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From Legally Confidential to Financially Confident: Resolving the Tension between Lawyers and Auditors over Contingent Liability Disclosure

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*

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ABSTRACT

Auditors review documented financial figures to test for their accuracy and materiality. Lawyers analyze evidential facts and records to build sound legal arguments. These parties work toward a mutual purpose: to present their clients as legitimate and compliant businesses. But what happens when the concrete facts upon which lawyers and auditors base their work are obscured by their inability to see into the future? In other words, how can these professions conjunctively handle *potential* future obligations brought about by contingent liabilities?

This study will attempt to resolve the tensions that emerge between lawyers and auditors when tasked with estimating the likelihood and financial value of contingent liabilities. It considers the strict regulations set forth by the ABA and FASB and how each side might circumvent the guidelines to allow for better collaboration. Addressing a focal point of contention between the legal and financial professions for decades, this study will also look at past attempts at mediating the conflict as well as current proposals to alter the contingent liability disclosure process. Most importantly, it distinguishes itself from prior research by implementing firsthand arguments from professionals in each field to improve the cooperative landscape. Collectively weighing previously attempted solutions, current regulatory barriers, and professional guidance, this study proposes a three-step solution toward initiating reform between lawyers and auditors to enhance the visibility, precision, and ease of disclosing contingent liabilities.

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"A knotty puzzle may hold a scientist up for a century, when it may be that a colleague has the solution already and is not even aware of the puzzle that it might solve."[1]

Isaac Asimov, author and professor of biochemistry, Boston College

INTRODUCTION

By definition, contingent liabilities create a major obstacle to efficiency in professions that rely on concrete information, substantive details, and definitive answers. This obstacle is uncertainty, and it heavily influences a wide variety of practices, particularly within the legal and financial industries. Maneuvering around uncertainty, though, is key to coming to a conclusive resolution in any sort of decision-making process. This skill requires that professionals rely on their own subjective reasoning and estimations to overcome uncertainty and ultimately arrive at a verdict. Accordingly, handling matters related to indefinite items such as contingent liabilities involves a great deal of personal opinion and bias. At the end of the day, however, any conclusion that hinges on such vague, unconfirmed evidence that is highly subject to human error lacks full validity. Essentially, the point at which any form of uncertainty emerges leads to a loss of conclusiveness in the decision-making process.

From a legal and financial standpoint, this inescapable vulnerability caused by uncertainty is very problematic. The public likes to think of professionals in these fields as proponents of fairness; lawyers seek justice through holding people to the standards of established legal doctrine, while accountants and auditors are responsible for the fair and accurate presentation of financial information. With such high expectations for these

[1] Asimov, Isaac, *The Robots of Dawn,* (New York: Random House Publishing Group, 1983).

legal and financial authorities to be impartial and precise in their reporting, there seems to be little room for supposition.

However, when uncertainty regarding future events presents itself, lawyers and auditors have little choice but to stray away from measurable, proven fact. They must attempt to use any information available to them to reason, hypothesize, and compute impending results. Consequentially, their expert-level interpretations of expected future outcomes form the basis from which related parties develop their own opinions. This reliance on lawyers and auditors to construct definite answers from vague, unpredictable circumstances is one of the core issues that contingent liabilities present.

Specifically, contingent liabilities create separate issues for lawyers and auditors that are both unique to the professions but also contradictory between the two sides. The need for lawyers and auditors to interact regarding the treatment of contingent liabilities generally arises when an entity undergoing an audit realizes that it may soon undergo legal proceedings. The audit team is already involved with handling the contingency by ensuring that it is properly valued to ensure the accurate presentation of financial statements. In addition, though, the entity will also hire legal counsel to help plead its case. With regard to these uncertain situations involving potential losses to enterprises,[2] each profession is challenged to independently handle these items. Furthermore, they must work with one another to arrive at the most accurate conclusion on the materiality of the contingent liability as possible.

