605:In-house Response to Auditors' Requests for Information: Does This System (Still) Work?

Jeana M. Littrell
Senior Attorney, Employment Litigation
FedEx Corporation

Stephen R. Martin II
Vice President—Law (Litigation)
Adelphia Communications Corporation

Mark N. Rogers
Corporate Counsel
Insight Enterprises, Inc.

Faculty Biographies

Jeana M. Littrell

Jeana M. Littrell is a managing director of litigation for Federal Express Corporation in Memphis, Tennessee. FedEx has developed a unique litigation model, relying almost exclusively on in-house attorneys to litigate employment and commercial cases and Ms. Littrell's team is primarily responsible for employment litigation. Ms. Littrell's responsibilities also include providing quality legal advice to all levels of management and working closely with other departments to focus on litigation prevention. Ms. Littrell previously served as a senior attorney for FedEx and won the Five Star Award in 2002, FedEx's highest award for outstanding performance.

Before joining FedEx, Ms. Littrell was in private practice providing a full range of legal services to employers, including advice and counsel, training, policy revision, investigations, representation in agency proceedings, and litigation.

Ms. Littrell's community service includes pro bono appointments as guardian ad litem and past service as a court appointed special advocate.

Ms. Littrell received her undergraduate and law degrees from the University of Memphis.

Stephen R. Martin II

Stephen R. Martin II is vice president-law (litigation) for Adelphia Communications Corporation in Greenwood Village, Colorado. His responsibilities at Adelphia include managing the company's litigation, providing legal advice to the company regarding risk management matters, and handling corporate compliance/ethics issues.

Prior to joining Adelphia, Mr. Martin worked at Qwest Communications Corporation in Denver as the company's investigative counsel and chief privacy officer handling internal investigations, corporate compliance, and privacy matters. Before Qwest, Mr. Martin was a senior litigation associate at Steptoe & Johnson LLP in Phoenix, Arizona. Prior to Steptoe, Mr. Martin was employed by MCI WorldCom as an associate litigation counsel responsible for handling governmental enforcement actions, investigations, and corporate compliance. Mr. Martin also served as a federal prosecutor with the United States Attorney's Office in Washington, DC and as an assistant attorney general with the Missouri Attorney General's Office in Jefferson City, Missouri.

Mr. Martin received a BA from the University of Denver, a JD from Creighton University, a LLM from Georgetown University, and is currently completing a MBA from the University of Denver.

Mark N. Rogers

Mark N. Rogers is corporate counsel for Insight Enterprises, Inc., a provider of IT products and services based in Tempe, Arizona. His responsibilities include corporate governance work with the board and its committees, SEC reporting, securities matters, and oversight of equity compensation plans, labor and employment, litigation, and intellectual property. Mr. Rogers sits on Insight's disclosure committee and on the investment committee for the company's 401(k) plan.

Prior to joining Insight, Mr. Rogers was general counsel for Integrated Information Systems, Inc. (IIS) in Tempe, Arizona. At IIS, Mr. Rogers provided counsel in the areas of SEC reporting, acquisitions, negotiation of contracts with vendors and customers, and restructuring work. Mr. Rogers' first in-house position was as general counsel of Excell Global Services, Inc., a provider of outsourced services to telecommunications companies in the United States, Canada, the United Kingdom, and Australia.

He is the current president of ACC's Arizona Chapter and does volunteer work for the Children's Cancer Center at Phoenix Children's Hospital.

Mr. Rogers received a BA from Brown University and a JD from New York University School of Law.

In-house Response to Auditors' Requests for Information: Does This System (Still) Work?

Jeana Littrell, Senior Attorney,
Employment Litigation, FedEx Corporation

Stephen R. Martin II, Vice President – Law (Litigation),
Adelphia Communications Corporation

Mark N. Rogers, Corporate Counsel,
Insight Enterprises, Inc.

In-house Response to Auditors' Requests for Information: Does This System (Still) Work?

Statements expressed in this presentation represent the views of the authors individually and do not necessarily represent the views of their employers.

