ETHICS WATCH

Ethical Obligations in Responding to Auditors' Requests

By Nathan M. Crystal

Law firms that handle litigation on behalf of business entities often receive letters either from their clients or the clients' auditors beginning as follows:

> Dear Counsel:
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> In connection with the preparation and audit of the financial statements of the [*entity name*] [*and the following subsidiaries and/or divisions*] for the reporting period ended [*date*], we request that you provide us the following information:

What are the ethical, legal, and practical considerations that lawyers should consider in responding to such requests?

The beginning point of analysis is the *American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* issued in 1975 ("ABA Policy"), 31 Bus. Law. 1709 (1976). The ABA Policy recognizes that responses by lawyers to auditors' requests for information in preparing financial statements involve a tension between two important policies. On the one hand, the American legal, political, and economic systems depend heavily on voluntary compliance with the law. Policies that inhibit the willingness of clients to seek the advice of counsel undermine voluntary compliance. A requirement that lawyers broadly disclose information to auditors undermines confidentiality and ultimately voluntary compliance. On the other hand, these same systems depend on the accuracy of financial statements. Auditors need information from clients and their lawyers about pending or prospective litigation to prepare accurate statements. Perhaps not surprisingly, the ABA Policy gives primary weight to the duty of confidentiality to clients.

The ABA Policy sets forth a number of specific obligations for lawyers when responding to auditors' requests. **First, the lawyer must obtain the client's informed consent to disclosure of information to the auditors.** ABA Policy ¶1. Because the law firm will be providing information relating to the representation of the client, the information is subject to the duty of confidentiality under Rule 1.6 and may not be revealed without client consent. Therefore, a lawyer may not ethically respond to a request that comes only from the auditor without client consent. The better and more typical practice is for the auditor to communicate its request for information to the client, who will then ask in writing that the law firm provide the necessary information to the auditor.

In addition, general consent by the client is insufficient; the client's consent must be **informed**. Informed consent requires the lawyer to discuss with the client the advantages, disadvantages, and implications of the consent. See SCRPC 1.0(g) and comments 6 and 7. In terms of advantages to the client, the client has an obligation to prepare and issue financial statements that are accurate, and it faces legal liability for inducing auditors to issue misleading statements. See Sarbanes-Oxley Act §303 and SEC Rule 13b2-2. One aspect of accuracy involves disclosure of "loss contingencies" in connection with pending or contemplated litigation. However, disclosure also has disadvantages. Disclosure of information can be useful to opposing parties in negotiation, can be treated as an admission that would be admissible in evidence against the client, and may amount to a waiver of the attorney-client privilege. The ABA Policy recommends that in connection with obtaining client consent, lawyers should have their clients review and approve a draft of their response before sending it to the auditors.

It is, of course, possible that a lawyer represents a client that may have contingent litigation **gains** rather than losses, for example a client who is the plaintiff in major patent litigation. However, for accounting purposes contingent gains are treated quite differently from contingent losses. Under FASB (Financial Accounting Standard Board) 5, contingent gains "are not reflected in accounts since to do so might be to recognize revenue prior to its realization." Financial statements may disclose contingent gains but "care shall be exercised to avoid misleading implications as to the likelihood of realization." FASB 5 ¶17.

Second, the firm may limit its response to the request. ABA Policy ¶4. The Policy provides a specific statement for law firms to use to incorporate the limitations set forth in the Policy. See ¶8. The Policy refers to the following specific limitations:

- the scope of the engagement given by the client, ¶2;
- the date as of which the information is furnished, ¶2;
- that the response is limited to matters to which the firm has given substantive attention, ¶2;
- that the firm disclaims any responsibility to update the response based on subsequent developments, ¶2;

- that the firm has made no review of the clients' transactions or other matters to identify loss contingencies except that, unless the response provides otherwise, the firm has made reasonable efforts to determine whether lawyers in the firm have provided legal consultation concerning loss contingencies involving overtly threatened or pending litigation, ¶2;
- that the response is limited to items that individually or collectively are material to the client's financial statements. The inquiry letter will often contain a definition of materiality; if the lawyer intends to use a different standard, the lawyer should discuss the proposed standard with the auditor and attempt to reach agreement on the criteria for materiality. ¶3.

Third, with regard to "loss contingencies" the firm may properly respond only to requests for the following types of matters, when the lawyer has been engaged with respect to the matter and has devoted substantial attention thereto ¶5:

> (a) overtly threatened or pending litigation, whether or not specified by the client;
> (b) a contractually assumed obligation which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;
> (c) an unasserted possible claim or assessment which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.

