

HOW TO RESPOND TO AUDIT LETTERS

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HOW TO RESPOND TO AUDIT LETTERS

I. ESTABLISHING INTERNAL PROCEDURES FOR A LAW FIRM'S HANDLING OF AUDIT RESPONSE LETTERS.

A. Centralized Control of Audit Inquiry Responses by Law Firm.

For proper control of letters and their uniform treatment by the law firm, the primary responsibility and regulation of this activity should be centered in one attorney or a group of attorneys within the firm, depending on the size of the firm (the "Committee").

B. Primary Functions of Committee.

1. Establish firm procedures regarding audit inquiry letters ("Inquiry Letter") and the firm's response letter to the auditor ("Response Letter").
2. Establish policies that will be consistently applied in evaluating claims, disclosing of unasserted claims and handling other sensitive issues.
3. A junior associate or paralegal (a "designated person") may be assigned with the first review of Inquiry Letters, the preparation of the form of Response Letter (based on a Committee approved form) and the survey of all attorneys who have billed time to the client.
4. Observation: Committee also may be given primary responsibility of overseeing and approving all formal written legal opinions rendered by the law firm.

II. SUGGESTED INTERNAL PROCEDURES TO BE FOLLOWED BY A LAW FIRM IN RESPONDING TO AUDIT INQUIRY LETTERS.

A. FIRST STEP: Approval of Inquiry Letter.

Committee or a designated person should review and approve all Inquiry Letters received by the law firm. Any Inquiry Letters not in conformance with the ABA-AICPA Compromise should be brought to the attention of the Committee.

1. Check each Inquiry Letter to see if it is in acceptable form.
2. Accept only Inquiry Letters that conform (at least substantively) to the ABA suggested form (a copy of which is attached to the ABA Statement). Recently, auditors have been including inquiries that are beyond the scope of Treaty (see VII.A. below).
3. Do not accept an Inquiry Letter that:
 - (a) asks something to the effect "please advise auditors of all claims against client of which

you have knowledge" (see III.C.1.(a) below); or

- (b) follows suggested form letter by indicating that the client has represented to the auditor that the law firm has not advised the client of any unasserted claim which is probable of assertion and must be disclosed, but then states: "Please furnish to [Auditing Firm] an explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated;" or
- (c) makes reference in any manner, other than the exact words of the last paragraph of the suggested form of Inquiry Letter attached as an exhibit to the ABA Statement, to the client's representation to the auditor that there are no unasserted claims which the attorney has advised are probable of assertion; or
- (d) is not executed by a client representative with sufficient officer authority (see III.A. below); or
- (e) indicates client has been required to specify unasserted claims without regard to FAS 5 standards (see paragraph (5) of ABA Statement); or
- (f) indicates that the client has been required to specify all unasserted claims as to which legal advice may have been obtained (see paragraph (5) of ABA Statement).

4. Without prior discussion with, and informed consent of, the client, do not prepare Response Letters which would:

- (a) encompass matters intended to be covered by an attorney-client privilege (see III.A.3. below); or
- (b) involve disclosure of unasserted claims (see IV. below).

B. SECOND STEP: Assignment of Drafting Responsibility for Response Letter.

With respect to each approved Inquiry Letter, the Committee should assign the responsibility of preparing the contingency responses and approving the Response Letter to an attorney ("attorney-in-charge") in the firm who either (i) is the primary client contact for the firm, or (ii) primarily handles litigation filed against the client. The firm may wish to assign the initial drafting responsibilities of the form of Response Letter to the designated person who will supplement the Response Letter with information from the attorney-in-charge.

C. THIRD STEP: Internal Retrieval of Facts Needed for Response Letter.

The designated person initially circulates the Inquiry Letter to each attorney in the firm who has had responsibility for any client matter since the prior year's Response Letter was prepared or who supplied information utilized in the prior year's Response Letter (the "surveyed attorneys") (see discussion under caption "Lawyer's Procedures" and "Retrieval" of First Report).

