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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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In-House Counsel: Considerations for Interacting with Auditors

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In-House Counsel: Considerations for Interacting with Auditors

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Introduction

This outline discusses the principal accounting, auditing and legal standards and requirements that undergird the relationship between a company's independent external auditor and its legal counsel, particularly the company's in-house counsel. The professional responsibilities of the two professions differ. The auditor is engaged to provide an independent, objective opinion, based on the performance of specified procedures, about the fairness of the entity's financial statements. In order to perform that function, the auditor is required to obtain evidential support for the company's assertions, including with respect to accounting for potential legal claims against the company. The lawyer, on the other hand, is required to act as the company's zealous advocate; for the lawyer to effectively represent the client and protect its interests, professional standards impose a duty of confidentiality, and the law protects the lawyer's communications with his or her client and the lawyer's work product from disclosure.

In the case of litigation, claims and assessments, the respective interests of independent auditors and lawyers have traditionally been balanced by the longstanding "Treaty" between the two professions. Still, there has been an increased focus in recent years on accounting for and disclosure of loss contingences by the Securities and Exchange Commission ("SEC"), accounting standard setters, and others. In many cases, that has led to expanded requests from auditors for information about loss contingencies and other legal matters, particularly with respect to large, "bet the company" lawsuits and major government investigations. In-house lawyers, in particular, often find themselves on the front lines in responding to these requests on behalf of their companies. They must responsibly address the auditor's needs for information while protecting their corporate client's legitimate interests in safeguarding privileged communications and avoiding prejudice to the entity's litigation position.

The outline first discusses the basic accounting and legal privilege principles that come into play in many dealings between the independent auditor and the company's counsel. It then describes the auditing standards that define the auditor's procedures with respect to litigation contingencies and the ABA Statement of Policy that governs the lawyer's response. Finally, the outline addresses the auditor's responsibilities with respect to fraud and illegal acts, which, when they come into play, can lead to particularly sensitive interactions between the auditor and the in-house lawyer.

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I. Basic Principles Underlying Lawyer-Auditor Interaction

a. Accounting Standard Governing Contingencies

1. The auditor's need for information regarding legal matters derives in the first instance from the requirements of U.S. generally accepted accounting principles ("GAAP") with respect to loss contingencies. The accounting standard, which has been in effect since 1975, is now codified in Accounting Standards Codification ("ASC") 450-20 (formerly Statement of Financial Accounting Standards No. 5).

2. ASC 450-20 prescribes the accounting treatment for contingencies, including requirements for accruing for and/or disclosing loss contingencies[1] arising from "litigation, claims, and assessments." The general structure of ASC 450-20 is as follows:

   A. *Asserted Claims*. A company must accrue for a loss contingency if both of the following conditions are met: (i) "Information available before the financial statements are issued or are available to be issued . . . indicates that it is *probable*[2] that an asset had been impaired or a liability had been incurred at the date of the financial statements" and (ii) "The amount of loss can be reasonably estimated." ASC 450-20-25-2. If the reasonable estimate of loss is a range, then "[i]f some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued." ASC 450-20-30-1.

   B. Among the factors that should be considered in assessing the probability of an unfavorable outcome are the following:

      i. The nature of the litigation, claim, or assessment

      ii. The progress of the case (including progress after the date of the financial statements but before those statements are issued or are available to be issued)

      iii. The opinions or views of legal counsel and other advisers, although, the fact that legal counsel is unable to express an opinion that the outcome will be favorable to the entity

[1] Loss Contingency – "An existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses." ASC 450-20-20.

[2] Probable – "The future event or events are likely to occur." ASC 450-20-20.

should not necessarily be interpreted to mean that the condition [for accrual] is met

iv. The experience of the entity in similar cases

v. The experience of other entities

vi. Any decision of the entity's management as to how the entity intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement).

ASC 450-20-55-12.

