

LAWYERS' LETTERS: WHAT THE EVIDENCE TELLS US

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SUMMARY

This experimental study builds on previous work that analyzes the efficacy of lawyers' letters in providing auditors with corroborating evidence about litigation contingencies. Practicing attorneys indicate their willingness to provide auditors with estimates of two constructs embedded in Statement of Financial Accounting Standard No. 5: (1) the likelihood of unfavorable outcomes and (2) the amount of potential damages. The findings indicate that (1) the potential loss of attorney-client privilege and (2) likelihoods of unfavorable litigation outcomes that approach auditors' lower bound for accrual both may inhibit lawyers' responses to auditors. Overall, these findings raise further doubts about the efficacy of a commonly used auditing procedure and increase concerns about whether litigation contingencies and corresponding expenses may be underreported in financial statements.

Keywords: Lawyers' letters, contingent liabilities, attorney-client privilege, audit evidence

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INTRODUCTION

Almost all organizations, whether publicly traded corporations, private companies, government entities or other not-for-profits, face various types of litigation. Typically, until a given incident is settled, whether in or out of court, the eventual outcome of any pending or threatened litigation is subject to uncertainty. Despite this uncertainty, however, Statement of Financial Accounting Standard (FASB) No. 5 (FASB 1975) requires reporting entities to accrue litigation contingencies and report them as liabilities and accompanying expenses in their financial statements when an unfavorable outcome is (1) *probable* and (2) *reasonably estimable*.¹ It has long been known (to the consternation of certain stakeholders in the financial reporting process, including auditors) that FASB No. 5 (1975) allows preparers substantial latitude in applying the concepts of “probable” and “reasonably estimable” in the preparation of their financial statements.

This latitude is available to management for several reasons. First, applying the two key concepts is subjective. Subjective judgments on the part of management are especially troublesome to the auditor. Second, management relies on its outside legal counsel in making such estimates, and deliberations between preparers and legal counsel are confidential such that the auditor is typically not privy to such discussions. In an attempt to manage earnings, management could apply pressure to outside counsel for favorable estimates of such concepts without threat of being discovered, and the auditor generally would never be informed of such pressures. Third, auditors have little basis, if any, to question the responses provided to them by outside legal counsel in response to requests for such information (i.e., lawyers' letters). On the

other hand, FASB No. 5 (1975) does provide that preparers include disclosures in the footnotes to financial statements if the loss is probable but not estimable or if the loss is reasonably possible.² However, such disclosures generally are not very informative.

To fulfill their responsibilities for gathering evidence to corroborate the accounting for litigation loss contingencies, auditors require that management request its outside legal counsel to supply a letter to the auditor that discusses any legal matters with which counsel has had substantive involvement (See Statement on Auditing Standards (SAS) No. 12, AICPA 1976). In such lawyers' letters, the client's outside counsel is expected to provide the auditor with "an evaluation of the likelihood of an unfavorable outcome" and, if one can be made, an estimate of "the amount or range of potential loss" (AICPA, AU 337.09). Under SAS No. 12, the auditor requests management to have outside counsel either furnish this information or comment on matters where Counsel's views differ from those provided by management. Further, SAS No. 12 requires that outside counsel provide a description of the nature of the pertinent matters, a comment about the progress of the case to date and the action the company intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement).

Lawyers' letters are essentially the only evidence auditors collect with respect to litigation matters. Accordingly, auditors rely heavily on the corroborating information contained in lawyers' letters in evaluating management's representations about litigation contingencies. Further, as noted above, if a lawyer representing an audit client indicates in his/her letter that a given potential litigation loss is either not probable or cannot be reasonably estimated, then the auditor has little, if any, basis for requiring management to report a liability and the corresponding expense in its financial statements. Although SAS No. 12 covers other audit procedures, such as inquiries of management and examination of the client's correspondence with legal counsel, those procedures are not considered alternative sources of the corroborating

evidence found in lawyers' letters. Moreover, auditors generally cannot turn to other legal experts (including their own counsel) because of the inability of such experts to access confidential details about the litigation and their lack of knowledge about how the client's lawyers plan to defend against the action (see Behn and Pany 1995, 67).

Given the nature of lawyers' letters and the reality that no alternative evidential substitute exists, analyzing the credibility of lawyers' letters in corroborating clients' litigation contingencies is relevant both to the audit's effectiveness as well as to the ultimate financial reporting result. Over the past decade, much effort has been directed toward enhancing audit effectiveness (e.g., see Public Oversight Board 2000; Sarbanes-Oxley Act of 2002; Center for Audit Quality). Analyzing the effectiveness of a selected audit procedure clearly is consistent with this emphasis. Moreover, the International Accounting Standards Board (IASB) currently is deliberating the accounting for litigation contingencies and the FASB recently issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards amending FASB No. 5 to address the reporting issues noted above (FASB 2008).

