

WHEN PROFESSIONS COLLIDE - LAWYERS' RESPONSES TO AUDITORS' REQUESTS

By Charles D. Lee

Most business lawyers periodically receive auditors' request letters. The letters come to the lawyer on the client's letterhead at the behest of the client's accountants who are conducting an audit of the client's business. Before responding to the letter the practitioner should understand the audit process, to which the auditors' letter is an adjunct, as well as the possible consequences that flow from the lawyer's response. In addition, every firm should have an established procedure for responding to auditor's inquiries.

THE AUDIT PROCESS

An audit is an examination of financial statements or other data that are derived from a businesses' accounting processes. The usual objective of the auditor's report is to provide an independent opinion on whether the company's financial statements present fairly the financial position of the business as of a specified date and in conformity with generally accepted accounting principles consistently applied.

To form an opinion regarding a company's financial statements, the auditor must consider those items that are material to the financial position of the business. The concept of materiality is fundamental to the audit process. The concept recognizes that some matters, individually, or in the aggregate, are important for the fair presentation of financial statements. The consideration of materiality is a matter of professional judgment made in light of surrounding circumstances, and necessarily involves both quantitative and qualitative considerations.

Quantitative considerations regarding materiality involve the nature and amount of an error in relation to one or more items in the financial statements. An amount that is material to one entity may not be material to another. For example, an error of \$2,000 in recording an invoice might be material to a company with sales of only \$20,000, and receivables of \$2500, but would probably not be material to a company with sales of \$20,000,000 and receivables of 2.5 million dollars.

Qualitative considerations may influence the auditor to decide that a quantitatively immaterial error may be material for other reasons. For example, a small error in the calculation of working capital that, if corrected, would result in default under a loan agreement could become material.

Information that may be material in respect to the financial condition of a business includes information regarding pending or threatened lawsuits as well as information concerning contingent claims that are not presently asserted. The latter known generally as contingent liabilities and technically as unasserted possible claims, has been the source of considerable controversy between lawyers and accountants. The controversy has been exacerbated by the increasing number of malpractice actions filed against accountants for failure to make required financial statement disclosures in connection with sales and purchases of securities. Accountants have responded, in part, by seeking more information from lawyers regarding undisclosed liabilities of the client. The club accountants have attempted to use is the threat of supplying a qualified opinion that might make an audited statement unacceptable for the purpose of required filings with the Securities and Exchange Commission and also the basis for default under many standard types of loan agreements and other contracts.

THE GRAND COMPROMISE

Because the needs and expectations of the accounting and legal professions in connection with the audit process are so widely disparate, the American Bar Association and the American Institute of Certified Public Accountants reached an agreement in 1976 on major issues. The resulting document is entitled **ABA Statement of Policy Regarding Lawyers' Response to Auditors' Requests for Information** and the primary guide is "The Auditor's Letter Handbook."

Two other important documents involved in this accord are the **American Institute of Certified Public Accountants Statements on Auditing Standards No. 12 -- Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments**, which is the AICPA equivalent of the ABA policy statement, and the **Financial Accounting Standards Board -- Statement of Financial Accounting Standards No. 5 -- Accounting for Contingencies**, which sets forth the accounting guidelines for the necessity and form of disclosure for contingent claims. Both explain the auditor's obligations and both are available from the AICPA.

THE AUDITORS' LETTER

The primary purpose of an auditors' letter is to gather or verify information as to what the auditors call "loss contingencies." These include liabilities that may arise from pending or threatened litigation or from unasserted possible claims or assessments.

The disclosure required of a lawyer in responding to an auditors' request is, to a large degree, determined by the request itself. An illustrative form of an auditors' request appears on this page.

Name and Address of law firm

Dear Sirs:

In connection with an examination of the consolidated financial statements of [**insert name of client**] (the "Company") and its subsidiaries at [**insert balance sheet date**] and for the [**insert fiscal period under audit**] then ended, our auditors, [**insert name and address of accounting firm**], have asked that we request you to furnish them with information concerning certain contingencies involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company and/or any of its subsidiaries. (For your convenience, a list of such subsidiaries is attached). This request is limited to contingencies which [**insert standard of materiality to be used**] and they therefore should be considered in connection with our audit.

Pending or Threatened Litigation (excluding unasserted claims).