1. Point to Remember: Determination of attorneys who performed services for the client can perhaps be done best by examining time records.
2. Active files pertaining to "asserted claims" (see definition in III.B. below) against client should be reviewed by attorney-in-charge as well as any litigation docket procedures maintained by firm.
3. Designated person should review prior year's Response Letter, check status of information contained therein with attorney-in-charge and coordinate all responses supplied by the surveyed attorneys.
4. Point to Remember: Law firm is not expected to make investigation to determine existence of unasserted claims (see discussion under caption "Retrieval" of First Report). However, if law firm has documented discussions with the client about disclosure of an unasserted claim, review perhaps should be given to that information (see V.C.4. below).
5. Point to Remember: With respect to asserted claims, SAS No. 12 contemplates that the client may list and describe facts concerning asserted claims in the Inquiry Letter and ask the attorney to comment thereon. This is not preferable (see III.C.3.(b) below).

D. FOURTH STEP: Preparing Draft of Response Letter.

1. Follow carefully the ABA Statement in preparing Response Letter (see guidelines under III below) and, in particular, the ABA's suggested form of Response Letter (copy attached to ABA Statement).
2. Attorney-in-charge oversees other attorneys involved in preparing Response Letter. Questions of interpretation of ABA Statement are directed to the Committee.
3. The primary attorney for a matter falling within the scope of a firm's response under the ABA Statement (see III.C. below) should probably be the one to prepare an appropriate description of such matter.
4. Final draft of Response Letter should be circulated for approval by the attorney-in-charge.

E. FIFTH STEP: Committee's Review and Approval of Final Draft of Response Letter.

1. Committee review and approval should be required where a Response Letter either:
 - (a) Does not conform strictly to ABA recommended form or the guidelines of the ABA Statement; or
 - (b) Includes an evaluation of pending litigation or some other asserted claim; or
 - (c) Includes any disclosure or other treatment of an unasserted claim; or
 - (d) Involves response to approved Inquiry Letter that does not satisfactorily conform to ABA Recommended form of Inquiry Letter.
2. Any Response Letter falling within one of the categories of subparagraph 1 above should be presented to and discussed with the client before it is sent to the auditor (see III.A. below).

F. SIXTH STEP: Execution of Response Letter.

1. Committee should execute Response Letters and attorney-in-charge should initial a copy of the final form (or send a confirmatory email) to evidence their respective review and approval.
2. Copy of Response Letter (with the corresponding Inquiry Letter attached thereto) should be kept in single client file.
3. Observation: Often auditors will phone or otherwise orally confer with attorneys for the purpose of obtaining information that they might otherwise not obtain via the Response Letter, *e.g.* off-the-cuff evaluation of claims. Auditor will then prepare a memo to his file of such conversation with the attorney. SAS No. 12 recommends that the auditor sometimes confer orally with the attorney (see paragraph 10 of SAS No. 12). However, with very limited exceptions, communications with auditors should be limited to Response Letter.
 - (a) Point to Remember: Consideration should be given by the law firm to adding a sentence to the ABA recommended form of Response Letter to the effect that "This letter represents the only authorized communication from this firm, and is the only communication from this firm upon which you may rely, regarding "loss contingencies" of XYZ Corporation and the other matters discussed herein" unless the law firm intends otherwise.
 - (b) Point to Remember: Standard form of Response Letter might also request that

auditor provide the law firm with copies of any memos that they may have prepared concerning oral conversations with the attorney or confirm that no such memo exists.

4. Any special oral discussions with auditors concerning matters covered by or relating to the Response Letter should be documented by the attorney for later reference if matter is sensitive in nature.
5. Response Letters involving evaluations, special legal considerations, treatment of an unasserted claim or some other special matter should be kept in a master file for later reference by the Committee.
6. The ABA recommended form of Response Letter might also be expanded to indicate the attorney's reliance upon the First Report and the Second Report. This would be helpful in making sure the auditor understands the law firm's view of its professional responsibility covered by paragraph 6 of the ABA Statement (see V. below).

