I. INTRODUCTION

Lawyers and accountants are different professionals in many ways. For accountants, most of their work is black or white. In providing services to a client, an accountant must comply with a wide array of rules concerning a client’s financial accounting and tax reporting. Compliance with accounting principles and auditing standards is just one of the items an accountant must evaluate in reviewing a company’s financial statements. In addition, an accountant’s client must comply with voluminous and highly complex tax laws. Most of these standards set forth the “right” way to account for any given financial statement item. While an accountant must still use professional judgment in estimating such items as bad debt reserves or depreciation allowances, the rules are fairly black and white for a majority of financial accounting decisions. For example, balance sheets must balance at the end of the day. The accountant must perform a search for unrecorded liabilities and make an accrual for any unrecorded amounts discovered. An accountant works hand in hand with the client to produce accurate financial statements.

For lawyers, however, things have always been greyer. For every cause of action, there are two sides to the story. Two lawyers, looking at the same set of facts, will make a different argument concerning liability depending on whether they sit on the plaintiff’s or defendant’s side of the courtroom. In addition, lawyers exist in an inherently adversarial environment. While a trial might clearly evidence this two-party conflict, business transactions also require an attorney to pursue his client’s needs at the expense of the other side. Whether in a trial or transactional setting, lawyers guard their clients’ confidences vigorously and avoid disclosure of key information to any other party. Therefore, an attorney’s reluctance to disclose any meaningful information in his or her response to an audit inquiry letter is understandable. In the context of responding to an audit inquiry letter, an attorney’s
most basic fear is that any evaluation or assessment of a client’s liability, or any estimate that the attorney might make, concerning a specific claim will be disclosed to an adversarial party and used against the client in a subsequent court proceeding. Over the past twenty years, court cases have validated this fear.

For lawyers, the audit inquiry letter has become a necessary evil. Inevitably, the attorney’s response to the audit inquiry letter is one of the last open items that an accountant attempts to wrap up at the end of audit field work. The response that is eventually received, however, may not actually be that useful to the accountant in evaluating loss contingencies. Most responses only result in verifying claims that the client has already disclosed to the auditor. In most instances, the auditor could actually obtain more information just by reviewing the pleadings filed at the local courthouse. One might say the attorney’s response says a lot while at the same time saying nothing at all.

Perhaps acknowledging some flaws in the current methods, the Auditing Standards Board formed a “Legal Inquiry Letters Reeducation Task Force.” Jointly comprised of members from the American Institute of Certified Public Accountants (“AICPA”) and members of the American Bar Association (“ABA”), the task force was “established to address concerns regarding language used by auditors in audit inquiry letters . . . and responses by attorneys to those letters.” Unfortunately, this task force was disbanded before taking any action.

This article will examine whether the attorney’s response to the audit inquiry letter serves any meaningful purpose. In addition, this article considers attorneys’ concerns when responding to audit inquiry letters and evaluates the validity of these concerns. Part I of this article reviews the current financial accounting and auditing standards that relate to audit inquiry letters and reviews the underlying purpose of the audit inquiry letter. In addition, Part I summarizes the ABA Statement of Policy that relates to attorneys’ responses to audit inquiry letters. Part II summarizes the major elements of the attorney-client privilege and the work product doctrine – two legal principles that underlie a majority of cases involving audit-inquiry letters. Part II also looks at the significant court cases involving the issue of audit inquiry letters over the years. Part III analyzes whether the fundamental purpose of the audit inquiry letter is being served. In addition, Part III looks at the validity of attorneys’ fears of audit inquiry letters and how their responses to these letters could be

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1 Highlights of Technical Activities, 20 IN OUR OPINION………..: THE NEWSLETTER OF THE AICPA AUDIT AND ATTEST STANDARDS GROUP 12 (2004).

2 Id.
changed in the future. Finally, Part IV concludes that serving the purposes of the
audit inquiry letter requires more forthcoming responses from attorneys.

II. REVIEWING THE GROUND RULES

A. Statement of Financial Accounting Standards No. 5: Accounting for Contingencies

Established in 1973, the Financial Accounting Standards Board (“FASB”) promulgates generally accepted accounting principles in the United States. Generally accepted accounting principles are financial accounting rules that have received substantial authoritative support. Preparation of a company’s financial statements must conform to generally accepted accounting principles, which reflect

the consensus at a particular time as to which economic resources and obligations should be recorded as assets and liabilities…, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.