Please furnish to our auditors details relating to all matters of pending or threatened litigation your firm is handling on our behalf, which meet the standard of materiality stated above, including (1) a description of the nature of each matter, (2) the progress of each matter to date, (3) how the company has responded or intends to respond (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss. Your response should include matters your firm was handling at [**insert balance sheet date**] as well as new engagements undertaken during the period from that date to the date of your response.

If one or more unasserted possible claims or assessments are to be listed in the inquiry letter, include the following paragraph. If not, the following paragraph (and caption heading) should be omitted for the reason that the lawyer should be apprised **only** that management has advised the auditor that management has disclosed to the auditor all unasserted possible claims that the lawyer has advised are probable of assertion and must be disclosed (as specified in FAS 5).]

Unasserted Claims or Assessments

We have informed our auditors that the following unasserted possible claims or assessments, for which you have been engaged and to which you have devoted substantive attention on our behalf in the form of legal consultation or representation, are considered by management to be probable of assertion and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome: **[insert information as appropriate; ordinarily management's information would include: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss]**. Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, if you have formed a professional conclusion that you must disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

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

[The auditor may request the client to inquire about additional specific matters; for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the Company, such as guarantees of indebtedness of others, for which the addressee of the letter of audit inquiry has been engaged and to which such addressee has devoted substantive attention on the client's behalf in the form of legal consultation or representation.]

[The letter may also state: "We have represented to our auditors that there have been disclosed by management to them all unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in the financial statement currently under examination." [or] "We have represented to our auditors that there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in the financial statements currently under examination."]

Very truly yours,

THE INFORMATION SOUGHT AND THE LAWYER'S OBLIGATIONS

An auditor's request generally encompasses three types of claims. The first, asserted claims, consist of pending or overtly threatened litigation. If material, any asserted claim must be disclosed regardless of whether the client has disclosed it to the auditor so long as the lawyer has devoted substantive attention to the claim. "Substantive attention" is not defined in the ABA statement, but essentially means that the claim must have come to the lawyer's attention in the course of his legal representation of the client and not in some other capacity, such as that of a director. Because substantive attention is not defined, some firms include in their response language defining substantive attention to mean, for example, that the firm has devoted some minimum number of billable hours to the claim.

The second type of claim embraced by the auditors' inquiry is the unasserted possible claim. While disclosure may be required, not every unasserted possible claim need be disclosed in the lawyer's letter of response. The **ABA Statement of Policy** notes three types of limitations. First, the lawyer has no obligation to disclose any matter unless he has given substantive attention to the potential claim. Second, a lawyer has no obligation to ask the client whether there are any possible unasserted claims that the client has not brought to the lawyer's attention. The primary burden of disclosure is thus placed on the client. Third, to require disclosure, an unasserted claim must meet all of the following criteria: (1) it is probable that the claim will be asserted; (2) that, if asserted, there is a reasonable possibility of an outcome unfavorable to the client; and (3) that resulting liability would be material to the financial condition of the client.

The third type of claim consists of contractually assumed obligations, such as liabilities arising from warranties. As with unasserted claims, claims in the third category need not be disclosed by the lawyer in his response unless the claims are identified in the letter of inquiry.

The lawyer is obliged to apprise the client of any claims he believes to be material and of the lawyer's duty in regard to disclosure. But except in circumstances in which the lawyer believes the necessity of disclosure is "beyond reasonable dispute," the lawyer should not disclose either contractually assumed obligations or unasserted possible claims that are not listed in the letter of inquiry.

If disclosure is required, the lawyer who fails to do so risks both civil and criminal liability under the securities laws. For example, under Section 32(a) of the Securities Exchange Act of 1934, it is a crime (1) to willfully fail to file a required report (or to file it late) in violation of Section 13(a) of the Act or (2) to "willfully and knowingly" make or cause any statement in a required report that is "false or misleading with respect to any material fact." A lawyer's failure to make a required disclosure in response to an auditor's request may very well "cause" a required statement or report to be materially false or misleading. If so, the lawyer's failure may fall under the statute.