C. If either one of the aforementioned conditions of ASC 450-20-25-2 is unmet, ASC 450-20 requires disclosure with respect to the loss contingency if it is *reasonably possible*[3] that a loss or an additional loss (above the amount accrued) may have been incurred. ASC 450-20-50-2, -3. That disclosure must include an estimate of the loss or additional loss, if the loss is estimable. ASC 450-20-50-4. No disclosure is required if the possibility of a loss is *remote*.[4]

D. *Unasserted Claims*. No disclosure is required of a loss contingency involving an unasserted claim or assessment "if there has been no manifestation by a potential claimant of a possible claim or assessment" unless (i) it is considered probable that a claim will be asserted and (ii) there is a reasonable possibility that the outcome will be unfavorable. ASC 450-20-50-6.[5]

E. Recent proceedings involving ASC 450-20:

i. In *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85, 93 (2d Cir. 2016), the court held that under ASC 450-20-50-6, where there has been a "manifestation by a potential claimant of an awareness of a possible claim," the threshold for disclosure of an unasserted claim was "reasonably possible," not "probable." In connection with a claim that SAIC failed to disclose a kickback scheme involving a New York City contract, the court held that the "manifestation of awareness" test was satisfied because the City of New York had publicly indicated its intent to consider claims against SAIC under the contract.

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[3] Reasonably Possible – "The chance of the future event or events occurring is more than remote but less than likely." ASC 450-20-20.

[4] Remote – "The chance of the future event or events occurring is slight." ASC 450-20-20.

[5] Another provision of ASC 450-20 dealing with unasserted claims does not contain the "manifestation of awareness" language. It provides: "If the judgment is that assertion is not probable, no accrual or disclosure would be required." ASC 450-20-55-15.

ii. In *SEC v. RPM International Inc.*, 282 F.Supp.3d 1 (D.D.C. 2017), the court denied defendants' motions to dismiss the SEC's complaint, which alleges that RPM and its general counsel failed to timely disclose a loss contingency, or record an accrual for, a Department of Justice investigation that ultimately resulted in a $61 million settlement. Notably, the SEC's complaint also alleges that RPM's GC withheld information about the claim and settlement status from RPM's CFO, CEO, Audit Committee and auditors, and that the GC made false oral and written representations to the auditors. With respect to its ASC 450 analysis, the court concluded that the SEC plausibly alleged that an "asserted claim" existed where a *qui tam* action had been filed and the company and its general counsel were aware of the complaint and knew that the DOJ was involved in the investigation to determine whether to intervene. The court went on to explain that even if the claim was "unasserted," the government had manifested an awareness of a possible claim and the "reasonable possibility" standard applied to determine whether disclosure was required. In reaching this conclusion, the court distinguished the case at hand from *In re Lions Gate Entertainment Corp. Securities Litigation*, 165 F.Supp.3d 1 (S.D.N.Y. 2016), and instead analogized the case to *SAIC*. For purposes of ruling on the motions to dismiss, the court concluded that the SEC's complaint sufficiently alleged that a loss to the company was "probable" and "reasonably estimable" so as to require an accrual for the period where the company was aware of the *qui tam* complaint, had already calculated an amount of liability to the government, and had begun discussing settlement options with the DOJ.

b. **Confidentiality and Privilege Considerations**

1. The rules of professional responsibility bind attorneys to protect the confidentiality of client information. "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. Model Rule of Professional Conduct 1.6(a). 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." *Id.*, Comment [2]. Because of this confidentiality obligation, in

the context of a financial statement audit, lawyers obtain the client's consent through its request that the lawyer respond to the auditor.

2. The policy reflected in Comment [2] is the basis for the attorney-client privilege evidentiary rule. Disclosure of attorney-client communications to auditors can waive attorney-client privilege. *E.g.*, *In re John Doe Corp.*, 675 F.2d 482, 488 (2d Cir. 1982) (conversation between outside accountant and general counsel of corporation about results of internal investigation of possible bribes waived attorney-client privilege); *In re Subpoena Duces Tecum Served on Willkie, Farr & Gallagher*, 1997 WL 118369, *3 (S.D.N.Y. 1997) (disclosure to auditors of results of internal investigation waived attorney-client privilege). Voluntary disclosure waives the attorney-client privilege because it is inconsistent with the confidential attorney-client relationship. *United States v. Deloitte*, 610 F.3d 129, 139-40 (D.C. Cir. 2010).

3. By contrast to the confidentiality protections applicable to attorneys, federal law does not recognize an accountant work-product privilege. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). Information disclosed to auditors is therefore potentially subject to discovery.

4. Disclosure of attorney work product—information prepared by or for an attorney in anticipation of litigation—to auditors does not automatically waive work-product protection. *United States v. Deloitte*, 610 F.3d at 139. Disclosing attorney work product to an auditor is not "selective disclosure" made to one party but not another, which would waive work-product protection, because a company's independent auditor is not an adversary. *Id*. at 142.