In March 1975, the FASB issued Statement No. 5, which governs accounting for contingencies. A loss contingency is defined as “an existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.” In assessing whether a loss contingency involving litigation,

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3 Statement No. 4, § 1026.01 n.1 (AICPA Accounting Principles Bd. 1970).
4 Id. at § 1026.01.
5 ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, (Fin. Accounting Standards Bd. 1975) (hereinafter “SFAS No. 5”).
6 The loss contingency that an auditor attempts to address in sending the audit inquiry letter is pending or threatened litigation. Other examples of loss contingencies include collectibility of receivables, obligations related to product warranties and product defects, and guarantees of indebtedness of others. However, these other types of loss contingencies are not considered within the scope of this article.
7 SFAS No. 5, ¶1.
claims, or assessments (whether asserted or unasserted) requires accrual and/or disclosure in the financial statements, the auditor must evaluate the following factors:

“(a) The period in which the underlying cause . . . of the pending or threatened litigation or of the actual or possible claim or assessment occurred; (b) The degree of probability of an unfavorable outcome; (c) The ability to make a reasonable estimate of the amount of loss.”

A loss contingency is classified as being probable, reasonably possible, or remote, based upon the likelihood that the future event confirming the existence of a loss will occur. A loss contingency is considered probable if “[t]he future event or events are likely to occur.” A loss contingency is classified as reasonably possible if “[t]he chance of the future event or events occurring is more than remote but less than likely.” A loss contingency is deemed remote if “[t]he chance of the future event or events occurring is slight.” Instead of specifying percentage guidelines to help classify a loss contingency, the FASB requires the auditor to exercise professional judgment.

The auditor’s classification of a loss contingency as either probable, reasonably possible, or remote determines how the loss contingency will be handled in the financial statements. A loss contingency is accrued, meaning charged against income, if (1) “[i]nformation available prior to issuance of the financial statements indicates that [the loss contingency] is probable” and (2) “[t]he amount of loss can be reasonably estimated.” Absolute certainty of a loss is not required; the likelihood need only be classified as probable. In addition to accruing the loss, the auditor may need to make a disclosure explaining the nature of the accrual.

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8 Id. ¶33.
9 Id. ¶3.
10 Id.
11 Id.
12 Id.
13 Id. ¶8.
14 Id. ¶84.
15 Id. ¶9.
The auditor should disclose a loss contingency in the footnotes of the financial statements if the likelihood of occurrence is classified as reasonably possible. The disclosure should identify the “nature of the contingency” and “give an estimate of the possible loss.” In the event the exact amount of the loss is not known, the disclosure should indicate the possible range of loss or state that no estimate of the loss is possible. Disclosure is required for unasserted claims or assessments if the assertion of a claim is probable and the likelihood that the outcome will be unfavorable is reasonably possible. In some instances, a loss arising after the date of the financial statements might require disclosure to prevent the financial statements of the company from being misleading. A loss contingency categorized as remote does not generally require disclosure in the financial statements.

B. Statement on Auditing Standards No. 12

Subsequent to the promulgation of SFAS No. 5, both the accounting and legal professions issued guidance that addressed audit inquiry letters. The Auditing Standards Board, a technical committee of the AICPA, develops Statements of Auditing Standards. Statement on Auditing Standards No. 12, Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments, was approved on January 7, 1976, and “provides guidance on the procedures an independent auditor should consider for identifying litigation.” When assessing litigation, the auditor should obtain information concerning the following factors:

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16 Id. ¶10.
17 Id.
18 Id.
19 Id.
20 Id. ¶11.
21 See generally, SFAS No. 5.
a. 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.

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

c. The degree of probability of an unfavorable outcome.

d. The amount or range of potential loss.\(^{24}\)

As part of the audit procedures, the auditor discusses litigation with company management to ensure that litigation existing as of the balance sheet date is identified and disclosed in the financial statements in accordance with SFAS No. 5.\(^{25}\) The auditor sends an audit inquiry letter to the lawyer as a means of confirming litigation, claims, and assessments identified by management.\(^{26}\)

C. The Audit Inquiry Letter

In many ways, the audit inquiry letter is similar to other confirmation letters sent to third parties during the course of a financial audit. Just as a cash confirmation confirms the bank balance of company cash accounts at the end of the year, the audit inquiry letter serves as corroboration of management’s representations concerning litigation.\(^{27}\) The audit inquiry letter is written on management’s letterhead and mailed to the attorney by the accountant. The lawyer returns the response directly to the accountant.

The audit inquiry letter should identify the company and any subsidiaries being audited and the corresponding audit period.\(^{28}\) The letter will request the attorney to confirm information that the client has provided to the auditors

\(^{24}\) SAS No. 12, ¶4.

\(^{25}\) Id. ¶5(d).

\(^{26}\) Id. The audit inquiry letter is only one of many auditing procedures performed to identify and evaluate litigation. Other audit procedures include reviewing minutes of stockholder meetings and board of directors; reading important documents, such as contracts, loan agreements, and leases; and identifying possible guarantees. SAS No. 12, ¶7.

\(^{27}\) SAS No. 12, ¶8.

\(^{28}\) Id. at ¶9(a).
concerning pending or threatened litigation, claims, and assessments. Alternatively, in the event management does not prepare a list of pending litigation, the letter will request that the lawyer prepare the list.

