." (See Appendix B of this briefing paper for the specific question and answer.)

6/ PCAOB Rule 3600T notes that the interim independence standards do not supersede the SEC auditor independence rules and, to the extent that a provision of the SEC rules is more restrictive (or less restrictive) than the interim standards, the auditor must comply with the more restrictive rule.

7/ AICPA Code of Professional Conduct, ET sec. 191, *Ethics Rulings on Independence, Integrity, and Objectivity,* "Ethics Ruling No. 95, Agreement With Attest Client to Use ADR Techniques." (See Appendix B of this briefing paper for the specific question and answer.)

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different types of litigation-related clauses and their effect on the auditor's independence.

On May 10, 2005, the Federal Financial Institutions Examination Council ("FFIEC") issued a proposed advisory for public comment that would alert financial institutions' boards of directors, audit committees, management, and external auditors "to the safety and soundness implications of provisions that limit the external auditor's liability in a financial statement audit."[8/] Specifically, the proposed advisory stated that "limitation of liability provisions,"[9/] by their very nature, "can remove or greatly weaken an external auditor's objective and unbiased consideration of problems encountered in the external audit engagement and induce the external auditor to depart from the standards of objectivity and impartiality required in the performance of a financial statement audit."[10/] Appendix A of the proposed advisory describes eight different types of provisions that would generally be considered unsafe and unsound practices when included in financial institutions' external audit engagement letters or agreements

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8/ The Federal Financial Institutions Examination Council ("FFIEC") issued the proposal, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, for public comment on behalf of the Office of Thrift Supervision, U.S. Department of Treasury; the Board of Governors of the Federal Reserve System Board; the Federal Deposit Insurance Corporation; the National Credit Union Administration; and the Office of the Comptroller of the Currency, U.S. Department of Treasury. Comments were due on June 9, 2005. (See Appendix D of this briefing paper for the proposed advisory.) The proposal has not yet been adopted.

9/ The proposed advisory uses the term "limitation of liability provisions" to collectively refer to agreements that: (1) indemnify the auditor against third-party claims; (2) hold harmless or release the auditor from liability for claims or potential claims that might be asserted by the client; or (3) limit the remedies available to the client.

10/ *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, Section IV. Proposed Advisory, *Limitation of Liability Provisions* (issued by FFIEC for public comment May 10, 2005).

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related to the financial statement audit.[11/] Under the proposed advisory, agreements to submit to binding alternative dispute resolution procedures also would "present safety and soundness concerns when they incorporate additional limitations of liability, or when mandatory ADR agreements operate under rules of procedure that may limit auditor liability."[12/]

On September 15, 2005, the AICPA issued for public comment a proposed new interpretation, 101-16 under Ethics Rule 101 – *Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters*, that would supersede Ethics Ruling Number 94, described above.[13/] The proposed ethics interpretation, which would apply to auditors of non-public companies, describes the different types of litigation-related clauses that the AICPA believes impair the auditor's independence because they create an "unacceptable threat to a member's independence that could not be mitigated sufficiently through the application of safeguards."[14/] The interpretation also describes several types of litigation-related clauses, including agreements in which the auditor

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[11/] The proposed advisory makes clear that the list is not all-inclusive and that the inclusion of "any other language that would produce similar effects is generally considered an unsafe and unsound practice."

[12/] *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, Section IV. Proposed Advisory, *Alternative Dispute Resolution Agreements and Jury Trial Waivers* (issued by FFIEC for public comment May 10, 2005).

[13/] Comments were due by December 16, 2005. If adopted, this proposal also will supersede "Ethics Ruling No. 95, Agreement With Attest Client to Use ADR Techniques."

[14/] AICPA Professional Ethics Executive Committee, *Proposed Interpretation 101-16*, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, Under Rule 101, Independence, *Attest Services Engagements* (September 15, 2005). (See Appendix C of this briefing paper for proposed interpretation.)

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would not be liable to the client for punitive damages and to submit disputes to ADR,[15/] that the AICPA believes do not impair the auditor's independence.

The AICPA believes that agreements in which the auditor would not be liable to the client for punitive damages would not impair the auditor's independence because the member would still remain "exposed to clients, and also to lenders, shareholders and other non-clients, for damages for any *actual* harm caused."[16/] The AICPA believes that the possibility that actual damages might be awarded against the auditor and that such damages could be significant would serve as a sufficient safeguard to mitigate the threats to the auditor's independence."[17/]

The AICPA's proposed interpretation applies only to attest services (including audits of financial statements). Further, the proposed interpretation states that litigation-related clauses related to non-attest services do not impair the auditor's independence.

**Specific Indemnification and Limitation of Liability Clauses**

The following table provides a summary comparison of the current SEC Codification and staff FAQ regarding indemnification agreements; the AICPA proposed interpretation on indemnification, limitation of liability, and ADR clauses; and the FFIEC proposed interagency advisory on limitation of liability and certain ADR provisions.

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[15/] Under the AICPA proposal, an agreement to resolve disputes through ADR only would impair independence if it limits the auditor's liability for actual damages or incorporates "a provision, procedure, or rule that would impair independence under the preceding guidance . . ."

[16/] AICPA Professional Ethics Executive Committee, *Proposed Interpretation 101-16*, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, Under Rule 101, Independence, *Attest Services Engagements* (September 15, 2005). (See Appendix C of this briefing paper for proposed interpretation.)

[17/] The AICPA proposal defines actual damages as "audit fees and other out of pocket costs as well as incidental or consequential damages" and punitive damages as "monetary recoveries by plaintiffs in private civil litigation that are in addition to actual damages."

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| Type of Clause | AICPA Proposed Interpretation | FFIEC Proposed Advisory |
|---|---|---|
| This table provides general information for discussion purposes only. It does not provide guidance for interpreting the AICPA and FFIEC proposals. | | |
| Auditor indemnified against claims based on auditor's negligence[18/] | Impairs independence[19/] | Unsafe and unsound practice[20/] |
| Auditor indemnified against claims based on knowing misrepresentation by audit client's management[21/] | Does not impair independence | Unsafe and unsound practice |

[18/] Under the SEC staff FAQ, "when the accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent."

[19/] Specifically, under the AICPA proposal, "[a]n indemnification or limitation of liability provision that seeks to limit or eliminate the member's liability with respect to actual damages arising from the member's negligence, willful misconduct, or fraudulent behavior would impair independence."

[20/] The FFIEC proposal states that the inclusion of limitation of liability provisions in audit engagement letters "will generally be considered an unsafe and unsound practice." That proposal describes a limitation of liability provision as any agreement to indemnify the auditor against third party claims; hold harmless or release the auditor from claims asserted by the client; or limit the remedies available to the client.

[21/] Under the SEC staff FAQ, an agreement to "release, indemnify or hold [the auditor] harmless from any liability and costs resulting from knowing misrepresentations by management" impairs independence.

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| Type of Clause | AICPA Proposed Interpretation | FFIEC Proposed Advisory |
|---|---|---|
| Auditor indemnified against claims based on audit client's negligence | Impairs independence[22/] | Unsafe and unsound practice |
| Auditor's liability limited to the amount of fees paid | May impair independence[23/] | Unsafe and unsound practice |
| Limitation of period during which audit client could otherwise file claim | Impairs independence | Unsafe and unsound practice |
| Limitation on audit client's right to assign or transfer claim | Impairs independence | Unsafe and unsound practice |
| Exclusion of punitive damages[24/] | Does not impair independence | Unsafe and unsound practice |

[22/] Specifically, under the AICPA proposal, "[a]n indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability with respect to actual damages arising from the client's negligence would impair independence."

[23/] Under the AICPA proposal, independence would be impaired if the auditor's liability for actual damages is limited in actions based on the auditor's negligence, willful misconduct or fraudulent behavior, or on the client's negligence. Independence would not be impaired if the auditor's liability for actual damages is limited in actions based on the client's knowing misrepresentation, willful misconduct, or fraudulent behavior. The proposal defines actual damages to include "audit fees and other out-of-pocket costs as well as incidental or consequential damages . . ." Under the proposal, therefore, a limitation on liability to the amount of fees paid would impair independence if it applied in those circumstances in which a limitation on actual damages would impair independence. As a result, if the provision applied to all claims by the client, it would impair independence under the proposal.

[24/] In a number of relevant contexts, including actions under the Securities Exchange Act of 1934, the law itself excludes the possibility of punitive damages. See, e.g., 15 U.S.C. § 78bb(a).

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| Type of Clause | AICPA Proposed Interpretation | FFIEC Proposed Advisory |
|---|---|---|
| Agreement to use ADR | Impairs independence only if it also limits the auditor's liability for actual damages or incorporates a provision that would impair independence | Presents safety and soundness concerns if it incorporates additional limitations of liability or if ADR rules may limit auditor liability |
| Unsuccessful party to pay adversary's legal fees | Does not impair independence | Silent |
| Auditor's liability limited to the amount of losses occurring during periods audited | May impair independence[25/] | Unsafe and unsound practice |

The following examples illustrate each type of litigation-related clause discussed in this paper.

**Auditor Indemnified Against Claims Based on Auditor's Negligence**

This clause protects the auditor from all liability arising from the auditor's negligence.

> Example: Audit client hereby indemnifies the auditor and holds them harmless from all claims, whether a claim be in tort, contract or otherwise, for any damages relating to the auditor's services provided under this engagement letter.

[25/] As in the case of a limitation on liability to the amount of fees paid, a clause limiting the auditor's liability to the amount of losses occurring during periods audited would limit the auditor's potential liability for actual damages. Thus, under the proposal, this clause should be treated, for independence purposes, as a limitation on liability for actual damages. (See footnote 23 for the relevant analysis.)

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**Auditor Indemnified Against Claims Based on Knowing Misrepresentation by Audit Client's Management**

This clause protects the auditor from all liability arising from the audit client's knowing misrepresentation by management.

> Example: Audit client hereby indemnifies the auditor and its partners, principals and employees and holds them harmless from all claims, liabilities, losses, and costs arising in circumstances where there was a misrepresentation by the audit client's management, regardless of whether such person was acting in the audit client's interests.

**Auditor Indemnified Against Claims Based on Audit Client's Negligence**

This clause protects the auditor from all liability arising from the audit client's negligence.