The purpose of this study is to conduct an exploratory empirical investigation of the efficacy of lawyers' letters using practicing attorneys as participants. The study builds on Krogstad, et al. (2002) who studied the same underlying issues using a group of second- and third-year law students (this study is discussed more fully below). Our experimental design manipulates both privilege and the likelihood of an unfavorable outcome. Although practicing attorneys' judgments were somewhat different than those of students in Krogstad, et al. (2002), our results clearly indicate that lawyers' responses to auditors are inhibited by (1) the absence of privilege and (2) likelihoods of unfavorable litigation outcomes that approach auditors' lower bound for accrual. These findings reinforce the concern that lawyers' letters may be an unreliable audit procedure for assessing litigation contingencies and their associated expenses.

The remainder of this paper is organized as follows. The next section reviews anecdotal findings and relevant literature in developing our hypotheses, while the third section describes the method. We present the results in the fourth section and devote the final section to discussing the results and directions for future research and practice.

HYPOTHESES DEVELOPMENT

Anecdotal Findings

Motivation for the present study arose from the opportunity as an expert witness to observe firsthand the effects of SAS No. 12 procedures. The real-world scenario, depicted in Figure 1, involved the purchase by a venture capitalist partnership of a corporate subsidiary from a large multi-national holding company on the basis of the subsidiary's net asset value of approximately \$27,000,000 as shown in its audited balance sheet. The balance sheet, audited by a "Big 4" accounting firm (Firm A), contained a \$500,000 accrual for litigation contingencies. As shown in Figure 1, Firm A had received lawyers' letters from many of the outside attorneys representing the company in its 73 pending and threatened legal actions and had placed reliance on these letters in auditing the litigation accrual.

(Insert Figure 1 about here.)

During the same period that the audit was occurring, the venture capitalists, as part of their due-diligence review, retained their own "Big 4" accounting firm (Firm B) to evaluate the adequacy of the company's \$500,000 litigation accrual. Firm B based its evaluation, in part, on responses from outside counsel, as also shown in Figure 1. However, these responses, requested by management and containing information similar to that provided in lawyers' letters to auditors, were originally directed to the corporate subsidiary's newly retained general counsel from whom Firm B auditors obtained them. In comparing the lawyers' responses in both firms'

work paper files, it became evident that in a number of instances outside counsel had provided general counsel with estimates of the likelihood of an unfavorable outcome and of potential losses while stating in their letter to the auditor (Firm A) that the likelihood of an unfavorable outcome and/or an estimate of potential loss could not be determined. As a result of its evaluation, Firm B recommended an additional \$1,500,000 accrual for litigation contingencies and alleged that 41 percent of the additional accrual resulted from additional information obtained by general counsel from outside attorneys. In 29 of the 73 legal actions, an accrual was proposed by Firm B where none had been proposed by Firm A. Although variations in elicitation procedures may have contributed to response differences,³ the disparities in the responses from the same group of lawyers in the two instances regarding the 73 legal actions strongly suggest that, at least in some cases, outside counsel was capable of forming FASB No. 5 estimates of likelihoods and corresponding losses but did not communicate such to Firm A. The accounting literature (discussed below) echoes this concern about the efficacy of lawyers' letters and suggests plausible contributing factors and hypotheses as to why lawyers may be reluctant to provide auditors with estimates of likelihoods and corresponding losses.

Relevant Literature

The accounting literature addressing lawyers' letters consists primarily of interpretative commentary on the relevant authoritative pronouncements, which are FASB No. 5, SAS No. 12, and the American Bar Association's (ABA) "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" (hereafter referred to as "Statement") and accompanying "Commentary" (reproduced as an appendix to SAS No. 12—see AU 337 C). It also includes a single behavioral study mentioned above.

Regarding interpretative commentary, Benson (1977), Fesler and Hagler (1989), Harrison and Pearson (1989), and Behn and Pany (1995) raise important issues regarding the efficacy of

lawyers' letters and the reliability of the evidence they represent. The primary issue involves the potential waiving attorney-client privilege if client "confidences" and "secrets" are communicated to auditors in lawyers' letters. This issue is at the crux of the audit procedure in terms of its ultimate potential to provide reliable audit evidence about litigation contingencies.

From the ABA's Statement (Preamble):

. . . the mere disclosure by the lawyer to the outside auditor, with due client consent, of the substance of communications between the lawyer and the client may significantly impair the client's ability in other contexts to maintain the confidentiality of such communications.

Further, paragraph 1 (c) contains cautionary language that lawyers "should bear in mind, in evaluating claims, that an adverse party may assert that any evaluation of potential liability is an admission." Thus, even before the lawyer begins to prepare a response to the auditor, the ex ante guidance is, essentially, that very little should be communicated regarding judgments about outcomes and/or potential losses. Previous interpretive commentary has highlighted lawyers' potential reluctance, based on the ABA position, to provide auditors with estimates of likelihoods and corresponding losses (Behn and Pany 1995; Harrison and Pearson 1989; Fesler and Hagler 1989; and Benson 1977).