Pending litigation is restricted to actions “with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.” The list of pending litigation should describe the nature of the litigation, including the proceeding, claim, or claims asserted, amount of damages sought, and whether the damages are covered by insurance. In addition, the list should identify the progress of the case (such as whether the case is during the discovery, trial, or appeal phase) as well as the action the company plans to take regarding the litigation (such as “to contest the matter vigorously or to seek an out-of-court settlement”). The list should also specify the likelihood of an “unfavorable outcome” for each pending claim and make an estimate concerning “the amount or range of [any] potential loss.”

Management should prepare a list of unasserted claims and assessments that it “considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome.” Like pending litigation, unasserted litigation is similarly restricted to matters for which the attorney has been engaged and to which he has devoted substantive attention in conjunction with representing the company. The lawyer is asked to comment on the list of unasserted claims only if his description or evaluation of the matter differs from the client’s.

29 Id. at ¶9(b).
30 Id.
31 Id.
32 Id. at ¶9(d)(1).
33 Id.
34 Id. at ¶9(d)(2).
35 Id. at ¶9(c).
36 Id.
37 Id. at ¶9(e).
The audit inquiry letter also requests the attorney to confirm that, in the event an unasserted possible claim comes to his attention during the course of providing legal services to the client, the attorney will consult with the client regarding disclosure and compliance with the requirements of SFAS No. 5. While the audit inquiry letter can be restricted to material litigation, the client, auditor, and lawyer must each understand any materiality limitations. Finally, the audit inquiry letter should “request that the lawyer specifically identify the nature of and reasons for any limitation on his response.”

D. ABA Statement of Policy

Around the same time the Auditing Standards Board was developing SAS No. 12, the ABA was writing similar guidelines for lawyers concerning the recommended approach for responding to an audit inquiry letter. On December 8, 1975, the ABA’s Board of Governors approved the ABA Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information (the “ABA Statement”). While auditors must comply with the requirements of both SFAS No. 5 and SAS No. 12, attorneys are not required to follow the ABA Statement when responding to audit inquiry letters. The ABA Statement is merely a guide.

The ABA Statement opens with a Preamble that comes across as both cautionary and defensive. The opening line of the ABA Statement proclaims, “The public interest in protecting the confidentiality of lawyer-client communications is fundamental.” The ABA Statement warns that the attorney’s disclosure of lawyer-client communications is fundamental.

38 Id. at ¶9(f). “In some circumstances, a lawyer may be required . . . to resign his engagement if his advice concerning financial accounting and reporting for litigation, claims, and assessments is disregarded by the client.” Id. at ¶11.

39 SFAS No. 12, ¶9.

40 Id. at ¶9(h). A lawyer’s refusal to comply with the requests made in the audit inquiry letter would be considered a scope limitation that prevents issuance of an unqualified audit opinion. Id. at ¶13.


42 AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy ¶8, at 9.

43 AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy Preamble, at 4.
client information to the auditor “may significantly impair the client’s ability in other contexts to maintain the confidentiality of such communications.”

While recognizing the importance of investors’ ability to rely on accurate and complete financial statements, the Preamble asserts that this public policy goal should not undermine the attorney-client relationship. The ABA Statement acknowledges that attorneys are most likely the best resource for obtaining information about claims that have been asserted, but strongly admonishes that “it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.”

Before replying to the auditor’s request for information, the lawyer should verify that the client representative who signed the audit inquiry letter is authorized to consent to the lawyer’s disclosure of information to the auditor. The lawyer may limit his or her response to the auditor in several ways. For example, the response need cover only matters that are “individually or collectively material” to the financial statements and to which the lawyer has given “substantive attention” via legal representation or consultation for the period covered by the audit. The lawyer may also limit the response by stating that the reply is intended only for the auditor’s information, thus preventing dissemination of the lawyer’s response to other individuals. Because these limitations are referenced specifically in the ABA Statement, they do not have to be explicitly stated in the attorney’s reply. If the attorney’s response is limited by information contained in the ABA Statement, however, the response should contain appropriate language indicating this limitation and should reference the full title of the ABA Statement.

Upon receipt of a proper client request, the lawyer may report the following matters to the auditor:

44 Id.

45 Id. at 4-5.

46 Id. at 5.

47 See AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy ¶1, at 5.

48 Id. ¶¶2,3, at 6.

49 See id. ¶7, at 9.

50 See id. ¶8, at 9.
(a) overtly threatened or pending litigation, whether or not specified by the client;
(b) a contractually assumed obligation which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor;
(c) an unasserted possible claim or assessment which the client has specifically identified and upon which the client has specifically requested, in the inquiry letter or a supplement thereto, comment to the auditor.\textsuperscript{51}

As the above language indicates, items (b) and (c) require that the client specifically identify these items in the audit inquiry letter in order for the attorney to comment on them. Regarding unasserted possible claims, the client should only ask the attorney to comment on a matter if the claim is probable of assertion and there is a reasonable possibility that the outcome will be both unfavorable and material to the financial statements.\textsuperscript{52}