> Example: The audit client shall indemnify, hold harmless, and defend the auditor against any and all claims, damages, demands, actions, costs, and charges arising out of, or by reason of the audit client's negligent acts or failure to act hereunder.

**Auditor's Liability Limited to the Amount of Fees Paid**

This clause limits the auditor's liability to the amount of the professional fees the audit client paid for the services performed regardless of the extent of damages.

> Example: In the event of any litigation proceedings as a result of the work performed by the auditor, the auditor's liability for damages is limited to the amount of the total fees paid to the auditor by the company for the work performed in connection with this engagement.

**Limitation of Period During Which Audit Client Could Otherwise File Claim**

This clause limits the audit client's ability to assert a claim against the auditor to a fixed period of time that is shorter than the applicable statute of limitations.

> Example: It is agreed by the audit client and the auditor or any successor in interest that no claim arising out of services rendered pursuant to this

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agreement by, or on behalf of, the audit client shall be asserted more than two years after the date of the last audit report issued by the auditor.[26]

**Limitation on Audit Client's Right to Assign or Transfer Claim**

This clause limits the audit client's legal right to assign or transfer a claim or potential claim to another party, such as in connection with a sale or merger of the audit client.

Example: The audit client agrees that it will not, directly or indirectly, agree to assign or transfer any claim against the auditor arising out of this agreement to anyone.

**Exclusion of Punitive Damages**

This clause protects the auditor from being liable for punitive damages.

Example: In no event will the auditor's liability under the terms of this agreement include responsibility for punitive damages.

**Agreement to Use Alternative Dispute Resolution**

This clause requires the audit client to submit disputes with the auditor to mandatory and binding ADR, such as binding arbitration or some other binding non-judicial dispute resolution process. Additionally, this type of clause may be paired with another type of limitation of liability clause, such as an exclusion of punitive damages.

Example: The audit client agrees to mandatory and binding alternative dispute resolution in lieu of a jury trial, and the auditor is not responsible for punitive damages under this agreement.

**Unsuccessful Party to Pay Adversary's Legal Fees**

This clause is an agreement between the auditor and the audit client that the unsuccessful party in a lawsuit or ADR will pay the legal fees and expenses of the successful party.

[26] The example assumes that the applicable statute of limitations is longer than two years.

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Example: The audit client and auditor agree that, in the event of a dispute between the parties, the unsuccessful party will pay the legal fees and expenses of the successful party.

**Auditor's Liability Limited to the Amount of Losses Occurring During Periods Audited**

This clause limits the auditor's liability to the amount of any losses that occurred during periods covered by the audit. Losses that occurred in later periods for which the auditor is not engaged are not recoverable.

Example: In the event the audit client is dissatisfied with the auditor's services, it is understood that the auditor's liability, if any, arising from this engagement, will be limited to the amount of any losses occurring during the periods covered by the audit, and shall not include any losses occurring in later periods for which the auditor is not engaged as the auditor.

**Discussion Questions –**

1. In general, does the inclusion of any litigation-related clause discussed in this paper in an audit engagement letter compromise the auditor's objectivity or otherwise affect the auditor's behavior or does it depend on the nature of the litigation-related clause?

2. Would it make a difference if the litigation-related clause immunized the auditor against all liability versus limiting the liability only between the auditor and the audit client but did not have an effect on the auditor's liability for third-party claims?

3. Do the following litigation-related clauses compromise the auditor's objectivity or otherwise affect the auditor's behavior such that they may impair the auditor's independence and, therefore, should be prohibited?

   a. Auditor indemnified against claims based on audit client's negligence

   b. Auditor's liability limited to the amount of fees paid

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c. Limitation of period during which audit client could otherwise file claim

d. Limitation on audit client's right to assign or transfer claim

e. Exclusion of punitive damages

f. Other litigation-related clauses

- Agreement to use ADR,
- Unsuccessful party to pay adversary's legal fees, or
- Auditor's liability limited to the amount of losses occurring during periods audited.

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

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***APPENDIX A***

**SEC, Office of the Chief Accountant, *Application of the Commission's Rules on Auditor Independence Frequently Asked Questions*, Other Matters – Question 4.**

**Question 4 (issued December 13, 2004)**

**Q**: Has there been any change in the Commission's long standing view (Financial Reporting Policies – Section 600 – 602.02.f.i. "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

**A**: No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent. Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence.

**SEC "Codification of Financial Reporting Policies," Section 602.02.f.i – Indemnification by Client.**

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at 'common law,' other than for their willful misstatements or omissions."

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular

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engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation.

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***APPENDIX B***

**AICPA, Code of Professional Conduct, ET Section 191, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 94, Indemnification Clause in Engagement Letters."**

**94. Indemnification Clause in Engagement Letters**

**.188** *Question*—A member or his or her firm proposes to include in engagement letters a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Would inclusion of such an indemnification clause in engagement letters impair independence?

**.189** *Answer*—No.

**95. Agreement With Attest Client to Use ADR Techniques**

**.190** *Question*—Alternative dispute resolution (ADR) techniques are used to resolve disputes (in lieu of litigation) relating to past services, but are not used as a substitute for the exercise of professional judgment for current services. Would a predispute agreement to use ADR techniques between a member or his or her firm and a client cause independence to be impaired?

**.191** *Answer*—No. Such an agreement would not cause independence to be impaired since the member (or the firm) and the client would not be in threatened or actual positions of material adverse interests by reason of threatened or actual litigation.

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***APPENDIX C***

**AICPA Professional Ethics Executive Committee, *Proposed Interpretation 101-16*, Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters, Under Rule 101, Independence (September 15, 2005).**

**PROPOSED INTERPRETATION 101-16, *INDEMNIFICATION, LIMITATION OF LIABILITY, AND ADR CLAUSES IN ENGAGEMENT LETTERS*, UNDER RULE 101, INDEPENDENCE**

***[Explanation]***

Since September 2004, the Professional Ethics Executive Committee (PEEC, or committee) has been actively studying the use of indemnification and limitation of liability provisions in member engagement letters and has engaged in numerous discussions and deliberations regarding the impact such provisions may have on a member's independence. In deliberating these issues, the PEEC considered guidance issued by other regulators, including the Securities and Exchange Commission (SEC), as well as the Proposed Advisory issued by the Federal Financial Institutions Examination Council (FFIEC) on May 10, 2005, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*. However, the PEEC was mindful that there are critical differences between public or regulated entities and nonpublic companies with respect to regulatory oversight and requirements; investor and marketplace communications, access, and interactions; and board of directors and audit committee composition, responsibilities, and procedures.

The PEEC believes that certain indemnification or limitation of liability provisions would result in an unacceptable threat to a member's independence that could not be mitigated sufficiently through the application of safeguards. For example, in cases where the member seeks to limit or eliminate his or her liability with respect to actual damages arising from the member's negligence or the client's negligence, independence would be considered to be impaired. In such cases, the threat to independence posed by a member's performance of insufficient attest procedures in reliance on the belief that he or she is protected through an indemnification or limitation of liability clause could not be reduced to an acceptable level. In addition, certain other provisions were identified by the PEEC as impairing a member's independence such as a limitation of the period during which the client would be otherwise legally entitled to file

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a claim and any limitation on the client's legal right to assign or transfer a claim or potential claim to its successors or assigns.

On the other hand, the PEEC believes that an indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability arising from the client's knowing misrepresentation, willful misconduct, or fraudulent behavior would not impair independence. This has been a long-standing position of the committee with respect to knowing misrepresentations, as reflected in ethics ruling no. 94 under Rule 101, *Indemnification Clause in Engagement Letters* [ET section 191.188], and the committee believes that position should be expanded to specifically include willful misconduct and fraudulent behavior. (Ethics ruling no. 94 is proposed for deletion as the guidance would be reflected in the proposed interpretation.) Specifically, the PEEC continues to believe that permitting a member and his or her client to agree to a limitation of liability or indemnity for claims resulting from knowing misrepresentations by management is fundamentally fair both to the client and to the member, and also furthers the public interest. Such a limitation of liability or indemnity is a significant deterrent to management fraud and shifts to the client, which is where it properly belongs, the responsibility for management's deliberate and improper misrepresentations. For example, such a clause would apply where a client intentionally misleads an auditor or lies to an auditor. However, the use of such a clause does not relieve the member, in the case of an audit, of the responsibility to comply with generally accepted auditing standards (GAAS) and does not eliminate his or her liability to shareholders, regulators or others for audits not conducted in accordance with those standards. The committee believes that the use of this type of limitation of liability and indemnification provision encourages management to completely and accurately disclose and communicate all pertinent matters to the member, and that result benefits the financial statement users.

The PEEC also believes that a limitation of liability agreement, in which a member would not be liable to a client for *punitive* damages, would not impair the member's independence provided the member remains liable to the client for actual damages. Specifically, the member still remains exposed to clients, and also to lenders, shareholders and other nonclients, for damages for any *actual* harm caused. The committee believes that the amount of actual damages can be significant, and can often equal hundreds of times (or more) the fees generated in connection with the engagement. Accordingly, the committee believes that the possibility that actual damages might be awarded against a member in favor of clients and/or nonclients serves as a sufficient safeguard to mitigate the threats to a member's independence. The committee also agreed that any agreement to limit or exclude punitive damage

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claims brought by lenders, shareholders, or other nonclient third parties should not be permitted and accordingly, independence would be considered impaired if a member enters into an agreement to be indemnified from third-party claims for punitive damages.

The proposed interpretation makes clear that the use of indemnification or limitation of liability provisions does not relieve a member from the requirement to exercise due professional care and comply with all professional standards (for example, in the case of an audit, specific performance standards under GAAS) as required by Rule 201, *General Standards* [ET section 201], and Rule 202, *Compliance With Standards* [ET section 202].

The proposed interpretation also provides guidance on arrangements whereby a member and client agree to use arbitration, mediation, or other alternative dispute resolution (ADR) methods to resolve a dispute between them, or agree to waive a jury trial. The PEEC does not believe independence would be impaired when a member and his or her client agree to use an ADR procedure to resolve disputes between them provided such a provision does not limit a member's liability for actual damages. Specifically, ADR clauses merely determine the forum in which a dispute will be heard and decided, and facilitate dispute resolution between the member and the client. However, if an ADR clause incorporates an indemnification or limitation of liability provision that would impair independence, then the ADR clause would also impair independence. In addition, the PEEC does not believe that waiver of a jury trial would impair independence provided such a provision does not limit a member's liability for actual damages. Such a waiver merely specifies one procedural aspect of a how a dispute will be resolved.

