Expanding Accountants’ Privilege: Implications for Auditors and Clients

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The notion of granting a “privilege” right to accountants — allowing auditors and accountants to avoid sharing confidential client-derived information with plaintiffs — is relatively new, but the trend toward allowing the privilege is growing.

Modeled after the attorney-client privilege, the accountant-client privilege differs both in logical foundation and, particularly in some jurisdictions, in formulation. Greater attention should be directed to these differences, as, inter alia, the nature and scope of the privilege might fundamentally change both the accountant-client relationship and the demand by clients or others for contemporaneous access to auditors’ working papers.

Legal scholars and courts have frequently opposed privilege on the grounds that it obstructs the public’s ability to obtain competent evidence in legal proceedings. In this regard, privilege is analogous to how a client-imposed “scope limitation” can thwart the ability of auditors to complete their examination of financial statements.

Notwithstanding this opposition, the attorney-client privilege has long been recognized based on the unique relationship between the parties. According to the 1984 Supreme Court decision in United States v. Arthur Young & Co, the attorney-client relationship differs from the relationship between public-company auditors and their clients.¹

How that decision should apply to services provided by accountants has been the subject of more recent statutes and court decisions. The Illinois Supreme Court’s March 2015 decision in Brunton v. Kruger, which held that the statutory accountants’ privilege is held by the accountant, suggests the need for greater consideration by both accountants and their clients.²

The issue of accountant-client privilege may arise in two distinct arenas: first, in the instance of third-party lawsuits arising from the failure of an auditee, e.g., to honor its debts; and second, in the context of suits by clients against their accountants, asserting malpractice or contractual breach. Both are frequent grounds for lawsuits, but demands made by clients pose ethical questions.³

Garden-variety suits by investors or lenders commonly occur when grossly misleading financial reporting is revealed even though “clean opinions” were rendered on one or more financial statements. Auditors are familiar with the “deep pockets” phenomenon whereby they are named in such matters regardless of the quality of the audits performed or the cleverness and conspiratorial character of the frauds perpetrated. However, published results of the Public Company Accounting Oversight Board — since 2002 the overseer of public company auditing — have found a high proportion of substandard audits — i.e., those not complying with generally accepted auditing standards — even when the financial statements opined upon are not materially deficient. Therefore, the empirical evidence suggests a need for improvement in audits.
Lawsuits in the second category — those initiated against accountants by their own clients — are the bane of private company audit practice as well as tax-only and other consulting relationships. When a client is required to bear the penalties imposed after a tax examination or loses money on investments suggested by the tax preparer or accountant, he can argue that the service provider failed to deliver the contracted-for services or breached a presumed fiduciary obligation.

Third parties may seek auditors’ working papers to assess the degree to which the accountants complied with generally accepted accounting standards. Of particular interest in such cases is the exercise of “due professional care,” demonstrations of an “attitude of professional skepticism,” and the gathering of “sufficient appropriate evidence.” Inspections by PCAOB and presumably also private peer reviews have revealed many instances in which auditors failed to demonstrate requisite skepticism and/or have rendered audit opinions not adequately supported by evidence. The working papers will typically reveal such failures.

In the litigation setting, plaintiffs will generally want to obtain expert witness testimony regarding those failings. Although such testimony can sometimes be provided without full access to working papers, it is much easier to provide if unfettered access to the working papers is obtained. The working papers will normally be probative in making such determinations and be most persuasive to the finder of fact. Thus, any limitation on the availability of such evidence will impose a high, but not necessarily insurmountable, hurdle for showing audit failure.

Lawsuits by clients against auditors present an additional, less obvious issue. The client has paid for the accountants’ work and would understandably assert that it owns the work product. Yet, in most instances, auditors or accountants retain their work product, such as analyses, internal memoranda and research results.

For example, although client-prepared materials must be returned, items such as work programs are typically deemed proprietary and the property of the accountants. These materials could include, inter alia, estimations of the riskiness of tax positions taken, even for those that had been formulated (or at least approved) by the client.

As early as 1990, eminent authority Denzil Causey noted at least 24 states provided some form of privilege for accountants, although not always extending to testimonial privilege and in more recent years this privilege has expanded. Almost universally, the privilege belongs to the client, not the accountant.

In Brunton the Illinois Supreme Court held that this privilege belongs to the accountant, not to the client, thereby departing from the model of attorney-client privilege (where the client retains the privilege). This result could fundamentally affect accountant-client relationships, particularly if replicated in other jurisdictions.

The expansion of the accountant-client privilege, even if retained by the client, is itself an interesting development. It appears to have been based on the 1996 U.S. Supreme Court Jaffee v. Redmond decision, which found a psychotherapist-patient privilege. Although that decision acknowledged the traditional position that privilege, per se, impedes full consideration of evidence, it nonetheless also recognized that exemptions, although “distinctly exceptional,” could be justified.

In other words, the high court seemingly accepted that expansions of privilege may be warranted, perhaps on case-specific bases. By doing so, it opened the door to what had been precluded: the assertion that accountants could claim privilege regarding work product produced in the course of client engagements, particularly engagements not associated with public filings of audited financial statements.