These materials have been prepared for informational purposes and are not legal advice.

Why do auditors request information from counsel?

- According to reports of independent auditors, the independent auditors audit: to obtain reasonable assurance about whether financial statements are free of material misstatement.
- The audit is an examination of the financial statements; the financial statements are the statements of management.
- Companies may not accrue for general or unspecified business risks, and reserves for general contingencies are not permitted.

Why do auditors request information from counsel?

- To issue a clean audit report, the independent auditors must ensure, among many, many other matters, that “loss contingencies” are adequately disclosed and that the accounting for loss contingencies is appropriate.
- So, auditors look to lawyers for information “concerning matters referred to the lawyer during the course of his representation of the client.” (ABA Statement of Policy)

Why do auditors request information from counsel?

- Materiality is a key concept.
  - The request should not ask for information about items that are not material.
  - The response may expressly state that only material items are addressed in the response.
- Although auditors' reports reach a "reasonable assurance" that financial statements are free of material misstatement, auditors may look for a higher degree of certainty in reaching that conclusion and may ask counsel for more comfort than reasonable assurance.

Why do auditors request information from counsel?

- "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."

American Accounting Association, Commitments & Contingencies, Evaluating Legal Responses, Double Trouble Case Study ("Double Trouble Case Study")

What are the basic guideposts along the way?

- **Audit:**
  - The American Institute of Certified Public Accountants Statement of Auditing Standards No. 12 ("SAS 12")
  - Financial Accounting Standards Board, Statement No. 5, "Accounting for Contingencies" ("FAS 5")
  - The American Institute of Certified Public Accountants Statement of Auditing Standards No. 99 ("SAS 99")
  - Financial Accounting Standards Board, Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss — an interpretation of FASB Statement No. 5" ("FIN 14")

What are the basic guideposts along the way?

- Audit (continued):
  - Financial Accounting Standards Board, Interpretation No. 30, "Accounting for Involuntary Conversions of Non-monetary Assets to Monetary Assets—an interpretation of APB Opinion No. 29" ("FIN 30")
  - The American Institute of Certified Public Accountants Statement of Position No. 94-6, "Disclosure of Certain Significant Risks and Uncertainties" ("SOP 94-6")
  - The American Institute of Certified Public Accountants Statement of Position No. 96-1, "Environmental Remediation Liabilities" ("SOP 96-1")

What are the basic guideposts along the way?

- Audit (continued):
  - The American Institute of Certified Public Accountants Emerging Issues Task Force Issue No. 90-8, "Capitalization of Costs To Treat Environmental Contamination" ("EITF 90-8")
  - The American Institute of Certified Public Accountants Emerging Issues Task Force Issue No. 93-5, "Accounting for Environmental Liabilities" ("EITF 93-5")
  - Securities and Exchange Commission Staff Accounting Bulletin No. 92, Topic 5-Y, "Accounting and Disclosure Related to Loss Contingencies" ("SAB 92")

What are the basic guideposts along the way?

- Legal:
  - The American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests For Information (1976) ("ABA Statement of Policy")
  - "Legal Proceedings" - Securities and Exchange Commission, Regulation S-K, Item 103 ("S-K 103")
  - American Bar Association, Model Rules of Professional Conduct, Rule 1.6 Confidentiality of Information ("MRPC 1.6")
  - SOX

What should the response include (and leave out)?

- The response carries the liability of an opinion.
- "Counsel should prepare these opinions in the same fashion as do outside lawyers responding to such requests from auditors."

  Carole Basri and Irving Kagan, Practicing Law Institute, Corporate Legal Departments, § 10:8, Legal Services Unique to In-House Counsel, Opinions of Counsel, Westlaw, PLIREF-CORPLEG s 10:8.
- Insist on a written request?
- What would scope of response be without a written request?

