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# **Audit Response Letters and Disclosures: In-House Counsel's Role in Balancing Auditor Demands and Company Privileges**

Scope of Lawyers' Responsibility Under the ABA Treaty When Responding to Information Requests

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TUESDAY, APRIL 9, 2019

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

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Today's faculty features:

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# *Audit Response Letters and Disclosures*

IN-HOUSE COUNSEL'S ROLE IN BALANCING  
AUDITOR DEMANDS AND COMPANY PRIVILEGES

APRIL 9, 2019

## *Panelists*

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## *Agenda*

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- 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*

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- 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*

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- 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*

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- 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*

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- 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*

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### 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*

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- 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

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

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- Originally issued in 1976; Updated in 1998 and 2003
- “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*

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- 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*

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- 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*

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- 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*

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- 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*

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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*

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- 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*

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- 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*

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- 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*

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- 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*

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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 verbal 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

## *In-House Counsel Interactions with Auditors*

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

## *Challenges for In-House Counsel*

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- Coordinating audit responses provided by outside counsel
- Preparing audit response letter for 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
- Implementing effective internal controls
  - Application of 2013 COSO Framework

## *Disclosing Litigation – A Litigator's Perspective*

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- 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*

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### 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*

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*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’”

## *Consequences of Operational Problems*

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*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*

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### 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*

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- 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*

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“[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*

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- 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
- 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*

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