Finally, the proposed interpretation states that independence would not be impaired if a member and the client agree that the unsuccessful party in a lawsuit or ADR between them will pay the legal fees and expenses of the successful party, and the interpretation clarifies that an indemnification or limitation of liability provision related to nonattest services performed for a client (that is, where the provision relates only to the nonattest services engagement and not the attest engagement) would not impair a member's independence with respect to that client.

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**PROPOSED INTERPRETATION 101-16, *INDEMNIFICATION, LIMITATION OF LIABILITY, AND ADR CLAUSES IN ENGAGEMENT LETTERS,* UNDER RULE 101, INDEPENDENCE**

[*Text of Proposed Interpretation*]

**Terminology**

The following specifically identified terms are used in this interpretation as indicated:

A. **Member.** The term *member* includes both a member and his or her firm.

B. **Indemnification.** An *indemnification* is a client's agreement to compensate a member for loss, damage or costs sustained or incurred by that member as a result of claims made against the member by a third party (for example, a lender or shareholder). An indemnification does not insulate a member from claims asserted by the client.

C. **Limitation of Liability Provisions.** A *limitation of liability provision* is a client's agreement to restrict the damages the client could recover from a member arising out of the member's performance of professional services. A limitation of liability provision does not insulate a member from claims asserted by third parties.

D. **ADR.** The term *ADR* refers to an alternative dispute resolution proceeding.

E. **Actual Damages.** *Actual damages* consist of audit fees and other out-of-pocket costs as well as incidental or consequential damages that are caused by the wrongful conduct (for example, economic losses).[1/]

F. **Punitive Damages.** *Punitive damages* are monetary recoveries by plaintiffs in private civil litigation that are in addition to actual damages. Such damages may be available, depending on circumstances and the

[1/] This term is defined solely for purposes of this interpretation and the laws in a particular jurisdiction may not define damages in this manner. Accordingly, members should consult their legal advisers when drafting engagement letters or similar arrangements to ensure that the types of damages are properly described.

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law of the relevant jurisdiction, absent exclusion by contract, to punish someone found liable in civil litigation.[2]

**Interpretation**

This interpretation provides guidance to members concerning the impact that certain indemnification and limitation of liability provisions may have on a member's independence when included in engagement letters or other agreements entered into with a client. Certain types of indemnification and limitation of liability provisions pose an unacceptable threat to a member's independence. The interpretation also provides guidance on arrangements whereby a member and client agree to use arbitration, mediation, or other ADR methods to resolve a dispute between them, or an agreement to waive a jury trial.

In all cases, the inclusion of an indemnification or limitation of liability provision does not relieve a member from the requirement to exercise due professional care and comply with all professional standards (for example, in the case of an audit, specific performance standards under generally accepted auditing standards (GAAS)) as required by Rule 201, *General Standards* [ET section 201], and Rule 202, *Compliance With Standards* [ET section 202].

Members should refer to ethics interpretation 101-6 [ET section 101.08] and ethics ruling no. 96 under rule 101 [ET section 191.192] for guidance on the impact on independence of threatened or actual litigation or ADR between the client and the member.

**Attest services engagements**

The following describe the impact of indemnification, limitation of liability, and certain other provisions in connection with an attest engagement.

Member's negligence, willful misconduct, or fraudulent behavior

An indemnification or limitation of liability provision that seeks to limit or eliminate the member's liability with respect to actual damages arising from the member's negligence, willful misconduct, or fraudulent behavior would impair independence.

[2] Ibid.

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Client's negligence

An indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability with respect to actual damages arising from the client's negligence would impair independence.

Client's knowing misrepresentation, willful misconduct, or fraudulent behavior

An indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability with respect to actual or punitive damages arising from the client's knowing misrepresentation, willful misconduct, or fraudulent behavior would not impair independence.

Unsuccessful party to pay adversary's fees (loser pays arrangement)

Independence would not be impaired if a member and the client agree that the unsuccessful party in a lawsuit or ADR between them will pay the legal fees and expenses of the successful party.

Punitive damages

A limitation of liability provision, in which a member would not be liable to a client for punitive damages, would not impair the member's independence provided the member remains liable to the client for actual damages.

Other limitations

A limitation of the time period during which the client would be otherwise legally entitled to file a claim, or a limitation or exclusion of actual damages occurring prior to the date on which such claims legally lapse, would impair independence. In addition, any limitation on the client's legal right to assign or transfer a claim or potential claim to its successors or assigns would impair independence.

ADR and waiver of jury trial

An agreement between a member and client to use arbitration, mediation, or other ADR method to resolve a dispute between them, or an agreement between a member and client to waive a jury trial in a dispute between them, would not impair the member's independence provided such provisions do not limit the member's liability for actual

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damages.[3/] However, if an ADR clause incorporates a provision, procedure, or rule that would impair independence under the preceding guidance, the ADR clause would impair independence.

**Nonattest services engagements**

An indemnification or limitation of liability provision related to nonattest services performed for a client would not impair a member's independence with respect to that client.

**Transition**

Independence would not be impaired as a result of the more restrictive requirements of this interpretation for engagements commenced prior to [*effective date dependent on publication date in the* Journal of Accountancy] where the member complied with all applicable independence interpretations and rulings in effect prior to [*effective date dependent on publication date in the* Journal of Accountancy].

[3/] Some jurisdictions may limit or fail to give effect to certain of these arrangements.

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### *APPENDIX D*

**Federal Financial Institutions Examination Council, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters* (May 10, 2005).**

**FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL**

**Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters**

**AGENCY:** Federal Financial Institutions Examination Council.

**ACTION:** Proposed interagency advisory; request for comment.

**SUMMARY:** The Federal Financial Institutions Examination Council (FFIEC), on behalf of the Office of Thrift Supervision (OTS), Treasury; the Board of Governors of the Federal Reserve System (Board); the Federal Deposit Insurance Corporation (FDIC); the National Credit Union Administration (NCUA); and the Office of the Comptroller of the Currency (OCC), Treasury (collectively, the Agencies), is seeking public comment on a proposed Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters. The proposal advises financial institutions' boards of directors, audit committees, and management that they should ensure that they do not enter any agreement that contains external auditor limitation of liability provisions with respect to financial statement audits.

**DATES:** Comments must be received on or before June 9, 2005.

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**FOR FURTHER INFORMATION CONTACT:**

*OTS:* Jeffrey J. Geer, Chief Accountant
or Patricia Hildebrand, Senior Policy Accountant

*Board:* Terrill Garrison, Supervisory Financial Analyst

*FDIC:* Harrison E. Greene, Jr., Senior Policy Analyst (Bank Accounting), Division of Supervision and Consumer Protection or
Michelle Borzillo, Counsel, Supervision and Legislation Section, Legal Division, at

*NCUA:* Karen Kelbly, Chief Accountant

*OCC:* Brent Kukla, Accounting Fellow

**SUPPLEMENTARY INFORMATION:**

**I. Background**

The Agencies have observed an increase in the types and frequency of provisions in certain financial institutions' external audit engagement letters that limit the auditors' liability. While these provisions do not appear in a majority of financial institution engagement letters, the provisions are becoming more prevalent. The Agencies believe such provisions may weaken an external auditor's objectivity, impartiality, and performance; therefore, inclusion of these provisions in financial institution engagement letters raises safety and soundness concerns.

While these provisions take many forms, they can be generally categorized as an agreement by a financial institution that is a client of an external auditor to:

- Indemnify the external auditor against claims made by third parties;
- Hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or

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- Limit the remedies available to the client financial institution.

Collectively, these and similar types of provisions are referred to in the proposed advisory as limitation of liability provisions.

**II. Comments**

The FFIEC has approved the publication of the proposed advisory on behalf of the Agencies to seek public comment to fully understand the effect of the proposed advisory on the inappropriate use of limitation of liability provisions on external auditor engagements. While public comments are welcome on all aspects of this advisory, the Agencies are specifically seeking comments on the following questions. Please provide information that supports your position.

1. The advisory, as written, indicates that limitation of liability provisions are inappropriate for all financial institution external audits.
   a. Is the scope appropriate? If not, to which financial institutions should the advisory apply and why?
   b. Should the advisory apply to financial institution audits that are not required by law, regulation, or order?
2. What effects would the issuance of this advisory have on financial institutions' ability to negotiate the terms of audit engagements?
3. Would the advisory on limitation of liability provisions result in an increase in external audit fees?
   a. If yes, would the increase be significant?
   b. Would it discourage financial institutions that voluntarily obtain audits from continuing to be audited?
   c. Would it result in fewer audit firms being willing to provide external audit services to financial institutions?
4. The advisory describes three general categories of limitation of liability provisions.

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a. Is the description complete and accurate?

b. Is there any aspect of the advisory or terminology that needs clarification?

5. Appendix A of the advisory contains examples of limitation of liability provisions.

   a. Do the examples clearly and sufficiently illustrate the types of provisions that are inappropriate?

   b. Are there other inappropriate limitation of liability provisions that should be included in the advisory? If so, please provide examples.

6. Is there a valid business purpose for financial institutions to agree to any limitation of liability provision? If so, please describe the limitation of liability provision and its business purpose.

7. The advisory strongly recommends that financial institutions take appropriate action to nullify limitation of liability provisions in 2005 audit engagement letters that have already been accepted. Is this recommendation appropriate? If not, please explain your rationale (including burden and cost).

**III. Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. Chapter 35), the Agencies have reviewed the proposed advisory and determined that it does not contain a collection of information pursuant to the Act.

**IV. Proposed Advisory**

The text of the proposed advisory follows:

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**Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters**

*Purpose*

This advisory, issued jointly by the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC) (collectively, the Agencies), alerts financial institutions'[1/] boards of directors, audit committees, management, and external auditors to the safety and soundness implications of provisions that limit the external auditor's liability in a financial statement audit. While the Agencies have observed several types of these provisions in external audit engagement letters, this advisory applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to financial statement audits.

