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The Growing Tension Between Auditors and Lawyers

By Thomas W. White

A company's lawyers and its independent accountants occupy different and, in certain respects, opposing roles in corporate governance. Lawyers are charged with maintaining their clients' confidences and acting as their zealous advocates. The legal profession therefore regards the attorney-client privilege and work-product doctrine as fundamental underpinnings of the profession's work and responsibilities. The attorney-client privilege enshrines the ability of clients to communicate with and receive advice from their lawyers in confidence. The work-product doctrine permits the lawyer to discover and evaluate facts, assess litigation risks, and develop litigation strategies free, in most cases, from discovery by opposing parties. Lawyers often contend that without these privileges, the ability of clients to obtain candid legal advice and thereby to conform their behavior to the law, as well as the clients' right to secure zealous representation in legal disputes, will be jeopardized.

A company's independent accountants, by contrast, provide an independent review of and opinion on a company's financial statements. Applying procedures specified by generally accepted auditing standards, they review the books and records of the company and, based on that review, attest that its financial statements have been prepared in accordance with generally accepted accounting principles and fairly present the company's financial condition, results of operations, and cash flows.

Director Summary: New governence rules may engender conflict between auditors and lawyers, as outside auditors increasingly seek previously privileged information to support their audit reports. In addition, auditors must be apprised of any illegal acts; existing ethical rules on disclosure may be inadequate for the current environment.

How Conflict Comes About

The roles of the two professions may come into conflict when auditors need information on legal matters to conduct their reviews or audits, and lawyers' professional obligations (as well as concerns about the consequences of a privilege waiver) limit their ability to disclose that information without client consent. This inherent tension between the professions and their roles has always existed. However, the landscape for public companies, at least, is rapidly evolving in light of the corporate scandals and the Sarbanes-Oxley Act, as well as developments in auditing standards and legal privileges and ethics. This may lead to heightened tension, if not conflict, as auditors and lawyers strive to carry out their separate responsibilities in the post-Sarbanes world.

The tension is most pronounced in two key areas: evaluation of loss contingencies, and detection and remediation of fraud and other illegalities. A fair presentation of an organization's financial condition and results necessarily must take account of loss contingencies, most notably the potential impact of actual or potential litigation and claims. Statement of Financial Standards No. 5 (FASB 5) requires establishment of reserves and/or financial statement disclosure based on an assessment of the probability of an outcome and the ability to quantify the potential loss. This assessment in the context of actual or potential litigation necessarily involves legal judgments.

Tension arises between the auditor's desire for confirmation from the company's attorneys about reserve or disclosure judgments and attorney's obligations to protect client confidences. The law is clear that disclosure of privileged communications and work product to accountants in the course of an audit is a waiver of these privileges, and the waiver makes the information discoverable by adversaries in litigation. Public disclosure of such matters, moreover, could prejudice the company by publicly disclosing the strengths and weaknesses of a case in litigation or even, in the

worst case, by disclosing unasserted potential claims that, absent the disclosure, might never materialize.

A Negotiated Peace

These opposing interests were reconciled in a historic "treaty" between the American Institute of Certified Public Accountants and the American Bar Association that has endured for almost 30 years. Under the "treaty," the company, the auditor, and the attorney engage in a ritualistic exchange of letters, the form of which is now virtually graven in stone. A company attorney, at the request of the company, provides a letter to the auditor that describes pending and overtly threatened litigation. The lawyer is required to provide assessments of the outcome of litigation only where an outcome is "probable" or "remote" and is required to estimate the loss only where the probability of inaccuracy of the estimate is slight. To the extent the attorney's assessment of the case does not meet the requisite level of certainty, the attorney disclaims any opinion. In addition, the lawyer undertakes to advise the client when the lawyer believes that disclosure of a matter is necessary in light of the clients' obligations to make full and complete public disclosure with respect to its financial statements.

This ingenious compromise provided some degree of assurance to auditors, yet protected the clients' interests in preserving the confidentiality of their attorneys' advice and judgments. Nonetheless, it did not eliminate the inherent contradiction. Over time, it appears that lawyers in many cases departed from the treaty and in response to requests of auditors or direction from clients, provided additional elaboration on the relatively cryptic discussions of litigation matters set forth in the attorneys' formal response letters.