For matters that require the communication of information to the auditor, the lawyer may disclose the “identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.”\textsuperscript{53} The ABA Statement cautions attorneys that an adverse party may assert the attorney’s evaluation of a claim as an admission at a later date.\textsuperscript{54} In addition, the Statement advises lawyers against predicting the outcome of claims “except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either ‘probable’ or ‘remote.’”\textsuperscript{55} In classifying the likelihood of an unfavorable outcome, the ABA Statement uses the terms “probable” and “remote,” but it does not use “reasonably possible” as used in SFAS No. 5. In addition, the ABA Statement defines “probable” and “remote” differently from SFAS No. 5. An unfavorable outcome is considered 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

\textsuperscript{51} Id. ¶5, at 6-7.
\textsuperscript{52} See id. at 7.
\textsuperscript{53} Id.
\textsuperscript{54} Id. ¶1(c), at 6.
\textsuperscript{55} Id. ¶5, at 8.
defense are judged to be slight.\textsuperscript{56} An unfavorable outcome is considered 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.”\textsuperscript{57} The Commentary to the ABA Statement states more broadly that “in most situations, an unfavorable outcome will be neither ‘probable’ nor ‘remote’ as defined.”\textsuperscript{58} In other words, furnishing judgments to the auditor about the outcome of litigation is unnecessary in most situations.

Likewise, although the lawyer may specify an estimated dollar amount of a “probable” loss, the ABA Statement discourages the lawyer from doing so. “[T]he amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation.”\textsuperscript{59} The ABA Statement recommends that a lawyer specify a dollar amount only if the likelihood that the loss estimate will be incorrect is slight.\textsuperscript{60} The lawyer should rarely provide a specific estimate of a loss amount for unasserted claims and assessments.\textsuperscript{61} “[A] decision to treat an unasserted claim as ‘probable’ of assertion should be based only upon ‘compelling judgment.’”\textsuperscript{62}

The ABA acknowledges that an attorney has a professional responsibility to refrain from knowingly assisting a client in violating securities laws and may be required to resign as counsel in the event the client disregards advice concerning disclosures.\textsuperscript{63} In fact, the auditor may assume that when the lawyer becomes aware of unasserted possible claim or assessments potentially requiring disclosure, he or she will discuss the need for disclosure and the applicable SFAS No. 5 requirements with the client.\textsuperscript{64} More specifically, the lawyer should encourage the client to disclose an

\textsuperscript{56} Id.

\textsuperscript{57} Id.

\textsuperscript{58} AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy Commentary, at 17.

\textsuperscript{59} AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy ¶5, at 8.

\textsuperscript{60} Id.

\textsuperscript{61} See id.

\textsuperscript{62} AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy ¶6, at 8.

\textsuperscript{63} AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy ¶6, at 8.

\textsuperscript{64} Id. at 8-9.
unasserted possible claim or assessment to the auditor if the lawyer feels 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.”

III. WHAT’S TO BE SCARED OF?: LOOKING AT THE CASE LAW

A. The Attorney-Client Privilege and Work Product Doctrine

The ABA Statement strongly emphasizes the importance of the attorney-client relationship and continually advises attorneys on how to limit their responses to audit inquiry letters. The motivating factor behind this emphasis is the fear that the attorney’s judgment concerning liability might subsequently be used or disclosed in a future court action. In the twenty-five years since SFAS No. 5, SAS No. 12, and the ABA Statement were promulgated, relatively few court decisions have addressed audit inquiry letters. Almost all of the cases that do address them focus exclusively on their discoverability and whether either the attorney-client privilege or the work product doctrine can be invoked to protect the audit inquiry letter from discovery.

The attorney-client privilege serves to protect confidential communications between a client and his lawyer and allows the client to make full disclosure to his lawyer when discussing legal matters. The Supreme Court has stated that the purpose of the privilege is “to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice.” When applying the attorney-client privilege in federal courts, judges look to the development of the privilege under the common law. At its most basic level, the attorney-client privilege requires that the “communication be made in confidence for the purpose of obtaining legal advice from the lawyer.” For example, a client cannot use the attorney-client

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65 AUDITOR’S LETTER HANDBOOK, supra note 41, Statement of Policy Commentary, at 18.


67 See FED. R. EVID. 501 (stating that the federal privilege law is guided by “the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience”).

privilege to keep opposing counsel from discovering the underlying facts of a case merely by communicating them to his or her attorney.\footnote{Upjohn, 449 U.S. at 395-96 (quoting Philadelphia v. Westinghouse Elec. Corp., 205 F. Supp. 830, 831 (E.D. Pa. 1962)).}

The attorney-client privilege may be destroyed in the event that any part of the confidential communication is subsequently disclosed to a third-party.

