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AUDITING

# Investigations and the Independent Auditor

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Auditors play a key role in internal company investigations. In addition to addressing the Company's responsibility to adequately investigate allegations of fraud or illegal acts, a clear understanding of the auditor's concerns and need to make professional judgments will assist counsel both in responding to the auditor and in more efficiently resolving the investigation itself.

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## I. Duties Of The Auditor

### A. The Auditor's Duty To Inform

Section 10A(a) of the Securities Exchange Act of 1934 requires that the auditor have procedures to detect illegal acts material to the company's financial statements. Information concerning potential illegal acts can come to a company's or its auditor's attention from a variety of other sources as well, such as internal audits, whistle-blowers, company reporting systems, company reviews, or government enforcement investigations. Whatever the source of the information, if the auditor becomes aware of actual or potential illegal acts, Section 10A(b) requires the auditor to inform management, to assure that the audit committee or the board is also informed and to conclude whether there is a material impact on the company's financial statements and whether the company has taken appropriate remedial measures.

Section 10A casts its net widely. Under Section 10A(f), an ''illegal act'' includes ''an act or omission that violates any law, or any rule or regulation having the force of law'' and not just those that relate to the com-

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pany's business activities.[1] Even the possibility of an immaterial illegal act will trigger the auditor's obligation to consider and report under Section 10A(b); the obligation arises whenever an illegal act ''has *or may have* occurred'' and ''whether or not perceived to have a material effect on the financial statements of the issuer.'' The auditor may not stand down under Section 10A(b) ''unless the illegal act is clearly inconsequential.'' As then Chief Accountant for the Securities and Exchange Commission's Division of Enforcement Howard Scheck put it, ''In my view, there does not need to be clear indicia of fraud before auditors' 10A radar should kick in.''[2]

Although the auditor's radar may kick in, the auditor may be unable to determine without investigation whether the act is immaterial or inconsequential. Under SAB 99, immateriality or inconsequentiality may well depend upon legality and management's intent.[3] Under PCAOB Audit Standards, ''[w]hether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence.''[4]

## B. The Auditor's Duty To Report

The auditor must determine that the audit committee or, if the company has no audit committee, the board of directors is adequately informed of the potential illegal act and must also conclude whether the illegal act has a material effect on the company's financial statements, whether the company has taken appropriate remedial action, and whether any failure to take remedial action will require the auditor's resignation or departure from the standard form of its report. If so, then the auditor must report its conclusions to the board.[5] If the board receives such a report, it has one business day to notify the SEC.[6] In practice these requirements typically drive the need for an investigation, and unless the matter involves a low-level employee or subsidiary, the auditor will likely request one. The auditor's typical communication to the audit committee or board may include:

- A description of the allegations, concerns and background facts.
- A statement of expectation that the audit committee or independent board members will be responsible for:
  - Determining the appropriate scope and procedures for the investigation;
  - Evaluating the sufficiency of the investigation's procedures;
  - Evaluating the findings and conclusion of the investigation; and
  - Determining what remedial actions, if any, are necessary.
- A request that the audit committee or independent board members consult legal counsel experienced with investigations:
  - To provide advice as to the scope and nature of investigation and related actions by the Company; and
  - To provide advice regarding the responsibilities of the company's management, audit committee and the board of directors in the circumstances.

## C. The Auditor's Duty To Assess

Independence and the need to avoid auditing its own work generally preclude the auditor from directing or setting the course for the investigation.[7] To meet the requirements of Section 10A, however, the auditor will need to assess the decisions of the audit committee and its counsel regarding the scope, conduct and conclusion of the investigation. Further communications with the audit committee will therefore often include:

- A statement that the auditor will conclude whether the scope of the investigation appears to be appropriate but will not be in the position of determining the scope or procedures to be performed, which is the Audit Committee/Board's responsibility.
- A request that the scope of the investigation, once determined, be discussed with the auditor to allow the auditor to communicate whether the scope of the investigation appears appropriate.
- A request for periodic updates and open communication between the auditor and the investigators during the investigation.
- A request that the Audit Committee/ Board/ investigators provide the auditor oral or written reports during and at the conclusion of the investigation, covering:
  - A detailed description of the scope and procedures performed or being performed including, but not limited to:
  - The transactions and areas reviewed;
  - The persons interviewed and the types of questions asked;
  - The documents reviewed, including document and e-mail searches performed and search strings used;

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[1] *See* SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 n.41 (Aug 19, 1999) (''SAB 99'').