G. SEVENTH STEP: Update of Prior Response Letter.

In connection with an update of a prior Response Letter, firms should follow the same internal procedures as for an initial request.

III. ABA GUIDELINES IN PREPARING RESPONSE LETTERS.A. Obtain Client Consent to Issuance of Response Letter.

Client's Consent to Attorney's Response to Auditor (Paragraph 1 of ABA Statement).

1. Reason for consent — CPR-4 requires that an attorney preserve the "confidences" and "secrets" of his client unless the client gives an informed consent to their disclosure.
 - (a) "Confidence" defined as information protected by attorney-client privilege under applicable law.
 - (b) "Secret" defined as other information gained through professional relationship that the client has requested to be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.
2. Point to Remember: Consent should be in writing:
 - (a) Inquiry Letter in form suggested by ABA constitutes a satisfactory consent.

- (b) Inquiry Letter should be signed by an officer with sufficient authority to grant consent.
- (c) Inquiry made directly by auditor (oral or written) must be ignored until consent obtained.

3. Point to Remember: Consent contained in standard form of Inquiry Letter probably will not be sufficient to permit attorney to disclose a confidence or secret or to evaluate a claim.

- (a) Before any such disclosure is made the client must be fully informed of the legal consequences — *e.g.* waiver of attorney-client privilege by disclosure to auditor.
- (b) If preserving attorney-client privilege with respect to any matter is considered appropriate, the attorney probably should not respond to the Inquiry Letter with respect to such matter.

B. Recognition of Three Categories of Loss Contingencies in Preparing Response Letter.

Based on FAS 5, the ABA Statement recognizes, for the purposes of preparing a Response Letter, that "loss contingencies" are divided into three categories: (1) overtly threatened or pending litigation; (2) contractually assumed obligations; and (3) unasserted claims (see paragraph 5 of ABA Statement).

1. Overtly threatened or pending litigation against the client ("asserted claims"): potential claimant has manifested to the client an awareness and present intention to assert a possible claim or assessment, unless the likelihood of litigation is "remote" (*i.e.* idle threats).
2. Contractually assumed obligation of client: include guarantees, warranties, etc.
3. Unasserted possible claim or assessment against the client ("unasserted claim"): where there has been no manifestation by a potential claimant of an awareness of and present intention to assert a possible claim or assessment.

C. Specific Requirements for Determining Whether a Particular Loss Contingency is to be Included in the Response Letter.

Attorney is only to discuss in his Response Letter loss contingencies satisfying specified requirements (see Paragraph 2 and 3 of ABA Statement and Paragraph 12 of SAS No. 12). The ABA-AICPA Compromise recognizes that an attorney is not expected to respond on all legal matters concerning a client with respect to which he or she has come in contact. Response Letter is to be limited in scope. A loss contingency must satisfy the following tests before

the attorney is expected to (or should) comment on such matter in the Response Letter:

1. Substantive Attention Requirement: Attorney is to comment only on loss contingencies to which he has given substantive attention and has been retained professionally by client.

(a) Point to Remember: Mere knowledge of a lawsuit or other loss contingency does not create any disclosure duty on part of the attorney to the auditor.

(b) Observation: In some cases, Response Letters might make reference to names of other law firms that are retained by the client and suggest auditors make an appropriate inquiry of them.

2. Materiality Requirement: The attorney is to include in the Response Letter only matters that he considers to be individually or collectively material to the presentation of the client's financial statements (see paragraph 3 of the ABA Statement).

(a) If the attorney undertakes to set definition of materiality for the purpose of his Response Letter, he should make it clear that his Response Letter is so limited. For example, the Response Letter might include the sentence: "For the purposes of this letter, we have disregarded and do not make mention of certain claims, no one of which amounts to \$100,000 and all of which aggregate less than \$200,000. Of course, the claimant in any of these matters could amend his pleadings and seek damages in an amount greater than that presently sought."

(b) Point to Remember: To avoid having to deal with insignificant matters, attorney, client and auditor probably should mutually agree to some reasonable standard of materiality with respect to the client's financial statements and set forth such standard in the Inquiry Letter and Response Letter (see discussion under caption "Pending or Threatened Litigation Matters" of First Report).