A second issue focuses on how auditors and lawyers may interpret the accrual and disclosure thresholds embedded in FASB No. 5 differently. Recall that one of the key thresholds in FASB No. 5 addresses the likelihood of an unfavorable outcome, especially whether that likelihood is judged as "probable." While cautioning members about communicating judgments, the ABA's Statement does provide for an exception in a relatively few clear cases in which the "prospects of the claimant not succeeding are judged to be *extremely doubtful*" [emphasis added]. Thus, the Statement essentially redefines the FASB No. 5 concept of "probable" as *extremely doubtful* that the client will prevail [emphasis added]. This redefining raises questions

about whether lawyers' responses to auditors' inquiries contain appropriate responses vis-a`-vis the intentions and expectations laid out in FASB No. 5 (Behn and Pany 1995; 62-64; Harrison and Pearson 1989, 81-84; Fesler and Hagler 1989, 12; Benson 1977, 77).

These two efficacy issues surrounding lawyers' letters have been discussed in the accounting literature for over 30 years, yet only one empirical study from the auditor's perspective has attempted to address how these issues affect lawyers' responses to auditors. Krogstad, et al. (2002) devised an instrument that approximated the anecdotal case reviewed above in which second- and third-year law students indicated their willingness to respond about the two conceptual assessments embedded in FASB No. 5, for two different situations involving litigation against a company. The results showed that in the absence of attorney-client privilege (e.g., similar to the audit scenario for Firm A as depicted in Figure 1), despite being able to make judgments about the likelihood of unfavorable outcomes and potential damages, second- and third-year law students were much less willing to communicate their judgments to auditors than under a privileged scenario (Firm B). Thus, that study provided the first empirical evidence that the auditing procedure embodied by lawyers' letters may be ineffective. In accordance with that study's suggestions to pursue the matter with practicing attorneys, we administered similar experimental materials to a group of practicing attorneys to further investigate the matter and determine the extent to which they exhibit the same or different behaviors. The hypotheses that follow address how the issues discussed above may affect practicing attorneys' responses to auditors in the context of lawyers' letters.

An issue that we emphasize here has to do with the distinction between the *accounting context* underlying this study and the *auditing procedure* upon which it focuses. Clearly, the accounting concepts "probable," and "estimable" drive litigation contingency financial reporting. However, it is the evidence obtained from the auditing procedure (i.e., communication from the

client's legal counsel through lawyers' letters) that affects the accounting/reporting result. Because the quality of the evidence obtained via lawyers' letters is an open question, the quality of the accounting/reporting result is also subject to question.

Privilege (H1)

A fundamental premise upon which Federal and State laws are based is the idea that preserving the confidentiality of communications between certain parties is in the public interest. This protection is referred to as the "*privilege* to refuse to disclose" and it protects communications such as between husband and wife, physician and patient, clergy and parishioner, and lawyer and client. The attorney-client privilege is a rule of evidence that preserves the confidentiality of client information in official legal proceedings or investigations. On the other hand, the work product doctrine protects materials prepared for trial (Crystal 1996, 75-76). Because communications between a client or the client's lawyer and the auditor generally fall outside the privilege umbrella (and the work product doctrine), any disclosures are subject to discovery and may also "impair the client's ability in other contexts to maintain the confidentiality of such communications" (ABA Statement Preamble).⁴ Despite cautionary language throughout, however, the ABA Statement (Preamble) supports lawyers providing some information to the auditor concerning pending litigation.

We expect concerns about lack of privilege, or fear of its waiver, to impede outside legal counsel's willingness to respond to auditors with assessments of likelihood of unfavorable outcomes and estimates of potential losses. Thus, in situations in which attorney-client privilege is not protected, we expect lawyer's to be less willing to communicate information about the likelihood of an unfavorable outcome and potential loss than when privilege is protected. These expectations are presented formally as H1a and H1b.

H1a: Lawyers responding under non-privilege scenarios are less willing to communicate their professional opinions about *likelihoods* of unfavorable outcomes for litigation contingencies than are those responding under privilege scenarios.

H1b: Lawyers responding under non-privilege scenarios are less willing to communicate their professional opinions about the *amounts* of potential losses for litigation contingencies than are those responding under privilege scenarios.

Likelihood (H2)

As mentioned above, the existing interpretive commentary has noted the contrasts between the ABA's interpretations of probabilistic terms and those contained in FASB No. 5 with which auditors are familiar. The several studies that address auditors' interpretations of the FASB No. 5 terms show that, on average, auditors' minimum threshold value for "probable" is approximately 67 percent (see Jiambalvo and Wilner 1985; Harrison and Tomassini 1989; Reimers 1992; Amer et al. 1994, 131-132; Lasward and Mak 1997, 20-21). In contrast, accounting researchers have generally assumed that because of the restrictive language in the ABA Statement, lawyers' minimum likelihood threshold, on average, is considerably higher than 67 percent (Harrison and Pearson 1989, 83; Behn and Pany 1995, 63-67). If such is the case, the adequacy of litigation accruals may be compromised.

(Insert Figure 2 about here.)