[2] *See* Howard Scheck, Remarks before the 2011 AICPA National Conference on Current SEC and PCAOB Developments, (December 6, 2011) (transcript available at http://www.sec.gov/news/speech/2011/spch120611hs.htm) (''Sheck Remarks'').

[3] ''As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.'' *See* SAB 99 at 45152. Under SAB 99, materiality considerations include ''whether the misstatement involves concealment of an unlawful transaction'' and whether ''management has intentionally misstated items in the financial statements to 'manage' reported earnings.'' *Id*.

[4] *See* AICPA Codification of Statements on Auditing Standards (''AU'') § 317.03 (''the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law'').

[5] Section 10A(b)(2).

[6] Section 10A(b)(3).

[7] *See e.g.* Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 33-8183, 17 C.F.R. § 249 (Mar. 31, 2003). (''The Commission's principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client.'')

  SRLR ISSN 0037-0665

- The hard drives imaged or back tapes reviewed or servers searched;
- The time period covered; and
- The persons who had knowledge of or participated or directed acts.
- Findings and conclusions concerning but not limited to:
- The sufficiency of the investigation;
- The merits of the allegations;
- Identification of persons who had knowledge, participated or directed the activity;
- The role of specific persons of concern or people the auditor relies on for purposes of the audit; and
- Any remedial actions.

## II. Communicating With The Auditor

Understanding the auditor's expectations will assist the audit committee and counsel in determining the scope and conduct of the investigation. If the auditor has concerns, finding out sooner rather than later could help avoid having to repeat or redo investigative procedures such as document searches or witness interviews.[8]

This principle applies from the outset and extends even to the audit committee's selection of counsel. In fulfilling its expectations, the auditor will need to consider the competence, objectivity and adequacy of the investigative team, including the law firm and any professional service firms or experts who assist in the investigation. This is something the SEC looks at and expects the auditor to consider as well.[9] It would be unwelcome news for an audit committee to retain counsel and proceed with an investigation only to find that issues with the selection of counsel or scope of the investigation require the process to begin anew.

The auditor's input will also likely improve the quality of the investigation. In conducting audits and reviews of the company's financial statements, the auditor will have acquired knowledge of the nature and structure of the company's accounts and of the persons most knowledgeable about the company's accounts, internal controls, processes and procedures. The auditor will likely have valuable input on custodians from whom to collect documents, search terms, interviewees and even questions for interviewees. And, as discussed above, if the investigation overlooks key personnel, documents or search terms, the auditor may be unable to conclude that the investigation and audit committee's response to the potential illegal act was adequate and may even question the objectivity of the investigation.

The company should seek to avoid surprising the auditor. For example, the auditor needs to consider whether the investigation was subject to scope limitations due to the unavailability of witnesses or documents. By bringing such matters promptly to the auditor's attention, the investigation team can avoid creating auditor mistrust and raising additional concerns about the quality and credibility of the investigation itself. In addition, the auditor may know of alternative sources of information that could mitigate the unavailability of particular witnesses or documents.

The audit committee and investigative team should discuss remedial actions and the basis for such remedial actions with the auditor. If an illegal act that had a material effect on the financial statements was identified, the auditor will need to assess whether timely and appropriate remedial actions were undertaken by the Company.[10] If company personnel having a role in accounting, financial reporting or overseeing internal controls were involved in wrongdoing, the auditor will have to make a professional judgment whether the auditor is willing to continue to be associated with the company's financial statements and whether the auditor is willing to continue to rely on the representations of company management and other personnel in the conduct of its work going forward. Remediation may include termination, reassignment or additional training of certain personnel. The findings of the investigation and remedial actions taken may also impact management's and the auditor's evaluation of the effectiveness of the Company's internal controls over financial reporting.