ABA Statement of Policy

- Client Consent to Response.
- It is proper to respond when: the "initial letter requesting the lawyer to provide information to the auditor is signed by an agent of the client having the apparent authority to make such a request . . . ."
  - No further consent needed unless the information discloses a confidence or a secret or requires an evaluation of a claim.

ABA Statement of Policy (continued)

- Normally the initial letter does not provide the necessary consent, since consent may "only be given after full disclosure to the client of the legal consequences of such action".
- When evaluating claims, keep in mind that an adverse party "may assert that any evaluation of potential liability is an admission".
- To secure the necessary consent, consider giving the client a draft of the response to review and approve before sending to the auditor.

ABA Statement of Policy (continued)

- Limitation on Scope of Response.
  - Appropriate to spell out the scope of engagement.
  - Appropriate to indicate the date of response and disclaim any undertaking to update.

ABA Statement of Policy (continued)

– "Unless the lawyer's response indicates otherwise, (a) it is properly limited to matters which have been given ***substantive attention*** by the lawyer in the form of ***legal consultation and, where appropriate, legal representation*** since the beginning of the period or periods being reported upon, and (b) ***if*** a law firm or ***a law department***, the ***auditor may assume*** that the firm or ***department has endeavored***, to the extent believed necessary by the firm or department, ***to determine*** from lawyers currently ***in the*** firm or ***department*** who have performed services for the client since the beginning of the fiscal period under audit whether such services involved ***substantive attention in the form of legal consultation concerning*** those ***loss contingencies*** referred to in Paragraph 5(a) below but, ***beyond that, no review*** has been made of any ***of the client's transactions*** or other matters ***for*** the purpose of ***identifying loss contingencies*** to be described in this response." (Emphasis added.)

ABA Statement of Policy (continued)

– Are there material items to which you have *not* given substantive attention?
– Are you distinguishing between information you gained in a "business" capacity and information you gained in a "legal" capacity?
– What processes are you using to gather information from other counsel in the department?

ABA Statement of Policy (continued)

- Response May Be Limited to Material Items.
  - What is material for one may not be material for another.
  - Quantitatively immaterial – could be material for other reasons (*e.g.*, small error in calculation that creates, or inaccurately prevents the creation, of an event of default under a line of credit or financing agreement).

ABA Statement of Policy (continued)

- Materiality (continued)
  - For §10(b) and Rule 10b-5, the Supreme Court said "an omitted fact is material if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor." *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).
  - "Material" will often pick up more than what is *required* disclosure under SEC Regulation S-K, Item 103.

ABA Statement of Policy (continued)

- Materiality (continued)
  - "Describe briefly any ***material*** pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities." SEC Regulation S-K, Item 103. (Emphasis added.)

ABA Statement of Policy (continued)

- Materiality (continued)
  - Instruction 2: "No information need be given with respect to any proceeding that involves primarily a claim for damages if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis."
  - A claim for damages involving less than 10 percent of current consolidated assets could well be material under *Basic Inc. v Levinson* but not otherwise a required disclosure under Instruction 2.

ABA Statement of Policy (continued)

- Materiality (continued)
  - "Assumptions used to determine whether items are material should also be disclosed. Materiality determinations are often critical, and can mean the difference between a company's missing or 'making' its numbers."
    Melvyn I. Weiss and Elizabeth A. Berney, "Restoring Investor Trust in Auditing Standards and Accounting Principles," 41 Har. J. on Legis. 29, 52 (Winter, 2004).

ABA Statement of Policy (continued)

- Limited Responses
  - If the response is limited in accordance with the ABA Statement of Policy, say it in the response.
  - If the response doesn't indicate that it is limited, it isn't, and you may inadvertently pick up liability.

ABA Statement of Policy (continued)

- Loss Contingencies
  - Appropriate to furnish information with respect to the following if "the lawyer has been engaged by the client to represent or advise the client professionally with respect thereto and he has devoted substantive attention to them in the form of legal representation . . . ."
    - Overtly threatened or pending litigation.
      - Potential claimant is aware of a possible claim and has manifested a present intention to assert a possible claim (unless likelihood of litigation is remote).