The prior 1973 decision in Couch v. United States and 1984 decision in Arthur Young generated a great deal of controversy among legal commentators, and together they arguably chilled further expansion — at least at the time — of the accountant-client privilege. The later Jaffee decision caused that issue to receive renewed attention, seemingly leading to the situation that exists today.

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Regarding the further development and expansion of the accountants’ privilege, much uncertainty remains. The recent finding in Illinois may be fact-constrained (it related to estate planning) and may or may not later be held generalizable to more routine accounting services, including audits. Additionally, the Illinois statute and Illinois Supreme Court interpretation may differ from other state statutes and court rulings.

More generally, scholarly consideration of privilege has often been guided by the so-called Wigmore criteria. As set forth in John Henry Wigmore’s seminal work, four criteria must be satisfied to justify expansion of a privilege:

- The communications must originate in a confidence that they will not be disclosed.
- This element of confidentiality must be essential to the full and satisfactory maintenance of the relation between the parties.
- The relation must be one that, in the opinion of the community, ought to be sedulously fostered.
- The injury that would inure to the relation by the disclosure of the communications must be greater than the benefit thereby gained for the correct disposal of litigation.

If Wigmore’s scheme is employed, the pragmatic character of the fourth criterion is likely to be the key to determining whether privilege is warranted in other circumstances. Critics of this criterion and, to a lesser extent, of all four criteria, claim that the framework is too malleable and that it could justify recognition of numerous new privileges.

Although courts have not generally applied the Wigmore criteria, they may do so in future cases. If this final criterion is credited, it may be argued that having access to accountants’ work product serves an important societal objective, even if it exposes them to legal liability.

The implications of the expanded accountant-client privilege for auditing firms facing litigation are several, and they vary depending upon whether it is the client (analogous to attorney-client privilege norms) or the accounting firm (the Illinois model following Brunton, and also the position under certain other states’ statutes) that holds the privilege.

If the accounting firm holds the privilege and litigation involves a third party (e.g., a lender injured by relying upon materially misstated financial reports), in many instances the accounting firm’s interests and the client’s interest will be aligned.

This would most obviously be the case if there are both financial statement deficiencies and audit weaknesses that arguably resulted in, or contributed to, the failure to detect noncompliance with generally accepted accounting principles or other issues.

If the client asserts the privilege and denies access, however, this may be problematic for the accountants. For example, if the working papers demonstrate that a quality audit had been planned and performed, and that only unavoidable “audit risk” — e.g., risk flowing from sampling of supporting evidence — was responsible for the fact that material errors or irregularities escaped audit attention, then the auditors might well be harmed by the client’s refusal to waive the privilege.

If the client holds the privilege and sues its auditors, no issue arises, inasmuch as the client will demand access to the working papers, which may or may not ultimately support the plaintiff’s arguments regarding malpractice or breach of contract. The plaintiff-client won’t assert privilege in such circumstances, as doing so would be counter to its interests.

The situation may differ if, as now in Illinois, the accountants hold the privilege. If there is any risk that the working papers will reveal flaws or omissions in the audit procedures employed (e.g., failures in setting adequate audit scopes, an insufficiency of professional skepticism or

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missteps in the evaluation of audit evidence) then the auditors might be better served to assert the privilege.

This general rule would be equally apropos whether the auditors are being sued by the client or by third parties. But the auditor’s assertion of the privilege may displease the client, particularly if the client is suing the accountants — although that relationship is probably ruined in any event.

When auditors are convinced that the working papers will show that a proper examination was performed, they may wish to waive the privilege and produce the working papers to the counterparty to avoid the negative implications that may ultimately prove useful for the plaintiff. In those situations, the failure to timely grant access to the working papers may later work to the accountants’ disadvantage.

The included table captures the various implications of granting or denying access to auditors’ work product.

In the author’s experience, an accountant’s decision to deny access during discovery and then later attempt to use lack of access to attack plaintiff’s (or plaintiff’s expert’s) arguments and opinions can backfire. In such a scenario, the court may invoke a “shield and sword” standard: that if the accountants used privilege to deny access, they cannot later use it to argue that the opposing party’s opinions are fatally flawed because of the lack of review of the working papers.

Careful judgment is accordingly urged in invoking accountants’ privilege if the evidence in the working papers is believed to be predominantly exculpatory. In practice, the more typical risk is that the working papers would support the plaintiff’s allegations, both because at least minor audit deficiencies are common and because fact-finders often view accountants and their malpractice insurance carriers as “deep pockets” able to compensate for losses in cases of negligence. In such instances, invoking privilege might be the optimal course of action.

Additionally, if the accountants’ privilege is deemed to rest with the accountants, it might be wise for the accountants to note this in the engagement letter with the client so that it becomes a contractual provision. It might come as a surprise to the client, but a strong client objection may be an early warning sign of a contentious client relationship — or even of a client’s inclination to sue its service providers. Thus, the objection may operate as a “client acceptance” threshold issue to be addressed before commencing work.