5. Attorney work-product protection applies not just to the attorney's written work, but also to accountant work papers reflecting attorney work product received orally from an audit client's attorney. *United States v. Deloitte*, 610 F.3d at 143.

II. Auditors' Interaction with Attorneys in the Audit Process[6]

The independent auditor is engaged to express an opinion, based on the performance of specific procedures, on whether an entity's financial statements fairly present the financial condition, results of operations and cash flows in accordance with GAAP. The audit comprises processes designed to enable auditors "to obtain reasonable assurance about whether the financial statements are free of material misstatement." AS 3101.08. "An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation." *Id*.

With respect to loss contingencies, the audit process has been governed since 1975 by an auditing standard, originally known as Statement on Auditing Standards No. 12, *Inquiry of a Client's Lawyer Regarding Litigation, Claims and Assessments*, and the American Bar Association's *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (the "ABA Statement of Policy").[7] Taken together, these two documents, often referred to as the "Treaty," have provided a mechanism that for over 40 years has balanced the auditors' needs for information to support its audit process regarding contingencies, and the legal profession's fundamental duty to protect clients' confidential information. The Treaty also ties into auditing standards regarding representations that management is required to provide to the independent auditors.

a. Statement on Auditing Standards 12 (AS 2505 (AU 337)/AU-C § 501)

1. Auditing Considerations for Litigation, Claims, and Assessments

A. Auditors are required to gather evidence with respect to litigation, claims, and assessments relevant to the following four factors:

i. The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.

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[6] Auditors follow auditing standards adopted by the Public Company Accounting Oversight Board ("PCAOB") for public company issuers and by the American Institute of Certified Public Accountants ("AICPA") for private companies. The PCAOB adopted interim auditing standards based on the AICPA's auditing standards in effect on April 16, 2003, though the PCAOB has superseded or amended many standards since that time. For its interim standards, the PCAOB adopted the AICPA's numbering format which cites auditing standards as "AU" followed by the standard number. The PCAOB's auditing standards adopted since 2003 are cited as "AS." Effective December 31, 2016, the PCAOB auditing standards were reorganized to integrate the AICPA standards and PCAOB standards. References to reorganized PCAOB auditing standards are cited as "AS," with the old prior standard cited parenthetically. References to AICPA auditing standards are cited to "AU-C." AU-C refers to the AICPA's Clarified Statements on Auditing Standards, which is a compilation of all AICPA auditing standards that the AICPA redrafted and converged as of February 2014. As relevant here, the AICPA's revised standards generally follow its prior "AU" standards, but there are differences in certain respects with the PCAOB standards.

[7] 31 BUS. LAW. 1709 (1976), *reprinted in* ABA BUSINESS LAW SECTION, AUDIT RESPONSES COMMITTEE, AUDITOR'S LETTER HANDBOOK 1 (2d. ed. 2013) ("Handbook").

ii. The period in which the underlying cause for legal action occurred.

iii. The degree of probability of an unfavorable outcome.

iv. The amount or range of potential loss.

AS 2505.04 (AU 337.04); *see* AU-C § 501.17.

B. Often, "management is the primary source of information about such matters." As a result, auditors should:

i. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.

ii. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by [ASC 450-20].

iii. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.

iv. Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with [ASC 450-20]. Also the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.

AS 2505.05 (AU 337.05); *see* AU-C § 501.16.

C. Because auditors cannot make legal judgments concerning information management provides, auditors "should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments." AS 2505.06 (AU 337.06); *see* AU-C §§ 501.18-.19.

D. Auditors also undertake other procedures that may disclose litigation, claims, and assessments. Such other procedures include: reading minutes of meetings of stockholders, directors, and appropriate committees; reading contracts, loan agreements, correspondence from taxing or other governmental agencies; obtaining information concerning guarantees from bank confirmations; and inspecting other documents for possible guarantees. AS 2505.07 (AU 337.07); AU-C § 501.16.

2. Inquiry of Client's Lawyer (AS 2505 (AU 337)/AU-C § 501.A69)

A. A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of information provided by management concerning litigation, claims and assessments. AS 2505.08 (AU 337.08); *see* AU-C §§ 501.18-.19.

B. Auditors may use evidential matter obtained from in-house counsel or a company's legal department to provide the necessary corroboration for information management provides concerning litigation, claims, and assessments. In-house counsel cannot serve as a substitute for information that outside counsel refuses to provide. AS 2505.08 (AU 337.08); AU-C § 501.19.