To retain the attorney-client privilege, the confidentiality surrounding the communications made in that relationship must be preserved. The purpose of the privilege is to foster full client disclosure to the lawyer; the privilege exists to assure the client that his private disclosures will not become common knowledge. The need to cloak these communications with secrecy, however, ends when the secrets pass through the client’s lips to others. Thus, a breach of confidentiality forfeits the client’s right to claim the privilege.\footnote{United States v. El Paso Co., 682 F.2d 530, 539 (5th Cir. 1982).}

When determining if the privilege has been waived as a whole, courts look to whether the disclosure represented a significant part of the prior communication.\footnote{Id. at 538 (quoting United States v. Davis, 636 F.2d 1028, 1043 (5th Cir. 1981)).}

The genesis of the work product doctrine can be found in the Supreme Court decision \textit{Hickman v. Taylor}.\footnote{329 U.S. 495 (1947).} In \textit{Hickman}, an attorney attempted to obtain opposing counsel’s notes from witness interviews he had conducted in preparation for trial.\footnote{Id. at 497.} The court noted that “memoranda, statements and mental impressions . . . fall outside the scope of the attorney-client privilege and . . . [could] not [be] protected from discovery on that basis.”\footnote{Id. at 508.} In carving out the work product doctrine, the Court stated that “[n]ot even the most liberal of discovery theories can justify unwarranted inquiries into the files and the mental impressions of an attorney.”\footnote{Id. at 510.}

While the work product doctrine shelters a lawyer’s research, analysis, legal theories,
and mental impressions; the Court pointed out that, just like the attorney-client privilege, the client could not use the work product doctrine to withhold relevant and non-privileged facts that are contained within the attorney’s materials.⁷⁶

The work product doctrine espoused in Hickman was later incorporated into the Federal Rules of Civil Procedure as Rule 26(b)(3).⁷⁷ Limitations exist, however, regarding work product protection. For example, the doctrine is limited to protecting “materials assembled and brought into being in anticipation of litigation.”⁷⁸ As stated in the Advisory Committee Notes to the Federal Rules of Civil Procedure, “Materials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other non-litigation purposes are not under the qualified immunity provided by [Rule 26(b)(3)].”⁷⁹ One of the differences between the attorney-client privilege and the work product doctrine is that all confidential communications between the client and the lawyer are protected under the attorney-client privilege, while only those documents created during the course of or preparing for litigation are protected under the work product doctrine.

Like the attorney-client privilege, the work product doctrine is not an absolute privilege and can be waived.⁸⁰ Unlike the attorney-client privilege, however, disclosure to a third party does not necessarily result in the waiver of the privilege under the work product doctrine.⁸¹ A waiver occurs only if the disclosure allows the opponent to gain access to the information.⁸² “[W]hen the disclosure is either inadvertent or made to a non-adversary, it is appropriate to ask whether the

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⁷⁶ *Id.* at 511.

⁷⁷ *See* FED. R. CIV. P. 26(b)(3) (“the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation”).

⁷⁸ *El Paso Co.*, 682 F.2d at 542.


⁸² *Id.*
circumstances surrounding the disclosure evidenced conscious disregard of the possibility that an adversary might obtain the protected materials.”

The following section will discuss how the courts have addressed the issue of audit inquiry letters’ discoverability. The cases discussed below show how courts rely heavily on the aforementioned rules concerning the attorney-client privilege and the work product doctrine when examining issues related to audit inquiry letters.

B. Audit Inquiry Letter Cases

The first relevant case is United States v. El Paso Company. While not directly involving audit inquiry letters, the El Paso court’s analysis and reasoning was later relied on in subsequent legal opinions of other courts. In El Paso, the Internal Revenue Service was seeking to enforce a summons regarding certain tax accrual workpapers of the El Paso Company in conjunction with a tax audit. El Paso’s tax department, which consisted of approximately 80 accountants and 10 attorneys, calculated these tax accrual workpapers in-house. The purpose of the tax accrual workpapers was “to insure that the corporation sets aside on its balance sheet a sufficient amount to cover [any] contingent tax liability.”

El Paso attempted to resist the summons of the tax accrual workpapers by asserting both the attorney-client privilege and the work product doctrine. As part of the tax pool analysis performed during the annual financial statement audit, El Paso disclosed the contents of the tax accrual workpapers to the auditors so that they might evaluate the adequacy of the tax pool analysis. In discussing the attorney-client privilege, the court found that revealing this information to the outside auditors destroyed confidentiality with respect to these documents. Once the

83 Id. at 1431.
84 682 F.2d 530 (5th Cir. 1982).
85 Id. at 532.
86 Id. at 541.
87 Id. at 535.
88 Id. at 538, 542.
89 Id. at 540.
90 Id.
confidentiality of the information was destroyed, the ability to claim the privilege was waived. In
terestingly, the court also noted that there was no way to tell which tax accrual workpapers
had been prepared by tax department attorneys (as opposed to accountants) such that the privilege
would apply.

In addition to finding that the attorney-client privilege was not available, the court also
determined that the work product doctrine could not prevent El Paso from complying with the IRS
summons. The court stated that the tax accrual workpapers were not prepared in anticipation of
litigation, in essence agreeing with the IRS that the papers were business work instead of legal
work. The function of the workpapers was to support a number on the balance sheet and to comply
with SEC regulations; thus they were more closely related to daily business than to
litigation.