From the client’s perspective, an accountants’ privilege that resides with the accountant may also trigger certain precautionary actions. It could serve as motivation for the client to demand, as a provision for each engagement, complete sets of all working papers prepared by the accountants, including internal memoranda documenting key audit decisions. Auditors likely will recoil from such a demand, but perhaps claiming “proprietary” interests in audit programs, but if the demand is made as a condition sine qua non, the auditors may well feel the need to acquiesce.

If the client is later sued by a third-party user of the audited financial statements, having those papers will either prove to be exculpatory (i.e., by showing that auditors had full access to details of the contested accounting for specific transactions and that they agreed with the client’s accounting) or serve to shift a portion of the blame to the accountants.

The accountants’ self-interest may well conflict with the clients’ interests. For example, if the financial statements include innocent but material errors and the client is sued by third-party users, the accountants may well assert privilege to protect themselves — even if doing so places the client in a more vulnerable position. Although this would probably spell the end of the relationship with the client, as a practical matter it might be a price willingly paid by an auditing firm faced with immediate or threatened litigation.

Naturally, if the privilege is held by the client, there is no need to have pre-lawsuit possession of the working papers. Nonetheless, clients might — out of an abundance of caution — still...
demand them. But if the client has contemporaneous access to the auditors’ work product and the engagement was obviously deficient, this may strengthen the claimant’s hand by suggesting that the client deliberately elected to employ substandard auditors to assist in its perpetration of a deviant reporting scheme.

The bottom line for both accountants and clients is this: The recent Illinois interpretation in Brunton that accountant-client privilege exists and resides with the accountants, and other states’ similar statutes or interpretive court decisions, should be given careful consideration.

NOTES

1 *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). “The [attorney] work-product doctrine was founded upon the private attorney’s role as the client’s confidential advisor and advocate, a loyal representative whose duty it is to present the client’s case in the most favorable possible light.” In contrast, “[b]y certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. ... To insulate from disclosure a certified public accountant’s interpretations of the client’s financial statements would be to ignore the significance of the accountant’s role as a disinterested analyst charged with public obligations.”


3 Ethics rules require auditors and accountants to return client-prepared information to the clients. Work product, such as audit programs, is the property of the accountants.


7 Under securities laws, auditors of “issuers” are already required to produce working papers if demanded by regulators, which would arguably waive privilege in any event. The Supreme Court, in the *Arthur Young* decision, 465 U.S. 805, observed that “[t]he integrity of the securities markets will not suffer absent some protection for accountants’ tax accrual workpapers. The independent auditor’s obligation to serve the public interest assures that that integrity will be preserved, without the need for a work-product immunity for such workpapers.”

8 See, e.g., *Couch v. United States*, 409 U.S. 322, 335 (1973); *Arthur Young*, 465 U.S. at 805. The *Couch* case did not directly arise from an accountant’s claim of privilege. Nonetheless, the court’s majority opinion remarked that no federal accountant-client privilege existed while the dissent noted a similarity between such a putative privilege and the attorney-client privilege. *Couch* was subsequently widely cited as a precedent for denying accountant-client privilege in federal courts. The *Arthur Young* case pertained to a criminal tax investigation of tax accrual working papers of an “issuer.” The district court found that no privilege existed. The appellate court reversed and found a limited privilege, although it concluded by ruling that the public interest outweighed any such privilege. The Supreme Court, in relevant part, found that the tax accrual working papers were not protected, but also found that some work-product privilege for accountants’ working papers might be acceptable. This case dealt with a publicly held company, for which working papers were otherwise (largely) accessible by authorities, and furthermore the issue was complicated by the auditors’ obligations under securities laws.

9 For an expansive discussion, see the Molony article, supra note 6.

the criteria have received broad academic support. However, there have been at least some important exceptions to that general observation. See, e.g., Ernst & Ernst v. Underwriters Nat’l Assurance Co., 381 N.E.2d 897 (Ind. Ct. App. 1978).

Among other reasons to resist providing working papers to clients is the likely loss of the element of surprise in conducting audits, which many view as being an important attribute of quality auditing.

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<table>
<thead>
<tr>
<th>Nature of lawsuit</th>
<th>Client grants access</th>
<th>Client denies access</th>
<th>Accountant grants access</th>
<th>Accountant denies access</th>
</tr>
</thead>
<tbody>
<tr>
<td>The client v. its CPA</td>
<td>Audit working papers reveal deficiencies</td>
<td>Audit working papers show no deficiencies</td>
<td>Audit working papers reveal deficiencies</td>
<td>Audit working papers show no deficiencies</td>
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<td>Third party (lender, etc.) v. both CPA and client</td>
<td>Helpful to plaintiffs, harmful to CPA and (probably also) to client</td>
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1. No reason to grant access, as plaintiff/client’s case is probably weak and will be difficult to prove without evidence
2. Granting access would reveal deficiencies in work, but that will likely be inferred anyhow if access is denied
3. No reason to grant access, as third-party plaintiff’s case is probably weak and will be difficult to prove without evidence

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