For example, if the lawyer's interpretation of the word "probable," based on the guidance found in the ABA Statement noted above, is 90 percent, and the lawyer's assessed likelihood of an unfavorable litigation outcome for a given client is 85 percent, the lawyer will not report the case to the auditor (see Figure 2). Clearly, based on empirical research on how auditors interpret the term "probable," auditors would require the client to book a reserve for the potential loss, assuming it is estimable. Even if lawyers are better calibrated with auditors than previously expected, they still may be less willing to respond with estimates of likelihood, especially when near the lower end of the auditors' "probable" range. Thus, we expect that lawyers will be less

willing to respond to the auditor about the likelihood of an unfavorable outcome when that likelihood is relatively low. These expectations are set forth formally as H2a and H2b:

H2a: Lawyers are less willing to communicate their professional opinions about the *likelihoods* of unfavorable outcomes when the likelihood of an unfavorable outcome is relatively low than when likelihood is high.

H2b: Lawyers are less willing to communicate their professional opinions about the *amounts* of potential losses when the likelihood of an unfavorable outcome is relatively low than when likelihood is high.

METHOD

Experimental Task

Our experimental task placed lawyer-participants in the role of outside legal counsel to Midwest Guaranty, Inc. (Midwest), a hypothetical closely-held insurance company that had recently entered into negotiations to merge with another insurance company. As part of the ongoing merger negotiations, Midwest requests the lawyers to prepare written professional opinions concerning ongoing litigation on two cases, Security Patrol and Ms. Jones. The case materials instructed the lawyers to focus their opinions on the likelihood of unfavorable outcomes to Midwest and the amounts or ranges of potential losses, if estimable, in the respective cases. For each case, lawyers were asked to provide an estimate of the likelihood of an unfavorable outcome and an estimate of the potential damages. The materials then asked the lawyers to indicate their *willingness* to communicate their judgment for each estimate to the auditor (in the nonprivilege case) or to general counsel (in the privilege case). These *willingness* judgments then become the dependent variable in the following analysis. Subsequent to completing the experimental instrument, lawyers completed an exit survey regarding demographic items as well as feedback on the experimental task and procedure.

The case scenarios were adopted from the Krogstad, et al. (2002) study with slight modifications. With the help of practicing attorneys, their experimental cases integrated substantive legal issues and we embedded our variable manipulations accordingly.⁵ The average time taken to complete the task was approximately 15 minutes.

Experimental Design

We implemented a 2 x 2 experimental design with one between-subject variable for privilege and one within-subject variable for likelihood (see Figure 3). For each of two scenarios, the lawyers were requested to make judgments of (1) the likelihood of an unfavorable outcome and (2) an estimate of the amount or range of potential loss for each scenario. Immediately following each of these judgments, respectively, the lawyers were asked to indicate how *willing* they were to communicate their judgments. The lawyers then were asked in follow-up questions why they were unwilling to respond if they so indicated. We used the first responses (i.e., actual estimates) and the latter responses (i.e., follow-up questions) for variable manipulation checks discussed later in this section. Note, however, that our focus is not on lawyers' ability to make accurate estimates of likelihoods and amounts, but rather on their *willingness* to provide estimates of likelihoods and amounts (whatever they are) under the various experimental conditions.

(Insert Figure 3 about here.)

Privilege

We operationalized the privilege treatment by varying the party to whom the lawyers were requested to respond both in the experimental task itself and in an attached letter from the President of Midwest. Under the "privilege" condition, lawyers' professional opinions were to be returned to an attorney and partner in the law firm of Logan & Young, the firm Midwest had retained as its General Counsel. The case materials indicated to the lawyers that their responses

would fall under privileged communication in both the task introduction sections and in the comments immediately preceding the response scales. In contrast, under the “non-privilege” condition, the case materials instructed the lawyers to respond directly to Midwest’s auditing firm and they were similarly instructed in the same two places that their responses did not fall within the realm of privilege.

Likelihood

We operationalized the “likelihood” treatment by varying the substantive complexity and fact patterns of the two case scenarios. The Security Patrol case involves a contract dispute while the Ms. Jones case is a tort action. Adjudicating contract disputes is inherently less complex when compared to adjudicating a typical tort action. Contract disputes are based on contractual terms between the parties. The outcomes are designed to make the injured party in the contract dispute whole. We designed the fact pattern for the Security Patrol case as a failed contractual obligation whose probability of unfavorable outcome for Midwest was relatively high.

In contrast, tort actions extend the theories of negligence to parties outside contractual boundaries and define duty in the broader context of social policy. As a result, tort law typically includes complicating factors that go beyond a contractual dispute such as conflicting expert testimony, consideration of degrees of fault, affirmative defenses, subjective and punitive damages, and a duty to mitigate damages, among others. We designed the Ms. Jones case to create a lower probability of an unfavorable outcome compared to the Security Patrol case.

