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Lawyers' Letters

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

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American Institute of Certified Public Accountants. Auditing Standards Executive Committee, "Lawyers' Letters" (1974). *Guides, Handbooks and Manuals*. 1244.

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American Institute of Certified Public Accountants

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January 25, 1974

To the Members of the American Institute
of Certified Public Accountants

Occasionally, a condition arises in practice which indicates a need for timely communication of information on a profession-wide basis. The attached commentary entitled, "Lawyers' Letters," deals with such a matter. It is not a statement on auditing standards or an interpretation of a statement on auditing standards. Its purpose is to make practitioners aware of a problem currently being encountered in practice and to assist them in meeting the problem.

Auditing Standards Executive Committee



LAWYERS' LETTERS

(A commentary of the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants.)

At its meeting in January 1974 the Auditing Standards Executive Committee took note of questions that have been raised by auditors with increasing frequency as a consequence of reluctance on the part of some lawyers, in some instances, to respond fully to letters of inquiry addressed to them by clients on behalf of auditors. The Committee understands that efforts have been made to reach an accommodation but that the open issues are not expected to be resolved soon. The Committee concluded that it should issue this commentary for the information of members of the Institute, to make practitioners aware of a problem currently being encountered in practice and to assist them in meeting the problem.

The Committee believes that it is in the interests of clients and of users of financial statements for auditors to continue to receive from lawyers adequate responses to reasonable inquiries. If auditors do not receive such responses, a client may receive an auditor's report containing a qualification of opinion that might have been avoided.

In many cases, the assistance of lawyers as to legal matters is essential to the processes of preparing and auditing financial statements. Management looks to lawyers for advice as to legal matters whose effects or potential effects need to be considered for recording or disclosure. In particular, management looks to lawyers for professional judgments as to the likely outcome of such matters; these judgments are useful in determining what effect, if any, is to be given to the matters in preparing financial statements.¹ For example, management needs advice to help it distinguish between a nuisance suit and a legal action constituting a significant threat to a company's financial position or results of operations. Auditors turn to a client's lawyers (with the client's approval) for audit evidence relating to legal matters that may affect financial statements. This procedure has long been a customary

¹

See Committee on Accounting Procedure, American Institute of Certified Public Accountants, Accounting Research Bulletin No. 50, paragraph 5 (1958); Securities and Exchange Commission, Regulation S-X, Rule 3-16(i) (3) (1973).

element of an audit conducted in accordance with generally accepted auditing standards.² It ordinarily is initiated by means of a letter of audit inquiry signed by the client.³

In some instances, lawyers have been reluctant to respond fully to letters of audit inquiry. Lawyers' principal concerns⁴ relate to: (1) uncertainty as to the meanings of terms used in the inquiries (e.g. "material," "contingent liability"); (2) unduly sweeping inquiries (questions as to whether the client has had "any transactions not in the normal course of its business" and, at least by inference, questions as to matters concerning which the lawyer's knowledge may have been merely casual); (3) possible adverse effects for the client (impairment of the attorney-client privilege, "discoverability" of information given to auditors, the possibility that continued acceptance by lawyers of a broad disclosure obligation will make clients reluctant to confide in them and thus impair clients' access to adequate legal counsel, the possibility that disclosure of a potential claim will stimulate a claimant to assert it); (4) the risk that lawyers themselves may incur liability in responding, either because of an omission or because of an incorrect evaluation.

The nature of the lawyer's response, or his failure to respond, may affect the auditor's opinion on the client's financial statements. If the auditor is unable to obtain adequate audit evidence regarding the possible effects or implications of legal matters, he may need to qualify his opinion or to disclaim an opinion.

- If the lawyer's response indicates that it does not deal with a category of information contemplated by the letter of audit inquiry, the auditor will consider whether he has been able to obtain audit evidence sufficient to justify expressing an unqualified opinion. If the response excludes some or all types of contingent liability, the auditor will ordinarily conclude that he cannot express an

²

This procedure is discussed in Statement on Auditing Standards No. 1 as follows: "Obtain from legal counsel a description and evaluation of any litigation, impending litigation, claims and contingent liabilities of which he has knowledge that existed at the date of the balance sheet reported on, together with a description and evaluation of any additional matters of such nature coming to his attention up to the date the information is furnished." Committee on Auditing Procedure, American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, Section 560.12 (1972).

³

Exhibit A, attached, is an example of a letter of audit inquiry.

⁴

Lawyers' concerns have been discussed, among other places, in an article by Richard E. Deer, "Lawyers' Responses to Auditors' Requests for Information," The Business Lawyer, April, 1973.

unqualified opinion.⁵ If the auditor concludes that he can express an opinion, but must qualify it because of the limitation on the scope of his audit, the opinion may read, in part: "...except for such adjustments and additional disclosures as might have been determined to be necessary if the scope of our examination had not been limited by our inability to obtain satisfactory evidence with respect to contingent liabilities, as discussed in the preceding paragraph,..." If the auditor concludes that he must disclaim an opinion, his report will describe the limitation on the scope of his audit in terms generally the same as those illustrated above for a qualified opinion. The report will state, however, that the auditor is unable to express an opinion on the financial statements.