In general, contingencies are burdensome to consider and challenging to calculate when it comes to evaluating information in the present. Indeed, lawyers are accustomed

[2] Financial accounting definition of a contingent liability per FAS 5 ("Statement of Financial Accounting Standards No. 5: Accounting for Contingencies").

to dealing with contingent items; in fact, these liabilities are commonplace in the indeterminate nature of their business. Since all lawyers are tasked with shaping, influencing, and ultimately determining future court decisions, they are no strangers to operating in the abstract. However, it is important to realize that lawyers do not work in complete ambiguity. Rather, they make decisions within a realm of opportunity. This means that while lawyers have leeway in interpreting facts, constructing assumptions, and speculating theories on probable outcomes, they must still consider the concrete facts and information surrounding the case. American Bar Foundation Researchers Stephen Daniels and Joanne Martin illustrate this operative landscape. They consider lawyers' mentalities as responsively creative rather than open-endedly dubious: "lawyers do not work in a world of predictability or one of uncertainty. For them the dichotomy probably makes little sense. They work in a world of the possible, one grounded in the variability and complexities of individual disputes and the processes that resolve them" (Daniels & Martin, "Plaintiffs' Lawyers", 337).

This culture in the law field—that is, being more open to unconstrained analyses of case evidence—makes the process of handling contingent liabilities less daunting for lawyers. For one, the general population already understands that when a lawyer relays information to the public, it is infused with his or her own bias. This preconception relieves lawyers of any expectations to respond neutrally or objectively, leaving them with more freedom to interpret the case. Furthermore, lawyers are not liable to anybody if their predictions regarding contingent liabilities turn out to be incorrect. Rather than be charged with negligence for miscalculating a contingent liability's value, or even fraud in cases with gross misestimates, lawyers simply acknowledge a loss on the trial and take a pay cut for their incongruences.

Alternatively, financial uncertainty arising from contingent liabilities places auditors in a much more precarious position. Although they are used to extensive demands by the government to evaluate the accuracy of estimates, ambiguity in financial statements is the bane of auditors' existences. For one, the professional responsibilities that auditors assume as the impartial reviewers of financial statements make them constantly subject to the risk of litigation. If an auditor mistakenly approves of an inaccurate estimate of a contingent liability, or if he or she fails to perform due diligence by overlooking a faulty estimate, he or she may place the firm in the crossfires of litigation. Although it is easy to blame auditors in these circumstances, they should not be vilified when erroneous reviews occur. With limited information made available to them, their miscalculations are often honest mistakes.

Partly due to confidentiality issues, and partly due to a culture of distrust toward third-party evaluators, auditors simply lack full insight into a company's functions. Because there are fewer resources available to thoroughly scrutinize estimates, oftentimes auditors have to rely solely on information given to them by clients. These disclosures are typically far from exhaustive. Some critics point out that auditors have access to a wide array of industry data and prior research on similar enterprises to draw from when assessing contingencies. However, when the efficiency of the audit is at stake, especially when the audit firm bills the client on an hourly basis, the last thing an auditor wants to do is frustrate the client by engaging the client in such meticulous tasks. This practice would not only hinder the audit's progress by initiating a complex estimation process, but it would also require the auditor to request more information from the client. The resulting dilemma highlights the primary reason why auditors' judgments on contingent liabilities are largely driven by the lingering danger of litigation. The Big Four Audit Firms[3] are particularly concerned with this threat. Even though they claim to focus strictly on quality performance and actively work toward maintaining a positive image in the public marketplace, "it is litigation exposure rather than reputation protection that drives perceived audit quality" (Khurana & Raman, "Litigation Risk", 492). As a result, the lack of information available to auditors increases the chances of misstatement and puts audit firms at risk of litigation. These factors create a sizable hindrance toward the end goal of precisely measuring contingent liabilities.

Though audit firms tend to operate with the threat of litigation in mind, compliance with professional standards, especially through upholding objectivity and fairness, is still their central focus. To examine how various degrees of liability to outside parties impact auditors' disclosures of contingent events, the Journal of Business Finance & Accounting conducted a study on "Accountability and Auditors' Judgments" (Buchman, Tetlock, & Reed, "Accountability and Auditors' Judgments", 390). This study measured the difference in frequency with which auditors disclosed contingent litigation depending on whether they faced pressure from the audited client, the audit team partner, or nobody at all. It is important to note that in this trial, the auditors were all made aware of the client's preferred method of disclosure. Figure 1 displays the empirical results of this study.

[3] The "Big Four" Accounting/Audit Firms include Deloitte & Touche, PricewaterhouseCoopers, Ernst & Young, and KPMG, all of which are limited liability partnerships.

