Audit Letters, Disclosures and Reserves, Oh My:
How to Manage the Other ADR

WMACCA Litigation Forum

May 7, 2014
Andrew E. Shipley, Partner, Perkins Coie LLP

Andy has litigated matters pending before state and federal tribunals across the country and abroad, including Australia, Canada, France, Germany and Italy, and regularly counsels clients on contractual, regulatory and IP matters. Before returning to private practice, he managed an in-house litigation / bid protest group for a multinational defense contractor and led an interdisciplinary team that developed and implemented the company’s first preferred provider program. He serves on the ABA’s Federal Practice Task Force, working with judges and lawyers to improve the practice of law in federal courts. He also serves on the Federal Circuit Bar Association’s Subcommittee on Government Contracts. He was named one of DC’s Super Lawyers for Government Contracts and is a 2014 recipient of the Burton Award for Distinguished Legal Writing.
As PwC's Washington Metro Assurance Leader, Scott is responsible for all aspects of PwC’s Assurance practice in Maryland, Virginia, and DC. Scott is the global engagement partner for some of the Firm’s largest clients in the technology sector. He has assisted clients in the software and internet sectors with two successful IPOs. He also advises large global private equity firms and has led many engagement teams for NYSE and NASDAQ-listed companies. In addition, Scott serves or has served as quality review partner for some of our largest and most complex clients in the Technology and Entertainment & Media sectors. He’s been based in Boston, New York, Tampa and Milan, Italy during his 25+ year career with PwC.
Suzette W. Derrevere, Senior Counsel, The Boeing Company

Suzette serves as Senior Counsel in the Boeing Law Department, practicing in the areas of litigation and investigations and cost policy. She has more than fifteen years’ experience as a government contracts lawyer, with expertise in all aspects of federal procurement law, including bid protests, contract disputes and claims, contract administration, government investigations, mergers and acquisitions, and compliance.

Suzette joined Boeing from Honeywell International Inc., where she served most recently as General Counsel to Honeywell Technology Solutions Inc. and Assistant General Counsel to Honeywell Defense & Space. Before that, she was a partner in the DC office of Perkins Coie, where she represented a variety of clients on government contract issues.
Audit Letters
Auditor versus Lawyer: Differing Roles

- Auditor: Ensures for investor that company’s financial statements fairly and accurately present the company’s financial condition, including any potential impacts due to loss contingencies such as litigation and unasserted claims.
- Lawyer: Overarching duty to client, with corresponding need to preserve attorney-client privilege and work product.
- Auditors and lawyers are subject to different standards of care that pull in different directions.
- The Great Compromise of 1975 a/k/a “The ABA Treaty”
  - ABA Statement of Policy
  - AICPA’s Statement on Auditing Standards No. 12 (precursor to PCAOB AU Sections 337 and 9337 – Inquiry of a Client’s Lawyer)
The ABA Treaty

- Seeks to address tension between auditor’s need for information and counsel’s need to protect ACP and work product
- Provides guidance but “does not represent a prescription for lawyer conduct.” Second Report of the Committee on Audit Inquiry Responses
- Does not require lawyers to “make determinations of what should be included in financial statements or to undertake interpretations of FAS5 [precursor to ACS 450-20 – Loss Contingencies]...” Id.
- Permits counsel to provide auditor with information regarding:
  - pending or overtly threatened litigation on which counsel has devoted substantial attention, and
  - unasserted claims if identified by client; counsel to consult with client regarding possible disclosure for those not identified
Recurring Issues

Evaluation of Outcome and Estimate of Loss

PCAOB: Request lawyer’s evaluation of likelihood of unfavorable outcome and estimate, if one can be made, of the amount of range of potential loss.

ABA: Counsel should not opine on outcome unless unfavorable outcome probable or remote and should not estimate potential loss unless probability for error is “slight.”

Unasserted Claim

ABA: Counsel’s primary obligation is to bring existence of matter to attention of responsible officer or employee of client so that client may determine appropriate handling of matter.

Inquiry of In-House Counsel

PCAOB: Audit inquiry letters should be sent to inside counsel if he or she has primary responsibility for and knowledge about matter BUT if significant enough, auditor may seek outside counsel’s confirmation that “that they have not formulated a substantive conclusion that differs in any material respect from inside counsel’s evaluation…”

Perceived Inconsistencies

Advice to client is not the same as response to audit letter – one is designed to provide client with information necessary to implement appropriate litigation defense strategies while the other is intended to assist in the development of accurate financials.
The Audit Letter Minefield

- Auditors seeking more information than called for by the Treaty (e.g., opinion letters)
  - Dangerous to stray beyond the information called for by the Treaty
    - SOX Section 303(a) makes it unlawful for any officer or director, or any person acting under their direction, to mislead or improperly pressure an auditor
    - Puts counsel at risk for mistaken evaluations or estimates

- The Materiality Threshold
  - Client Request letter should identify the materiality threshold outside counsel is to use in developing list of responsive matters

- The Privilege Problem – Auditors use audit letters to create documents intended for use by the investing public
  - Courts divided as to whether ACP / work product have been waived and treat audit response letters as routine business communications, not prepared for “purpose of legal advice” or prepared “in anticipation of litigation”
  - Some courts find waiver of ACP but not of work product protections
Probing the Privilege Issue

- Some states recognize an accountant-client privilege; others do not.
- Generally, courts consider work papers and litigation reserves to be privileged or work product not subject to discovery; outcome may depend on which test particular state has adopted: “because of” or “primary motivating factor”:
  - *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009)
  - *United States v. Deloitte*, 610 F.3d 129 (D.C. Cir. 2010)
- Transmitting documents to auditors will waive ACP but may not waive attorney work product protection.
  - ACP and work product doctrine serve different purposes.
  - In *Deloitte*, government argued that the work product was waived. Court disagreed: “as an independent auditor, Deloitte cannot be Dow’s adversary...Further, Deloitte’s power to issue an adverse opinion, while significant, does not make it the sort of litigation adversary contemplated by the waiver standard.”
Does the Treaty Work?