Agreements by financial institutions to limit their external auditors' liability or to submit to certain alternative dispute resolution (ADR) provisions that also limit the external auditors' liability may weaken the external auditors' objectivity, impartiality, and performance and thus, reduce the Agencies' ability to rely on external audits. Therefore, such agreements raise safety and soundness concerns, and entering into such agreements is generally considered to be an unsafe and unsound practice.

In addition, such provisions may not be consistent with the auditor independence standards of the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA).

*Background*

A properly conducted external audit provides an independent and objective view of the reliability of a financial institution's financial statements. The external auditor's objective in an audit of financial statements is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external

[1/] As used in this document, the term financial institutions includes banks, bank holding companies, savings associations, savings and loan holding companies, and credit unions.

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auditor considers the financial institution's internal control over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management, which enables management to take appropriate corrective action. For these reasons, the Agencies encourage all financial institutions to obtain external audits of their financial statements. The Federal Financial Institutions Examination Council's (FFIEC) Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations[2/] notes "[a]n institution's internal and external audit programs are critical to its safety and soundness." The policy also states that an effective external auditing program "can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by" the FDIC.

Typically, a written engagement letter is used to establish an understanding between the external auditor and the financial institution regarding the services to be performed in connection with the external audit of the financial institution. The engagement letter commonly describes the objective of the external audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (*e.g.*, fees and billing). As with any important contract, the Agencies encourage boards of directors, audit committees, and management to closely review all of the provisions in the external audit engagement letter before agreeing to sign. To assure that those charged with engaging the external auditor make a fully informed decision, any agreement such as an engagement letter that affects the financial institution's legal rights should be carefully reviewed by the financial institution's legal counsel.

While the Agencies have not observed provisions that limit an external auditor's liability in the majority of external audit engagement letters reviewed, the Agencies have observed a significant increase in the types and frequency of these provisions. These provisions take many forms,[3/] but they can be generally categorized as an agreement by a financial institution that is a client of an external auditor to:

- Indemnify the external auditor against claims made by third parties;

[2/] Published in the Federal Register on September 28, 1999 (64 FR 52319–27). The NCUA, a member of the FFIEC, has not adopted the policy statement.

[3/] Examples of auditor limitation of liability provisions are illustrated in Appendix A.

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- Hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or

- Limit the remedies available to the client financial institution.

Collectively, these and similar types of provisions will be referred to in this advisory as "limitation of liability provisions."

Financial institutions" boards of directors, audit committees, and management should also be aware that certain financial institution insurance policies (such as error and omission policies and director and officer liability policies) may not cover the financial institutions' losses arising from claims that are precluded by the limitation of liability provisions.

*Limitation of Liability Provisions*

Many financial institutions are required to have their financial statements audited while others voluntarily choose to undergo such audits. For example, banks, savings associations, and credit unions with $500 million or more in total assets are required to have annual independent audits.[4/] Certain savings associations (for example, those with a CAMELS rating of 3, 4, or 5) and savings and loan holding companies are also required by OTS regulations to have annual independent audits.[5/] Furthermore, financial institutions that are public companies[6/] must have annual independent audits. The Agencies rely on the results of external audits as part of their assessment of the safety and soundness of a financial institution's operations.

In order for an external audit to be effective, the external auditors must be independent in both fact and appearance, and they must perform all necessary

[4/] For banks and savings associations, see Section 36 of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831m) and Part 363 of the FDIC's regulations (12 CFR part 363). For credit unions, see Section 202(a)(6) of the Federal Credit Union Act (12 U.S.C. 1782(a)(6)) and Part 715 of the NCUA's regulations (12 CFR part 715).

[5/] See OTS regulation at 12 CFR 562.4.

[6/] Public companies are companies subject to the reporting requirements of the Securities Exchange Act of 1934.

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procedures to comply with generally accepted auditing standards established by the AICPA and, if applicable, the standards of the PCAOB. When a financial institution executes an agreement that limits the external auditor's liability, the external auditor's objectivity, impartiality, and performance may be weakened or compromised and the usefulness of the external audit for safety and soundness purposes may be diminished.

Since limitation of liability provisions can impair the external auditor's independence and may adversely affect the external auditor's performance, they present safety and soundness concerns for all financial institution external audits. By their very nature, these provisions can remove or greatly weaken an external auditor's objective and unbiased consideration of problems encountered in the external audit engagement and induce the external auditor to depart from the standards of objectivity and impartiality required in the performance of a financial statement audit. The existence of such provisions in an external audit engagement letter may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the benefits otherwise expected to be derived from the external audit. Accordingly, financial institutions should not enter into external audit arrangements that include any limitation of liability provisions. This applies regardless of the size of the financial institution, whether the financial institution is public or not, and whether the external audit is required or voluntary.

*Auditor Independence*

Currently, auditor independence standard-setters include the AICPA, the SEC, and the PCAOB. Depending upon the audit client, an external auditor is subject to the independence standards of one or more of these standard-setters. For all credit unions under NCUA's regulations, and for other non-public financial institutions that are not required to have annual independent audits pursuant to Part 363 of the FDIC's regulations or pursuant to OTS's regulations, the Agencies' rules require only that an external auditor meet the AICPA independence standards; they do not require the financial institution's external auditor to comply with the independence standards of the SEC and the PCAOB.

In contrast, for financial institutions subject to the audit requirements in Part 363 of the FDIC's regulations or subject to OTS's regulations, the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the

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independence requirements and interpretations of the SEC and its staff.[7/] In this regard, in a December 13, 2004, Frequently Asked Question (FAQ) on the application of the SEC's auditor independence rules, the SEC reiterated its long-standing position that when an accountant and his or her client enter into an agreement which seeks to provide the accountant immunity from liability for his or her own negligent acts, the accountant is not independent. The FAQ also states that including in engagement letters a clause that would release, indemnify, or hold the auditor harmless from any liability and costs resulting from knowing misrepresentations by management would impair the auditor's independence.[8/] The SEC's FAQ is consistent with Section 602.02.f.i. (Indemnification by Client) of the SEC's Codification of Financial Reporting Policies. (Section 602.02.f.i. and the FAQ are included in Appendix B.)

Based on this SEC guidance and the Agencies' existing regulations, limitation of liability provisions are already inappropriate in auditor engagement letters entered into by:

- Public financial institutions that file reports with the SEC or with the Agencies;
- Financial institutions subject to Part 363; and
- Certain other financial institutions that OTS regulations at 12 CFR 562.4 require to have annual independent audits.

In addition, many of these limitation of liability provisions may violate the AICPA independence standards. Because limitation of liability provisions may impair an auditor's independence and may adversely affect the external auditor's objectivity,

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[7/] See FDIC Regulation 12 CFR Part 363, Appendix A—Guidelines and Interpretations; Guideline 14, Role of the Independent Public Accountant—Independence; and OTS Regulation 12 CFR 562.4(d)(3)(i), Qualifications for independent public accountant.

[8/] AICPA Ethics Ruling 94 (ET § 191.188–189) currently concludes that indemnification for "knowing misrepresentations by management" does not impair independence. At this writing, the AICPA's Professional Ethics Executive Committee has formed a task force that is studying the use of indemnification clauses in engagement letters and how such clauses may affect an auditor's independence.

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impartiality, and performance, the provisions present safety and soundness concerns for all financial institution external audits.

*Alternative Dispute Resolution Agreements and Jury Trial Waivers*

The Agencies have also observed that some financial institutions are agreeing in their external audit engagement letters to submit disputes over external auditor services to mandatory and binding alternative dispute resolution, binding arbitration, or some other binding non-judicial dispute resolution process (collectively referred to as mandatory ADR) or to waive the right to a jury trial. By agreeing in advance to submit disputes to mandatory ADR, the financial institution is effectively agreeing to waive the right to full discovery, limit appellate review, and limit or waive other rights and protections available in ordinary litigation proceedings. While ADR may expedite case resolution and reduce costs, financial institutions should consider the value of the rights being waived. Similarly, by waiving a jury trial, the financial institution may effectively limit the amount it might receive in any settlement of its case. The loss of these legal protections can reduce the value of the financial institution's claim in an audit dispute.

The Agencies recognize that ADR procedures and jury trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. However, financial institutions should take care to understand the ramifications of agreeing to submit audit disputes to mandatory ADR or to waive a jury trial before an audit dispute arises.

In particular, pre-dispute mandatory ADR agreements in external audit engagement letters present safety and soundness concerns when they incorporate additional limitations of liability, or when mandatory ADR agreements operate under rules of procedure that may limit auditor liability. Examples of such limitations on liability include provisions:

- Capping the amount of actual damages that may be claimed;
- Prohibiting claims for punitive damages or other remedies; or
- Shortening the time in which the financial institution may file a claim.

Thus, financial institutions should not enter into pre-dispute mandatory ADR arrangements that incorporate limitation of liability provisions, whether the limitations on liability form part of an audit engagement letter or are set out separately.

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The Agencies encourage all financial institutions to review each proposed external audit engagement letter presented by an audit firm and understand the limitations on the ability to recover effectively from an audit firm in light of any mandatory ADR agreement or jury trial waiver. Financial institutions should also review the rules of procedure referenced in the ADR agreement to ensure that the potential consequences of such procedures are acceptable to the institution. In addition, financial institutions should recognize that ADR agreements may themselves contain limitation of liability provisions as described in this advisory.

*Conclusion*

Financial institutions' boards of directors, audit committees, and management should ensure that they do not enter any agreement that contains external auditor limitation of liability provisions with respect to financial statement audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that alter their legal rights.

The inclusion of limitation of liability provisions in external audit engagement letters and other agreements that are inconsistent with this advisory will generally be considered an unsafe and unsound practice. The Agencies may take appropriate supervisory action if such provisions are included in external audit engagement letters or other agreements related to financial statement audits that are executed (accepted or agreed to by the financial institution) after the date of this advisory. Furthermore, if boards of directors, audit committees, or management have already accepted an external audit engagement letter or related agreement for a fiscal 2005 or subsequent financial statement audit (*i.e.*, fiscal years ending on or after January 1, 2005), the Agencies strongly recommend that boards of directors, audit committees, and management consult with legal counsel and the external auditor and take appropriate action to have any limitation of liability provision nullified.