With regard to "unasserted possible claims," because of the policy reasons set forth above, the Policy states that clients should ask for lawyer responses to auditor requests for information about such claims **only** "if the client has determined that it is probable that a possible claim will be asserted, that there is a reasonable possibility that the outcome (assuming such assertion) will be unfavorable, and that the resulting liability would be material to the financial condition of the client." ¶5. Lawyers should not respond to broad auditor requests for information about possible claims. Id. For example, a lawyer should not respond to a request for "your evaluation of the client's possible liability for any claims for which the client has retained your firm's services." The Policy makes it clear that lawyers may properly respond only to requests for information about the three types of claims: "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."

Fourth, the firm may properly respond with information about the status of the case. A law firm may identify the proceeding or matter, the stage of the proceeding, the claims asserted, and the position taken by the client.

Fifth, because of the inherent uncertainties of litigation, lawyers should ordinarily refrain from expressing judgments about the outcome of the matter, except in relatively few cases, in which a lawyer is able to express an opinion that an unfavorable outcome is either "probable" or "remote."

Under FASB 5 auditors must make a charge on the client's financial statement for loss contingencies that are **both** probable and for which the amount can reasonably be estimated. If one of these conditions is not met, disclosure rather than accrual may be necessary. Commentary ¶5.1

Under the ABA Policy an unfavorable outcome is "probable" only when the claimant's prospects of not succeeding are "extremely doubtful." At the other extreme, depending on the circumstances, a law firm may be able to provide an opinion to the auditors that an unfavorable outcome of a matter in litigation is "remote." An unfavorable outcome is "remote" only if the claimant's chances of succeeding are "slight."

In the great majority of cases, however, a law firm will not be able to give an opinion that an unfavorable outcome is either probable or remote. See Commentary ¶5.2. The Policy states that "[n]o inference should be drawn, from the absence of such a judgment, that the client will not prevail."

As to overtly threatened or pending litigation, because outcomes are inherently uncertain, a lawyer should not express a specific dollar amount or range of outcome unless the probability of inaccuracy of the estimate is slight. Since the outcome of unasserted possible claims is even more uncertain than claims that are overtly threatened or pending, "[i]n most cases, the lawyer will not be able to provide any such estimate to the auditor." Therefore, a law firm will typically issue a statement like the following:

> Because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as those terms are defined in the ABA Statement), we express no opinion with respect to the likelihood of an unfavorable outcome or the amount or range of potential loss if the outcome should be unfavorable. State Bar of Texas CLE, *How to Respond to Audit Letters* 68 (July 29, 2005).

Sixth, lawyers have ethical obligations in addition to the principles set forth in the Policy. In particular, lawyers have obligations to counsel their clients about the client's disclosure obligations under applicable law, to avoid assisting client fraud, and to withdraw from representation when required or permitted under the rules of professional conduct. See ¶6.

Seventh, unless otherwise stated in the lawyer's response, the response is only for the infor-

mation of the auditors in preparing financial statements. It may not be quoted in the financial statements or disclosed by the auditors to third parties without the lawyer's prior written consent. However, the response may be disclosed when required by court order or when necessary to defend the auditor against charges of misconduct, provided written notice is given to the lawyer. ¶7.

While the ABA Policy provides significant guidance to lawyers, it is only a guide. Lawyers may in appropriate cases supplement or modify the approach set forth in the Policy. ¶8. The Policy is accompanied by a lengthy commentary that is an integral part of the Policy and elaborates on the principles discussed above. In addition, an appendix to the Policy includes sample response letters that lawyers may use. In using or modifying the Policy, lawyers must always keep in mind the possibility of malpractice liability to their clients, liability to third parties for misrepresentation, and enforcement actions by the SEC or state securities departments.

If a law firm that is not handling significant litigation for a client receives an audit letter, a response like the following might be made: "After reasonable inquiry directed to members of the firm, the firm has determined that it has not been engaged and/or has not provided substantial attention to the company with regard to any overtly threatened or pending litigation that may be material to the financial statements of the company."

Although the ABA issued its policy in 1975, it is still applicable under the Model Rules. See SCRPC 2.3, comment 7.

Because responses to auditors' requests require a firm-wide determination and analysis of pending matters, the firm must adopt appropriate policies and procedures for responding to auditors' requests. See SCRPC 5.1. See State Bar of Texas CLE, *How to Respond to Audit Letters* (July 29, 2005), Appendix B, containing a form of law firm response letter.

In the 40 years since the ABA issued its Policy, many changes have occurred in the accounting and legal professions, most notably the passage of the Sarbanes Oxley Act in 2002, resulting in the creation of the Public Company Accounting Oversight Board and the adoption by the SEC of standards governing lawyer conduct. To be sure, a number of new issues have arisen. For an excellent discussion of some of these issues, see State Bar of Texas CLE, *How to Respond to Audit Letters* (July 29, 2005). The Audit Response Committee of the ABA Business Law Section publishes highly useful material online, for example, *Statement on Updates to Audit Response Letters* (October 22, 2014). Nonetheless, "the ABA Statement has proven to be adaptable to these changes and has continued to fulfill the purposes to which it was directed." *Auditor's Letter Handbook* 6 (2012). ⚖