Two of the first cases about the discoverability of audit inquiry letters produced different
results in different jurisdictions. In United States v. Arthur Young & Company, the government
sought discovery of an audit inquiry letter prepared in connection with the annual audit of Cities
Service Oil and Gas. The audit inquiry letter contained the outside attorney’s analysis and mental
impressions regarding a

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91 Id.
92 See id. at 541.
93 Id. at 545.
94 See id. at 539, 543.
95 Id. at 543-44.
96 Id. at 543.
97 Id.
99 Id. at *3.
pending case between Cities Service and the Department of Energy, including the potential effects of the lawsuit on the financial statements. The court found that the audit inquiry letter was protected by the work product doctrine and that the privilege had not been waived because “the documents were provided to [the accounting firm] under a specific assurance of confidentiality.” The work product doctrine protected the letter from discovery because “[t]he audit process required Cities’ counsel to provide the [outside auditor] with candid assessments and opinions of pending and potential litigation.” The lawyer’s interpretations, mental impressions, and opinions concerned a matter in litigation or in anticipation of litigation and were therefore protected under the work product doctrine.

After losing in the Oklahoma district court in *Arthur Young*, the government sought enforcement of a subpoena for the exact same documents in an action against Gulf Oil Corporation in a Texas district court. Gulf Oil had entered into a merger agreement with Cities Service. After also losing in the Texas district court, the government appealed the decision to the Temporary Emergency Court of Appeals. Although two district courts in different jurisdictions had found otherwise, the Court of Appeals ruled that the audit inquiry letter did not qualify for work product protection. The court justified its decision by stating that “[i]f the primary motivating purpose behind the creation of the document is not to assist in pending or impending litigation, then a finding that the document enjoys work product immunity is not mandated.” The court determined that the audit inquiry letter was solely prepared for the business purpose of helping prepare audited

100 See id. at *3-4.

101 Id. at *7.

102 Id. at *9-10.

103 See id. at *11.


105 Id.

106 See id.

107 Id. at 297-98.

108 Id. at 296.
financial statements that would comply with federal securities laws. Citing El Paso as support for its decision, the court concluded that the audit inquiry letter had not been prepared “in anticipation of litigation,” which is a requirement for receiving work product protection.

Not quite six months later, another district court found a completely opposite interpretation of the phrase “in anticipation of litigation” in Tronitech, Inc. v. NCR Corporation. Tronitech attempted discovery of an audit letter prepared by NCR’s counsel for NCR’s accountants that discussed the financial implications of the lawsuit between NCR and Tronitech. In finding that the audit letter was protected by the work product privilege, the court explained that “[a]n audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation, and it is comprised of the sum total of the attorney’s conclusions and legal theories concerning that litigation.” The court stated that the Arthur Young court’s decision was based upon the “principles and purposes underlying the work product doctrine,” while the Gulf Oil decision relied on interpreting the phrase “prepared in anticipation of litigation” as meaning “created in order to assist in litigation.” The Tronitech court obviously found the Arthur Young court’s reasoning more convincing.

In Independent Petrochemical Corporation v. Aetna Casualty and Surety Company, an insurance company succeeded in compelling the production of letters written by Independent’s counsel to its accountants. Because the documents in question

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109 Id. at 297.

110 Id.


112 Id. at 655.

113 Id. at 656.

114 Id. at 657.

115 Id.


117 Id. at 298.
were prepared for the purpose of complying with federal securities laws,118 the company unsuccessfully argued that the documents were covered by the attorney-client privilege or the work product doctrine.119 With respect to the attorney-client privilege, the court concluded that the letters were “clearly . . . written in connection with the rendering of accounting services.”120 The court stated that the letters “were not intended to convey confidential attorney-client information, but even if they were, such a privilege was waived by the disclosure [to the accountants].”121 Regarding the applicability of the work product doctrine, the court found that the letters “were not prepared to assist [the corporation] in present, or reasonably anticipated, litigation but rather they were prepared to assist [the accountants] in the performance of regular accounting work done by such accounting firms.”122 Because the court determined that the letters were not prepared for litigation purposes, it ordered production of the documents.123

By the late eighties, lawyers who were not already wary of responding to an audit inquiry letter took notice after a New York City district judge issued a sealed opinion involving Drexel Burnham Lambert.124 Drexel Burnham Lambert engaged attorneys to conduct an internal investigation regarding allegations of securities fraud.125 The attorneys then subsequently used the information from their investigation to respond to an audit inquiry letter from Drexel’s independent auditors.126 The federal prosecutors sought the results of the investigation from outside counsel by issuing a subpoena.127 The attorneys refused to comply with the subpoena and argued that the information was protected by the attorney-client

118 Id. at 297-98.

119 See id. at 298.

120 Id. at 297.

121 Id.

122 Id. at 298.

123 See id.


125 See id.

126 See id.

127 Id.
privilege and the work product doctrine. In a sealed opinion, the judge ordered the production of the investigation materials, presumably finding that the attorneys waived the privileges by discussing the finding of the investigation with the outside auditors. The end result was essentially a subject-matter waiver due to the information conveyed in the lawyer’s response to the audit inquiry letter.