Financial institutions' boards of directors, audit committees, and management should also check with their insurers to determine the effect, if any, on their ability to recover losses as a result of the external auditors' actions that were not recovered because of the limitation of liability provisions.

As indicated in the Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the Agencies' examiners will consider the policies, processes, and personnel surrounding a financial institution's external auditing program in determining whether (1) the engagement letter covering external auditing activities is

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adequate and does not raise any safety and soundness concerns and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards.

**Appendix A**

**Examples of Limitation of Liability Provisions**

Presented below are some of the types of limitation of liability provisions (with an illustrative example of each type) that the Agencies observed in financial institutions' external audit engagement letters. The inclusion in external audit engagement letters or agreements related to the financial statement audit of any of the illustrative provisions (which do not represent an all-inclusive list) or any other language that would produce similar effects is generally considered an unsafe and unsound practice.

*1. "Release From Liability for Auditor Negligence" Provision*

In this type of provision, the financial institution agrees *not* to hold the audit firm liable for *any* damages, *except* to the extent determined to have resulted from the willful misconduct or fraudulent behavior by the audit firm.

*Example:* In no event shall [the audit firm] be liable to the Financial Institution, whether a claim be in tort, contract or otherwise, for any consequential, indirect, lost profit, or similar damages relating to [the audit firm's] services provided under this engagement letter, except to the extent finally determined to have resulted from the willful misconduct or fraudulent behavior of [the audit firm] relating to such services.

*2. "No Damages" Provision*

In this type of provision, the financial institution agrees that in *no event* will the external audit firm's liability include responsibility for *any* claimed incidental, consequential, punitive, or exemplary damages.

*Example:* In no event will [the audit firm's] liability under the terms of this Agreement include responsibility for any claimed incidental, consequential, or exemplary damages.

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*3. "Limitation of Period To File Claim" Provision*

In this type of provision, the financial institution agrees that *no* claim will be asserted after a fixed period of time that is shorter than the applicable statute of limitations, effectively agreeing to limit the financial institution's rights in filing a claim.

*Example:* It is agreed by the Financial Institution and [the audit firm] or any successors in interest that no claim arising out of services rendered pursuant to this agreement by, or on behalf of, the Financial Institution shall be asserted more than two years after the date of the last audit report issued by [the audit firm].

*4. "Losses Occurring During Periods Audited" Provision*

In this type of provision, the financial institution agrees that the external audit firm's liability will be limited to any losses occurring during periods covered by the external audit, and will *not* include any losses occurring in later periods for which the external audit firm is not engaged. This provision may not only preclude the collection of consequential damages for harm in later years, but also may preclude any recovery at all. It appears that the external audit firm would have no liability until the external audit report is actually delivered and any liability thereafter might be limited to the period covered by the external audit. In other words, it might limit the external audit firm's liability to the period before there is any liability. Read more broadly, the external audit firm might be liable for losses that arise in subsequent years only if the firm continues to be engaged to audit the client's financial statements in those years.

*Example:* In the event the Financial Institution is dissatisfied with [the audit firm's] services, it is understood that [the audit firm's] liability, if any, arising from this engagement will be limited to any losses occurring during the periods covered by [the audit firm's] audit, and shall *not* include any losses occurring in later periods for which [the audit firm] is not engaged as auditors.

*5. "No Assignment or Transfer" Provision*

In this type of provision, the financial institution agrees that it will *not* assign or transfer any claim against the external audit firm to another party. This provision could limit the ability of another party to pursue a claim against the external auditor in a sale or merger of the financial institution, in a sale of certain assets or line of business of the financial institution, or in a supervisory merger or receivership of the financial institution. This provision may also prevent the financial institution from subrogating a claim against

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its external auditor to the financial institution's insurer under its directors' and officers' liability or other insurance coverage.

*Example:* The Financial Institution agrees that it will not, directly or indirectly, agree to assign or transfer any claim against [the audit firm] arising out of this engagement to anyone.

6. *"Knowing Misrepresentations by Management" Provision*

In this type of provision, the financial institution releases and indemnifies the external audit firm from any claims, liabilities, and costs attributable to any knowing misrepresentation by management.

*Example:* Because of the importance of oral and written management representations to an effective audit, the Financial Institution releases and indemnifies [the audit firm] and its personnel from any and all claims, liabilities, costs, and expenses attributable to any knowing misrepresentation by management.

7. *"Indemnification for Management Negligence" Provision*

In this type of provision, the financial institution agrees to protect the external auditor from third party claims arising from the external audit firm's failure to discover negligent conduct by management. It would also reinforce the defense of contributory negligence in cases in which the financial institution brings an action against its external auditor. In either case, the contractual defense would insulate the external audit firm from claims for damages even if the reason the external auditor failed to discover the negligent conduct was a failure to conduct the external audit in accordance with generally accepted audited standards or other applicable professional standards.

*Example:* The Financial Institution shall indemnify, hold harmless and defend [the audit firm] and its authorized agents, partners and employees from and against any and all claims, damages, demands, actions, costs and charges arising out of, or by reason of, the Financial Institution's negligent acts or failure to act hereunder.

8. *"Damages Not To Exceed Fees Paid" Provision*

In this type of provision, the financial institution agrees to limit the external auditor's liability to the amount of audit fees the financial institution paid the external

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auditor, regardless of the extent of damages. This may result in a substantial unrecoverable loss or cost to the financial institution.

*Example:* [The audit firm] shall not be liable for any claim for damages arising out of or in connection with any services provided herein to the Financial Institution in an amount greater than the amount of fees actually paid to [the audit firm] with respect to the services directly relating to and forming the basis of such claim.

**Note:** The Agencies also observed a similar provision that limited damages to a predetermined amount not related to fees paid.

**Appendix B**

**SEC's Codification of Financial Reporting Policies, Section 602.02.f.i and the SEC's December 13, 2004, FAQ on Auditor Independence**

*Section 602.02.f.i—Indemnification by Client, 3 Fed. Sec. L. (CCH) ¶ 38,335, at 38,603–17 (2003):*

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at 'common law,' other than for their willful misstatements or omissions."

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other

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cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation. (Emphasis added.)

*U.S. Securities and Exchange Commission; Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions; Other Matters—Question 4 (Issued December 13, 2004):*

Q: Has there been any change in the Commission's long standing view (Financial Reporting Policies—Section 600—602.02.f.i. "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

A: No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent. Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from knowing misrepresentations by management would also impair the firm's independence. (Emphasis added.)

Dated: May 4, 2005.

**Tamara J. Wiseman,**

*Executive Secretary, Federal Financial Institutions Examination Council.*

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**BILLING CODE 6720–01–P, 6210–01,–P, 6714–01–P, 7535–01–P, 4810–33–P**

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# Responding to Auditor Requests

The ripples and repercussions from Enron, WorldCom, Tyco, and the other financial reporting scandals have touched many professions. Coping with the requirements of the Sarbanes-Oxley legislation (SOX) has radically affected how accountants and auditors tackle their jobs. Now attorneys are also getting swept into the tide toward more scrutiny, and have taken on added obligations for assisting the auditors in preparing a clean bill of health.

In January 2003, the Securities and Exchange Commission published new rules, designed to implement section 307 of SOX. Taken in their entirety, the SEC rules, the American Bar Association Statement of Policy, and the SOX legislation affect all lawyers who represent public companies, including in-house counsel.

You may be wondering: why should auditors come to me, of all people, for information about their companies' financial statements? There are three main areas in which they may need to solicit your help—and in which you will often be bound to provide answers. These areas are:

- Ensuring that the financial statements are free of material misstatements;
- Confirming that accrual items are appropriate; and
- Ensuring that loss contingencies are adequately disclosed.

On a less diplomatic note, the American Accounting Association notes that "lawyers have never been known for simplified language, and, therefore, reading a legal representation letter can often be a cause of great frustration for an auditor." Ahem.

The new system is still in its early days, and will doubtless evolve along with developments in case and statutory law. Auditors seem to be setting a higher standard in asking for assurances from counsel than the reasonable assurances that auditors themselves provide in their letters. Eventually, refinements will need to reflect the changing role of in-house departments and the mixed roles of in-house counsel.

Meanwhile, your task of conveying and interpreting this information is a critical one. The position may be complex, and you need to understand the parameters of what you should and should not disclose.

### Some Basic Legal Guideposts

- The American Bar Association, Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (1976) (ABA Statement of Policy)
- Securities and Exchange Commission, Regulation S-K, Item 103, "Legal Proceedings" (S-K 103)
- American Bar Association, Model Rules of Professional Conduct, Rule 1.6, "Confidentiality of Information" (MRPC 1.6)
- The Sarbanes-Oxley Act

### THE SCOPE

When you are asked for a response, you will probably come up with several immediate questions of your own:

- Should I insist on a written request?
- How far do my responses need to go?
- Should I give my client a draft of the response before I send it to the auditor?
- Which matters can I leave out?

But do you need to respond at all? The answer is yes, if the initial letter requesting you to provide information to the auditor has been signed by an authorized agent of your client. However, you must of course fully explain to your client any legal consequences of your disclosures—and keep in mind that an adverse party might assert that an evaluation of potential liability is an admission. In some larger law departments, as general counsel you may have to rely on others. Cover your bases, and consider showing

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your client a draft of your response before you send it to the auditor. It might even be a good idea to share the draft response with your company's chief accounting officer.

Once you are ready to respond, how far should you go? Remember that your response carries the liability of an opinion, so you should prepare it with the same care an outside lawyer would use to respond to similar requests from auditors. If your response is limited to material items, as described in the ABA Statement of Policy, then say so loud and clear. Otherwise you might pick up liability.

Now is the time to draw lines in the sand. You should spell out the scope of the engagement, mention the date of your response, and disclaim any undertaking to update it. (If auditors eventually request updates, you should try to provide them in writing rather than verbally. A limited bring-down letter approach might work.) You are basically only responsible for information relating to legal consultation and representation. Make sure to distinguish between what you have learned in a legal context and what you have gleaned in a business capacity. Unless you tell them otherwise, the auditors can assume that your answers are limited to matters to which you and your department have given serious attention.

**Materiality**

The overriding function of an audit is for independent auditors to obtain reasonable assurance that financial statements are free of *material* misstatements.