C. Illustrative Audit Inquiry Letter to Legal Counsel (AS 2505A (AU 337A) /AU-C § 501.A69)

i. Auditors send requests for confirmation from a client's counsel by an inquiry submitted to counsel under the client's signature. The letter requests various types of information regarding litigation, claims, and assessments.

ii. The inquiry asks the lawyer to confirm that if, in the course of performing legal services with respect to unasserted claims, the lawyer concludes that disclosure is required or that the client should consider disclosure, the lawyer will so advise the client and consult regarding requirements of ASC 450-20.

A current example of an inquiry letter to in-house counsel is contained in the Appendix.

D. The standard indicates that "in special circumstances," the auditor may obtain information in a conference with the lawyer.

i. Such a conference "may be appropriate when the evaluation of the need for accounting for or disclosure of litigation, claims, and assessments involves such matters as

the evaluation of the effect of legal advice concerning unsettled points of law, the effect of uncorroborated information, or other complex judgments."

ii. "The auditor should appropriately document conclusions reached concerning the need for accounting for or disclosure" of litigation contingencies.

AS 2505.10 (AU 337.10); *see* AU-C § 501.A65.

E. The auditing standard acknowledges that the lawyer may limit his response to the inquiry letter in certain respects. A lawyer's response to the inquiry letter, together with the procedures directed to management, provide the auditor with sufficient audit evidence to satisfy itself regarding the accounting for and disclosure of pending and threatened litigation, claims and assessments. The lawyer's representation regarding his responsibility to his client in respect of disclosure obligations also provides sufficient audit evidence regarding unasserted claims and assessments required to be disclosed. AS 2505.11-.13 (AU 337.11-.13); AU-C §§ 501.A55-.A57.

b. **ABA Statement of Policy**

1. Scope of and Limitations on Lawyer's Response

A. Pursuant to the Statement of Policy, when properly requested by the client, a lawyer may provide information concerning matters related to loss contingences for which the lawyer has been engaged. These matters include:

i. *overtly threatened or pending litigation*, whether or not specified by the client;

ii. *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;

iii. *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.

ABA Statement of Policy ¶ 5.

B. The ABA Statement of Policy defines "overtly threatened litigation" to mean that "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." "Unasserted claims" are 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." ABA Statement of Policy ¶ 5.

C. Under the ABA Statement of Policy, the client should request the lawyer to provide information about specific unasserted claims only if the client has determined that the standard for disclosure under ASC 450-20 has been met. The lawyer should not respond to general inquiries regarding unasserted claims.

D. The ABA Statement of Policy provides that lawyers should refrain from expressing an opinion on the outcome of litigation, except when, in the rare case, the outcome is:

i. *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.

ii. *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 ¶ 5.

E. The lawyer should provide an estimate of the amount or range of potential loss only if he believes that the probability of inaccuracy of the estimate is slight. *Id*.

F. The lawyer is required to confirm to the auditor the client's understanding that, if in the course of performing legal services for a client with respect to an unasserted claim which may call for financial statement disclosure, the lawyer has formed a conclusion that the client must disclose or consider disclosure concerning the unasserted claim, the lawyer, as a matter of professional responsibility to the client, will so advise the client and consult with the client concerning the question of such disclosure and the requirements of ASC 450-20. ABA Statement of Policy ¶ 6.

2. Illustrative Form of Response Letter for Use by Inside General Counsel (included in AS 2505A, Ex. II, Annex A (AU 337C, Annex A)/AU-C § 501.A70)

A. The auditing standards include illustrative forms of response letters for outside counsel and inside general counsel, which were developed by the ABA Committee on Audit Letter Responses but are not part of the Statement of Policy.

B. The principal difference between the two forms is that while the outside counsel may limit its response to particular matters to which it provided substantive attention or representation, the inside general counsel form represents that the general counsel has general supervision for the legal affairs of the company and that, in such capacity, the general counsel has "reviewed litigation and claims threatened or asserted involving the Company and [has] consulted with outside legal counsel" where appropriate. The general counsel's response speaks for the general counsel and lawyers over which he or she exercises general supervision.

A current example of a response letter from in-house counsel is contained in the Appendix.