New regulatory requirements regarding audit documentation may increase the tension. The Public Company Accounting Oversight Board has adopted new documentation requirements for auditors. In addition, the deputy chief accountant of the Securities and Exchange Commission (SEC) indicated in a recent speech that auditors must require more documentation to support management judgments underlying accruals (or lack thereof) for contingencies, including as necessary, legal assessments. Requiring attorneys to provide written support for management's reserve decisions very likely would intrude on the legal privileges.

Disclosure of Illegal Acts

Situations involving possible fraud or illegal conduct represent the other area where the issues are particularly acute. This area, of course, is of particular interest in light of the recent fraud scandals and investigations. Auditors, not surprisingly, are demanding increased levels of disclosure and assurance in these cases. Section 10A of the Securities Exchange Act provides that if in the course of conducting an audit an accounting firm "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," it must take certain steps. The audit firm must "determine whether it is likely that an illegal act has occurred," and, if so, assess its possible effects on the issuer's financial statements. The firm is required to inform management and assure that the audit committee is informed of such illegal acts unless they are "clearly inconsequential." The firm is then required to assess the adequacy of any remedial actions that are taken in response to the report of the illegal act. Ultimately, if the accounting firm is not satisfied with the company's actions, it may be required to render a qualified audit opinion or withdraw from the engagement.

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Determining whether an illegal act has occurred, the potential impact on the company and its financial statements, and the adequacy of remedial actions can, and usually does, involve legal judgments. Relying explicitly or implicitly on section 10A, auditors have come to expect to be fully informed about the company's assessment of conduct in question, as well as its actions in response to evidence of possible illegal conduct, including counsel's factual findings and legal conclusions as a result of any investigation.

Similarly, the auditing standards for detecting fraud may lead to inquiries into legal matters. Statement of Auditing Standards 99, which became effective in 2002, requires the auditor, among other things, to make inquiries of management with respect to its knowledge of fraud, suspected fraud, or allegations of fraud or suspected fraud. It also directs the auditor to make inquiries of others about the existence or suspicion of fraud. Such persons can include in-house legal counsel. These new

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requirements, too, contribute to increased assertiveness by accountants to be provided with potentially privileged attorney information.

Confidentiality Rules May Be Shifting

At the same time that auditors' responsibilities are causing them to probe more deeply into legal matters, attorneys are confronting what may be fundamental changes in the precepts of confidentiality that have underpinned their professional duties and responsibilities. As widely noted, government authorities, including the Department of Justice and the SEC, increasingly view a waiver of the attorney-client privilege as an element of "cooperation" with a federal investigation. The SEC's attorney responsibility rules, adopted pursuant to section 307 of the Sarbanes-Oxley Act and codified as part 205 of the SEC's rules, embody a strong principle that attorneys are required to report possible material violations of the securities laws and other types of illegal conduct "up the ladder" within the organization.

The rule permits attorneys in certain circumstances to report imminent or continuing material violations of law to the SEC, notwithstanding longstanding state ethical rules that may be to the contrary. The SEC has not to date adopted controversial proposals to mandate "reporting out" of violations. Nonetheless, the statute and the implementing regulations proceed from a premise that protection of investors and the public interest in full disclosure may override the traditional principles of lawyer-client confidentiality. Whether or not these developments mean the attorney-client privilege is "under attack," as some have claimed, attitudes toward the privilege are evolving—and not in favor of the traditional views embraced by American jurisprudence for hundreds of years.

Of more direct relevance to the attorney/auditor relationship is the possible impact of section 303 of the Sarbanes-Oxley Act and SEC Rule 13b2-2 adopted under this section. The rule prohibits an issuer's directors, officers, or persons acting under their direction from taking actions to "coerce, manipulate, mislead, or fraudulently influence" an auditor in connection with an audit or review of an issuer's financial statements, in circumstances where the person providing the information knows or should know that his or her actions, if successful, could result in the issuer's financial statements being materially misleading. Notably, the SEC has stated that this rule encompasses "providing an auditor with an inaccurate or misleading legal analysis." The clear import is that lawyers can violate this rule in the communications they make to auditors, although it is not clear whether outside counsel would be acting "under the direction" of a director or officer. Hypothetically, even an audit letter response that conforms to the treaty could violate this rule, if it omitted information subsequently thought to be material.