Materiality is a key concept, and you may expressly state that you are only addressing material items in your response. While the ABA Statement of Policy allows you to limit your information to material items, the issue is: What is material?

A range of definitions applies to materiality, a concept that may be open to differing interpretations in various circumstances. For instance, a small error in calculation could suddenly become material if it created an event of default under a line of credit. The assumptions used to determine materiality are often critical. They can mean the difference between a company's missing or making its numbers.

Litigation proceedings may qualify as material if they either:

- Pass a reasonable investor test; or
- Exceed 10 percent of the consolidated current assets of the company and its subsidiaries.

If you conclude that legal proceedings are material, you will need to include:

- The name of the court or agency where they are pending;
- The date instituted;
- The principal parties;
- A description of the factual basis; and
- The relief sought.

**Contingencies**

To issue a clean audit report, the independent auditors must be satisfied that loss contingencies have been adequately disclosed. At the same time, they also need to be satisfied with the accounting methods. Accountants keep a sharp lookout that companies are not accruing for general or unspecified business risks. They make sure companies are not stockpiling reserves against general contingencies, as these can be used to smooth earnings or distort the financial picture. As the accountants delve, they look to lawyers for information about contingencies which the lawyer may have advised on or attended to.

It is proper for you to provide information on loss contingencies if you have already devoted considerable time and effort to claims for threatened or pending litigation. You even have a contractual obligation to speak out if the client has specifically identified a claim and asked you to comment to the auditors.

In such cases, you should tell the auditors:

- The nature (identification) of the proceedings;
- The stage of the proceedings;
- The claim(s) asserted; and
- The position taken by the client.

This is not a time to wax lyrical. You should normally refrain from expressing your own judgment or opinion as to an outcome, except to say whether you consider it probable or remote.

Beware of estimating dollar amounts of potential losses from claims in most cases! Unless you are feeling thoroughly confident that there is little chance you are off the mark, as an attorney you should not be making estimates for most unasserted claims, and you should definitely not be contributing your opinion about the adequacy of reserves. Although some finance teams may urge lawyers to approve amounts reserved, you may need to remind them that it would not be appropriate in your role. Consider sitting down with the financial person and stating that it is up to him or her to use judgment in setting the reserves.

## Probable vs. Remote

**1. ABA Statement of Policy**

*Unfavorable Outcome Probable:*

- Prospects for claimant not succeeding are extremely doubtful.
- Prospects for your client succeeding are slight.

*Unfavorable Outcome Remote:*

- Prospects for your client not succeeding are extremely doubtful.
- Prospects for claimant are slight.

**2. FAS 5**

- *Probable*: The future events are likely to occur.
- *Reasonably Possible*: The chance of the future event occurring is more than remote but less than likely.
- *Remote*: The chance of the future event occurring is slight.

Note that there is a subtle difference between the ABA Statement of Policy and FAS 5. (And remember how the accountants were complaining that the attorneys did not use clear and simple language?)

**PROFESSIONAL RESPONSIBILITY**

You may recall that several of the recent accounting scandals, such as the Enron debacle, derived from off-balance sheet transactions that had never been fully disclosed. The ABA Statement of Policy addresses your own professional obligations in the realm of public disclosure. For example, it is up to you to draw attention to the following issues, if they are likely to become material:

- Amounts of revenues, expenses, and cash flows arising from off-balance sheet arrangements;
- Nature and amounts of any interest retained, securities issued, and other indebtedness in connection with such arrangements;
- Nature and amounts of any other obligations or liabilities arising from such arrangements; and
- The triggering events or circumstances that could cause them to arise.

Suppose you do the right thing: You offer advice advocating public disclosure, and your sound advice is ignored. The bad news is that the Code of Professional Responsibility might actually require you to resign, to avoid any taint of a cover-up. At least you do not have to make a noisy withdrawal by blowing the whistle, disavowing the work, or notifying the authorities. (Be aware that this area is still under debate.) In the meantime, auditors can take it as a given that the attorney has considered, and advised the client on, disclosure requirements for an unasserted possible claim.

The ABA has updated and clarified the area of professional responsibility for attorneys in its Statement of Policy. It has developed these updates as general guidelines, which you can now incorporate by reference. It expressly states, however, that its updated language does not preempt any of the other more rigorous ethical rules. The SEC also affirms that its rules prevail over any inconsistent state laws.

**Doing the Right Thing**

So here is your updated game plan. Let us say you learn of some credible evidence that any agent of your company is involved in a material violation of federal or state securities law. You must:

- Notify the chief legal officer (CLO), or both the CLO and the CEO;
- If CLO/CEO does not respond appropriately, report evidence of the wrongdoing to the audit committee, another committee of independent directors, or the full board; and
- As a supervisory attorney, make sure your subordinate attorneys comply with the rules.

You are off the hook if your CLO/CEO persuades you that:

- There is no past, ongoing, or future violation;
- The problem has been fixed; or
- Further investigation is called for.

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**Fraud**

Fraud is an auditor's bête noire. You should at least be aware of the minimum procedures required to detect such wrongdoing under SAS 99. These are:
- Increased emphasis on professional skepticism;
- Discussion with management;
- Unpredictable audit tests; and
- Responding to management override of controls.

You ought to understand the auditor's own role here, too. Here is what the auditor must do if he suspects an illegal act may have occurred:
- Determine the effect on the financial statements;
- Inform management;
- Make sure that the audit committee or board of directors is adequately informed;
- Report conclusions to the board if senior management has not taken remedial actions; and
- Resign or report to the SEC within one business day—unless the board has reported to the SEC.

Fraud is a serious offense, and needs to be addressed at the highest levels. First, SOX § 303 required the SEC to adopt rules making it unlawful for an officer or directors, or anyone acting for them, to take any action to influence, coerce, manipulate, or mislead an auditor. The SEC did as it was told and issued a rule on May 20, 2003 prohibiting the top brass from causing an auditor to render the financial statements materially misleading. Here, top brass means president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer. You can breathe a bit more easily; the SEC has declined to amend the definition to include general counsel or chief legal officer specifically. (The definition does, however, cover those who set corporate governance and legal policies.)

## Other Updates

- SOX § 307—requiring the SEC to adopt "minimum standards of professional conduct" for lawyers practicing before the SEC
- SEC Release 33-8185, "Implementation of Standards of Professional Conduct for Attorneys," January 29, 2003, at *www.sec.gov/rules/final/33-8185.htm*
- Part 205 (17 CFR Part 205), "Standards of Professional Conduct For Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer"

## Accounting Treatment for Asserted Claims

| Likelihood of Unfavorable Outcome | Ability to Reasonably Estimate the Potential Loss: Reasonable Estimate | Ability to Reasonably Estimate the Potential Loss: No Reasonable Estimate |
|---|---|---|
| Probable | Accrue and, if necessary, disclose to avoid misleading financial statements | Disclose contingency and range of possible loss or state that no reasonable estimate is possible |
| Reasonable | Disclose contingency and estimated amount of possible loss | Disclose contingency and range of possible loss or state that no reasonable estimate is possible |
| Remote | Neither accrue nor disclose, unless guarantee | Neither accrue nor disclose, unless guarantee |



You need to become familiar with management's increased responsibilities, too, under the fairly recent changes of SOX § 404. Management needs to:
- Establish and maintain an internal control structure;
- Assess the effectiveness of the internal control structure;
- Prepare a management report on the structure and its effectiveness; and
- Secure an attestation from the external auditor on the effectiveness of the internal control structure.

Management's year-end statement must describe whether or not the internal control is effective, and must note any material weakness. In this case, a material weakness means a *significant deficiency* that is likely to cause a material misstatement of annual or interim financial statements.

The ACC Board of Directors has endorsed a proposal to resolve the auditor issue. Authored by David Brodsky of the Corporate Counsel Consortium, the proposal suggests a method by which in-house counsel can offer auditors the information sought while preserving the attorney-client privilege as to third parties. See *www.acca.com/protected/article/attyclient/debate.pdf*.

ACC has developed a Leading Practice Profile on Leading Practices in Providing In-house Legal Support to the CFO and Finance Function, available on ACCA Online[SM] at *www.acca.com/protected/article/governance/lead_cfo.pdf*.

Need more advice on this issue? ACC's 2005 Annual Meeting (October 17-19, Washington, DC) has programs about:
- Effective Strategies for Responding to Government Audits, and
- Dealing with Accountants and Auditors.

Plus, confirmed faculty include representatives from J.C. Penney Corporation, KPMG LLP, and Covad Communications Company.

For more information go to *www.acca.com/am/05*.

### PROCESS FOR RESPONDING

Now you have some idea of when you need to respond to requests for information, and of how far you should go. So once you get to the nitty-gritty, how should you prepare a response from start to finish? Your first task is to establish the threshold for materiality, working in conjunction with the auditors and the Audit Committee:
- Communicate with the auditors in advance to set the threshold.
- Consider the Audit Committee Charter.
- Consider Audit Committee requirements.
- Consider which reports are given to the Audit Committee.
- Investigate how to find information throughout the business.
- Examine how the business reports information to you.
- Coordinate efforts.
- Scale efforts for the business.

**Dangers of the Process**

Responses carry certain pitfalls that you should be aware of, particularly in the areas of:
- confidentiality;
- privilege; and
- work product doctrine.

On the confidentiality front, the ABA Section of Litigation has squarely stated that the scope of the attorney-client privilege should be the same for in-house and outside counsel. In a global world, note that communications with employed counsel may not be privileged in jurisdictions outside the United States. The usual exceptions apply—to prevent death, bodily harm, and so forth—and would include the prevention of fraud, or of substantial injury to another's financial interests. Disclosure to the auditor in the year-end audit process is a voluntary, deliberate disclosure, and, as such, is generally sufficient for a waiver of attorney-client privilege.

Work product doctrine is broader than attorney-client privilege. It can protect those materials you or your agents have prepared, whether or not you have disclosed them to the client. This doctrine is addressed under Rule 26 of the Federal Rules of Civil Procedure. That rule states that disclosure of "work product" to a third party does not waive protection of the doctrine, unless it significantly increases the

opportunity for adversaries to obtain the information.

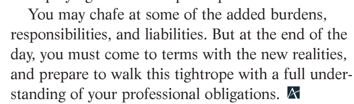
As a final caution, the current trend in case law appears to be one of making more things discoverable. In giving access to case management databases or spreadsheets, you may therefore risk letting these materials become discoverable. This can leave you in a very tough position if the auditors still refuse to sign the audit letter without your materials.