Disclosure of Litigation

Panel A: All Auditors

	*Accountable To:**			
	No One	*Client*	*Partner*	*Total*
Disclosure Method:				
No disclosure	5 (15%)	2 (6%)	4 (15%)	11 (12%)
Footnote disclosure	28 (85%)	30 (94%)	23 (85%)	81 (88%)
Total	33 (100%)	32 (100%)	27 (100%)	92 (100%)

*No auditor selected accrual of the contingent liability. χ^2 for Panel A = 1.519, d.f. = 2, significance = 0.46780.

Figure 1. Auditors' disclosure of information across various experience levels[4]

The data reveal that there were no statistically significant differences in disclosure of the litigation between the groups of varying accountability. Accordingly, this research proves that even when auditors have knowledge of a client's disclosure preference on the financial statements, their decisions about how to disclose litigation do not change. In other words, the auditors maintained their own professional skepticism and judgment even under pressure to comply with perceived client and partner desires. These results provide reassurance to the general public that auditors presumably act in the best interests of promoting full and accurate disclosure rather than simply pleasing the company being audited or the partner on the audit.

However, the industry's emphasis on ethical decision-making incites issues between not only audit firms in competition but also between audit firms and law firms. First, an auditor's lack of accountability to outside motivations serves as a platform for clients to "opinion-shop" among audit firms. This means that if one firm refuses to endorse a company's accounting treatment of contingent liabilities, the company can

[4] Buchman, Tetlock, & Reed, "Accountability and Auditors' Judgments", 390. The figure displays the combined results for trials with auditors of both "experienced" and "inexperienced" rank. The authors specify that the two subsets are distinguished by "those subjected experienced in our decision context and those subjects without experience in our decision context" (386). The "decision context" refers to whether or not the auditor has previously been involved in the process of reporting contingent litigation.

easily approach another audit firm and leverage the competition between the firms as a means of eliciting the reporting treatment it desires. This continuing trend in the financial services industry is the result of "how professional firms have become vulnerable to intensified market forces in the last quarter of the twentieth century" when they began to compete in "audit price wars" (Rostain & Regan, *Confidence Games,* 52-55). From this movement, it is apparent that the steadfast belief in objectivity in reporting contingencies might ironically encourage other companies to act less ethically. By agreeing to accept clients in exchange for a guarantee to disclose contingent liabilities in a favorable manner, audit firms no longer act in the best interests of financial statement users.

Another issue raised by the auditor's commitment to impartiality is that it weakens communication efforts between lawyers and auditors pertaining to contingent liabilities. When auditors are more intrinsically focused on their own accountability to professional standards, they are immediately less lenient to other external concerns. As a result, they are likely to be less considerate of the lawyer's point of view on how to handle contingent liabilities. Here is where the core conflict manifests: at the fundamental difference between the auditor's need to follow accounting practices and the lawyer's need to act within legal guidelines. On top of it all, both sides are not just expected but required to act on their clients' best interests. This call for both parties to abide by not only their own principles, but also by the regulatory frameworks set out by each profession's industry standards, promulgates the conflict between lawyers and auditors in their attempts to disclose contingent liabilities.

CHAPTER 1: THE REGULATORY CONFLICT

Though ideological disagreements between lawyers' and auditors' approaches to handling contingent liabilities differentiate the two sides, the regulatory standards that govern each field are what maintain the chasm between these professions. Those working within the worlds of accounting and law alike are subject to fundamentally distinct but equally high levels of scrutiny. Each industry's governing bodies, which cater to people and businesses on seemingly unrelated issues, rely on industry-specific considerations. As such, when they separately developed principles for lawyers and accountants to abide by, they took on an egocentric, internal approach. From the general tone to the specific provisions within each regulatory body's "rulebook", it is apparent that each profession gave little thought as to how its own code of conduct would overlap and intervene with the standards from other industries. Therefore, when it comes to adhering to the financial and legal guidelines dictating the treatment of contingent liabilities, lawyers and accountants find themselves largely deadlocked.