ABA Statement of Policy (continued)

  - Contractually assumed obligation, if the client has specifically identified it and has requested comment to the auditor.
  - An unasserted possible claim or assessment, if the client has specifically identified it and has requested comment to the auditor.

ABA Statement of Policy (continued)

– If no manifestation of an awareness of and present intention to assert a potential claim, the client should request that the lawyer furnish information to the auditor only if:
  - ***the client*** has determined that it is probable that the claim will be asserted (probable is intended to mean "reasonably certain");
  - that there is a reasonable possibility that the outcome will be unfavorable; and
  - that the resulting liability would be material.

ABA Statement of Policy (continued)

– What information should the lawyer provide?
  - identification of the proceedings;
  - the stage of the proceedings;
  - the claim(s) asserted; and
  - the position taken by the client.

ABA Statement of Policy (continued)

- Normally refrain from expressing judgment as to outcome unless "probable" or "remote" (no inference drawn from lawyer not expressing a judgment).
  - "[A]n 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***". (Emphasis added.)
  - "[A]n 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***". (Emphasis added.)

ABA Statement of Policy (continued)

- Request that the lawyer estimate the dollar amount of potential loss or range of loss if an unfavorable outcome is not remote.
  - Appropriate to estimate only when "the probability of inaccuracy" is slight.
  - Not appropriate to estimate for most unasserted claims.
- An estimate, if any, is not necessarily the same as what the company reserves for the contingency (be careful of divergence, though) and the lawyer should not express any opinion on the adequacy of the reserves.
- "The lawyer should not be asked, nor need the lawyer undertake, to furnish information to the auditor concerning loss contingencies except as contemplated by this Paragraph 5."

ABA Statement of Policy (continued) and FAS 5

- FAS 5.
  - Probable: "The future events are likely to occur."
    - Compare "probable" under the ABA Statement of Policy and FAS 5 – could reach a different result (i.e., "Legal" could decide not to express a judgment as to outcome, but "Finance" could determine that is probable and estimable and make an accrual).
    - "Although not acknowledged in [SAS 12], there is a subtle difference in the definitions in FAS 5 and the ABA policy statement. Clients should be aware that a lawyer's response following the ABA policy statement may not provide all information necessary for them to comply with the reporting obligations set forth in FAS 5."
      (Double Trouble Case Study)

ABA Statement of Policy and FAS 5 (continued)

- Reasonably Possible: "The chance of the future event or events occurring is more than remote but less than likely."
- Remote: "The chance of the future event or events occurring is slight."

ABA Statement of Policy and FAS 5 (continued)

Accounting Treatment for Asserted Claims			
		Ability to Reasonably Estimate the Potential Loss	
		Reasonable Estimate	No Reasonable Estimate
Likelihood of an Unfavorable Outcome	**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
	Reasonably Possible	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

ABA Statement of Policy and FAS 5 (continued)

- Primary Accounting Considerations:
  - Period of underlying "cause";
  - Degree of probability of the unfavorable outcome; and
  - Ability to make a reasonable estimate of the amount of loss.
- Notes Regarding Subsequent Events, But Prior to Issuance of Financial Statements:
  - Type 1 Event: confirms a condition that existed prior to year-end; adjust year-end financial statements.
  - Type 2 Event: condition did not exist at balance sheet date; consider disclosure if significant.

ABA Statement of Policy (continued)

- Lawyer's Professional Responsibility.
  - Consider "need for or advisability of public disclosure."
    - e.g., Securities and Exchange Commission Regulation S-K, Item 303(a)(4)(i)(C), "Management's Discussion and Analysis of Financial Condition and Results of Operations" (regarding MD&A for full financial years):
      - "The amounts of revenues, expenses and cash flows of the registrant arising from [off-balance sheet] arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the registrant in connection with such arrangements; and the nature and amounts of any other obligations or liabilities (***including contingent obligations or liabilities***) of the registrant arising from such arrangements that ***are or are reasonably likely to become material*** and the triggering events or circumstances that could cause them to arise . . ." (Emphasis added.)
  - Code of Professional Responsibility may require resignation if advice regarding public disclosure is disregarded.
  - Auditor may assume that the lawyer has considered disclosure requirements for an unasserted possible claim and has advised the client on disclosure.

