

# City Bar Maps Lawyers' Role In Dealing with Auditors - Part II

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In Part I of this article, published in January, we summarized some of the "Best Practices" recommended by the City Bar Task Force on the Lawyer's Role in Corporate Governance. Our summary was limited to four of the five areas covered by the Report issued by the Task Force: 1) the role of General Counsel in a public company; 2) the role of outside counsel; 3) the management of law firms retained to represent public companies; and 4) the role of lawyers engaged to conduct internal investigations of public companies. A public company was defined in the Report as a corporation with a class of stock held widely enough to require registration with the SEC and the filing of reports under Section 15(d) of the Securities Exchange Act of 1934.

In Part II, we discuss a fifth area reviewed by the Task Force- the relationship between lawyers and company auditors in dealing with financial disclosures by public companies. As a preamble to its discussion of Best Practices in this area, the Task Force recognized the obstacles facing the two professions in achieving a common objective, i.e., "accurate reporting and appropriate corporate conduct."

Ideally, auditors and lawyers would work together to achieve this common objective. The principal obstacle to a closer relationship between them is that lawyers and auditors have "differing" roles auditors are independent "outsiders" reporting directly to the public, while lawyers function essentially as confidential advisors to management. "Those contrasting roles, and the present climate surrounding the auditing of public companies, with litigation and regulatory risk ever present, make the realization of...idealized coordination unlikely." In the absence of any encouragement or direction by the SEC and the Public Company Accounting Board, "it will be difficult for lawyers and accountants to alter significantly their traditional arm's length relationship *sua sponte*."

Notwithstanding the obstacles to cooperation, the Task Force reminded lawyers that they have an important role to play "in connection with their clients' financial disclosures," and it proceeded to list its recommendations for Best Practices in fulfilling that role.

## Best Practices for Lawyers

**1. Understanding Accounting Concepts.** A lawyer who would advise a public company on issues of financial disclosure and financial structuring has a responsibility to acquire a basic familiarity with all the relevant accounting concepts. These concepts are "central to issues on which companies require legal advice." Law firms should provide training in these concepts for their attorneys. In-house lawyers with responsibilities in financial, transactional or public disclosure functions should also be trained. [Editor's note: The Task Force offers no specific recommendation on how this training should be accomplished, especially for in- house lawyers.]

**2. Lawyer consultation on financial disclosure.** Because many accounting issues facing public companies have taken on legal overtones, it is vital that lawyers be actively consulted on matters of financial disclosure. Lawyers should be involved in the process leading to preparation and issuance of the disclosures, even though they are not primarily responsible for them.

One means for involving "lawyers in mitigating the risk of accounting misdeeds" and improving controls over corporate governance is to require lawyer and management to focus on the internal control provisions of Section 404 of the Sarbanes Oxley Act ("SOX"). Under that Section, the SEC was directed to adopt rules requiring every reporting company (except registered investment companies) to include in its annual report "a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting," as well as an assessment of the effectiveness of these controls. Section 404 also requires each registered accounting firm that prepares or issues an audit report on a company's annual financial statement "to attest to and report on" management's assessment of internal control over financial reporting." The SEC has defined the term "internal control over financial reporting" as follows:

[a] process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles...." 17 C.F.R. § 240.13a-15(f).

After reviewing these directives, the City Bar Task Force concluded:

In our view, a system of internal controls that does not require the financial staff to consult with the in-house lawyers (and outside lawyers when there is no appropriate in-house counsel) most familiar with a particular subject or account is not a robust system of internal controls. ...an effective system of controls meeting the requirements of SOX 404 should involve active consultation with counsel.

## **Reporting a Lawyer's Knowledge**

The Task Force described several areas in which counsel's "knowledge and experience" would be essential to the accurate preparation of financial statements:

- Establishing litigation reserves. Only counsel can serve adequately as the source for information about existing and threatened litigation, and about "what is reasonably probable" as a charge to income on account of the litigation. Statement of Accounting Standards No.5, Financial Accounting Standards Board.
- Accounting for patents. An in-house lawyer may have knowledge about the status of a patent carried as an asset on the company's balance sheet - e.g., she may know when the patent will expire, or that it has been challenged, or that it has a defect which would require it to be written off or written down.
- Distribution and collection. A lawyer familiar with the company's distribution and collection procedures may know of a customer who is disputing a debt, or has stopped paying an invoice, or "of a defect in the company's ability to collect." The lawyer's knowledge should be made available to management and the auditors in the process of accounting for the company's receivables and reserves.

