

Audit Response Letters and Disclosures: Counsel's Role in Balancing Auditor Demands and Company Privileges

Lawyers' Responsibility and Limitations Under the ABA Treaty When Responding to Audit Requests

THURSDAY, OCTOBER 8, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Kenneth E. McKay, Shareholder, **Baker Donelson**, Houston, TX

Maryann A. Waryjas, Strategic Advisor, **Morrow Sodali**, Bonita Springs, FL

Alan J. Wilson, Senior Associate, **WilmerHale**, Washington, DC

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Audit Response Letters and Disclosures

COUNSEL'S ROLE IN BALANCING
AUDITOR DEMANDS AND COMPANY PRIVILEGES

OCTOBER 8, 2020

Panelists



Ken McKay

kmckay@bakerdonelson.com



Maryann Waryjas

maryann.waryjas@hercrentals.com



Alan Wilson

alan.wilson@wilmerhale.com

Agenda

- Basic ground rules
- Privileges
- Challenges for in-house counsel
- Disclosing litigation — a litigator's perspective
- Special challenges — government investigations
- Consequences of operational problems
- Internal processes in responding
- Looking forward — critical audit matters
- Selected issues in response letters
- Questions

Audit Letters – Basic Ground Rules

- ASC 450-20 (f/k/a FAS 5)
- PCAOB AS 2505/ AICPA AU-C § 501 (Inquiry of a Client's Lawyer)
- ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

Accounting for Loss Contingencies

- ASC 450-20 (f/k/a FAS 5) governs financial statement accrual and disclosure requirements for loss contingencies, which are categorized into the following three categories of probability:
 - Probable - “The future event or events are likely to occur”
 - 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”
- Materiality filter

Accounting for Loss Contingencies – Asserted Claims

- Accrual required if both of the following are met:
 - “Information available before the financial statements are issued or are available to be issued . . . indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements” and
 - “The amount of loss can be reasonably estimated”
- If either of the above conditions is unmet,
 - Disclosure must be provided if the loss contingency is reasonably possible
 - An estimate of the loss or additional loss should be disclosed if estimable
- No disclosure or accrual required if the possibility of a loss is remote

Accounting for Loss Contingencies – Unasserted Claims and Assessments

- No disclosure is required “if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment” unless:
 - Probable that a claim will be asserted and
 - Reasonable possibility that the outcome will be unfavorable
- “If the judgment is that assertion is not probable, no accrual or disclosure would be required”

Auditing Loss Contingencies

Applicable auditing standards

- PCAOB AS 2505/ AICPA AU-C § 501 (Inquiry of a Client's Lawyer)
 - Governs auditors' inquiry of a client's lawyer to corroborate information provided by management concerning litigation, claims and assessments
 - In-house counsel cannot serve as a substitute for information outside counsel refuses to provide
- PCAOB AS 2805/ AICPA AU-C § 580 (Management Representations)
 - Governs auditors' responsibility to obtain written representations from management, including representations regarding loss contingencies (disclosed/accrued and undisclosed)

Possible Waiver of Privilege

- Inherent “tension” in the relationship between the societal functions of an attorney and an independent auditor impacts the question of whether disclosure of information otherwise privileged should be considered waived as a result of providing it to an auditor
- An auditor’s function is inherently public shining light on a company’s financial statements
- An attorney’s function is inherently private to provide confidential counsel to the client only without the risk of public disclosure

Attorney-Client Privilege

- The rules of professional responsibility bind attorneys to protect the confidentiality of client information. Model Rule of Professional Conduct 1.6(a) provides:
 - “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 other provisions.
 - Comment [2] This “fundamental principle in the client-lawyer relationship . . . contributes to the trust that is the hallmark of the client-lawyer relationship. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct.”

ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

- Originally issued in 1976
- “Overtly threatened or pending” litigation
 - Litigation is “overtly threatened” where a “potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote”
- Generally refrain from expressing an opinion on the outcome of litigation, except where the outcome is either:
 - Probable - “an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight”
 - Remote - “an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight”

ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

- Lawyers' responses requiring client instruction:
 - Contractually assumed obligations
 - Unasserted claims - matters “where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment”
 - Clients should be urged to disclose information regarding unasserted possible claims or assessments to auditors “where in the course of the services performed for the client it has become clear to the lawyer that (i) the client has no reasonable basis to conclude that assertion of the claim is not probable . . . and (ii) given the probability of assertion, disclosure of the loss contingency in the client's financial statements is beyond reasonable dispute required”
 - If client declines, lawyer should consider professional responsibility
- Confirmation of professional responsibility to advise client regarding disclosure obligations

Sarbanes-Oxley Section 303: Improper Influence on Conduct of Audits

- Resulted in 17 CFR 240.13b2-2
- Does this requirement to disclose matters imposed by the new rule possibly conflict with compliance with the disclosure restrictions (“probable”/”remote”) required by the ABA Statement of Policy?
- Does this tend to impact the application of the attorney-client privilege by requiring certain disclosures otherwise privileged?

Potentially Privileged Information Frequently Requested

- Independent auditors frequently request documents prepared for or associate with pending or anticipated litigation. In fact, “shadow investigations” by auditors are becoming increasingly common relating to matters subject to litigation or arbitration.
- Auditors may seek information beyond matters publicly filed in pleadings or available in deposition transcripts, including internal documents such as:
 - Presentations made to the board of directors or special committees
 - Reports from internal investigations
 - Legal opinions from outside counsel regarding viability of claims/defenses
 - Key documents relating to the litigation assembled by litigation counsel
 - Opinions from consulting or undisclosed experts relating to damages models or calculations
 - Results of mock trials or jury research

Potentially Privileged Information Frequently Requested

- All of these types of information contain closely-guarded secrets of a company, much of which will be protected from discovery in a lawsuit or external investigation by the attorney-client privilege

Limitations to the Attorney-Client Privilege Involving Communications with In-House Counsel

1. Officer titles: Courts routinely apply a higher standard to in-house counsel communications regarding the application of the attorney-client privilege especially when in-house counsel serve in dual capacities, including performing non-legal business functions within the organization, including such things as conducting investigations, regulatory compliance work, corporate governance and negotiating business terms of a transaction. There is a particularly heightened scrutiny where dual titles such as corporate secretary, vice president, etc. are present.
2. International communications: Some countries do not recognize any attorney-client privilege (France, Italy, Sweden) while others have significant limitations as it applies to in-house counsel. *Akzo Nobel* case in 2010 from the European Court of Justice excluded from the scope of the privilege communications between in-house counsel and the entity's employees citing a lack of independence and the "dual-purpose" of their employment. But see the *Belgacom* case (Belgium 2013).

Disclosure of Privileged Information to Independent Auditors

- In most jurisdictions, disclosure to an independent auditor would constitute waiver of the attorney-client privilege, in whole or in part.
- Thus, the dilemma. A company wants to provide all the necessary information for an auditor to prepare a thorough and informed opinion, but at the great risk of waiving the privilege over information that could be devastating in the hands of an adverse party.

Work Product Privilege

- A possible alternative to achieve both goals is to invoke the work product privilege which typically protects information prepared by a party and its counsel in anticipation of litigation
- **Federal Rule of Civil Procedure 26(b)(3)***
 - Work product: “documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party’s attorney, consultant, surety, indemnitor, insurer, or agent”

*The definition and exceptions to the work product privilege varies to some degree in courts operating under state procedural law and rules

Advantage of Invoking the Work Product Privilege

- Importantly, the work product privilege is not automatically waived by disclosure to an auditor. For a waiver to occur, the information must be disclosed to an adversary or create a risk that the information will be disclosed to an adversary.

Split of Authority on Waiver

- Majority Rule: Disclosure of work product to an auditor does not waive the work product privilege. The power to issue an adverse opinion or the need to scrutinize and investigate a company's books and records does not rise to the level of an "adversary".
- Minority Rule: Disclosure of work product to an auditor waives the work product privilege. Independent auditors are inherently adversarial to the companies they audit as an auditor must not share a common legal interest with the company being audited putting them in a position of an "adversary".
- Result: Majority "no waiver" jurisdictions encourage full disclosure facilitating the most informed audit opinion.