ABA Statement of Policy (continued)

- 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 http://www.sec.gov/rules/final/33-8185.htm.
  - PART 205 - Standards of Professional Conduct For Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer.

ABA Statement of Policy (continued)

- Updates (continued):
  - "The language which we adopt today clarifies that this part does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, the ***Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state*** or other United States jurisdiction in which an attorney is admitted or practices." SEC Release 33-8185. (Emphasis added.)
  - If the lawyer learns of "credible evidence" that any agent of the company has engaged or is engaged in a "material" violation of federal or state securities laws, the lawyer must notify the chief legal officer (CLO) or both the CLO and the chief executive officer (CEO) (unless the company has established a special committee of independent board members to receive such reports, a qualified legal compliance committee or QLCC).

ABA Statement of Policy (continued)

- Updates (continued):
  - If the CLO/CEO does not respond "appropriately" by persuading the lawyer (1) that there is no past, ongoing, or reasonably likely future violation, (2) that the problem has been remedied, or (3) that further investigation is necessary, the lawyer must report the evidence of wrongdoing to the company's audit committee, another committee of independent directors, or the full board of directors.
  - If/when the lawyer receives an appropriate response from the CLO/CEO or the board, the lawyer's obligations under the SEC rules are satisfied.

ABA Statement of Policy (continued)

- Updates (continued):
  - A "supervisory attorney" is responsible for making reasonable efforts to make sure "subordinate attorneys" comply with the rules. If a subordinate attorney reports to a supervisory attorney, the subordinate attorney's obligations are satisfied, and the supervisory attorney is responsible for any further reports.
  - "Noisy withdrawal" is not required . . . for now.
  - Defense counsel may assert a colorable defense.

ABA Statement of Policy (continued)

- Limitation on Use of Response
  - Unless otherwise stated: solely for the auditor's information in connection with the audit.
  - May be furnished in compliance with a court process.

ABA Statement of Policy (continued)

- General
  - ABA Statement of Policy was developed for "general guidance of the legal profession".
  - The lawyer may incorporate the ABA Statement of Policy by reference.
- Question: Prepare something less than a full response as a PBC (prepared by client) document?
  - Risk: not having the protections of the ABA Statement of Policy or other enumerated guidelines (so, risk of giving a misleading response).

Process for Responding

- How should in-house counsel prepare (from start to finish) a response?
  - Communicate with the auditors in advance to establish an appropriate materiality threshold.
    - This threshold may not be the same as, and may well be lower than, the disclosure required by S-K 103.
  - Role of the Audit Committee in establishing this threshold.
    - Consider Audit Committee Charter.
    - Consider Audit Committee Requirements (SEC, SROs).
  - What reports are given to the Audit Committee?

Process for Responding (continued)

- What reports are given to the Audit Committee?
- How do you find information throughout the business?
- How does the business report information to you?
- There is no "one size fits all" answer.
  - Co-ordinate efforts.
  - Scale efforts for the business.

Process for Responding (continued)

- What are the dangers of the process?
  - Confidentiality:
    - The Section of Litigation of the American Bar Association has squarely stated that the scope of the attorney-client privilege should be the same for in-house counsel and outside counsel.
      - "**Recommendation:** RESOLVED, that the American Bar Association supports the principle that the attorney-client privilege for communications between in-house counsel and their clients should have the same scope and effect as the attorney-client privilege for communications between outside counsel and their clients."

        ABA Report on Attorney-Client Privilege for In-House Counsel, Barry F. McNeil, Chair, Section of Litigation, August 1997, Westlaw, PLIREF-CORPLEG 9 Exh. 9A.
    - Communications with "employed" counsel may not be privileged in other jurisdictions (outside the U.S.).