In both cases, because we wanted to integrate as much realism as possible and desired lawyers to come to their own conclusion regarding likelihood, we could only approximate the strength of the “likelihood” manipulation. This is because that strength would be a direct function of the lawyers’ subjective evaluation of the legal issues embedded in the respective

cases. Lawyers' estimates of the likelihood of unfavorable outcomes thus provide rough manipulation checks. Averaged across the between-subject treatment, these estimates were 87.29 percent and 56.52 percent for the Security Patrol and the Ms. Jones cases, respectively. The difference in these averages is highly significant ($t=13.13$; $p<0.0001$). Our exit survey elicited participants' assessments of the probability ranges associated with the FASB No. 5's concepts of "probable" and "reasonably possible." The mean and standard deviation of the minimum "probable" threshold across all lawyer-participants was 72.88 percent and 11.54, respectively (range of 39-90). Thus, lawyers' mean probable threshold is 5 to 6 percentage points above that generally found for auditors. Furthermore, lawyers' consensus (as measured by the standard deviation) approximates that found for auditors (e.g., 11.7–Reimers 1992, 40; 13.0–Harrison and Tomassini 1989, 646). Accordingly, lawyers' mean assessed likelihood of unfavorable outcome exceeds auditors' mean "probable" threshold for the Security Patrol case and falls below that threshold for the Ms. Jones case.

As noted above, we manipulated the likelihood variable within subjects to economize on the number of subjects required for the experiment. To control for order effects, we randomized the order of the presentation of the two cases across subjects such that if any order effects are apparent, we can control for them in the analysis below.⁶

Participants and Experimental Procedure

We recruited lawyers for this study on a voluntary basis from two separate continuing professional education workshops held on a Midwestern university law school's campus. The instructor of the workshops provided us with time to briefly motivate the study, introduce the task, illustrate the use of the response scales, guarantee anonymity, and dispel any suspicion that deception was involved. We instructed participants not to discuss the cases among themselves until after the session, and not to consult any references for assistance. We randomly distributed

the instrument to 56 lawyers attending the workshop and indicating an interest in participating in the study. We collected the instruments as participants completed the task. We eliminated three responses that were incomplete in that they did not provide the requested judgments, and one response that was completed in less than 10 minutes, suggesting that the participant did not give due consideration to the substance of the case materials.

The lawyers for this study reported mean years of experience of 7.63 (range 1 – 38). They also reported that the mean number of times they had been involved with preparing similar responses in their work was approximately 6 times (range 0 – 16); thus, they have moderate task experience, at least with respect to preparing lawyers' letters. This is not to say that they have moderate experience in making the legal judgments involved. Participants rated the representativeness of their responses to real-world judgments to be an average of 6.5 on a scale from 0 (not representative at all) to 10 (very representative).

Despite lawyer-participants' backgrounds and their self-reported ratings on representativeness and experience, as a group they were not very familiar with the ABA Statement. Only one participant (2 percent) reported being "thoroughly familiar" with it while 16 (31 percent) indicated they were "somewhat familiar." The remaining participants (67 percent) indicated that they were unfamiliar with the document. Fewer participants were familiar with FASB No. 5. Twelve (28 percent) reported that they were "somewhat familiar" and one (2 percent) reported being "thoroughly familiar" with this document. We anticipated that lawyers having experience providing lawyers' letters to auditors would be more conversant with these documents.

STATISTICAL ANALYSIS AND RESULTS

Table 1 reports cell means and standard deviations for the dependent variables. The first entry in each cell is mean willingness to provide an estimate of the likelihood of an unfavorable

outcome (hereafter referred to as the “likelihood response”); the second entry in each cell is willingness to provide an estimate of the potential damages (hereafter referred to as the “damages response”). The table is split by case version, with descriptive statistics for the high likelihood case scenario (Security Patrol) in the first column and descriptive statistics for the low likelihood case scenario (Ms. Jones) in the second column. Clearly, the auditor requires a response on both items to be able to evaluate a given potential litigation contingency for financial reporting purposes. However, the descriptive statistics on willingness show that lawyer’s in the privilege scenarios are more willing to respond for both likelihood and damages.

(Insert Table 1 about here.)

To test the hypotheses, a repeated measures analysis of variance (ANOVA) was performed for each of the two willingness-to-respond dependent variables. Panels a and b of Table 2 show the results of these analyses.⁷

(Insert Table 2 about here.)

Privilege (H1)

H1a and H1b predict that, in the presence of privilege, lawyers’ willingness to respond with estimates of the likelihood of an unfavorable outcome and of the potential monetary damages, respectively, is higher than in the absence of privilege. The ANOVAs in Panels a and b of Table 2 show that privilege had a significant effect upon both the willingness to provide estimates of the likelihood of an unfavorable outcome and willingness to provide an estimate of potential damages. ($F=14.31, p=0.0004$; $F=11.87, p=0.0012$, respectively). Comparing the two means in the right-hand cells in Table 1 between privilege and non-privilege shows that the effects are in the expected direction. That is, the mean for the likelihood response is 82.93 for the privilege treatment and only 55.22 for the non-privilege treatment ($t=3.78; p=0.0004$), while the mean for the damages response is 83.26 for the privilege condition and only 58.62 for the

non-privilege condition ($t=3.44$; $p<0.0012$). Thus, these results are consistent with both H1a and H1b.

Likelihood (H2)

H2 predicts that lawyers will be less willing to respond to auditors when the perceived likelihood of an unfavorable outcome is relatively low. As noted, we implemented the likelihood manipulation by varying the substance of the underlying case scenarios with the contract case (Security Patrol) representing the “high” likelihood condition and the tort case (Ms. Jones) representing the “low” likelihood condition. Thus, H2 predicts that lawyers will be less willing to respond for the tort case than for the contract case.