- If the lawyer's response reports the existence of a matter that may constitute a material liability or contingent liability, but the lawyer does not express an opinion as to the probable outcome which the auditor can use to evaluate the potential effects of the matter, the auditor may conclude that there is an uncertainty whose effects on the financial statements he cannot evaluate. This conclusion may lead him to the further conclusion that he cannot express an unqualified opinion, even though disclosure regarding the matter is adequate.⁶ If the auditor concludes

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The following are examples of unsatisfactory responses:

- This firm as a matter of policy does not disclose information privileged by reason of the attorney/client privilege, and such information to the extent available to the firm is not taken into account in responding to requests from auditors for information.
- We can advise you only with respect to actual litigation or disputes in which we are involved as counsel for the Company, and we cannot respond to inquiries relating to other contingent liabilities.

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The following are examples of responses which may lead an auditor to conclude that he cannot express an unqualified opinion:

- In our opinion, the Company has meritorious defenses.
- In our opinion, the Company has a good chance of prevailing in this action.
- We are unable to express an opinion as to the merits of the litigation at this time. The Company believes there is absolutely no merit to the litigation.
- This litigation has just been begun and we have not had an opportunity to form an opinion as to the likely outcome.

The following are examples of responses which may lead an auditor to conclude that he can express an unqualified opinion:

- In our opinion, plaintiff's case is without merit.
- In our opinion, the Company will successfully defend the action.
- In our opinion, the client will not sustain damages in excess of 7 a nominal amount.

that he can express an opinion, but must qualify it because of the existence of an uncertainty, the opinion may read in part: "...subject to the effects, if any, of the outcome of the lawsuit discussed in the preceding paragraph,..." If the auditor concludes that he must disclaim an opinion, his report will refer to the uncertainty in terms generally the same as those illustrated above for a qualified opinion. The report will state, however, that the auditor is unable to express an opinion on the financial statements.

Until the issues concerning lawyers' letters are resolved to the mutual satisfaction of both lawyers and auditors, consideration of the following suggestions may be useful.

- Auditors may indicate willingness to accept lawyers' letters that omit burdensome numbers of small items. This may be accomplished by specifying, in letters of audit inquiry, or in discussions with lawyers, amounts such that matters whose effects are expected to be of a lower order need not be reported. The word "material," or a variant, should not be used in specifying such amounts, in order to avoid implying that greater amounts are necessarily material.
- Auditors may define "contingent liability," either in letters of inquiry or in discussions with lawyers. The following definition of "contingency" appearing in paragraph 1 of Accounting Research Bulletin No. 50,⁷ may be useful.

"In accounting a contingency is an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss. A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency."

- Auditors may omit, from letters of audit inquiry, questions that may appear to be unduly sweeping, such as a question as to whether there have been "any transactions not in the ordinary course of the client's business."
- Lawyers and auditors may be able to agree on wording for the lawyer's response that would provide for excluding, from the response, matters as to which the lawyer has neither advised

⁷ See footnote 1.

nor been consulted by the client.

The Committee hopes that the auditors and lawyers will continue to work together to resolve differences in views concerning letters of audit inquiry and lawyers' responses to them.

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The following are examples of wording which auditors and lawyers may find acceptable:

- While this firm represents the Company on a regular basis, this response does not include matters as to which the Company is represented by other counsel and as to which we have not advised or been consulted by the Company.
- This firm represents the Company only in connection with certain /real estate transactions/ /describe other specific matters, as appropriate/ and has not been engaged for any other purpose.
- The Company is a party to a number of agreements, such as leases and contracts of purchase or sale, all of which may involve possible liabilities. Such matters are not covered by this response, except to the extent that we have advised or have been consulted as to claims or other possible liabilities thereunder.

ILLUSTRATIVE INQUIRY LETTER TO LEGAL COUNSEL
(Not intended as a model)

Letterhead of Client

Date

Name and address of law firm

Gentlemen:

In connection with an examination of our consolidated financial statements at balance sheet date and for the period then ended, please furnish to our independent auditors name and address of auditors a description of any litigation, of which you have knowledge, involving the Company or any of its subsidiaries which was pending at the date indicated above or which has subsequently been initiated. In addition, please furnish to them a description of any other matters, of which you have knowledge involving impending litigation or claims by or against, or a contingent liability of, the Company or any of its subsidiaries at the date indicated above or arising subsequently.

In describing the matters reported, please state the amounts involved and your opinion as to the probable outcome, including, to the extent possible, an estimate of the ultimate liability or amount to be realized.

The letter may be changed, if desired, to make use of suggestions described in the accompanying commentary.

The auditor may decide to request information in addition to that described in this letter.

Yours very truly,

Name of Client

By Name of client official