Lawyers operate under the ethical and regulatory guidelines determined by the American Bar Association (ABA). Per its mission statement, the ABA seeks "to serve equally [its] members, [its] profession and the public by defending liberty and delivering justice as the national representative of the legal profession." To strive toward this mission, the ABA defines its four primary goals as serving its members, improving the legal profession, eliminating bias and enhancing diversity, and advancing the rule of law (ABA, "Mission and Goals"). Most of the regulation surrounding legal practices derives from the Lawyer Ethics & Regulation Group as well as the Professionalism Group within the ABA. In terms of oversight, states will oftentimes establish a state bar, as in the State Bar of California, and counties within states might also create a bar association, such as the Los Angeles County Bar Association, which direct and oversee the standards for professional conduct within their respective jurisdictions. Between the Lawyer Ethics & Regulation and Professionalism groups, the ABA releases reports on sweeping initiatives, standards of policy pertaining to specific issues, and standards of professional conduct/courtesy governing lawyers' accountability in practice.

Within the ABA, the Audit Responses Committee delegates how lawyers should handle auditor inquiries related to financial reporting and disclosure issues. This committee specifically addresses inquiries pertaining to the existence, likelihood, and value of contingent liabilities (ABA, "Audit Responses Committee"). Lawyers can utilize the *Auditor's Letter Handbook* as a point of reference for handling the overall process of responding to formal audit letter inquiries. More specifically pertaining to the treatment of contingent liabilities, though, lawyers will refer to the *ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information.* As a convenience to lawyers, the statement contains a general overview of the accounting profession's *probable, reasonably possible, and remote*[5] standard, and then evaluates this issue from a legal perspective.

Through this statement, the ABA's ultimate conclusion on how lawyers should respond to auditors' requests basically releases them from any obligation to provide an opinion on the probability of a contingent loss. First, the literature points out that lawyers rarely make quantifiable predictions regarding the likelihood of a lawsuit's outcome. It

[5] The probable/reasonably possible/remote standard resides in FASB Codification, discussed on page 11.

goes on to assume that even when lawyers make these projections to contextualize the case, the estimate of likelihood has nothing to do with the sort of statistical or empirically grounded evidence that auditors want. Secondly, the ABA points out that the predicted dollar value of the contingent liability has little to no relevance. It supposes that not only would this value fluctuate over the different stages of the lawsuit, but it would also reflect an imprecise estimate of worth. With these concerns, the ABA statement essentially argues that forcing lawyers to estimate legal outcomes would be futile and reckless. In the end, the ABA concludes that "as a general rule, it should not be anticipated that meaningful quantifications of 'probability' of outcome or amount of damages can be given by lawyers in assessing litigation" (Keller, "Audit Response Letters"). Thus, while the ABA's concerns about lawyers unjustifiably and inaccurately evaluating contingent liabilities are certainly legitimate, it is obvious that ABA regulations require lawyers to do little to nothing on their end of this complicated, two-sided process.

Auditors and accountants, on the other hand, adhere to the provisions of the Financial Accounting Standards Board, or FASB. Though the Securities and Exchange Commission (SEC) possesses legal authority over public companies' financial accounting practices, it relies heavily on the FASB's presence in the private sector to represent and respond to the public interest. The FASB's mission statement outlines its goal: "to establish and improve standards of financial accounting and reporting…that provide decision-useful information to investors and other users of financial reports." Accordingly, the FASB "encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the Financial Accounting Foundation's Board of Trustees" (FASB, "Facts About FASB"). Through establishing, evaluating, and improving Generally Accepted Accounting Principles,[6] the FASB delineates the doctrines and regulations that U.S. companies adhere to when reporting their financial position and preparing financial statements. It does so through the Accounting Standards Codification, which organizes and enforces accounting practices in accordance with its Conceptual Framework for developing accounting standards. To implement these principles, the FASB issues pronouncements in the form of Statements of Financial Accounting Standards, Statements of Financial Accounting Concepts, Interpretations, and Bulletins. As a result, when auditors review clients' financial reports, they are responsible for ensuring that entities, namely public companies, are operating within the governance of GAAP, as laid out by the FASB.

Since contingent liabilities embody all things vague and uncertain that the accounting profession so vehemently detests, the FASB has released extensive literature on the treatment of contingent liabilities. This literature has mostly arisen from the issuance of *FAS 5: Accounting for Contingencies*. Much of the content in FAS 5 applies specifically to loss contingencies and how to recognize their incurrence. First, it requires that a contingent liability must be categorized according to where it falls on a spectrum ranging from probable, reasonably possible, and remote likelihood of occurrence. According to the statement, *probable* encompasses when the future event(s) is/are likely to occur. Likewise, *reasonably possible* defines the chance of the future event(s) occurring as being less than probable but more than remote, meaning that *remote* describes a slight chance of the future event(s) occurring (SFAS No. 5, FASB). FAS 5 proceeds to provide a number of examples of loss contingencies both in the statement

[6] Henceforth referred to as GAAP.

itself as well as in the appendices, outlining realistic simulations of how to report contingent liabilities.