3. Updates

A. Auditors increasingly request that a client's lawyer "bring down" or update a previously issued response, in order to ensure that the information provided by the lawyer is current as of the date the auditor issues an opinion or consents to use of its opinion. Updates are not discussed in the ABA Statement of Policy. In 2015, the ABA Business Law Section Audit Responses Committee issued guidance on appropriate practices for lawyers in responding to updates. *Statement on Updates to Audit Response Letters*, 70 BUS. LAW. 489 (2015). The statement has been incorporated into AICPA auditing standards, but not PCAOB standards. *See* AU-C § 501.A72.

c. **Government Investigations**

1. Government investigations present special issues that are not directly addressed by the ABA Statement of Policy. The Statement includes as an example of an unasserted claim as to which assertion may be probable, "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." ABA Statement of

Policy ¶ 5. This example illustrates a situation where the client should request the lawyer to furnish information to the auditor.

2. 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 Statement of Policy, unasserted claims are not required disclosures unless the client specifically identifies them and asks the lawyer to comment. *Id*.

3. In 1976, the ABA Committee on Audit Inquiry Responses provided interpretive guidance where there is a pending investigation against a client but no charges have been overtly threatened. The Committee stated that "if 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." The Committee advised that whichever approach is adopted—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—such "approach should be consistently followed with respect to such client until the auditor has been advised of a change in approach." *Second Report of the Committee on Audit Inquiry Responses Regarding Initial Implementation of the Statement of Policy*, 32 BUS. LAW. 177, 185 (1976), *reprinted in* Handbook at 47.

d. **Management Representations (AS 2805 (AU 333)/AU-C § 580)**

1. Auditors obtain written management representations to confirm the many management assertions made during the audit. Most of these representations concern financial accounting matters, but several relate to legal matters.

   A. For purposes of written representations, the AICPA defines "management" as "management and, when appropriate, those charged with governance." AU-C § 580.08. The PCAOB's corresponding section, AS 2805 (AU 333), provides no such definition.

   B. Management may make inquiries of "others who participate in preparing the financial statements and assertions therein . . . ," such

as "[i]nternal counsel who may provide information essential to provisions for legal claims." AU-C § 580.A4.

C. Nothing in AICPA or PCAOB guidance states that in-house counsel must provide a written management representation, as opposed to an audit letter response.

2. The auditing standards provide that management's representations should address, among other matters, the following legal and legal-related matters:

A. That "all financial records and related data . . ." have been made available (AS 2805.06(c) (AU 333.06(c)); *see* AU-C § 580.11);

B. "Completeness and availability of all minutes of meetings of stockholders, directors and committees of directors" (AS 2805.06(d) (AU 333.06(d)); *see* AU-C § 580.A9);

C. "Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices" (AS 2805.06(e) (AU 333.06(e)); *see* AU-C § 580.A9);

D. "Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements" (AS 2805.06(i) (AU 333.06(i)); *see* AU-C § 580.12(c));

E. "Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others" (AS 2805.06(j) (AU 333.06(j)); *see* AU-C § 580.12(d));

F. "Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency" (AS 2805.06(o) (AU 333.06(o)); *see* AU-C § 580.13);

G. "Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with" ASC 450 (AS 2805.06(p) (AU 333.06(p)); *see* AU-C § 580.15); and

H. "Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by" ASC 450 (AS 2805.06(q) (AU 333.06(q)); *see* AU-C § 580.A18).

3. "Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations." AS 2805.08 (AU 333.08); AU-C § 580.A22.

4. Where management representations conflict with other audit evidence, auditors should investigate and consider whether reliance on management representations relating to other aspects of the financial statements is appropriate and justified. AS 2805.04 (AU 333.04); *see* AU-C § 580.A31.

III. Auditors' Obligation Regarding Fraud and Illegal Acts

Securities laws and auditing standards provide guidance to auditors when dealing with fraud and illegal acts. Such guidance includes auditing procedures, reporting obligations, and disclosure requirements. The auditor may call upon the lawyer to evaluate the significance of certain illegal acts. The client may call upon the lawyer for advice in responding to certain audit inquiries pertaining to alleged fraud or illegal acts.

a. Detecting and Responding to Fraud

1. Definition of Fraud: Fraud is defined as "an intentional act that results in a material misstatement in financial statements that are the subject of an audit." AS 2401.05 (AU 316.05); *see* AU-C § 240.11.

2. Primary Responsibility: "The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management." AU-C § 240.04; *see* AS 2401.04 (AU 316.04).