3. Special Requirement for Unasserted Claims and Contractually Assumed Obligations: Unasserted claims and contractually assumed obligations of the client are never disclosed or otherwise discussed in the Response Letter in the absence of a specific request (*i.e.* specifically identifying the claim or obligation requested to be commented on) to do so in the Inquiry Letter by the client.

(a) See discussion of treatment of unasserted claims by the ABA-AICPA Compromise under IV below.

(b) An asserted claim must be included in Response Letter if it meets the materiality and substantive attention requirements stated above, regardless of whether the client makes any specific mention or request to do so in the Inquiry Letter.

(1) Under SAS No. 12, the client has the choice in Inquiry Letter of either (i) listing asserted claims and describing such matters and asking the attorney to comment as to accuracy of such information or (ii) requesting that the attorney provide his own list and description of such matters.

(2) Point to Remember: It is preferable that the attorney prepare a list and description of the asserted claims rather than comment on the client's description of such matters (see discussion under caption "Pending or Threatened Litigation Matters" under First Report). Thus, encourage the client to request by Inquiry Letter that the attorney prepare the list and description. The client should be so notified before preparation of Inquiry Letter to keep from having the client revise the letter to preferable form.

D. Information to be Set Forth in the Response Letter About Loss Contingency That Falls Within Scope of Attorney's Response.

1. Information to be supplied (or commented on) to the auditor by the attorney on each matter falling within the scope of his Response Letter (see paragraph III.C.3.(b) above for discussion of alternative procedures for communication attorney's information about loss contingencies.): identify (a) proceeding or matter; (b) stage of proceeding; (c) claims asserted; and (d) position taken by client.

2. Information not likely to be supplied to auditor by attorney (see paragraph 5 of ABA Statement).

(a) Evaluation of Outcome — Attorney will not advise the auditor as to whether outcome of an asserted claim will be favorable or unfavorable to client, except:

(1) in relatively few cases where unfavorable outcome is either "probable" or "remote".

- (i) “Probable” means that the prospects of claimant losing are extremely doubtful and prospects of client winning are slight.
- (ii) “Remote” means that the prospects of client not prevailing are extremely doubtful and prospects of claimant winning are slight.
- (iii) “Reasonably Possible” means that the prospects (of client winning) are neither “probable” nor “remote”.

Note: ABA Statement amplifies the meaning of the above definitional terms of FAS 5.

- (2) ABA View — The ABA Statement cautions that “... in most situations, an unfavorable outcome will be neither ‘probable’ or ‘remote.’”
 - (3) Effect of law firm inability to conclude that prospects of unfavorable outcome to client are either “probable” or “remote.”
 - (i) Inference to be drawn by auditor. Under FAS 5, in the absence of such judgment by the attorney, no inference is to be drawn by the auditor that the client will not prevail.
 - (ii) Qualification of audit opinion. If the attorney is unable to give an opinion on outcome, the auditor may well deem it necessary to qualify the audit opinion as to the uncertainty of the outcome of the matter in question.
- (b) Evaluation of Potential Amount of Loss — Estimate of potential amount or range of loss is not likely to be supplied by the attorney.
- (1) Attorney will not advise the auditor of the client’s loss exposure unless he believes that the probability of inaccuracy of estimate of amount or range of potential loss is slight. Exposure is inherently difficult to predict.
 - (2) ABA View — ABA Statement cautions that, in most cases, the attorney will not be able to estimate the potential amount of loss.

(c) Points to Remember:

- (1) If the attorney evaluates the outcome or predicts the range of loss, he may in hindsight be judged by standards set forth in ABA Statement. Thus, attorneys should avoid evaluating claims, except in the most certain of cases (if there are any).
- (2) Opinion in those in-between cases should be something like “... and relying on the terms defined in the ABA Statement of Policy, we are unable to form a judgment that it is ‘probable’ or ‘remote’ that the outcome of the lawsuit will be unfavorable to the Company.”
- (3) Do not say “... an unfavorable outcome to the Company is ‘reasonably possible’” — may be an admission prejudicial to the client (see discussion under caption “Evaluation of Outcome” of First Report).
- (4) Observation: In order to avoid possible waiver of attorney-client privilege and the risks inherent in evaluating claims, some law firms may decide as a general policy not to evaluate any claims. Of course, this may lead an auditor to qualify its audit opinion.