Furthermore, FAS 5 defines the conditions under which accountants accrue loss contingencies as well as the guidelines for the proper disclosure of these items. To accrue a loss contingency, information regarding an impaired asset or incurred liability must be available before the issuance of financial statements. The FASB reasons that this definition of available information about the contingency implies that it is probable that some event or events will occur to confirm the loss. In addition, the amount of the contingent loss must be reasonably estimated for reporting. If the contingency meets both of these requirements, FAS 5 mandates that it should be accrued using a deduction in income.

Aside from this general framework, the statement also defines other scenarios in which disclosure of a contingent liability should occur in order to preserve the accuracy of financial statements. These alternative circumstances for disclosure include when contingent losses are reasonably possible, when additional information arises to support at least a reasonable possibility of a loss or impairment, and when losses fall into a special category of "guarantees" (SFAS No. 5, FASB). The FASB lays out a thorough basis for auditors to assess the definition, likelihood, accrual, and disclosure of contingent liabilities so that evaluation of these items is as methodical yet defined as possible. As a very basic reference to determine whether or not to report contingent liabilities, auditors typically adhere to the following decision matrix, which summarizes the pronouncements of FAS 5:

	What is the **probability** of occurrence?			
Is the value of the contingent liability **reasonably estimable**?		**Probable**	**Reasonably Possible**	**Remote**
	Known	Liability accrued and disclosure note	Disclosure note only	No disclosure required*
	Yes	Liability accrued and disclosure note	Disclosure note only	No disclosure required*
	No	Disclosure note only	Disclosure note only	No disclosure required*
*Except for certain guarantees and other specified off-balance sheet risk situations				

Figure 2. Contingent liability disclosure decision matrix (7)

This decisive framework starkly contrasts that enforced by the ABA by requiring that professionals follow intricate rules in their assessments rather than simply pass off the responsibility to evaluate contingencies to another party.

Bearing the defined standards of each industry in mind, lawyers and auditors alike face the burden of avoiding a wide range of pitfalls that can impair their professional decision-making. Lawyers, for one, view the task of supplying information to auditors in their response letters as a hazardous endeavor: "as you draft a response, you are entering a minefield, thick with issues relating to waiver of privilege, terms of art such as 'probable' and 'remote,' risk of disclosure to litigation opponents, and the only 'treaty' affecting most domestic U.S. lawyers." Therefore, lawyers always bear in mind that "missteps bring severe consequences" (Allen, "Walking Through the Minefield", 10). The need to figuratively tiptoe around legal measures set in place by the ABA while

[7] J. David Spiceland, James F. Sepe, and Mark W. Nelson, *Intermediate Accounting* (New York: McGraw-Hill/Irwin, 2013).

simultaneously acting in accordance with FASB standards makes lawyers nervous and uncomfortable. It also impairs their operational efficiency as they are constantly held liable for making sound, accurate judgments.

The foreign, confusing nature of accounting literature to non-accountants that Allen alludes to brings up another issue for lawyers. That is, lawyers are challenged with having to deal with arbitrary terms when handling contingent liabilities with auditors. When technical language such as “probable”, “reasonably possible”, and “remote”, for example, presents itself in an audit letter, lawyers must devote extensive time and resources to acquainting themselves with the corresponding accounting regulations. In theory, since a lawyer is only bound by constraints imposed by the ABA, he or she could simply ignore the accounting rules and follow his or her own legal intuition. However, lawyers are aware that auditors rely heavily on their professional judgments, and the fact that a lawyer’s sole opinion “bring[s] severe consequences” to the audit gives lawyers essentially no choice but to learn the proper financial accounting practices (Allen).