3. Audit Considerations

   A. An auditor must obtain "reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." AS 2401.01 (AU 316.01); *see* AU-C § 240.05.

   B. "The auditor should make inquiries of management and the audit committee concerning the client's compliance with laws and regulations and knowledge of violations or possible violations of laws or regulations." AS 2405.08 (AU 317.08); *see* AU-C § 240.18. The auditor should also inquire of those charged with governance, including the audit committee, how they "exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks." AU-C § 240.20; *see* AS 2405.08 (AU 317.08).

C. Further, "Unless all of those charged with governance are involved in managing the entity, the auditor should make inquiries of those charged with governance (or the audit committee or, at least, its chair) to determine their views about the risks of fraud and whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity." AU-C § 240.21; *see* AS 2405.08 (AU 317.08).

D. If management fails to provide "satisfactory information that there has been no illegal act," the auditor should perform additional auditing procedures, which include consulting "with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements." AS 2405.10 (AU 317.10); *see* AU-C §§ 240.19, .A19.

4. Auditor Reporting and Disclosure

A. Auditing standards require the auditor to report fraud to appropriate levels of management and to the audit committee. *See* AS 2401.79-.82 (AU 316.79-82); AU-C §§ 240.39-.41.

B. "If the auditor has identified or suspects a fraud, the auditor should determine whether the auditor has a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances." AU-C § 240.42; *see* AS 2405.23 (AU 317.23).

C. "The auditor has a responsibility, under certain conditions, to disclose possible fraud to the Securities and Exchange Commission to comply with certain legal and regulatory requirements. These requirements include reports in connection with the termination of the engagement, such as when the entity reports an auditor change and the fraud or related risk factors constitute a *reportable event* or are the source of a *disagreement*, as these terms are defined in Item 304 of Regulation S-K and Item 16F of Form 20-F. These requirements also include reports that may be required pursuant to Section 10A(b) of the Securities Exchange Act of 1934 relating to an illegal act that the auditor concludes has a material effect on the financial statements." AS 2401.81A (AU 316.82(a) n.41).

b. **Investigations of Illegal Acts**

1. The Auditor's Duty to Investigate Possible "Illegal Acts" Under Section 10A of the Securities Exchange Act

A. Section 10A of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j-1, imposes on public company auditors an obligation to investigate potential illegal acts and to report such illegal acts in certain circumstances.

B. "Illegal act" for purposes of Section 10A "means an act or omission that violates any law, or any rule or regulation having the force of law." Exchange Act, § 10A(f).

i. "Illegal act" in Section 10A does not exclude "'personal misconduct by the entity's personnel unrelated to their business activities.'" Materiality, SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 n.41 (Aug. 19, 1999) (quoting AU 317.02).

C. Section 10A(b) prompts a required investigation into "illegal acts" if in the course of conducting an audit of an issuer, the registered public 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 . . . ." (emphasis added)

i. "[U]nder the plain and unambiguous terms of the statute an auditor becomes subject to the § 10A requirements upon acquiring knowledge of information indicating that an illegal act *may have* occurred." *SEC v. Solucorp Indus., Ltd.*, 197 F. Supp. 2d 4, 10 (S.D.N.Y. 2002) (emphasis added).

D. The auditor is required to investigate the possible illegal act to

i. determine whether it is likely that an illegal act has occurred; and

ii. if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages.

Exchange Act, § 10A(b)(1)(A).

2. Reporting an Illegal Act

A. After detecting and investigating an illegal act, the auditor must, as soon as practicable, inform the appropriate level of management and make sure the audit committee or board of directors is adequately informed with respect to the illegal act, "unless the illegal act is clearly inconsequential." Exchange Act, § 10A(b)(1)(B).

B. If, after determining that the audit committee is adequately informed as to the illegal act reported by the auditor, the auditor is required to report the matter to the full board of directors if it concludes that

i. the illegal act has a material effect on the issuer's financial statements;

ii. senior management has not taken, and the board of directors has not caused management to take "timely and appropriate remedial actions with respect to the illegal act"; and

iii. the failure to take remedial action is reasonably expected to warrant departure from a standard audit report or the auditor's resignation.

Exchange Act, § 10A(b)(2).