The ANOVA in Panel a of Table 2 shows that the case manipulation has no significant effect upon willingness to provide estimates of likelihood ($F=0.29$; $p=0.5925$). This is reinforced by comparing the means in Table 1. The left-hand side of the first two cells in the bottom row of Table 1 shows that the mean likelihood (collapsing across privilege) for the Security Patrol case was 70.44 while it was 68.76 for the Ms. Jones case. This difference is in the expected direction, but as indicated in Panel a of Table 2, the difference is not significant. Therefore, this result is not consistent with H1a.

The ANOVA in Panel b of Table 2 shows that the likelihood manipulation is significant ($F=4.60$; $p=0.0368$). Comparing the right-hand side of the first two cells in the bottom row of Table 1 shows that the mean likelihood response is 74.08 for the high likelihood case (Security Patrol) and 68.75 low likelihood case (Ms. Jones). The difference, 5.33, is in the expected direction, and significant ($t=2.05$; $p=0.0229$, *one-sided*). Thus, the results are consistent with H2b.

DISCUSSION AND FUTURE RESEARCH

This paper provides the first empirical findings based on responses from practicing attorneys examining concerns about the efficacy of lawyers' letters arising from the effects of privilege and of potential differences between auditor and lawyer likelihood thresholds. Our findings clearly indicate that the potential waiver of attorney-client privilege may result in significant reductions in lawyers' willingness to respond; thus, this waiver in practice may inhibit lawyers' responses to auditors. Further, lawyers are found to be more reluctant to provide estimates of potential damages (but not estimates of likelihood) as the likelihoods of unfavorable litigation outcomes decline. Thus, the results regarding privilege and those for likelihood (insofar as providing estimates of damages) appear problematic for auditors since litigation contingencies qualifying under FASB No. 5 for accrual or footnote disclosure may never come to auditors' attention. Thus, from an auditor's standpoint, the most pressing issue concerns the extent to which lawyers, responding on behalf of their clients, will actually provide both (1) estimates of the likelihood of an unfavorable outcome, and (2) estimates of the potential damages when these two elements are required by FASB No. 5.

Our results must be considered in light of at least two limitations. First, although we were able to access practicing attorneys that had, on average, over six years of experience, they were not very familiar with either the ABA "Statement" or FASB No. 5, nor were they correspondingly highly experienced with providing lawyers' letters. This is not to say that they did not understand the legal issues underlying the case. Our use of practicing attorneys, nonetheless, adds to the external validity of the results and answers the call of Krogstad, et al. (2002) to access practicing attorneys.

Second, our task itself may have biased the results. In the privilege treatment, the context of the manipulation is altered from responding to general counsel (privilege) to responding to the

auditor (non-privilege). It is possible that changing this context, in and of itself, unintentionally contributed to the strong main effect for this treatment. We minimized the effects of any such potential influences by manipulating this variable between-subjects, by using parallel wording consistent with SAS No. 12, emphasizing the presence or absence of privilege separately from the respective contexts, and by directly linking the task to the estimation of contingent liabilities for financial statement purposes only (as opposed to other purposes for communication of such information from outside lawyers to general counsel). In addition, using the merger context may have led to more or less willingness to respond to auditors than a typical audit situation because mergers involve unique considerations, pressures, stakeholders' interests and trade-offs.

These limitations preclude policy prescriptions based on the results. Yet our findings provide a number of implications for both practice and research. First, standard setters and practicing auditors should note that the perceived lack of attorney-client privilege affects lawyers' willingness to disclose likelihoods and amounts. This result is consistent with the concerns raised both by the anecdotal evidence and relevant literature motivating this study. Moreover, as discussed above, FASB No. 5 contingency accruals are the end result of both the concepts underlying that accounting standard along with the interaction between the auditor and the auditee's legal counsel in the form of lawyers' letters. Our results strongly suggest that litigation contingencies may be significantly understated on balance sheets and income statements of U. S. companies. Nevertheless, Quinlivan (1991) argues that these concerns may be more apparent than real, noting the ambiguity of the law in this context coupled with a paucity of cases involving attorney-client privilege in relation to lawyers' letters. Regardless, the FASB, IASB, PCAOB, Auditing Standards Board, and other stakeholders should understand the potential evidential problems that are suggested by the results and should consider designing other procedures to obtain the evidence that lawyers' letters are expected to provide (e.g.,

avenues to increase willingness to respond) and/or seek further clarification of ambiguous concepts, procedures and responsibilities. For example, could the procedure be enhanced by involving the auditee's in-house counsel?

Overall, our experimental findings and observations suggest lingering questions that provide opportunities for future research. First, in addition to manipulating likelihood by varying the substance of the case (i.e., Security Patrol versus Ms. Jones), we also could have indicated to the lawyer-participants that the "lead" lawyer for the client, along with other members of the team, concluded that the likelihood of unfavorable outcome was X or Y, where $X > Y$ for the Security Patrol case compared to the Ms. Jones case. That is, we could have controlled this manipulation further with such language. Having said that, clearly, lawyers' responses show that their actual estimates of likelihood do vary in the anticipated direction for the Security Patrol case versus the Ms. Jones case.