MUST THE LAWYER PREDICT THE OUTCOME

Financial Accounting Standards No. 5 (FAS 5) deals with accounting for contingencies. It defines a loss contingency as "an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur. Resolution of the uncertainty may confirm the loss or impairment of an asset or the

incurrence of a liability." FAS 5 classifies the likelihood of the occurrence of a loss contingency in a range from probable to remote. A probable loss contingency is a future event that may materially affect the client's finances and that is likely to occur. A reasonably possible loss contingency is one where the chance of the future event or events occurring is more than remote but less than likely. A remote loss contingency relates to those situations where the chance of the future event or events occurring is slight.

The ABA Statement requires a lawyer to predict ultimate liability for asserted or unasserted claims, or the amount or range of a potential loss if the result is expected to be unfavorable, only in the following circumstances: (1) It is clear that a favorable outcome for the client is extremely doubtful (designated as "probable" liability claims) or; (2) The prospects of success by the claimant are judged to be extremely slight (designated as "remote" liability claims), and; (3) The probability of inaccuracy of the estimate is minimal. Because the outcome of very few claims is sufficiently clear to meet the standards, a lawyer will rarely feel compelled to make an outcome or damages prediction.

FORMAT FOR THE RESPONSE

The ABA recommends a standard format for responding to auditors' inquiries. The form for outside counsel that is included with the ABA Statement appears on page ____.

Name and address of accounting firm]

In re: [Name of client]

[and subsidiaries]

Dear Sirs:

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

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

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

or]

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

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

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

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

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

[Insert information as appropriate].

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

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

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

Very truly yours,

The ABA Statement is a guide for attorneys and does not purport to impose any ethical requirements on the attorney to adhere to its provisions, but unless the

circumstances make its use inappropriate, the ABA-recommended response format should be utilized on a consistent basis. Use of the standard format imposes certain limitations on the response which are very helpful to the law firm.

For example, paragraph 1 of the commentary to the ABA statement permits the law firm to adopt internal procedures to gather information for the response. These procedures may vary, based on factors such as the scope of the engagement and the complexity and magnitude of the client's affairs. The law firm may adopt procedures which avoid undue cost to the client in light of the anticipated benefit. Thus, an independent review of client files and contractual agreements of the client may not necessarily be required prior to responding to an auditors' letter, if the cost outweighs the anticipated benefit.

Additional useful language is set forth in paragraph 2(b) of the ABA Statement and notes that unless otherwise indicated in the response, the auditor is not entitled to assume the law firm conducted a review of the "client's transactions" or other matters in preparing the response.

GATHERING INFORMATION FOR THE RESPONSE

Each lawyer in the firm who has worked for the client should be polled prior to responding to the auditors' request. Law firms typically poll their attorneys concerning pending litigation and overtly threatened litigation, whether the client is an actual or potential plaintiff or defendant. This is necessary because the term "loss contingency" includes situations in which an asset is impaired or a liability is incurred. If the client is the plaintiff, the lawyer generally is unable to determine if the client may have recorded its claim as an asset (e.g. as an account or note receivable). If so, the defenses to the client's claim may reflect an impairment of the asset. Accordingly all litigation for the client should be revealed in response to the auditor's letter and be included in the polling request of lawyers in the firm.

Generally speaking, a written inquiry should be sent to each lawyer presently in the firm. The inquiry should solicit a written response by a date certain.

PREPARING THE RESPONSE

The response should adhere strictly to whatever standard form of response the firm has adopted unless a modification has been approved by the partner in the firm who is knowledgeable on the subject of auditors' letters.

The ABA Statement discourages lawyers from giving legal opinions concerning asserted claims. Opinions are discouraged because of the difficulty in classifying, with any degree of confidence, a claim as either probable or remote. No phrase such as "the company believes the claim is without merit" or "the company believes it has meritorious defenses," should be included in the response unless the facts clearly justify such a statement under the ABA Standards. When asked for an opinion, many firms hedge with statements similar to the following:

The Company is a defendant in a suit brought in the United States District Court for Kansas, claiming damages of three million dollars allegedly resulting from product defects in respect to a product manufactured by the Company. Discovery is incomplete and we express no opinion as to the ultimate outcome of the litigation.

The response should generally be reviewed and signed by at least two partners. This is particularly true if there is any deviation from the ABA-recommended standards and format. Any significant deviation should be documented in the file.

Copies of responses to auditors' inquiries should be kept in the client's file and in a central repository, appropriately indexed. Poll results should be kept with a response in the central file.