The ABA quickly responded in December 1989. While not mentioning Drexel Burnham by name, the Report of the Subcommittee on Audit Inquiry Responses stated that “[b]ecause of a recent court case and other judicial decisions involving lawyer’s [sic] responses to auditor’s [sic] requests for information, an area of uncertainty or concern has been brought to the Subcommittee’s attention.” Lawyers were advised to encourage clients to put the following sentence in the audit inquiry letter: “We do not intend that either our request to you to provide information to our auditor or your response to our auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege.” The report also encouraged lawyers to put a similar statement in their responses to audit inquiry letters. The report also acknowledged, however, that inclusion of this language might not prevent a court from determining that the client had waived the privileges. The AICPA announced that the inclusion of this anti-waiver language was not considered a scope limitation for audit purposes.

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128 See id. at 3, 20.

129 Id.


131 Id.

132 Id. at 55.

133 Id.

134 Id.

135 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS PROFESSIONAL STANDARDS (CCH), Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337, AU §9337.28 (Feb. 1990).
Finally, in *Vanguard Savings and Loan Association v. Banks*, the defendants sought letters prepared by outside counsel in response to an accounting firm’s audit inquiry letter request for comment on loss contingencies. The court ordered the plaintiffs to produce the letters to the extent that they contained facts concerning the various loss contingencies but allowed a redaction of any portions of the letter that contained attorney work product. The defendants argued that the work product privilege should not apply because the letters were not prepared in anticipation of litigation. The court, however, found that the attorneys’ response “contain[ed] thoughts and conclusions by plaintiffs’ attorneys in evaluating legal claims” and was thus protected as opinion work product. The court noted that the audit inquiry letter requested information concerning the “expected result including any probable loss” and found that this request “[c]learly . . . [sought] counsel’s mental impressions and legal opinions which are protected from disclosure under the work-product doctrine.”

### IV. Time for Reeducation

#### A. Why Attorneys Are Reluctant to Say More

A review of relevant court decisions shows that the attorney-client privilege will not protect disclosure of the attorney’s response to the audit inquiry letter. The primary problem with this privilege is that the attorney is disclosing information to an outside party (the independent auditor). While the reasoning behind this rule is understandable, problems arise when courts apply it blindly in an auditing context.

First, in the course of performing an audit, the independent auditor confirms several types of information with outside parties. For example, it confirms with banks the year-end cash balances in checking and savings institutions. In addition, lenders confirm information regarding company loans, including year-end value, interest rates, covenant violations, and guarantees. Similarly, the audit inquiry letter

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137 See id. at *9.

138 Id. at *10.

139 Id. at *11.

140 Id. at *12.

141 Id. at *10-11.
attempts to confirm information regarding loss contingencies that the client has disclosed to the accountant.

Second, both courts and attorneys have historically discounted the confidentiality inherent in the accountant-client relationship. Rule 301 of the Code of Professional Conduct, as promulgated by the AICPA, states, “A member in public practice shall not disclose any confidential client information without the specific consent of the client.”\textsuperscript{142} Infraction of any of the rules makes a member liable to disciplinary action. In addition, although an accountant-client privilege is not available under the Federal Rules of Evidence; many states, including Tennessee, provide for such a privilege by statute.\textsuperscript{143} Like the attorney-client privilege, however, the accountant-client privilege may be waived if the information is disclosed to third parties or to the public.\textsuperscript{144} In confirming client information via the response to the audit inquiry letter, the attorney must communicate with the auditor. The current privileges do not allow the attorney to disclose information to the accountants, even though the client could communicate separately with the attorney and the accountant and have the information remain privileged in some states. It seems illogical that, by attempting to confirm the client’s information with the client’s consent, either the accountant or the attorney can destroy the privilege.

In addition, courts are split on whether responding to the audit inquiry letter waives the work product privilege. Courts that denied the privilege primarily cited that the letter was prepared for a business reason and not for litigation purposes. While this argument certainly has merit, one of the main functions of the document is to learn about pending or anticipated litigation. The letter provides information from the client regarding claims and assessments and asks the attorney to assess the claims. The letter also asks the attorney to estimate an amount or range of loss on those claims for which he or she has predicted an unfavorable outcome.