An auditor's conclusion on the adequacy of the investigation may influence government enforcement investigators in a later investigation.[11] Ensuring that the auditor has all necessary information and is fully informed about the investigation process can be beneficial when the auditors are asked for interviews or testimony during subsequent government investigations. Senior management and audit committees should therefore be proactive in working with auditors.

Courts have emphasized the importance of communication between a company and its outside auditor during an internal investigation. In *SEC v. Roberts*,[12] the court noted that encouraging communication between auditors and companies furthers the ''strong public policy of encouraging critical self-policing by corporations.''[13] By working together with the auditor, a company can more effectively complete the internal investigation.

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[8] *See* Gary DiBianco & Andrew Lawrence, *Investigation and Reporting Obligations under Section 10A of the Securities Exchange Act: What Happens when the Whistle is Blown?*, Securities Fraud National Institute (Sept. 29, 2006) (''As a practical matter, the possibility of remedial actions being unacceptable to the auditor is greatly reduced if the auditor is kept apprised of the status of the investigation and of actions that are being considered by the company'').

[9] ''We will be asking questions that bear on the credibility of management's investigation[.]'' *See* Sheck Remarks.

[10] *See* Daniel V. Dooley, Section 10A Audit Requirements Under the Securities Exchange Act of 1934: A Play in Five Acts, http://www.law.yale.edu/documents/pdf/SEA-Section_10A_Audit_Requirements-A_Play_in_Five_Acts.pdf (''Whatever remedial actions are required, they need to be taken seriously by management and directors, done promptly and effectively, and undertaken in complete cooperation (including the fullest measure of communication) with the independent auditors'').

[11] *See* Dooley, *supra* note 10 (if the auditor is dissatisfied with the investigation, it would have to report to the SEC. Further, ''any Section 10A reporting by independent auditors also is likely to interest the DOJ'').

[12] 254 F.R.D. 371 (N.D. Cal. 2008).

[13] *Id.* at 382.

## III. Possible Consequences of Sharing Information with The Auditor

Despite the benefits, audit committees and their counsel should be mindful that disclosure to the auditors can impact the protections of the attorney-client privilege and work product doctrine.

### A. Impact On Attorney-Client Privilege

''The attorney-client privilege protects confidential communication by a client to an attorney made in order to obtain legal advice.''[14] The privilege may be waived by sharing the protected information with a third party. While the attorney-client privilege may still apply when a disclosure is made to an accountant because the accountant's assistance is necessary or highly useful in advising the client, the same is not true when the disclosure is made to an outside auditor during an internal investigation.[15] Disclosure of documents to an independent auditor ''destroys the confidentiality seal required of communications protected by the attorney-client privilege.''[16] Companies should therefore understand that the attorney-client privilege will not protect information shared with outside auditors.

### B. Impact On Work Product Protection

The work product doctrine protects from discovery documents or materials prepared by an attorney or an attorney's agent in preparation for litigation. [17] Because its application is based on the content of an item, the work product doctrine may extend to documents created by an outside auditor that record a company's attorney's thoughts and opinions.[18] Like the attorney-client privilege, work product protection can be waived through disclosure.[19] Unlike the attorney-client privilege, however, the disclosure results in waiver only if it is ''inconsistent with the maintenance of secrecy from the disclosing party's adversary.''[20] Waiver of work product protection is found when information is disclosed directly to an adversary or to a conduit to an adversary.[21] Determining whether disclosure to an outside auditor waives work product protection depends upon whether the auditor is seen as an adversary to the company and whether the company can reasonably expect the information disclosed to remain confidential.