**A New World**

Attitudes to professional responsibilities and behavior are in a constant state of evolution. The ABA has revised its rules to be more aligned with all "up-the-ladder" reporting, as SOX has expanded reporting duties to the CLO, CEO, the Audit Committee, or in extreme circumstances, even to the outside Board of Directors.

The ramifications of the 2002 accounting scandals profoundly shocked the investment community and the general public alike. In order for the U.S. securities markets to function efficiently and transparently, a huge overhaul was required. Each member of the business community is expected to play some part in the chain of creating a fair, visible, and level playing field for all participants.

You may chafe at some of the added burdens, responsibilities, and liabilities. But at the end of the day, you must come to terms with the new realities, and prepare to walk this tightrope with a full understanding of your professional obligations.



*This Toolkit is drawn from Course #605 at the ACC 2004 Annual Meeting, presented by Jeff Kelsey, managing director–litigation, Federal Express Corporation; Stephen R. Martin II, vice president–law (litigation), Adelphia Communications Corporation; and Mark N. Rogers, corporate counsel and assistant secretary of Insight Enterprises, Inc. The course materials are available on ACCA Online℠ at www.acca.com/am/04/cm/605.pdf.*



# 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:

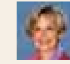
1. You bet!
2. Afraid so.
3. No, it's like leaving war solely to the generals; scary to contemplate.
4. Perhaps, but it will also give you an opportunity to significantly decrease your liability by addressing these issues. The ostrich approach simply does not work well.

When a company goes under for financial mismanagement or fraud, or even if it survives, the human toll is significant. For a significant number of 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.



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## 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℠ 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 compensation 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 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.

## 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*.

Thus, it is **imperative** that the board link executive compensation to **ethical** and **legal** conduct.

**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)?
- 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 answers 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

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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.
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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.*
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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.*
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# Recent Trends in INTERNAL INVESTIGATIONS

Both in-house and outside counsel seem to have a new job these days: tracking down allegations of wrongdoing. The investigations can range from misuse of the company car by a low-level manager to securities fraud by the CEO. The development of this new legal sub-specialty has been stimulated by the rash of corporate scandals in recent years, and while predictions vary about how this area will evolve over the next few years, the authors believe that the "gumshoe business" for counsel will be affected by several trends blowing through corporate America.



## Trend One: There Will Be More Internal Investigations

The factors that have generated internal investigations in the last five years are only increasing for several reasons:

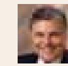
### More Whistleblowers

Famous whistleblowers like Sherron Watkins of Enron are emboldening others to come forward with tales of corporate misconduct, both real and imagined. Some employees are motivated by a desire to right wrongs. Others may be worried about being fired for incompetence and are looking for cover by blowing the whistle on their company (legitimately or otherwise). Sarbanes-Oxley provides a civil cause of action and criminal prosecution for those who retaliate against a whistleblower.[1] Although most cases of retaliation referred to the Department of Labor have been dismissed, there have been several notable successes by whistleblowers. For example, in *Welch v. Cardinal Bankshares*, the CFO successfully sued for reinstatement and backpay, claiming that his termination was in retaliation for raising accounting issues.[2]

Another motive for whistleblowing may be the desire to strike it rich. *Qui Tam* lawsuits have grown in size and number, until there is now a *Qui Tam* bar of plaintiff attorneys. Whistleblowers can collect 15 to 25 percent of settlements or judgments involving fraud against the government. The Department of Justice reports that in fiscal year 2005, of the $1.4 billion collected for fraud against the government, $1.1 billion was the result of *Qui Tam* lawsuits, in which $166 million was paid to the whistleblowers.[3]

Of course, the fact that a whistleblower has ulterior motives does not mean that their allegations are without merit. Often whistleblowers would have kept their knowledge of corporate misconduct to themselves but for the chance to protect their jobs, settle a score, or make some money.

In most internal investigations, attempts to unmask an anonymous whistleblower may be counterproductive or unjustified. First, such efforts may lead to claims of retaliation. Second, the identity is usually irrelevant to the important issue: Is the allegation true?

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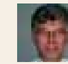

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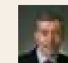

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### Improved Compliance Programs

As companies improve their compliance programs, more allegations of misconduct surface. Codes of conduct encourage asking questions, and may even mandate reporting wrongdoing. The ability to report possible wrongdoing anonymously (e.g., through a "helpline") is mandated by Sarbanes-Oxley,[4] and is one of the components of an effective ethics and compliance program identified by the US Sentencing Commission.[5] Effective compliance programs help ensure that employee allegations will not be ignored or result in retaliation. Nothing makes a company look worse than encouraging whistleblowing and then not investigating the allegation or retaliating against the whistleblower.

Of course it is more than just looking bad. Substantively, failure to take action after being alerted to wrongdoing can create corporate liability where none previously existed. For example, reports of sexual harassment that are ignored by management can convert improper behavior by one employee into an actionable hostile work environment.[6]

### More Government Investigations

The trend toward criminalizing the violation of regulatory requirements is continuing in the arenas of health care, securities, the environment, and elsewhere. Although many FBI agents and assistant US attorneys are now devoted to terrorism, that should not cause anyone to think that corporate crime will be ignored. The SEC had a 45 percent budget increase in 2003. By 2005, over 1,000 staff members had been added. Just as an increase in surgeons leads to more surgeries, an increase in SEC lawyers, investigators, and accountants will lead to more enforcement actions. The effect of the SEC budget increase has been delayed as it has taken time to hire and train new personnel. The US Attorneys Offices have taken advantage of this source of manpower by working more closely with the SEC, sometimes using the SEC's investigators instead of the FBI.

### More Demands for Investigations by Auditors

The relationship between a company and its auditors has been transformed in the post-Enron era. Once ac-

### ACC Extras on… Investigation Trends

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  This **webcast** will focus on the nuts and bolts of conducting an effective internal investigation. It also will discuss some of the more difficult questions that need to be addressed in virtually every internal investigation. *www.acc.com/resource/v7325*

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- "Whistleblower/Internal Investigations & How to Respond to the SEC"
  In this **online CLE program**, learn how to establish an effective process for receiving and evaluating whistleblower reports, your ethical obligation when faced with these reports, how to use whistleblower reports to meet your legal obligations, and how to deal with SEC while maintaining your legal ethics and loyalty to your client. *www.acc.com/resource/v7790*

**Other Resources**

- Internal Investigation Process
  This **quick reference** chart will show you the process of an internal investigation. *www.acc.com/resource/v7949*

- Internal Investigation Procedure
  This **sample form** enumerates the procedure of an internal investigation. *www.acc.com/resource/v7950*

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cused of being lap dogs, auditors now more resemble attack dogs. Auditors are under great pressure. An indictment of an accounting firm can be fatal, and Arthur Andersen's dead body proves it. The new Public Company Accounting Oversight Board (PCAOB) is aggressively reviewing accountants' work. Audits must now be designed to detect illegal acts.[7] To prove their "independence," as required by Sarbanes-Oxley, auditors seem to be stepping out of an advisory role and adopting more of a regulatory stance. In response to this environment, auditors who come across suspicious circumstances are demanding independent, outside investigations of individuals or issues, sometimes walking away from an audit until the investigation is complete. With only the "Final Four" mega-audit firms remaining, companies have little choice but to order an investigation.

**Board Members Will Demand Investigations**

Board members are not only increasingly worried about their own liability, but have been charged with a more proactive role. The business judgment rule, which used to shield directors, has taken some hits. Shareholder derivative suits may demand that directors be sued for breach of fiduciary duty for



### Key Subjects to Include in Your Internal Investigation Guidelines

- If there is a reasonable basis to believe that there may have been a violation of law or company policy, use due diligence to collect and evaluate relevant facts.
- Investigation will comply with law.
- Treat all persons with respect and fairness.
- Extent of investigation to be guided by seriousness of allegations and quality of information.
- Investigators to be impartial and will consider all relevant facts.
- Use discretion and maintain confidentiality to the extent possible.
- Cooperation from employees and business partners is expected.
- Move quickly, but minimize business disruption wherever possible.
- No retaliation for good faith reporting or cooperation.
- Decision-making on discipline separated from investigating.
- Process and results to be documented.

allowing misconduct to occur. In 2003, the Delaware Court of Chancery found that the Walt Disney directors who were alleged to be derelict in the hiring of Michael Ovitz may not be entitled to the protection of the "exculpatory charter provision" of Delaware law and the company's by-laws.[8] As a result, directors are increasingly demanding that management investigate possible misconduct. Even in the absence of a red flag, the directors may want to be assured there is no problem, such as whether there has been a backdating of stock options.

**Trend Two: Less Pressure to Waive Attorney-Client Privilege**

In the post-Enron era, the pendulum has swung far to the side of criminalization of regulatory violations and aggressive tactics by regulators. There are signs recently, however, that the pendulum is beginning to swing back. One sign of this "warming" trend is the opposition to the government's practice of coercing companies to waive the attorney-client privilege as part of their cooperation with the government.

The Thompson Memorandum[9] provided federal prosecutors with guidelines that they are to consider when deciding whether to indict a business entity. This decision can result in a corporation being crippled or killed. A health care company may not survive debarment from Medicare. As already noted, Arthur Andersen essentially was destroyed just by the bringing of an indictment.

A key factor in the guidelines is the extent of a company's cooperation and voluntary disclosure. Part of that analysis was the company's willingness "to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection." While many prosecutors insist that they only seek privilege waivers in exceptional cases, in practice, waivers have been coerced on a regular basis. In a survey of over 1,200 in-house and outside corporate counsels by ACC, almost 75 percent disclosed that a "culture of waiver" exists in government agencies.[10]

More recently, however, ACC and a broad coalition of business groups, criminal defense attorneys, and civil libertarians that formed to oppose coerced waiver, have found a receptive ear in Congress. ACC and this same coalition persuaded the US Sentencing Commission to vote on April 5, 2006, to remove commentary from the organizational sentencing guidelines that gave a corporation credit for waiving privileges.[11] More importantly, in December 2006, the Department of Justice issued the McNulty Memorandum, which substantially retreated from the Thompson Memorandum.[12] If a prosecutor is seeking factual information, such as copies of key documents, witness statements, or purely factual interview memoranda, the US attorney must consult with the head of the assistant attorney general for the Criminal Division before granting the prosecutor's request. If, however, the prosecutor is seeking attorney-client communications or nonfactual attorney work product such as legal advice given before, during, or after the alleged misconduct, the prosecutor must get written approval from the deputy attorney general prior to seeking the waiver. The McNulty Memorandum cautions that prosecutors should seek such a waiver in only rare circumstances and that a refusal to waive may not be held against a company in making charging decisions.