IV. UNASSERTED CLAIMS — TREATMENT BY ABA STATEMENT.

A. The Attorney Does Not Communicate With the Auditor About an Unasserted Claim Unless Requested to do so by the Client:

- 1. As noted in III.C.3. above, Response Letters never include comments on unasserted claims unless client properly requests such comment in the Inquiry Letter.
- 2. SAS No. 12 (paragraph 9.C.) provides that the Inquiry Letter include a list prepared by management that describes and evaluates unasserted claims and assessments that management considers to meet the tests set forth in paragraph B below.

B. Client Determination of Unasserted Claims to be Specified in Inquiry Letter for the Attorney’s Comments:

Under the ABA Statement (paragraph (5)), the client specifies and requests in the Inquiry Letter the attorney’s comments on an unasserted claim only if, in the opinion of the client, the unasserted claim satisfies the following four tests:

1. **FIRST TEST: Assertion of the Claim is “Probable”** — the client concludes that the prospects of the claim being asserted seem reasonably certain and the prospects of non-assertion seem slight.
 - (a) A conclusion that the assertion is probable must be supported by extrinsic evidence strong enough to establish a presumption that the claim will happen.
Note ABA and FAS 5 view: It is unlikely, absent relevant extrinsic evidence, that the client or anyone else will be able to conclude that the assertion of a probable claim will be made.
 - (b) Point to Remember: ABA Statement contemplates that most unasserted claims will not satisfy the “probable” of assertion test. A decision to treat an unasserted claim as “probable” of assertion should be based only upon compelling judgment.
 - (c) Point to Remember: The client makes the determination, not the attorney, as to what unasserted claim is “probable” of assertion and thus identified in the Inquiry Letter.
2. **SECOND TEST: There is a Reasonable Possibility of Unfavorable Outcome if Claim Asserted** — the client concludes that there is a reasonable possibility that the outcome (assuming assertion) will be unfavorable to the client.
3. **THIRD TEST: Unasserted Claim is Material** — the client concludes that the resulting liability (assuming unfavorable outcome) would be material to its financial condition.
4. **FOURTH TEST: Attorney’s Consultation** — The client may request comment from the law firm on an unasserted claim only if the client has engaged the law firm to consider such matter and such law firm has devoted substantial attention to the matter.

NOTE: In applying the first three tests, the client is to utilize the concepts of “probable,” “remote” and “reasonably possible,” as described in the ABA Statement and FAS 5 (see III.D.2. above).

Point to Remember: The law firm should attempt to advise its clients, in advance of the preparation of their Inquiry Letters, of the ABA Statement method of requesting attorneys to comment on unasserted claims so that the client will not specify an unasserted claim in the Inquiry Letter without having first applied the above tests.

C. **Client Representation to the Auditor as to Complete Disclosure of all Unasserted Claims That the Attorney Has Advised the Client Require Disclosure.**

1. **Attorney Placed on Notice About Client Representation.** Under the ABA-AICPA Compromise, the auditor is to communicate to the attorney, or the client will communicate to the same effect in the Inquiry Letter, as follows:

“We are [writing to inform you that (name of company) has represented to us] [representing to our auditors] that (except as set forth below, and excluding any matters listed in the letter of audit inquiry) there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in its financial statements at [balance sheet date] and for the [period] then ended.”