DISCOVERY OF AUDIT RESPONSE LETTERS

One of the primary problems associated with a response to an auditor's letter has been the lawyer's concern that disclosure of certain matters to the auditor would constitute a waiver of any attorney-client privilege in respect to the information disclosed. The ABA statement attempts to balance the attorney's need to avoid inadvertent waivers of the attorney-client privilege in responding to the auditors' letter with the auditors' need for complete and accurate information in audited financial statements.

Is the lawyer's response discoverable? No reported Kansas case addresses the issue. The possibility is troubling and was addressed in the commentary to the ABA Statement:

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

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

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

The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between the lawyers and the 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."

Unfortunately there is no consensus among the courts that have addressed the discoverability of audit response letters. Litigants who have been confronted with a discovery request seeking an audit response letter, and who have resisted discovery, have argued privilege (attorney-client, accountant-client, or both), work product exclusion, or relevancy as bases for refusing to produce the audit response letter.

The argument that an audit response letter was not relevant and constituted work product was persuasive to the federal magistrate in Tronitech, Inc. v. NCR Corporation. As to relevancy, the Court, with little discussion, held the audit

response letter was not relevant because it was clearly inadmissible at trial and contained only opinions which could not conceivably lead to admissible evidence.

In addressing the issue of whether the audit response letter constituted counsel's work product and was thus exempt from discovery, the Court acknowledged that work product protection applies only to materials prepared in anticipation of litigation or for trial, but held that an audit letter "is not prepared in the ordinary course of business but rather arises only in the event of litigation." Based upon that conclusion, the Court determined the audit letter did constitute work product and was not discoverable.

Two other courts, when confronted with disputes regarding discovery of lawyer's responses to auditor's requests, found the letters to be discoverable. In United States v. Gulf Oil Corp., the Court dismissed a claim that the audit letters constituted work product: "...we hold that these documents do not constitute attorney work product because they were created primarily for the business purpose of compiling financial statements which would satisfy the requirements of the federal securities laws."

Similarly, a work product exclusion argument was rejected in Independent PetroChemical Corp. v. Aetna Casualty & Surety Co. The Court further held that any attorney-client privilege associated with the audit response letter was waived when the letter was furnished to the auditor.

It is difficult to reconcile the decision in **Tronitech**, prohibiting discovery, with the decisions in **Gulf** and **Independent**. The difficulty is largely a result of the Court's questionable reasoning in **Tronitech**.

Given the broad scope of discovery the Court's finding in **Tronitech** that the audit letter was not relevant, even for purposes of discovery, is probably wrong. Most courts favor disclosure of nonprivileged materials, like insurance coverage, that tend to promote settlement. That policy has been embraced by the Kansas Supreme Court. At least in courts adhering to the more liberal view of the scope of discovery, it is arguable that audit response letters containing realistic opinions regarding the potential liability exposure of the lawyer's client are discoverable notwithstanding their substantive irrelevancy.

Flatly wrong is the **Tronitech** holding that audit letters are prepared in anticipation of litigation and thus constitute work product. Lawyer's responses to audit letters are prepared primarily to assist in the audit process. Thus the conclusion in **Tronitech** that the response is subject to the work product privilege is questionable at best.

While **Gulf** and **Independent** probably reflect the current state of the law, there are compelling public policy reasons to ordinarily deny discovery of audit response letters. As noted in the preamble to the ABA Statement, "...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." Until discovery of audit response letters is either legislatively or judicially prohibited, the uncertainty regarding the status of the documents may very well lead to a lack of

candor on behalf of the client in identifying potential liabilities and by the lawyer in responding to requests from their client's auditors.

CONCLUSION

Lawyers and auditors have fundamentally antithetical obligations. Auditors seek disclosure while lawyers seek to prevent it. The ABA Statement recognized and addressed the inherent conflict between the auditor's responsibilities and concerns regarding liability for nondisclosure of material liabilities and the lawyer's responsibilities and concerns regarding disclosure and consequent waiver of privilege. By providing a framework for auditors' requests and lawyers' responses, it has helped to resolve the long standing dispute between the professions.

The ABA Statement was achieved only after long and intensive negotiations between the ABA and the AICPA. The effort required, and the uncertainty of whether the lawyer's response is protected from discovery, should serve as reminders that responses to auditors' requests must be prepared systematically and with the caution that attends preparation of any other legal opinion.

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