The McNulty Memorandum is a major retreat under pressure by the department. Prosecutors will be much more hesitant to demand privilege waivers.

However, the desire on the part of corporations to avoid indictment is enormous. Many corporations will continue to waive privileges in an effort to get the maximum favorable treatment from the government. Now, however, one would hope that it will be more a matter of choice than capitulation to a demand.

As a degree of calm returns after the corporate scan-

In most **internal investigations,** attempts to unmask an **anonymous whistleblower** may be counterproductive or unjustified. First, such efforts may lead to **claims of retaliation.** Second, the **identity is usually irrelevant** to the important issue: **Is the allegation true?**

dals earlier in the decade, it has become clearer that requiring a company to give up its legal rights is not consistent with the promotion of compliance. Why talk to your lawyer if the conversation goes directly to the government?

**Trend Three: Fewer Oral Reports**

The trend toward less pressure to waive privilege may lead to more written reports of internal investigations. Previously, one way to deal with the pressure to waive privilege had been to avoid creating written reports. If a written report was turned over to the government, almost all courts have found that the attorney-client privilege is waived to everyone.[13] Corporations were naturally reluctant to make an investigative report available to plaintiff's attorneys who read about the investigation in the newspaper or in an SEC filing.

Based on the same reasoning, investigators may have presented their report to the board orally with directors being instructed not to take notes. Then, if the company decided to waive privilege, the investigators could repeat the oral report to the government, but if requested by a plaintiff's attorney in discovery, there was no written report to produce. Theoretically, a plaintiff could request the investigators' notes and memoranda of interview, and depose the investigators. Few plaintiff's counsel, however, want to engage in an inevitable court battle over privilege.

Written reports have many advantages. First, it looks more transparent to have a written work product and creates a better impression with regulators and the public. An oral report is inherently suspicious. Why is there no written report? Second, the production of a written report to the government is much more valuable to the government and will be appreciated. Third, a written report can be easily shared with other parties, such as the company's boards, auditor, bankers, and stock exchange who have an interest in learning what the investigators found. The "administrative" advantages are obvious. One of the authors has given the same oral report of an investigation on 10 occasions. One written report would have been much more efficient. Finally, a well-written report can provide a clearer, more consistent basis than an oral report for the ultimate decisions the company makes concerning the matter investigated.

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If the **investigator** misses fraudulent activities, the company or **shareholders may sue** for **malpractice.** On the other hand, if the investigator wrongly accuses someone of misconduct, the **investigator may be sued** for defamation.

**Trend Four: More Executives Will Have Their Legal Fees Paid by Their Employer**

Whether companies pay the attorney's fees of their employees, and the implications of such payments, has been a hotly contested issue. The Thompson Memorandum, discussed above, established guidelines to determine when federal prosecutors will exercise their discretion to indict a business entity, such as a corporation or partnership. An indicia of a corporation's non-cooperation was "protecting its culpable employees and agents" by a "promise of support." "Culpable" was not defined. Is it anyone under investigation or only someone determined to be guilty? The McNulty Memorandum retreats from this aggressive position and states that a company will only be punished for advancing legal fees if it is part of an effort to obstruct the investigation.

Prosecutors will also be deterred by the decision of Judge Lewis Kaplan in the KPMG tax shelter case.[14] In the KPMG case, the Court found that KPMG would have advanced fees but for the existence of the Thompson Memorandum and the implied threats made by the prosecutors. The Court held that the Department of Justice as a matter of policy, and in practice, violated the defendants' right to counsel and due process by causing KPMG to stop advancing their legal fees. The Court did not dismiss the indictment, but instead allowed the defendants to file claims against KPMG for their legal fees.

The impact of the McNulty Memorandum and the KPMG decision remain to be seen. They should deter the government from even discussing with a corporation whether it will advance fees to employees. Corporations inclined to advance fees should be emboldened to do so. Indeed, failure to do so may subject the corporation to liability. The by-laws of many corporations permit or even require the corporation to advance legal fees to executives who are under investigation. The executive often must sign an "undertaking" requiring him/her to repay the money if the executive is proven to have engaged in fraud or acted in bad faith.

**Trend Five: More Employees Will Be Prosecuted For Lying to Outside Counsel**

Despite the desire of many corporations to advance legal fees, the fear of prosecution still is likely to drive many business entities to do anything they think will put them in the better graces of the government, including refusing to advance legal fees to their executives. In the Computer Associates case, the government—for the first time—prosecuted employees for lying to outside counsel in the course of an investigation.[15] The defendants were interviewed by two sets of outside counsel, one conducting an investigation for the company, and another for the audit committee. The government's theory is that because the company was cooperating with the government, the defendants expected that their answers would be passed on to the government by outside counsel. By lying to outside counsel, defendants intended to obstruct the government's investigation.

The same theory was pursued recently by the U.S. Attorney in Houston.[16] The defendant was charged with lying to El Paso Corporation's outside counsel, believing that the lies would be passed on to government agencies investigating natural gas pricing.

This prosecution theory raises a number of issues. First, the same theory could apply to investigations by in-house counsel, although it is less foreseeable that the answers will be passed on to the government.

Second, should investigating counsel, inside or outside, warn the witness that if the witness lies during the interview, the witness may be prosecuted for obstruction of justice? On the one hand, it seems only fair to warn the witness of this possibility. The warning also may make the witness more likely to tell the truth. On the other hand, by giving the warning, investigating counsel may be supplying the government with exactly the link it needs to prove that the witness knew that its lies would be passed on to the government. Thus the warning may become a self-fulfilling prophecy.

The authors recommend that investigating counsel give the standard warning:[17] Counsel represents only the company. What the witness says is confidential to the company pursuant to the attorney-client privilege and may be revealed by the company at its discretion. This warning must be given in every interview conducted by counsel in order to preserve the attorney-client privilege. It warns

the witness that his/her answers could be revealed outside the company without specifying that the investigators will report to the government. Whether the answers will be revealed, or to whom, is the decision of the company, not the investigators.

We expect to see an increase in prosecutions for lying to counsel during an internal investigation. If the government attempts to interview a corporate executive, the executive is likely to retain his/her own attorney who may advise him/her not to participate in the interview. However, executives rarely decline to answer questions from corporate investigators who may appear less threatening. Also, refusing to answer questions posed by the corporate investigator can result in sanctions, including termination. If the target will not talk to the government, and the government cannot make a case on the underlying violation, the only possible prosecution of a corporate executive may be for lying to outside counsel.

#### Trend Six: More Trouble for The Investigators

As the number and significance of investigations increases, so will problems for the investigators. Investigations carry inherent dangers. First, the investigator may be unable to uncover a fraud due to an inability to obtain documents or interview witnesses outside the company. Second, investigation is not a science. Conclusions are often based on credibility assessments: Were accounting errors the result of an intent to deceive or the product of ignorance? Even experienced investigators may reach different conclusions based upon the same evidence.

If the investigator misses fraudulent activities, the company or shareholders may sue for malpractice. On the other hand, if the investigator wrongly accuses someone of misconduct, the investigator may be sued for defamation.

We are beginning to see actions taken against the investigators. In 2004, the SEC threatened action against an attorney who assisted in an internal investigation at Endocare. On July 27, 2006, the City of San Diego sued Vinson and Elkins, alleging that the firm's investigations of the city were a whitewash. Vinson and Elkins previously had been criticized for investigating its own legal work for Enron.

#### Guidelines for In-house Counsel

What should in-house counsel do in the face of this fluctuating legal environment? A few guidelines are in order:

- Make sure appropriate members of the legal staff, and other persons likely to be involved in investigations, get training on how an investigation should be conducted and that there is documentation of who received the training.
- Consider developing on-line refresher training as well as reference documents to help guide people conducting investigations.
- Ensure that persons assigned to investigate an allegation can do so objectively and do not have an interest in the outcome of the matter.
- Adopt an internal investigations policy that covers the key investigation principles, which are outlined in the sidebar, "Key Subjects to Include in Your Internal Investigation Guidelines," found on pg. 28.
- Establish policies and communications designed to ensure there is no retaliation against persons who, in good faith, report suspected misconduct.
- Treat the fact-finding process and the decision-making based on the investigation as distinct parts of the process. Typically, this means that the investigators should present the facts to the board or senior management to then decide what action is appropriate based on those facts.
- Have qualified outside counsel available to assist with or conduct an investigation if internal resources are not adequate or appropriate. Have a different firm, preferably one that does no other work for the company, available to investigate matters of the highest sensitivity.
- Whenever a serious allegation of wrongdoing is made, move quickly to secure evidence—suspending normal document retention periods for potentially relevant documents, and investigate—and document the steps you take to diligently investigate the allegation.
- Monitor legal developments to avoid surprises.

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

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Notes

1. Sarbanes-Oxley Act of 2002, Pub L 107-204, 116 Stat 745, §§ 806 and 1107.
2. *www.oalj.dol.gov/Decisions/ALJ/Sox/2003/WELCH_DAVE_v_CARDINAL_BANKSHARES.*
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5. United States Sentencing Guidelines, § 8B2.1(b)(5)(C) and App. C. amend. 673.
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8. *In re the Walt Disney Company Derivative Litigation*, Memorandum Opinion, Case No. 15452, May 28, 2003. The Delaware Supreme Court subsequently affirmed the Chancellor's verdict that the plaintiff did not prove bad faith by the Board. *In re Walt Disney Co. Derivative Litigation*, Del. No. 411, 2005, June 8, 2006, but the protection in other states for a Board that was characterized as a "rubber stamp" may not be so great.
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12. *www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.*
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14. *United States v. Stein et al,*, S1 05 Crim 0888 (S.D.N.Y. June 26, 2006).
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