C. If an issuer's board of directors receives a report from the auditor described in Section 10A(b)(2), the issuer is required to inform the SEC within one business day and provide a copy of its notice to the auditor. If the auditor does not receive a copy of the notice within the one-business day period, it must either resign from the engagement or furnish a copy of its report to the SEC within one business day after the failure to receive notice. If the auditor resigns, it also must provide a copy of its report to the SEC. Exchange Act, § 10A(b)(3).

3. Auditing Standards

A. AS 2405 (AU 317) and AU-C § 250 outline procedures auditors must follow when investigating "illegal acts." The standard defines "illegal acts" as "violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated

to their business activities." AS 2405.02 (AU 317.02); *see* AU-C § 250.11 (using the term "noncompliance"). These auditing standards are similar to Section 10A, which defines "illegal act" as "an act or omission that violates any law, or any rule or regulation having the force of law", except that the auditing standard does not encompass personal misconduct. Exchange Act, § 10A(f).

B. If information comes to an auditor's attention that suggests the existence of an illegal act that could have a material effect on the financial statements, an auditor must perform targeted audited procedures to determine whether such an illegal act has occurred. If an auditor becomes aware of a potential illegal act, an auditor should discuss the act with management to determine the nature and circumstances of the act. If management fails to provide a satisfactory response, an auditor should then consult the client's legal counsel or other specialists regarding relevant laws and regulations and potential effects on the financial statements.

C. Upon concluding an illegal act has occurred, an auditor should consider the impact of such illegal act on the financial statements and the disclosures thereto. For audits of public companies, AS 2405.17 (AU 317.17) requires an auditor to "assure himself that the audit committee is adequately informed as soon as practicable and prior to the issuance of the auditor's report with respect to illegal acts that come to the auditor's attention." Similarly, for audits of non-public entities, an auditor must make sure those "charged with governance" are "aware of matters involving identified or suspected non-compliance." AU-C § 250.21. Auditors should consider the materiality of any illegal act and consider the impact on the auditor's report. AS 2405.18-21 (AU 317.18-21); AU-C §§ 250.24-.26.

c. **SEC Rule 13b2-2**

1. SEC Rule 13b2-2(a), 17 C.F.R. § 240.13b2-2(a), provides that directors and officers of an issuer shall not, directly or indirectly,

A. make or cause to be made a materially false or misleading statement to an accountant in connection with; or

B. omit to state, or cause another person to omit to state, any material fact necessary in order to make the statement made, in the light of the circumstances under which such statements were made, not misleading to an accountant in connection with:

ii. any audit or examination of the financial statements of the issuer, or

iii. the preparation or filing of any document or report required to be filed with the SEC.

2. Paragraph (b) of Rule 13b2-2 prohibits any officer or director of an issuer, or any other person acting under their direction, from taking any action to "coerce, manipulate, mislead, or fraudulently influence" an auditor in the course of an audit or review of the financial statements of that issuer if the officer or director knew that if such action were successful "could result in rendering the issuer's financial statements materially misleading." Such actions include, among others, influencing an auditor to not communicate matters to the issuer's audit committee, to not perform audit or other procedures required by generally accepted auditing standards, or to issue a report that is not warranted due to material violations of generally accepted auditing standards, GAAP, or other professional or regulatory standards.

Appendix A[1]

Sample Audit Inquiry Letter from CFO to General Counsel

[DATE]

[NAME AND ADDRESS OF ISSUER]

Attn: [NAME AND TITLE OF CLO/GC]

Dear [NAME]:

In connection with an audit of the consolidated financial statements of [NAME OF ISSUER] ("[XXXX]") and its subsidiaries (collectively, the "Company") at December 31, 20[XX] and for the period then ended, please furnish our auditors, [NAME OF FIRM], with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of [XXXX] or any of its subsidiaries or affiliates (identified in the attached Schedule A) in the form of legal consultation or representation. This request is limited to contingencies amounting to $XXX,XXX individually or items involving lesser amounts that exceed $XXX,XXX in the aggregate for [MAJOR SUBSIDIARIES] and to contingencies amounting to $XXX,XXX individually or items involving lesser amounts that exceed $XXX,XXX in the aggregate for [OTHER SUBSIDIARIES] (the "Threshold Amounts").

Regarding pending or threatened litigation, claims and assessments (excluding unasserted claims), please include in your response: (1) the nature of each matter, (2) the progress of each matter to date, (3) how the Company is responding 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 response or outcome and an estimate, if one can be made, of the amount or range of potential loss.

We understand 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, if you have formed a professional conclusion that we should 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 Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 450, Contingencies. Please specifically confirm to our auditors that our understanding is correct.