Protecting Privileged Information During an Audit

1. Confirm that the work product privilege actually applies to the litigation or claim-related information to be disclosed
2. Ensure that the auditor engagement letter is clear about the auditor's duty of confidentiality generally and enunciate that the auditor will conform disclosures in the audit report to the terms of the ABA Statement of Policy
3. Provide only those materials essential to the audit and not an entire lawyer case file
4. Consider oral disclosure of such information to the audit team
5. Identify any audit workpapers that may contain or reference privileged information
6. Respond and require outside counsel to respond based upon the terms of the ABA Statement of Policy
 - If an unfavorable outcome is neither “probable” or “remote”, the attorney should express no opinion regarding the outcome of the matter

Protecting Privileged Information During an Audit – Case Law Update

- *In re RPM Int'l Inc.*, No. 20-5052, Dkt. No. 1840933, Order (D.C. Cir. May 1, 2020)
 - D.C. Circuit denied a mandamus petition by company and declined to provide additional guidance on the applicability of the attorney client and work product privileges when sharing information with auditors
 - Company required to produce unredacted interview memoranda that company's outside counsel prepared during an internal investigation
 - District Court applied the “because of” test and pointed to the fact that the company's audit committee chair testified that the internal investigation was conducted to gain comfort before the board signed the 10-K
 - The SEC, thus, contended that the interview memoranda were not prepared for multiple purposes and that there was just a singular purpose for the investigation, meaning the company failed the “because of” test and the interview memoranda were not work product

Protecting Privileged Information During an Audit – Case Law Update Practice Pointers

- Pay special attention to resolutions authorizing the retention of counsel to conduct an internal investigation, including the stated purposes of the retention
- If an interview from an internal investigation should be memorialized in writing, ensure the writing states the reasons for which the interview is documented and the provides context for the information contained in the writing
- Carefully consider how to convey the substance of witness interviews to auditors
- Conduct of privilege review of an auditor's proposed production to third parties

In-House Counsel Interactions with Auditors

- In-house counsel's relationship with auditors differs from outside counsel's
- Auditor's engagement letter
 - Materiality considerations
 - Confidentiality and arbitration clauses
 - Data privacy protections
- Communications to and from outside counsel
- Management representation letters

Challenges for In-House Counsel

- Coordinating audit responses provided by outside counsel
- Preparing audit response letter for in-house legal department and associated audit inquiry letter from CFO to in-house legal department
- Balancing protection of attorney-client privilege and work-product protection with auditors' demands for comfort
- Reviewing management representation letters and managing requests for management representation letters from in-house counsel
- Ensuring effective internal controls in place
 - Consider, for example, COVID-19 implications

Disclosing Litigation – A Litigator's Perspective

- Privilege considerations
- Pending matters
 - Liability assessment
 - Exposure quantification
 - Relevance of settlement offers
- Overtly threatened matters
 - Distinguishing meritorious from naked threats
- Treatment of internal investigations
 - Coordination with and differences between litigation counsel and securities disclosure counsel

Disclosing Litigation – A Litigator’s Perspective

Exchange Act Section 10A (illegal acts) matters

- Auditors must make several determinations when it “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”
 - Determine likelihood that an illegal act occurred
 - Consider possible effect on the financial statements
 - Inform appropriate level of management or the board
 - Report to the audit committee if management does not take timely and appropriate remedial action
 - Audit committee to inform SEC within 1 business day of receiving such a report

Special Challenges – Government Investigations

- Government investigations often present special issues that are not directly addressed by the ABA Statement of Policy
- Paragraph 5 of the ABA Statement of Policy provides, as an example, that “an investigation by a government agency where enforcement proceedings have been instituted or where the likelihood that they will not be instituted is remote, under circumstances where assertion of one or more private claims for redress would normally be expected”
- Many government investigations are considered unasserted claims because, although there may be the potential for a claim, they have not ripened into an overt threat of litigation, claims, or assessments
 - Under the ABA Statement of Policy, unasserted claims are not required disclosures unless the client specifically identifies them and asks the lawyer to comment

Special Challenges – Government Investigations

- 1976 ABA Committee on Audit Inquiry Responses interpretive guidance where there is a pending investigation against a client but no charges have been overtly threatened:
 - “[I]f the client wishes the lawyer to report such investigations and similar matters to the auditor in a manner similar to reports by the lawyer of pending litigation which the lawyer is handling, it would not be improper for the lawyer to do so since a third-party inquiry (which may develop into the assertion of a claim or assessment) already will have been commenced”
 - The Committee noted that “[i]n most cases, however, the lawyer will not be able to provide any information to the auditor concerning the investigation other than the existence thereof and the fact of the client’s involvement”
 - Follow a consistent approach on a client-by-client basis—whether the lawyer regularly reports such matters or only reports those as to which the client has determined the matter to involve an unasserted possible claim considered to be probable of assertion and to have a reasonably possible chance of an adverse result