Second, although our participants were experienced lawyers, we noted that they had moderate task experience, and little familiarity with the ABA Statement and FASB No. 5. A question that remains open for further research is whether attorneys who have high familiarity with this guidance, as well as extensive task experience in writing lawyers' letters would respond differently.

Third, we requested lawyers to provide their judgment about their *willingness* to respond to the parties involved, but did not require them to make a decision as to whether they would actually respond. Lawyer-participants may not, therefore, have directly considered the analysis of the immediate trade-offs between relevant costs and benefits of providing such a response.

ENDNOTES

¹FASB Interpretation No. 14 (1976), “Reasonable Estimation of the Amount of a Loss,” suggests that specifying a range of loss constitutes a “reasonable estimate” and that if no amount within the range is a better estimate of loss than any other amount, the minimum should be accrued, when applicable.

² See Fesler and Hagler (1989) for an analysis of such litigation disclosures.

³ Procedural variations in the elicitation of information from lawyers may have contributed to response differences. For example, the company’s executive vice president requested the lawyers’ letters for Firm A while the senior vice president of administration requested the letters for general counsel. More importantly, letters requesting lawyers’ responses to Firm A followed SAS No. 12 wording guidance while those requesting responses to general counsel sought lawyers’ estimates of “realistic reserves.” Nevertheless, as a result of its evaluation, Firm B proposed an additional \$1,500,000 accrual for litigation contingencies.

⁴ Causey and Causey (1991) report that state statutes adopting limited accountant-client privilege are of doubtful value. The state in which the study was conducted has not adopted such statutes.

⁵ Krogstad, et al. (2002) consulted with practicing lawyers in developing the cases and four lawyers pilot tested their task. Two of the lawyers assisting in the pilot testing phase had accounting backgrounds and were employed in the tax area of a “Big 4” accounting firm. A

third lawyer was employed as general counsel for an insurance company and the fourth lawyer was in private practice. Slight modifications to the task were made in response to feedback.

⁶ Based on our design, we believe the likelihood of any demand effects associated with the within-subject likelihood manipulation is insignificant (see Schepanski et al. 1992).

⁷ The presentation order of the cases was alternated to control for order effects on the within-subject portion of the design cases (i.e., the likelihood manipulation); order did not significantly affect participants' responses for willingness to estimate likelihood ($F=1.72$; $p=0.1958$) or damages ($F=2.28$; $p=0.1370$), and so are not included in the analysis. Similarly, MANOVAs also were run with a variable for participants' familiarity with the ABA's "Statement", familiarity with FASB No. 5, and years of experience. None of the variables was significant in either model.