- Contracts and agreements. A lawyer who participates in the process of drafting, negotiating, or reviewing a distribution or other contract of the company will have unique and important knowledge that may determine when income can be recognized by the company.
- Other matters. The Task Force did not cite any other instances in which counsel would have special knowledge requiring disclosure either to management or the company's outside auditors, but it did remind lawyers to be wary of other similar instances.

The Task Force recognized that counsel is not charged with the responsibility to determine the proper accounting treatment of information in his possession, or even with understanding its significance. In the case of a company contract, for example, it's the auditor's job to determine whether and when income should be recognized, as well as the other accounting consequences of the contract to the operating statement and the balance sheet of the company. But to the extent the lawyer's knowledge is relevant to the financial reports, it should be made known to the people "responsible for proper accounting," who should be required to consult with the lawyer "when it is reasonably foreseeable that the lawyer is knowledgeable about ....facts regarding material transactions."

A requirement that financial and auditing personnel check with the lawyers would prevent them from shutting the lawyers out of the financial process. Instead, lawyers would become "an essential part of internal controls." And, if the lawyers were consulted, they could not disclaim responsibility for failing to reveal what they know:

"while the lawyer may not know all of the intricacies regarding public accounting, the lawyer would be held responsible for what he does know and for ensuring that the appropriate accounting personnel know the essential facts in his possession concerning each material transaction."

Regarding the form that consultation with counsel should take, the Task Force suggested written certification or confirmation by the lawyer to financial personnel of the facts within his personal knowledge relevant to "a proposed disclosure." Also, the process of certification by the lawyer might be an appropriate part of the company's machinery for supporting the certifications of financial statements by the CEO and the CFO required by SOX § 302, "another context in which consultation with the company's internal and external lawyers is essential." Regardless of the form of consultation, best practices would actively involve lawyers in the system of internal controls and in the process of complying with the certification requirements of SOX § 302.

**3. The 1975 ABA-AICPA "Treaty".** The Treaty between the two professional associations was intended to provide guidance to lawyers in their response to auditors' inquiries concerning asserted and unasserted claims against the company (i.e., loss contingencies). The Task Force concluded that the Treaty did not need to be modified "in light of such recent developments as adoption of the SEC's lawyer conduct rules and the 2003 amendments to the ABA Model Rules."

However, it reminded lawyers that the new rules can impact lawyer conduct by requiring a report-up if management resists "the lawyer's advice that a clearly material unasserted claim be disclosed to its auditors and in the financial statements." Also, if management resists the lawyer's advice, the lawyer might be "disabled" from responding to an auditor's inquiry letter if his response would omit his prior confidential advice to the client and, as a result, mislead the auditor and "hence violate SEC Rule 13b2

2(b)." If the lawyer withheld the response letter, it would be likely "to trigger a dialogue between the client and its auditor" that would cause the disclosure issue to surface.

**4. Reporting claims directly to the Audit Committee.** As recommended by the ABA-AICPA Treaty, external counsel to the company confirm in their responses to an auditor 's letter that their practice is to consult with the company whenever, in the course of performing legal services, they learn of an unasserted claim that may require disclosure on the company's financial statement. Because these consultations usually occur only with company management, they are subject to the attorney-client privilege. The result is that the decision whether to disclose a particular unasserted claim is left to management.

The Task Force recommended that this practice be modified in one respect. In the opinion of the Task Force, the modification would be consistent with the spirit if not the literal requirements of the SEC's lawyer conduct rules. The modification would consist of advising counsel to make the company's Audit Committee aware of possible unasserted claims, as well as of any advice, "if rendered to management," that the unasserted claims should be disclosed to the company's auditors or in the company's financial statements.

**5. & 6. Attorney-Auditor Privilege and Due Diligence.** The City Bar Task Force also discussed two other issues faced by lawyers and auditors in their relationship with each other. The first issue: Lawyers and auditors exchange many communications. Should these communications be covered by a new privilege, the attorney-auditor privilege? The second issue: Do the present procedures utilized by lawyers in conducting due diligence with respect to financial disclosures (including in public offerings) require change or modification? The discussion of these issues by the Task Force was too expensive to be covered in this space. We will cover the discussion in the March issue.