The disjointed ABA and FASB rules draw attention to a widely debated topic in the accounting field: the utility of GAAP’s principles-based system contrasted by the International Financial Reporting Standard’s[8] rules-based system. In the U.S., lawyers must navigate GAAP’s vague accounting standards while still abiding by direct law mandates set forth by the ABA. Alternatively, a rules-based framework such as the IFRS’s would more appropriately accommodate the ABA’s tight restrictions on legal practices. Overall, the uncomplimentary nature of the relationship between the ABA’s and FASB’s standard-setting processes calls for modification on the FASB’s side to

[8] The international standard-setting body for accounting practices, henceforth referred to as the IFRS.

create a more definitive, rules-oriented GAAP framework. This objective, though, calls for sweeping reforms in American accounting practices that are hardly plausible at this point in time. On the whole, though, it is obvious that the accounting industry asks a lot of its legal counterparts when it comes to assessing contingent liabilities.

Lawyers are not the only professionals who have to depend on knowledge from outside of their industry to accurately assess contingent liabilities; auditors also express their own concerns with how to navigate relations with lawyers in determining contingent liabilities. In evaluating the financial impact of a lawsuit on a company's books, auditors must solicit approximations from legal advisors on not just the probability of litigation, but also the resulting events that would ensue from litigation. In this regard, auditors depend on lawyers to "analyze and present in a separate section of the notes to the financial statements the contingent assets/liabilities, namely the generating events, as well as the estimations regarding the event that will transform them into balance sheet items" (Cenar, "Accounting Policies", 240). Though, as described earlier, these reporting requirements are significantly burdensome to the lawyer, an auditor cannot perform his or her duty to the client without the lawyer's comprehensive opinion. Ultimately, if an auditor cannot solicit this information from a lawyer, he or she will be held accountable for any discrepancies that arise between GAAP's provisions and the client's reporting of contingent liabilities.

Thus, it would appear that the responsibility to accurately estimate and disclose contingent liabilities is primarily pinned on the lawyer. On one hand, placing this duty on the lawyer seems fair. Not only do legal oversight privileges grant lawyers more immediate access to information pertaining to potential lawsuits, but they also have more sway to rely on intuition to drive professional decision-making. Simply put, lawyers know and practice the law—legal standards to which all parties are subject—to a much greater extent than auditors do. However, lawyers should not be fraught with maintaining client confidentiality while concurrently reporting this sensitive information to outside parties. The expectation that lawyers should know and utilize all GAAP guidelines to come up with a precise estimate of contingent liabilities is unreasonable. Even more, the prospect of a lawyer using financial accounting standards to accurately compute the value of a contingent liability in the same manner as an auditor would is simply unrealistic.

The regulatory discrepancies between the legal and financial accounting industries pertaining to the treatment of contingent liabilities reveal a sizable disconnect between the two professions. While lawyers are essentially given permission by the ABA to waive their responsibility to provide auditors with substantive information, auditors are faced with the FASB's requests for hefty, meticulous reporting measures to extract these arbitrary details. At its core, this issue represents an imbalance of supply and demand; lawyers fail to supply ample information to auditors, and auditors hold incredibly high expectations for the volume of material lawyers should provide. This divide between the professions brings the matter back to the issue of uncertainty. With such a large gap separating the two parties' potential for collaboration, each must fill the gap with ambiguous estimates and assumptions regarding the other side's area of expertise. Since contingent liabilities are such instrumental components of both lawyers' and auditors' assessments of lawsuits, there needs to be a way to create some overlap between the two sides.

CHAPTER 2: THE HISTORY OF CONTINGENT LIABILITY REPORTING

Lawyers and auditors have been plagued by the issue of uncertainty brought about by contingent liabilities for decades. Specifically, the process of handling contingent liabilities has been a major source of contention and reform in the financial reporting industry. Before the advent of the ABA and the FASB, companies were mainly concerned with contingencies from a financial standpoint, owing to the possibility of high litigation costs and how they might impact income. As a result, contingent liabilities were only addressed in the general context of sensible and ethical accounting practices. With no formal FASB standard for reporting contingent liabilities until 1975, companies' individual preferences for bookkeeping determined how they would handle contingencies. These preferences obviously contained a great deal of bias and reflected companies' motives to optimize current financial standing. Only when each profession enacted separate, stringent rules around contingent liabilities did the lawyer-accountant conflict arise. Up until then, much of the debate around contingent liabilities drew primarily from the accountant's responsibility to report fairly and accurately.