#### 1. Outside Auditors and Companies are Not Adversaries

The prevailing view is that disclosure to an independent auditor is not disclosure to an adversary for purposes of work product waiver.[22] The court in *Lawrence E. Jaffe Pension Plan*, noted, ''[t]he fact that an independent auditor must remain independent from the company it audits does not establish that the auditor also has an adversarial relationship with the client as contemplated by the work product doctrine.''[23] In *Deloitte*, the court held that the relationship between an auditor and the company is not adversarial, reasoning that the determining factor should not be whether the outside auditor could be the company's adversary in any conceivable future litigation but whether they could be adversaries in the sort of litigation the information disclosed addresses.[24] Further, the power of an independent auditor to issue an adverse opinion regarding the company does not create an adversarial relationship.[25] Instead of being potential adversaries, most courts see auditors and companies as having common interests, which precludes a finding of waiver for information disclosed.26 These courts find that the auditors and companies have aligned interests in seeking ''to prevent, detect and root out corporate fraud.''[27]

#### 2. There is a Reasonable Expectation of Confidentiality in Information Disclosed to Outside Auditors

Work product disclosed to auditors remains privileged because auditors are also not conduits to adver-

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[14] *Id.* at 374.

[15] *Cavallaro v. U.S.*, 284 F.3d 236, 247 (1st Cir. 2002).

[16] *In re Pfizer Inc. Sec. Litig.*, 1993 BL 887, at *7 (S.D.N.Y. Dec. 23, 1993).

[17] *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004). The doctrine has been partially codified in Federal Rule of Civil Procedure 26(b)(3)(A), which states that documents and tangible things prepared in anticipation of litigation or for trial by or for another party or its representative are not discoverable. The court may order disclosure if the party can show a substantial need for the material, as well as an inability to obtain the equivalent information without undue hardship. Further, Federal Rule of Civil Procedure 26(b)(3)(B) provides that even if this exception applies, the court must still ''protect against disclosure of the mental impressions, conclusions, opinions or legal theories of a party's attorney or other representative concerning the litigation.''

[18] *See U.S. v. Deloitte LLP*, 610 F.3d 129, 136 (D.C. Cir. 2001) (''Under *Hickman*, however, the question is not who created the document or how they are related to the party asserting work-product protection, but whether the document contains work product—the thoughts and opinions of counsel developed in anticipation of litigation.'')

[19] *Roberts*, 254 F.R.D. at 375.

[20] *Id.* at 140 (quoting *Rockwell Intl. Corp. v. U.S. Dept. of Justice*, 235 F.3d 598, 605 (D.C. Cir. 2001)).

[21] *Deloitte*, 610 F.3d at 140. *But see Merrill Lynch*, 229 F.R.D. at 446 (finding no waiver when the disclosing party and the third party have a common interest). *See also Gutter v. E.I. Dupont de Nemours & Co.*, 1998 BL 97, at *3 (S.D. Fla. May 18, 1988) (finding that ''[D]isclosure to outside accountants waives the attorney-client privilege, but not the work product privilege, since the accountants are not considered a conduit to a potential adversary.'').

[22] *See e.g. Deloitte*, 610 F.3d at 129; *Merrill Lynch*, 229 F.R.D. at 441; *Roberts*, 254 F.R.D. at 371; *SEC v. Berry*, 2011 BL 58274 (N.D. Cal. Mar. 7, 2011); *In re JDS Uniphase Corp. Sec. Litig.*, 2006 BL 4202 (N.D. Cal. Oct. 5, 2006); *SEC v. Schroeder*, 2009 BL 90534 (N.D. Cal. April 27, 2009); *United States v. Baker*, 2014 BL 441725 (W.D. Tex. Feb. 21, 2014); *Lawrence E. Jaffe Pension Plan v. Household Int'l., Inc.*, 237 F.R.D. 176 (N.D. Ill. 2006) . *But see Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002) (Disclosure of the Special Litigation Committee's meeting minutes to the outside auditor waived work product protection. The court reasoned that the auditor's interests were not aligned with those of the company because an independent auditor has a public responsibility to the corporation's creditors and shareholders, as well as to the investing public, and therefore must maintain independence from the corporation at all times. *Id.* at 116. The court ruled that disclosing work product to the auditor therefore did not ''serve the privacy interests that the work product doctrine was intended to protect.'' *Id.* at 117.

[23] 237 F.R.D. at 183.

[24] *See Deloitte*, 610 F.3d at 140-41 (disclosure would have been a waiver if instead of being independent, the auditor had been affiliated with a potential adversary).