Special Challenges – Government Investigations

SEC v. RPM International Inc., 282 F.Supp.3d 1 (D.D.C. 2017)

- District Court denied defendants’ motions to dismiss enforcement action involving company and its general counsel where SEC alleges failure to disclose a material loss contingency for a DOJ investigation into a violation of the False Claims Act following a whistleblower *qui tam* complaint

In re Lions Gate Entertainment Corp. Securities Litigation, 165 F. Supp. 3d 1 (S.D.N.Y. 2016)

- Receipt of a Wells Notice regarding an SEC investigation did not amount to a pending proceeding or a proceeding “‘known to be contemplated by governmental authorities’ under Item 103” of Regulation S-K; nor did the Wells Notice constitute “‘pending or threatened litigation” for purposes of ASC 450

Indiana Pub. Ret. Sys. v. SAIC, 818 F.3d 85 (2d Cir. 2016)

- “The ‘probability’ standard applies in lieu of the ‘reasonable possibility’ standard only if the loss contingency arises from ‘an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment’”

Special Challenges – Establishing Estimated Exposure

In the Matter of BorgWarner Inc., SEC Release No. 34-89677 (Aug. 26, 2020)

- SEC settled charges against company for materially misstating financial statements by failing to report over \$700 million in liabilities associated with future asbestos claims, where the company allegedly conducted no substantive quantitative analysis to estimate asbestos claims liability yet had nearly 40 years of historical raw claims data
- Counsel preparing audit response letters are reminded of their professional responsibility under paragraph 6 of the Statement of Policy (“may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances”)

Consequences of Operational Problems

In the Matter of General Motors Company, Accounting and Auditing Enforcement Release No. 3850 (Jan. 18, 2017) (involving ignition defect)

- \$1 million fine for violating Section 13(b)(2)(B) of the Exchange Act by not devising and maintaining a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles
- GM failed to make a timely evaluation of whether certain potential recall campaigns were reasonably possible and should be considered for disclosure, as required by ASC 450

Internal control over financial reporting remains an area of SEC focus

- In-house counsel should be involved in documenting quarterly accruals

Internal Processes in Responding

Outside counsel

- Centralized v. decentralized approach
- Internal survey of attorneys
- Communication with client
- Final internal review and approval process

In-house counsel

- Discussions with legal department and executive team
- Review of controls regarding contingency reporting
- Quality control and risk mitigation procedures

Looking Forward – Critical Audit Matters

- On June 1, 2017, the PCAOB adopted revised auditing standard AS 3101 governing the form and content of unqualified audit reports, including a new requirement to disclose “Critical Audit Matters” (CAMs)
- Defined as matters arising from the audit that were communicated or required to be communicated to the audit committee and that
 - Relate to “accounts or disclosures that are material to the financial statements” and
 - Involved “especially challenging, subjective, or complex auditor judgment”

Looking Forward – Critical Audit Matters

“[A] matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a critical audit matter. **For example, a potential loss contingency that was communicated to the audit committee, but that was determined to be remote and was not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not meet the definition of a critical audit matter;** it does not relate to an account or disclosure in the financial statements, even if it involved especially challenging auditor judgment. The same rationale would apply to a potential illegal act if an appropriate determination had been made that no disclosure of it was required in the financial statements; the matter would not relate to an account or disclosure that is material to the financial statements.”

PCAOB Release No. 2017-001, at 20-21 (June 1, 2017)

Looking Forward – Critical Audit Matters

- PCAOB discussion of remote contingencies implies that the auditor's consideration of management's decision to accrue for or disclose a loss contingency could result in a CAM, if the other criteria for CAM discussion are met
 - A handful of audit reports have identified loss contingencies as a CAM since the standard took effect with respect to audits of large accelerated filers with fiscal years ending on or after June 30, 2019
- Nothing in AS 3101 or PCAOB releases changes the auditor's responsibilities to make inquiries of the issuer's attorneys or the responsibility to respond to such inquiries pursuant to the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information

Selected Issues in Response Letters

- Effective date of response and scope of matters covered by response
- Matters settled during relevant time period
- Materiality thresholds
 - Audit inquiry letters may state an amount individually and in the aggregate
- Insurance matters
 - Netting generally prohibited in financial statements