Over a century ago, contingent liabilities simply went undisclosed. This approach seems logical; not only did it relieve companies of the burden of having to justify their estimates, but it also saved them time, human capital, and the inconvenience of arriving at an agreement on valuation. In the absence of any form of GAAP to abide by, regulatory bodies had no basis from which to charge companies with improperly handling contingent liabilities. In turn, companies gained relief from litigation threats. With the freedom to deal with the lingering possibility of a lawsuit however they chose, most companies decided to leave contingent liabilities off of their financial statements. In doing so, companies achieved a major market advantage by presenting their balance sheets with as few future economic obligations[9] as possible.

As it turns out, the proposal for companies to simply leave contingent liabilities off the balance sheet posed major concerns for users of financial statements. In general, companies not held accountable to addressing current threats to their financial positions and reputations in the market were automatically given more sway to act unreliably and irresponsibly. Furthermore, it placed more of a burden on the general public to try and assess the companies' activities. With regard to interpreting companies' current financial statuses, predicting their future performance, and holding them to ethical standards, allowing companies to dismiss contingent liabilities from their financial data proved negligent.

On the surface, failure to disclose contingent liabilities skews a company's financial data when these lawsuits actually become permanent losses. When a company loses a case, the settlement itself is accompanied by various legal fees and statutory costs, accumulating into sizable litigation expenses (Shavell, "Suit and Settlement vs. Trial", 2). Omitting these exuberant fees creates issues for companies in terms of maintaining consistency in not just financial reporting, but also in representing their market performance. The general public, particularly investors, do not necessarily appreciate when a company's income takes a sudden blow due to previously undisclosed matters that the company may have known about for months, even years, in advance.

[9] Per Spiceland, Sepe, and Nelson, the financial accounting definition of liabilities is "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events"

Disregarding contingent liabilities also gives rise to the possibility that a sudden appearance of these lawsuits would cause adverse investor reactions, significantly destabilizing the market. Adding to the unpredictability of investor reactions, failure to record these contingencies would make people's economic behavior even more volatile. To this point, a look into the case of the Chicago, Rock Island, and Pacific Railroad Company from 1903-1904 reveals how the materiality of these non-disclosures manifest in consumer reactions. During this time when there were no standards governing contingent liability disclosure, the Chicago, Rock Island, and Pacific Railroad Company amassed 307 court cases. As one might guess, none of these cases made their way onto the company's financial statements. However, in their study on the impact of nondisclosure in annual reports, Roger Daniels and Dale L. Flesher found that if the company had followed the requirements of FAS 5, "decisions made by financial-statement users could have been influenced." As a result, they argue that "the contingent liabilities of the Chicago, Rock Island, and Pacific Railroad Company of 1903 and 1904 would have been material" (Daniels & Flesher, "The Chicago, Rock Island, and Pacific Railroad Company", 64). This study points out that when an item's presence or absence on the financial statements influences its users' opinions, this effect in and of itself constitutes materiality. Therefore, it is pertinent that these decision-making or decision-breaking items are recorded.

Perhaps most importantly, when companies are not held accountable to reporting contingent liabilities, they have the potential to evade the ethical standards of business. Not only do most companies want to uphold an image of corporate responsibility and morality, but at the very least, they owe a degree of honesty and transparency to those in the general public who purchase their goods and services. This issue also appears in the aforementioned case of the Chicago, Rock Island, and Pacific Railroad Company with regard to ethical and unethical practices. Although Daniels and Flesher find that the 307 cases were monetarily immaterial to the company's financial statements, its extensive list of real and potential liabilities raised issues. The Company was being litigated for various cases of malpractice; the list ranged from small charges such as loss of shipments and property damages all the way to extreme cases of employee injury and even employee and passenger death (Daniels & Flesher, "The Chicago, Rock Island, and Pacific Railroad Company", 59). Regardless of whether or not modern standards of materiality versus immateriality should be applied to this century-old circumstance, this case almost certainly calls for disclosure. Most people would agree that when it comes to humaneness and looking out for the best interests of the general public, these liabilities should be made clear in some capacity. Particularly in today's society, with so much attention being devoted to upholding ethical standards in corporate practices, this failure to disclose contingent liabilities and thereby misinform the public of a company's activities is not acceptable.