Process for Responding (continued)

- (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
- (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
  - (1) to prevent reasonably certain death or substantial bodily harm;
  - (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
  - (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
  - (4) to secure legal advice about the lawyer's compliance with these Rules;
  - (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
  - (6) to comply with other law or a court order.
- MRPC 1.6

Process for Responding (continued)

- Attorney-Client Privilege
  - Voluntary disclosure would generally suffice to show a waiver of the attorney-client privilege. See, e.g., Upjohn Co. United States, 449 U.S. 383 (1981).
  - Circuit split regarding limited, or selective, waiver of the privilege.
  - Primary purpose of the response is not to render legal advice.
  - Disclosure to the auditor (in the year-end audit process) is a voluntary, deliberate disclosure.

Process for Responding (continued)

- Work Product Doctrine
  - Federal Rules of Civil Procedure - Rule 26.
  - General Rule: Disclosure of "work product" to a third party does not waive protection of the doctrine unless it substantially increases the opportunity for adversaries (or potential adversaries) to obtain the information.
  - John K. Villa, Corporate Counsel Guidelines, The Work-product Doctrine and In-House Corporate Counsel Analysis, §2.12 Waiver, Exceptions and the Loss of Work-Product Protection – Deliberate Disclosures, Westlaw, CORPCG §2.12, citing *In re Grand Jury Subpoena*, 220 F.3d 406 (5th Cir. 2000), *In re Grand Jury Proceedings*, 43 F.3d 966 (5th Cir. 1994), *Shields v. Sturm, Ruger and Co.*, 864 F.2d 379 (5th Cir. 1989), *Peralta v. Cendant Corp.*, 190 F.R.D. 38 (D.Conn. 1999), *In re Imperial Corp of America*, 167 F.R.D. 447 (S.D.Cal. 1995), *In re Grand Jury Subpoenas Dated December 18, 1981 and January 4, 1982*, 561 F.Supp. 1247 (E.D.N.Y. 1982) and Restatement (Third) of The Law Governing Lawyers § 91 cmt. b (2000).
  - Analysis:
    - Were there common interests (co-defendants during trial preparation)?
    - Was disclosure under a guarantee of confidentiality?

More on Accounting: Fraud

- Should auditors be looking for fraud?
- SAS 99.
  - Requires affirmative minimum procedures to detect material fraud.
  - Four key points:
    - Increased emphasis on professional skepticism.
    - Discussions with management.
    - Unpredictable audit tests.
    - Responding to management override of controls.

More on Accounting: Fraud

- § 10A of the Securities Exchange Act
  - If the auditor detects or becomes aware that an illegal act has or may have occurred, the auditor must determine whether it is likely that an illegal act has occurred, and, if so, determine the possible effect of on the financial statements and, as soon as practicable, inform management and assure that the audit committee (or board of directors if there is no audit committee) is adequately informed unless the illegal act is clearly inconsequential.

More on Accounting: Fraud

- § 10A of the Securities Exchange Act (continued)
  - If the auditor concludes that the illegal act has a material effect on the financial statements of the issuer; senior management has not taken (and the board of directors has not caused senior management to take), timely and appropriate remedial actions and the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement, the auditor must directly report its conclusions to the board of directors.

More on Accounting: Fraud

- § 10A of the Securities Exchange Act (continued)
  - The board must inform the SEC within one business day after the receipt of such report and shall give a copy of the notice to the SEC. If the auditor doesn't receive a copy of the notice, the auditor must resign or give its report to the SEC within one business day (the auditor also must provide its report to the SEC if it resigns).
  - These changes to the Exchange Act were part of the Private Securities Litigation Reform Act of 1995 (PSLRA).

(Fairly) Recent Changes

- SOX § 404, Management Assessment of Internal Controls.
  - Establishing and maintaining an internal control structure.
  - Assessing the effectiveness of the internal control structure.
  - Preparation of a management report on the structure and its effectiveness.
  - Securing an attestation from external auditor on the effectiveness of the internal control structure.