All of these considerations are leading to a tug-of-war among auditors and attorneys. Auditors are asking lawyers, both in-house and outside counsel, for representations and opinions that go beyond the four corners of the treaty. Among other things, auditors have asked lawyers to confirm that they are not aware of any unasserted claims or that they have disclosed all illegal acts of which they are aware to auditors, the audit committee, or both. In some cases, they are asking in-house counsel to execute expansive representation letters comparable to those signed by other members of senior management. Auditors are requesting legal opinions or confirmations from attorneys to support or document legal judgments that underpin accounting for specific transactions. In cases of internal investigations of possible illegal acts, the auditors are insisting on being kept fully informed about the progress of the investigation, its findings, and the corrective actions adopted in response to the findings. Auditors are also getting at potential illegalities through provisions in engagement letters that require management to disclose known, suspected, or alleged fraud. Although each of these matters comes at the issue from a different direction, all either explicitly or implicitly could require corporate attorneys to disclose their legal advice or work product.

In response to these developments, many lawyers are retrenching. They are reviewing the treaty and their internal audit-letter response procedures. They are resting on the treaty and declining to provide more information than is required under the four corners of the treaty. They are avoiding informal discussions of legal matters with auditors, or at least attempting to do so. Particularly in light of Rule 13b2-2, they are relying on strict compliance with the treaty as the best defense against possible claims that their communications with auditors were misleading. It remains to be seen how these approaches will play out in

the post-Sarbanes world. It is uncertain whether the treaty will survive in its present form, or whether its procedures are adequate to address concerns arising from illegal acts and internal investigations that do not amount to litigation or claims covered by the treaty. A new dialogue between the accounting and legal professions will undoubtedly ensue, and these issues will play out over a period of years.

How to Deal with the Tension

In the meantime, what should companies be doing to address these developments? Some suggestions include:

• Boards, audit committees, management, and lawyers need to be very cognizant of the changing landscape. Sarbanes-Oxley placed renewed emphasis on the paramount importance of full and accurate public disclosure and the pre-eminent interest of protection of investors. Companies must recognize that in certain respects the auditors are now more empowered than ever to demand and receive candid assessments of legal matters that are relevant to the accuracy and integrity of the financial statements.

• Audit committees, management, and company lawyers should review their procedures for discussing litigation matters with auditors and be sure they consider the implications of such discussions. Many companies prepare internal litigation schedules that include not only basic information about pending matters but also assessments or even settlement values. Some companies in the past routinely provided these schedules to the auditors or discussed them at audit committee meetings in the auditors' presence. At other companies, in-house lawyers routinely discuss legal assessments with auditors and sometimes direct outside counsel to do so. Companies should re-assess the appropriateness and scope of such disclosures.

• Corporate counsel need to advise boards about, and boards need to comprehend, the risks of waiver of corporate privilege in situations that, by definition, involve either actual or threatened litigation, or actual or potential illegal conduct. Any waiver poses the risk the information disclosed to the auditors will be discoverable by regulators or opponents in litigation, particularly securities class actions. The corporation thus runs the risk of helping its adversaries make their cases. The result may be a chilling of open communication between lawyer and client, and of candid assessments about litigation exposure, that the attorney-client privilege and work product doctrines are intended to promote. Nonetheless, there may be no alternative but to waive the privilege or risk the consequences (for example, an auditor refusing to issue an unqualified opinion without access to privileged information).

Bear in mind that both lawyers and accountants serve a common objective: protecting the interests of the company and its investors and stakeholders

• Perhaps most importantly, companies should strive for openness and cooperation with the company's independent auditors. Where the auditors have reason to believe—based on experience and otherwise—that management and the board recognize their obligations and will be candid with the auditors, it is more likely that the auditors will respect the company's need for preserving legal privileges and work with the company to develop means of disclosure that may minimize privilege waivers. For example, lawyers and auditors could work out arrangements under which the lawyers disclose facts and factual conclusions that may satisfy the needs of the accountants but that do not amount to disclosure of legal advice to the clients or the attorney's mental impressions and conclusions derived from the facts.

In sum, public companies and their boards need to be cognizant of the potential for conflict between auditors and take care, especially in times of corporate crisis, to seek to mitigate it. Increasingly, this may mean being asked to waive the legal privileges, and companies need to understand the potentially serious consequences of doing so. At the same time, companies, their lawyers, and their accountants must bear in mind that both lawyers and accountants serve a common objective: protecting the interests of the company and its investors and stakeholders. One can certainly ask whether it is really in the interests of a company or its stockholders to disclose a potential claim or outcome which otherwise might never have resulted in an actual loss to the company. But current policy elevates the principle of integrity of financial reporting over such pragmatic considerations. Lawyers and auditors, working together while recognizing each others' separate roles, will have to develop new ways to serve their clients' legitimate interests while advancing the important public interests in financial statement integrity and disclosure. ■

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