2. **Point to Remember:** If the attorney receives communication from the auditor indicating that the assurances of management are broader or otherwise differ from the above quoted language, the attorney should reject the communication as not being in accordance with the ABA-AICPA agreed procedures (see discussion under caption “Unasserted Claims or Assessments” of First Report).
3. **Point to Remember:** In accord with the ABA Statement, the attorney should not confirm to the auditor the completeness of management’s list of any unasserted claims set forth in the Inquiry Letter or the accuracy of management’s advice to the auditor concerning its disclosure of all unasserted possible claims advised as necessary by the attorney (see discussion under caption “Unasserted Claims or Assessments” of First Report) (see II.A.3.(b) above).
4. **Potential Gap in Disclosure Between Auditor and Attorney:** Since the ABA Statement does not permit the attorney to comment on unasserted claims in the absence of a specific request by the client, the attorney can have knowledge of unasserted claims (which he considers “probable” of assertion and, if asserted, reasonably possible to result in an unfavorable outcome to the client), yet be unable to communicate that fact to the auditor. Auditor has no complete assurance that the client has revealed all unasserted claims with respect to which the attorney has given the client legal advice.

5. Solution to Problem? See V. below.

V. ATTORNEY'S RESPONSIBILITY TO CONSULT WITH CLIENT ABOUT DISCLOSURE OF UNASSERTED CLAIMS — THE TOUCHSTONE OF THE ABA-AICPA COMPROMISE.

A. Auditor's Reliance on Attorney's Professional Responsibility to Consult With Client About Unasserted Claims and Required Disclosure.

1. ABA Statement Recognizes General Professional Obligations of the Attorney to His Client With Respect to Disclosure Matters:

- (a) Obligation of attorney in representing client is to advise him concerning the need for or advisability of public disclosure of a wide range of events and circumstances.
- (b) Attorney cannot knowingly participate in any violation by the client of the disclosure requirements of the securities laws.
- (c) In proper circumstances, attorney is required under the CPR to resign his engagement if his advice concerning disclosure is disregarded by the client.

2. ABA Statement Permits Auditor to Place Reliance on Attorney's Professional Responsibility to Client With Respect to Disclosure of Unasserted Claims — According to paragraph (6) of the ABA Statement, "The auditor may properly assume that, if during the attorney's course of performing legal services for the client, with respect to a matter recognized to involve an unasserted claim ... which may call for financial disclosure, the attorney has formed a professional conclusion that the client must disclose or consider disclosure concerning such claim ... [he], as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and applicable standards of FAS 5."

- (a) The Inquiry Letter to the attorney will recite the client's understanding that the attorney has the above-described professional responsibility, and will request that the attorney confirm in his Response Letter the client's understanding as being correct.
- (b) In the Response Letter, the attorney will confirm to the auditor as correct the client's understanding of his professional responsibility recited above.

B. Scope of Attorney's Duty to Consult With Client About Unasserted Claims and the Application of FAS 5.

1. Conditions Requiring Consultation With Client: The following four tests must be satisfied before an attorney is obligated to consult with the client about the disclosure of an unasserted claim in the context of FAS 5:

(a) FIRST TEST: The unasserted claim must come to the lawyer's attention "in the course of performing legal services for the client."

(1) Point to Remember: The attorney is not expected to go out of his way to search out or develop facts with regard to an unasserted claim. The ABA Statement speaks in terms of unasserted claims recognized by the attorney in connection with the legal work performed by him for the client (see discussion under caption "Unasserted Claims or Assessments" of First Report).

(b) SECOND TEST: The unasserted claim must be "recognized [by the attorney] to involve an unasserted possible claim or assessment".

(1) Point to Remember: The recognition of an unasserted claim falling within the ambit of the attorney's professional responsibility to consult with the client is subjective in nature. The attorney does not commit to recognize unasserted claims but only that "he will not dismiss without consideration an unasserted claim if, in fact, [i] he realizes one is present [ii] in connection with the matter or matters with respect to which he is providing legal services and [iii] recognizes that it may call for financial statement disclosure." (See Second Report.)

(c) THIRD TEST: The unasserted claim must also be recognized by the attorney to be one that "may call for financial statement disclosure".

(1) Point to Remember: Subjectively, the attorney must believe that the unasserted claim is of sufficient substance and merit to deserve attention by the client.