- “Corporations send the letters because the auditors insist that the letters be sent. The corporations don’t much care what the law firm responses say...because the corporations don’t use the letters for anything. Remarkably, the auditors don’t really use these communications for anything, either... I’d be delighted to learn that we’re not all engaged in a heroic waste of time, and the audit letter kabuki dance should continue.”

  -- Mark Hermann, Aon’s Chief Counsel for Litigation, and Global Compliance Officer

- Corporations should not rely too heavily on the Treaty because it is “not part of the accounting codification” and is not a “defense” that justifies noncompliance with ASC 450.

  -- Wayne Carnall, then Chief Accountant of the SEC’s Division of Corporate Finance
Disclosures
Multiple Disclosure Regimes

- Regulation S-K, Item 103 sets forth disclosure requirements for material legal proceedings
- Regulation S-K, Item 303 sets forth requirements for Management’s discussion and analysis (MD&A)
- Tension between company obligation to comply with ASC-450 and Item 103 can lead to extended factual recitations that lose sight of risk exposure
- In response to flood of lengthy individuated matter disclosures, SEC decided it would accept disclosures that aggregate logically related claims
Framework for Disclosure

- Disclosure required if *material* loss is *reasonably possible*. Disclosure must include:
  - Nature of contingency
  - Estimate or range of reasonably possible loss or statement that estimate cannot be made along with reasons why it cannot be made.
  
  **Example from Merck Annual Report:**
  
  the Company is unable to reasonably estimate a possible loss or range of possible loss for such matters until the Company knows, among other factors, (i) what claims, if any, will survive dispositive motion practice, (ii) the extent of the claims, including the size of any potential class, particularly when damages are not specified or are indeterminate, (iii) how the discovery process will affect the litigation, (iv) the settlement posture of the other parties to the litigation and (v) any other factors that may have a material effect on the litigation...

- Generally no requirement to disclose fact or amount of accrual unless failure to do so would make financial statements misleading
  - Large accruals generally disclosed
Triggers for SEC Comments

- Inadequate explanation as to why reasonably possible loss cannot be estimated
- No information concerning expected legal costs
- Insufficient detail regarding a disclosed matter, e.g., failure to disclose name of tribunal, date proceeding initiated, identity of parties and requested relief
- Differences among statements found in footnotes, management discussion, press releases and analyst calls
- Failure to use precise terminology from ASC-450
- Unexplained new accrual or change in amount of previously disclosed accrual
- Insufficient detail as to new developments used to justify change in accrual
Evaluating the Contingency

- When a loss contingency exists, the likelihood that the future event will confirm the loss ranges from **probable** to **remote**.
  - **Probable**: The future event or events are likely to occur
  - **Reasonably Possible**: The chance of the future event or events occurring is more than remote but less than likely
  - **Remote**: The chance of the future event or events occurring is slight
  - **Don't use your own terminology**: SEC looks askance at variances from the above, e.g., reasonably likely.
What Difference Does it Make?

- If the loss is *probable*, it must be accrued if it is reasonably estimable.
- If a material loss is *reasonably possible*, it is not recognized as a loss in the company's financial statements but must be disclosed in the footnotes along with an estimate of possible loss.
- If *remote*, no disclosure is required.
Recognizing the Loss

- An estimated loss from a loss contingency shall be accrued by a charge to income (reserved) if both of the below conditions are met:
  - Information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
  - The amount of the loss can be reasonably estimated.
The Reason for the Rules

- Purpose of these conditions is to require accrual when losses are reasonably estimable and relate to the current or a prior period while preventing accrual of amounts so uncertain that they would impair the integrity of the financial statements.
  - Prevents artificial smoothing of financial statements over time
- General or unspecified business risks do not meet conditions for accrual
  - No cookie jar reserves
Estimating the Loss

- If some amount within a range of loss appears 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, the minimum amount in the range shall be accrued.

- The problem with 0: if the minimum number is $0 and it's just as likely as any other outcome, even a seven figure one, no amount can be reserved.
Setting the Reserve

Considerations:
- Prior experience with these types of cases
- History of others in similar situations
- Views of counsel
- Expert analyses
- Settlement posture
Reserves Offer No Financial Protection

- An accounting reserve does not involve the setting aside of specific assets to cover possible loss. It is an accounting method of allocating costs among accounting periods and does not impact cash flow. Accruals do not protect assets or satisfy claims not covered by insurance.
- ASC 450 does not affect the fundamental business economics of deciding whether to maintain sufficient liquid assets to pay claims or to purchase insurance.
- The use of accounting reserves is not an alternative to insurance in protecting against risk.