To say that requesting this information from the attorney is strictly business ignores that the underlying purpose is to confirm litigation exposure. The response to the audit inquiry letter is intimately connected with litigation. “But for” the client having claims filed against it, for which the accountant needs an evaluation from a professional familiar with the contingent nature of the matter, the audit inquiry letter would not be necessary. If a client is not involved in any litigation and the attorney

\textsuperscript{142} AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS CODE OF PROFESSIONAL CONDUCT R. 301 (1988).


confirms this via a response letter, a subsequent request to discover the audit letter is a moot point since the response never really disclosed anything. The Tronitech court seemed to understand that the entire cycle of communications exists only because of litigation. To attempt to classify the document as a business or litigation document ignores the inherent dual role of the audit inquiry letter. While the letter’s overall purpose is to ensure adequate financial statements, if it did not fundamentally relate to litigation matters there would be no need to communicate with the attorney at all.

Although in Vanguard the defendant attempted to argue that the letter was not created in anticipation of litigation, the court clearly understood the bigger picture. An attorney’s response clearly involves the type of mental impressions, thoughts, and opinions that should, without question, receive work product protection because they are blatant evaluations of claims. One possible solution is for the attorney to specifically qualify and set off the work product portion of his or her response by stating, “The following information relates to mental impressions, thoughts, and opinions of the attorney, and in the event this document is subsequently sought via discovery measures, the following paragraphs should be redacted from the document before complying with all future discovery requests.”

B. Why the Attorney’s Response to the Audit Inquiry Letter May Be Inadequate

In Gulf Oil, the defendants resisted disclosing the audit inquiry letter on policy grounds, stating that without work product protection attorneys will not be candid in their responses. The court dismissed this argument by believing that attorneys will not violate “legal and ethical obligations to render candid and complete opinions.” An argument exists, however, that courts have forced attorneys to be less than forthcoming in their responses by denying them work product protection. The result is an attorney response that contains statements that are nothing more than disclaimers. An attorney can intentionally word a response to be so vague that it contains a lot of language that says very little.

145 See Tronitech, Inc., 108 F.R.D. at 656 (stating that an audit letter “arises only in the event of litigation” and is protected by the work product privilege).


147 Gulf Oil Corp., 760 F.2d at 297.

148 Id.
The ABA Policy Statement does not require the attorney to evaluate claims by classifying them as either “probable” or “remote.” \(^{149}\) In fact, even though these are the categories used by SFAS No. 5, an attorney is not restricted to these terms in communicating any evaluation to the auditor. \(^{150}\) The language attorneys were using caused such confusion that the AICPA eventually issued an interpretation guide to help “translate” an attorney’s response. \(^{151}\) The guide identified the following legal language as communicating a “remote” likelihood of an unfavorable outcome to the auditor: “the possible liability to the company in this proceeding is nominal;” “the company will be able to defend this action successfully;” and “plaintiff’s case against the company is without merit.” \(^{152}\) The interpretation also identifies language that is considered unacceptable and that requires the auditor to follow up with the attorney. \(^{153}\)

The need to translate the attorney’s language used in the response potentially identifies another area of concern. The possibility that an “expectation gap” exists between what the auditor requests and what the attorney provides is quite real. For example, the audit inquiry letter requests disclosure of material litigation. Over the years, however, accountants themselves have struggled with determining when an item is material. Materiality is a concept not easily defined. The SEC recently issued Staff Accounting Bulletin No. 99 – Materiality, which criticized the use of qualitative benchmarks in evaluating whether an item is considered material. \(^{154}\) However, materiality has both a qualitative and quantitative aspect. Although the audit inquiry letter specifies a materiality standard, questions still exist concerning whether the attorney’s view of materiality coincides with the auditor’s view. For example, an individual claim might be considered immaterial, but it could become material when viewed collectively with other potential claims.

Finally, the ABA Policy Statement and SFAS No. 5 use different definitions for the terms “probable” and “remote.” These different definitions may make it

\(^{149}\) AICPA PROFESSIONAL STANDARDS § 9337.19.

\(^{150}\) Id.

\(^{151}\) Id. at § 9337.20.

\(^{152}\) Id.

\(^{153}\) Id. at §9337.22.

easier for attorneys to classify claims in a grey area between the two extreme classifications and may make it harder for an auditor to satisfactorily comply with SFAS No. 5.

V. CONCLUSION

To really discover the adequacy or inadequacy of an attorney response to an audit inquiry letter, one would have to make an after-the-fact comparison by contrasting a material judgment to the attorney’s evaluation of the claim in his or her response. However, this type of hindsight would seldom be practical. In any event, the audit inquiry letter response can only disclose a limited amount of information. The attorney may be unaware of accident reports, EEOC complaints, or cases forwarded first to a company’s insurance carrier.

The time seems right for a “reeducation” of both attorneys and accountants. A change in the ABA Statement making it less hostile to the process would be productive. In light of recent corporate scandals, the audit inquiry letter arguably is not doing enough to disclose potential loss contingencies. For example, the audit inquiry letter could conceivably request information concerning other entities formed on behalf of the corporate client during the year or for a summary of transactions involving officers or directors. While the response to the audit inquiry letter may leave something to be desired, court decisions over the past twenty years have only hindered improvements to the process. In order to achieve meaningful change, reeducation may need to include the courts themselves in addition to attorneys and accountants.