(2) The attorney has no duty to bring to the attention of his client matters that the attorney believes to be frivolous or

otherwise lacking in meaningful substance.

(d) **FOURTH TEST:** The lawyer must have “formed a professional conclusion that the client should disclose or consider disclosure.”

(1) To be obliged to consult with the client about a recognized unasserted claim, the attorney must form the professional conclusion that there is a substantial likelihood that: (i) the unasserted claim is probable of assertion; (ii) if asserted, there is a reasonable possibility that the outcome will be unfavorable; and (iii) the unasserted possible claim is material to the client.

(2) These tests are the same ones that the client must utilize in deciding whether he should request in the Inquiry Letter for the attorney to comment on a particular unasserted claim. Thus, the attorney may rely on same guidance given by the ABA Statement (see IV.B. above).

2. **Point to Remember:** The satisfaction of the above four tests is to be based solely on the facts and information at hand. The attorney has no duty to search out or develop facts.

C. Manner of Advising and Consulting With Client About an Unasserted Claim.

1. Primary obligation of the attorney is to make the client aware of the existence of the unasserted claim so that the client may appropriately consider the need for disclosure. According to the Second Report, once the attorney has informed the client of the unasserted claim, his responsibilities under paragraph (6) of the ABA Statement are fulfilled.

2. The attorney should consult with a representative of the client who has sufficient authority and who is fully aware of the disclosure requirements of FAS 5.

3. With respect to the client’s consideration of the disclosure of the unasserted claim, the attorney should offer his assistance subject to the limitation of his professional knowledge and expertise.

4. **Point to Remember:** The law firm should probably document for later reference (i) any consultations with the client about an unasserted claim, (ii) the resulting conclusions of the client about disclosure, and (iii) in the absence of disclosure by the client, the law firm’s decision

regarding the duty to withdraw from representation.

D. Impact of This Professional Responsibility on Attorneys:

1. Every attorney, not just the securities lawyer, must be conversant with FAS 5 and recognize his or her responsibility under the ABA Statement with respect to unasserted claims if he or she is executing a Response Letter containing the paragraph regarding his or her professional responsibility of advising the client about disclosure of unasserted claims.

2. Each member of a law firm must be alert to the need for consultation with his or her client about FAS 5 once he or she recognizes that an unasserted possible claim exists.

3. **Point to Remember:** Even though the attorney may counsel with the client about FAS 5, it is the client who applies the standards to determine whether an unasserted claim is “probable” of assertion.

4. **Point to Remember:** If the law firm does not represent a client on a regular and continuing basis, it may not be appropriate for an attorney to agree that he or she has a professional responsibility to counsel with the client about unasserted claims (see Second Report).

VI. ATTORNEY’S RESPONSIBILITY WHERE CLIENT REFUSES TO DISCLOSE TO AUDITOR AN UNASSERTED CLAIM THAT THE ATTORNEY BELIEVES MUST BE DISCLOSED.

A. The Great Dilemma:

What happens when the attorney believes that an unasserted claim is probable of assertion and must be disclosed to the auditor, but the client disagrees and refuses to specify such item in the Inquiry Letter?

Observation: It is unlikely that the attorney will face this problem in connection with the preparation of Response Letters because his duty to resolve this issue would be when he recognizes the existence of an unasserted claim, which could be at any point in time.

B. Attorney’s Duty to Withdraw from Representation.

1. The ABA Statement provides that where, in the lawyer’s view it is clear that:

(a) the client has no reasonable basis to conclude that the assertion of a claim is not probable; and

(b) given the probability of assertion, disclosure of the loss contingency in the client's financial statement is, beyond reasonable dispute, required; the lawyer should withdraw from the engagement.

2. The ABA Statement says withdrawal is very undesirable and, thus, the attorney should do so only where there can be no reasonable doubt that non-disclosure would be a violation of the law.

C. The Auditor's Salvation?

The attorney's withdrawal if the client has no reasonable basis for concluding that assertion of a claim is not "probable" (see discussion under caption "Unasserted Claims or Assessments" of First Report).