[25] *Deloitte*, 610 F.3d at 140.

26 *Roberts*, 254 F.R.D. at 381.

[27] *Merrill Lynch*, 229 F.R.D. at 449.

  SRLR ISSN 0037-0665

saries; there remains a reasonable expectation of confidentiality in the information shared with outside auditors.[28] An expectation of confidentiality arises when the parties share common litigation interests or when they have executed a strong and sufficiently unqualified confidentiality agreement.[29]

Confidentiality can be reasonably expected when disclosing information to an independent auditor because the American Institute of Certified Public Accountants Code of Professional Conduct requires independent auditors to refrain from disclosing confidential client information.[30] The qualifications to this obligation do not significantly diminish the reasonableness of a company's expectation of confidentiality.[31]

The auditor's obligation to issue an opinion on the company's financial statements does not undermine the reasonable expectation of confidentiality. ''An independent auditor can fulfill its duties and render an opinion concerning a company's public financial statements without revealing every piece of information it reviews during the audit process.''[32]

## IV. Documenting Expectations Of Confidentiality May Mitigate Risk

Beyond keeping communications with the auditor within the parameters of work product protection, the company may be able to further mitigate the risk that such communications will waive work product protection by executing a confidentiality agreement with the auditor. Clearly documenting expectations of confidentiality could help to avoid misunderstandings with or inadvertent disclosure by the auditor and assist a court in later finding that work product protection was not waived.[33]

Any confidentiality agreement should describe the auditor's relationship to the company, why confidential information is provided to the auditor and the auditor's agreement to confine the use of the information to the provision of its services. Such provisions could help persuade a court that the parties were disclosing information because of their common interest in policing against corporate fraud and not in connection with any adversarial proceeding.

The confidentiality agreement should of course express the company's intention to share the confidential information without waiving any privilege, including work product protection. As discussed above, the company's stated intent not to waive the attorney client privilege is not likely to control, but there is no reason to concede the issue at the outset.

The confidentiality agreement should provide an explicit procedure for identifying information as confidential. If information is shared orally, it should promptly be summarized in writing and marked confidential. This will avoid misunderstandings about what information is confidential and will again give a court additional certainty that the auditor agreed to maintain the confidentiality of specific identified information. At the same time, the company should seek to reduce the risk that government enforcement would interpret the confidentiality agreement as an attempt to gag the auditor. The agreement should provide that information that is otherwise publicly available or known, obtained or developed by the auditor from independent non-confidential sources is not confidential information. In addition, the agreement should make clear that the auditor is not prohibited from disclosing even confidential information to the extent required by law, regulation, or professional standards or by judicial or administrative process.

To allow the company to assert privilege or work product protection, the agreement should provide for notice to the company in the event that confidential information is requested or subpoenaed from the auditor. Upon receipt of such notice, the company should expect to prepare and promptly submit a privilege log. The SEC's Enforcement Manual provides, for example, that the SEC staff should request a privilege log at the time of production and that a failure to provide sufficient detail to support a claim of privilege can result in waiver of the privilege.[34] Depending on the volume of confidential information shared with the auditor, the company may therefore want to consider preparing a log in advance if government enforcement investigations are then active.

## Conclusion

The auditor is required to have access to a company's internal investigation. Understanding when, why and how to communicate with the auditor during the investigation will facilitate a more expeditious conclusion of the investigation while maintaining the company's relationship with the auditor going forward.

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[28] *Deloitte*, 610 F.3d at 141.

[29] *Id.* at 142.

[30] *See id.* (referring to Rule 301 of the American Institute of Certified Public Accountants Code of Professional Conduct, which provides that public accountants shall not disclose confidential client information without the client's consent. AICPA Code of Professional Conduct § 301.01.).

[31] *Id.*

[32] *Id.* at 142-43.

[33] *See id.* 142.

[34] SEC, Division of Enforcement, Enforcement Manual (Oct. 9, 2013), *available at* www.sec.gov/divisions/enforce/enforcementmanual.pdf.