(Fairly) Recent Changes (continued)

- SOX § 404 (continued).
  - Is not capturing a loss contingency a "Material Weakness" or a "Significant Deficiency?"
    - Material Weakness (in internal control): Significant Deficiency (or combination of significant deficiencies) that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.
    - Significant Deficiency: Control deficiency (or combination of control deficiencies) that adversely affects the company's ability to initiate, authorize, record, process or report external financial data reliably – in accordance with GAAP – such that there is more than a remote likelihood that a misstatement that is more than inconsequential will not be prevented or detected.

(Fairly) Recent Changes (continued)

- SOX § 404 (continued).
  - Material Weakness = Disclosure.
  - "Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include *disclosure* of *any material weakness* in the registrant's internal control over financial reporting identified by management. 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 . . . ."

    Securities and Exchange Commission Regulation S-K, Item 308(a)(3), "Internal Control Over Financial Reporting" (Emphasis added.)

(Fairly) Recent Changes (continued)

- SOX § 303.
  - Required the SEC to adopt rules making it unlawful for an officer or director – or anyone acting under their directions – of an issuer "to take any action to fraudulently influence, coerce, manipulate, or mislead" an accountant auditing the issuer's financial statements "for the purpose of rendering such financial statements materially misleading."

(Fairly) Recent Changes (continued)

- SOX § 303 (continued).
  - SEC Rule 13-b2-2, SEC Release 34-47890, "Improper Influence on Conduct of Audits," May 20, 2003, at http://www.sec.gov/rules/final/34-47890.htm
  - The final rules "prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to coerce, manipulate, mislead, or fraudulently influence the auditor of the issuer's financial statements if that person knew or should have known that such action, if successful, could result in rendering the financial statements materially misleading."

(Fairly) Recent Changes (continued)

- SOX § 303 (continued).
  - The term "officer" includes the company's "president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated." The term "executive officer" includes an issuer's chief executive officer and other officers who perform policy-making functions for the issuer.
  - The SEC declined, in response to comments, to amend the definition to include an issuer's general counsel or chief legal officer but noted that the existing definitions cover those who "set corporate governance policies and legal policies for an issuer."

(Fairly) Recent Changes (continued)

- SOX § 303 (continued)
  - The SEC changed the order of the basic prohibition, taking the position that "fraudulently" only modifies "influence" and not "coerce," "manipulate" or "mislead".
  - The final rules moved to an negligence standard.
  - The phrase "[u]nder the direction of" creates a broader reach than "supervision of".
  - The non-inclusive list of types of conduct which the SEC believes could constitute improper influence includes, directly or indirectly, "[p]roviding an auditor with an ***inaccurate*** or misleading legal analysis". (Emphasis added.)

(Fairly) Recent Changes (continued)

- SOX § 303 (continued)
  - "Attorneys may have to reevaluate their responses to auditors relating to unasserted claims, threatened, and outstanding litigation and the whole process surrounding Statement of Auditing Standards (SAS) 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments and SFAS 5."

    Harold S. Bloomenthal, Sarbanes-Oxley Act in Perspective, § 7:16. RULE 13B2-2(B)—IMPROPER INFLUENCE ON CONDUCT OF AUDITS, Westlaw SEC-SOAP § 7:16.
  - Question: will the PCAOB revisit this area?

(Fairly) Recent Changes (continued)

- SOX § 802.
  - Requires auditors to maintain audit records for 5** years. Violation could result in fines or imprisonment for up to 10 years, or both.
  - SEC Release 33-8180, "Retention of Records Relevant to Audits and Reviews," January 24, 2003 at http://www.sec.gov/rules/final/33-8180.htm.
  - ** The final rules moved the retention period from 5 to 7 years.

Does this system work?

- Yes, but . . .
  - Improvements needed to reflect:
    - the changing role of in-house departments;
    - the mixed roles of in-house counsel; and
    - significant case law and statutory changes.

Does this system work?

- Questions?
- Thank you.