1. If the attorney has not withdrawn, apparently the auditor can assume that the attorney has not formed a professional judgment that it is clear the client must make some kind of disclosure relating to the financial statements, which the client has refused to do.
2. Point to Remember: Just because an attorney's judgment about the likelihood of a claim is contra to that of the client does not mean that he or she must automatically withdraw from representation.

VII. CURRENT DEVELOPMENTS

A. Increase in Number of Non-Standard Inquiry Letters.

There appears to be a recent increase in the number of Inquiry Letters that do not conform to the ABA-AICPA Compromise.

1. Some recent examples of non-conforming requests include:
 - (a) Request for information regarding financing statements filed under the Uniform Commercial Code;
 - (b) Request for information regarding assignments of the client's assets;
 - (c) Requests for examinations of income tax returns; and
 - (d) Request for information regarding compliance with fiduciary duties.
2. Firms should resist responding to inquiries that are outside of the ABA-AICPA Compromise (see II.A. above).
3. Firms could consider a specific reference to the non-conforming inquiry in the Response Letter with the statement that the firm is not responding to such inquiry in accordance with the terms of the ABA-AICPA Compromise.

B. Communications With Auditors After the Sarbanes-Oxley Act.

Rule 13b2-2(b) of the Securities Exchange Act of 1934, as amended (implementing §303(a) of the Sarbanes-Oxley Act of 2002), has heightened the risk of potential firm exposure in connection with responding to Inquiry Letters.

1. Rule 13b2-2(b) prohibits officers and directors, and persons acting under their direction, from coercing, manipulating, misleading or fraudulently influencing the auditor of the issuer's financial statements when the officer, director or other person knew or should have know that the action, if successful, could result in rendering the issuer's financial statements materially misleading.
2. Under Rule 13b2-2(b), attorneys are covered as "persons acting under the direction" and could be subject to liability if their actions are deemed, under a negligence theory, to "result in rendering financial statement materially misleading."
3. Firms should follow the ABA-AICPA Compromise in responding to Inquiry Letters. Improper disclosure in a Response Letter could expose a firm to liability under Rule 13b2-2(b).

C. Inquiry Letters Requesting Compliance with Part 205 of the Sarbanes-Oxley Act.

Part 205 to Title 17, Chapter II of the Code of Federal Regulations (implementing §307 of the Sarbanes-Oxley Act of 2002) prescribes standards of professional conduct for attorneys appearing and practicing before the Securities and Exchange Commission (the "SEC").

1. Some Inquiry Letters request confirmation that the auditor has been informed of all illegal activities and that any evidence of material violations of securities laws or similar violations have been "reported up."
2. Differing opinions exist as to whether a response to an Inquiry Letter constitutes "appearing and practicing" before the SEC.
3. Regardless, 205 is separate from the ABA-AICPA Compromise and should not affect the response to the Inquiry Letter.

VIII. RESOURCE MATERIALS.

A. Official Pronouncements by ABA and AICPA (referred to collectively herein as the "ABA-AICPA Compromise" or the "Treaty").

1. "ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" ("ABA Statement").

2. Statement on Auditing Standards No. 12 (“SAS No. 12”) entitled “Inquiry of a Client’s Lawyer Concerning Litigation, Claims and Assessments”.
- B. Statement of Financial Accounting Standard No. 5 (“FAS 5”) — “Accounting for Contingencies”.**
- C. Supplemental Reports on ABA Statement by Committee on Audit Inquiry Responses of Section of Corporation, Banking and Business Law of ABA.**
1. First Report (herein so called) — “Introductory Analysis and guide” — published in the April, 1976, issues of Business Lawyer.
 2. Second Report (herein so called) — “Regarding Initial Implementation” of ABA Statement — published in the November, 1976, issue of Business Lawyer.
- D. Secondary Information Helpful in Preparing Response Letters.**
1. Canon 4 of Code of Professional Responsibility (herein called “CPR”) which deals with an attorney’s ethical obligations not to disclose confidences and secrets.
 2. Attorney-client privilege and how it may be waived.