The Company has represented to the auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450.

[1] The samples in this Appendix A were provided by Maryann Waryjas, Senior Vice President, Chief Legal Officer and Corporate Secretary of Herc Holdings Inc.

Your response should include matters that existed at December 31, 20[XX] and during the period from that date to the date of your response and should be sent to [NAME, ADDRESS AND CONTACT PERSON AT AUDIT FIRM], no later than [DATE].

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

Very truly yours,

[NAME]

Chief Financial Officer

Sample General Counsel Audit Response Letter

[DATE]

[NAME AND ADDRESS OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM]

Re: [NAME OF ISSUER]

Ladies and Gentlemen:

By letter dated [DATE] (the "Request Letter") from [NAME], Chief Financial Officer of [NAME OF ISSUER] ("[XXXX]"), I have been requested to furnish you certain information in connection with your examination of the financial statements of [XXXX] and the subsidiaries and affiliates that were listed in the letter (collectively, the "Company").

My response is limited to matters to which lawyers currently employed at the Company and under my supervision have devoted substantive attention as legal counsel to the Company; this response does not include information received in any other role. My response also is limited to the Threshold Amounts (as defined in the Request Letter). The information contained in this response also is limited to matters that existed as of December 31, 20[XX] or during the period from that date to [DATE].

The Company does not intend to waive attorney-client privilege or the attorney work product privilege with respect to any document, information or communication which the Company has provided to me or the attorneys under my supervision or I or the attorneys under my supervision have provided to the Company. In addition, my response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege with respect

to any of my related files, records or documents or those of any of the attorneys under my supervision.

In connection with this letter, I have reviewed the responses sent to you from attorneys responsible for loss contingencies involving the Company and listed on Appendix A hereto (the "Outside Counsel Responses"), copies of which you provided to me on [DATE]. In rendering this response to you, I have relied on the Outside Counsel Responses.

Subject to all limitations set forth in this letter, I advise you that neither I nor any of the attorneys under my supervision has given substantive attention to, or represented the Company in connection with, any material pending or threatened litigation, claim or assessment coming within the scope of clause (a) of paragraph 5 of the ABA Statement of Policy Regarding Lawyers Responses to Auditor's Requests for Information (December 1975) (together with the related commentary, the "ABA Statement") except as described in the Outside Counsel Responses.

In accordance with Paragraph 5 of the ABA Statement, it is my policy to refrain from expressing judgments as to the outcome of the Company's legal proceedings and matters unless an unfavorable outcome is either probable or remote. I also refrain from estimating the amount or range of potential loss resulting from any matter unless I believe that the probability of inaccuracy of the estimate is slight. In view of these considerations, I express no judgments as to the probable future outcome or range of loss which may result from any of the matters described above or referenced in this letter. In the absence of any such judgments, no inference should be drawn that the Company will or will not prevail in any matter or that my views with respect to any matter may or may not differ from those expressed by others.

This response is limited by, and in accordance with, the ABA Statement; without limiting the generality of the foregoing, the limitations set forth in the ABA Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the ABA Statement and the accompanying Commentary (which is an integral part thereof). Consistent with the Commentary relating to Paragraph 6 of the ABA Statement, this will confirm 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, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the management of the Company and will consult with the management of the Company concerning the question of such disclosure and the applicable requirements of FASB ASC Subtopic 450-20, Contingencies – Loss Contingencies (a codification of Statement of Financial Accounting Standards No. 5). Since requests for information concerning unasserted claims or assessments which are not specifically identified by the Company are outside of the scope of Paragraph 5 of the ABA Statement, I make no comment with respect to the statements in the Request Letter concerning "unasserted claims or assessments." My failure to comment thereon should not be interpreted as indicating that I either agree or disagree with such statements and representations.

This letter speaks as of the date hereof only, and I disclaim any undertaking to advise you of changes which hereafter may be brought to my attention or to the attention of the attorneys under my supervision.

This letter is solely for your information and assistance in connection with your audit of and report with respect to the financial condition of the Company and is not to be quoted or otherwise referred to in any financial statements of the Company or related document, nor is it to be filed with, furnished to or relied upon by any governmental agency or other person without my prior written consent.

Very truly yours,

[NAME]
[TITLE]

Attachment:

APPENDIX A

OUTSIDE COUNSEL RESPONSES

[LIST NAMES AND DATES]