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FIGURE 1

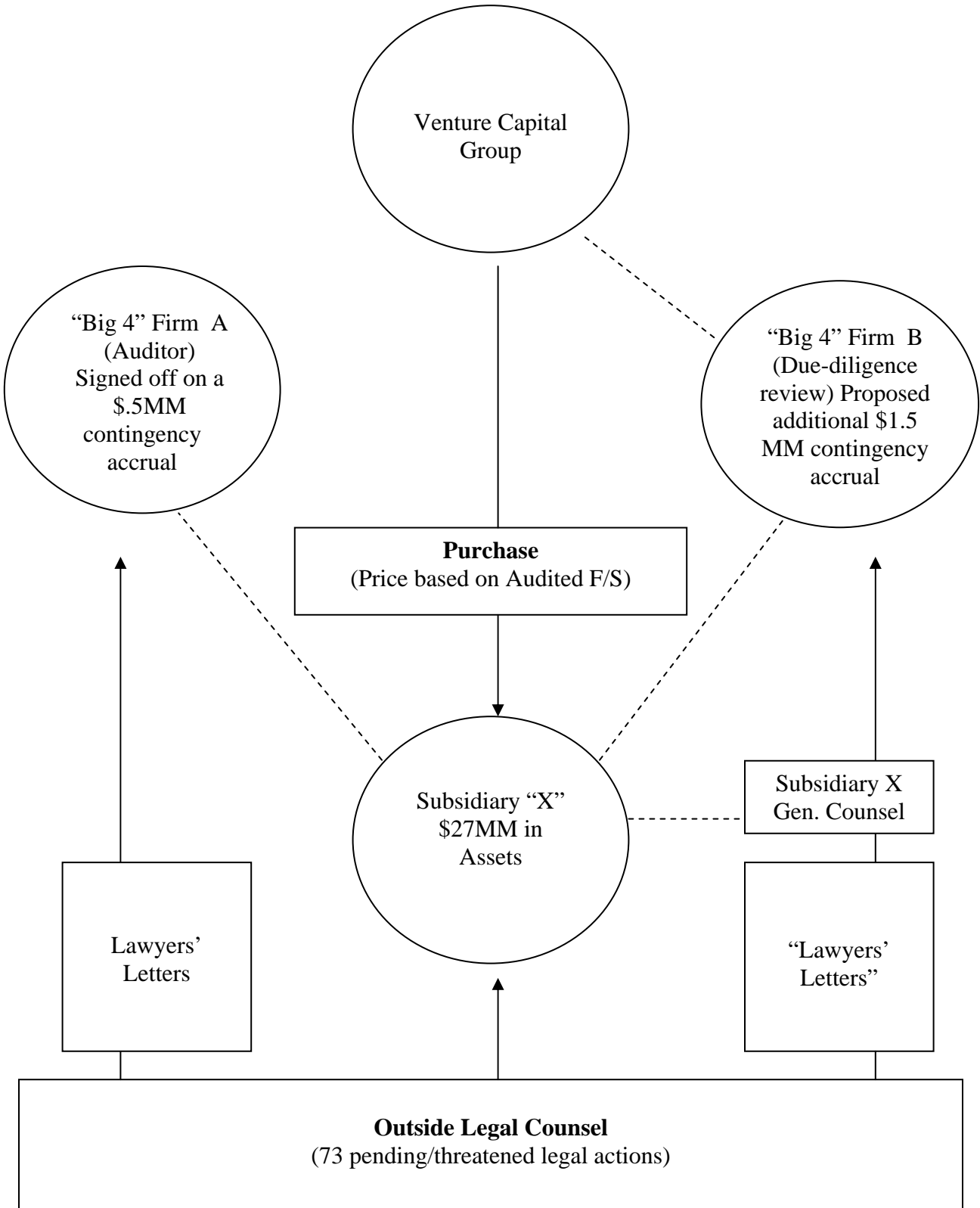
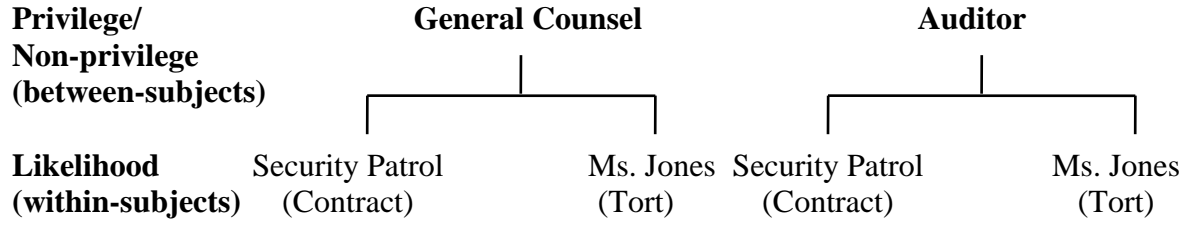


FIGURE 3

Experimental Variable Manipulations



Note: Mean likelihood assessments by participants were 72.26% for the Security Patrol case and 68.76% for the Ms. Jones case.

TABLE 1

Descriptive Statistics--Willingness to Respond with an Estimate of Likelihood and Damages: Cell Means (Std. Devs.) and Cell Sizes by Experimental Condition*

Manipulation	Case				Means across Cases	
	Security Patrol (Higher Likelihood)		Ms. Jones (Lower Likelihood)			
	Willingness to communicate estimates of:					
	Likelihood	Damages	Likelihood	Damages	Likelihood	Damages
Privilege	84.41** (21.4) N = 27	83.89** (21.6)	81.44** (24.5) N = 27	82.63** (22.5)	82.93** (22.0) N = 27	83.26** (21.7)
Non-Privilege	55.36 (33.7) N = 25	63.48 (30.4)	55.08 (33.3) N = 25	53.76 (33.8)	55.22 (30.4) N = 27	58.62 (29.6)
Condition Means	70.44** (31.3)	74.08** (27.9)	68.76** (31.7)	68.75** (31.7)	69.61** (29.6)	71.41** (28.4)

*The scale for these dependent variables was a 101 point scale anchored with “completely unwilling” on the left and “completely willing” on the right.

**Cell entry is significantly greater than 50 ($p < 0.01$), indicating general willingness to disclose.

TABLE 2**Analyses of Variance – Willingness to Respond****Panel a. Willingness to Respond:
Estimate of the Likelihood of Unfavorable Outcome**

<i>Variable</i>	<i>SS</i>	<i>Degrees of Freedom</i>	<i>MS</i>	<i>F-Ratio</i>	<i>p-Level</i>
<i>Between-subject:</i>					
A (Privilege)	19928.55	1	19928.55	14.31	0.0004
<i>Within-subject:</i>					
B (Likelihood)	68.26	1	68.26	0.29	0.5925
<i>Interactions:</i>					
AxB	46.72	1	46.72	0.20	0.6857

**Panel b. Willingness to Respond:
Estimate of Amount of Potential Damages**

<i>Variable</i>	<i>SS</i>	<i>Degrees of Freedom</i>	<i>MS</i>	<i>F-Ratio</i>	<i>p-Level</i>
<i>Between-subject:</i>					
A (Privilege)	15761.07	1	15761.07	11.87	0.0012
<i>Within-subject:</i>					
B (Likelihood)	782.38	1	782.38	4.60	0.0368
<i>Interactions:</i>					
AxB	464.61	1	464.61	2.73	0.1046