Gradually, it became clear to the accounting community that nondisclosure of contingent liabilities posed both financial and ethical issues for public and private companies alike. In response, with no former definitive guidelines as to how to report contingent liabilities, the government-sponsored Committee on Accounting Procedure released Accounting Research Bulletin #28 in 1953. This framework became the first authoritative source to outline the suggested accounting treatment for contingent liabilities (Daniels & Flesher, "The Chicago, Rock Island, and Pacific Railroad

Company", 56). Though it was a pivotal step toward the regulation of contingent liability disclosure, ARB #28 provided only vague recommendations to companies as to how they should treat these financial statement items in line with historical precedent. It stated that "contingent liabilities may be disclosed in the financial statements without recording them as assets and liabilities." In other words, companies could still easily avoid imposing these obligations on income-generating items. Even further, the bulletin declared that "it is customary accounting practice to show them on the balance sheet as deductions from the related contingent assets so that no effect upon financial ratios and relationships results" (Restatement and Revision, 1953). Accordingly, it became obvious that the bulletin was issued with an air of leniency and conservancy in mind. In short, it was not designed to reinvent accounting standards. Rather, ARB #28 ended up easing the flow of the transition between the deregulated reporting of the early 1900s and the staunchly defined rules that would come along with FAS 5.

Thus, in 1975 the FASB passed FAS 5 as a new component of GAAP. As delineated in the previous chapter, the intended purpose of FAS 5 was to 1) apply the likelihood of a contingency's occurrence to its appearance on the financial statements, and 2) define when it is appropriate to disclose the contingencies, given availability of information on timing and estimates. FAS 5 laid the basic groundwork for more definitively handling the uncertainty behind instances of contingencies. However, the standard gave little guidance as to how auditors should solicit from outside parties the information pertinent to defining contingent liabilities.

As a result, shortly after FAS 5 entered the financial reporting field, the FASB released Statement on Auditing Standards No. 12 in 1976. SAS 12 specified how auditors should inquire of clients' lawyers concerning litigation, claims, and assessments (AICPA, SAS No.12). The addition of SAS 12 to the auditing framework for reporting contingencies was crucial to informing accounting professionals on how to retrieve information on lawsuits and cases that give rise to contingent liabilities. This statement not only identifies auditing considerations in this process, but it also provides auditors with known limitations for lawyers. As a result, auditors have a better idea of what kinds of confidential information lawyers will be willing to surrender. The release of SAS 12 reflects a concerted effort on the financial reporting side of the equation to equip accountants and auditors with perspective on what challenges lawyers face. It is important to note, though, that while SAS 12 highlights the main issues that put auditors and lawyers into opposition, it does little to actively solve the conflict.

During this time, accountants and auditors were not the only professionals on the receiving end of tighter, more definitive rules surrounding contingent liability disclosure. As formerly explained in Chapter 1, the ABA released the *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* in 1975 to aid lawyers in deciding what information to provide to auditors. In essence, this was the legal field's effort toward bridging the gap between auditors' and lawyers' expectations as to what casework can make its way into audit documentation. More recently, the ABA published the *Auditor's Letter Handbook* in 2013 to institute a thorough basis from which lawyers can draft responses to auditor letters. These publications from the legal side of reporting contingent liabilities represent an equally pervasive effort on the lawyers' behalf toward mediating the issue of transparency. However, though it is clear that these recent developments in financial and legal regulations around disclosing contingent liabilities have led to progress in reporting, the current framework is still far from perfect.

Unfortunately, these previous and current methods of reporting contingent liabilities provide little insight into how they should be handled in today's society—a corporate world forced to cope with amended laws, tightened regulations, and renewed business practices. Not only are the preexisting measures outdated and insufficient, but they also fail to solve both the problem of uncertainty behind contingent liabilities as well as the need for cooperation between lawyers and auditors. If they had already done so, this conflict would not exist. Looking forward, it seems necessary to start at the very roots of each profession to see what causes them to diverge over contingent liabilities. Accordingly, devising an immediately viable plan for easing the tension between lawyers and auditors involves surveying the professionals who personally handle these issues on a day to day basis.

CHAPTER 3: PROFESSIONAL CONSIDERATIONS AND OPINIONS

This chapter presents firsthand accounts from highly experienced attorneys and auditors regarding what they believe to be the focal issues behind contingent liability disclosure. For lawyers, not only does the *ABA Statement of Policy*[10] weigh heavily on their reporting decisions, as previously mentioned, but longstanding legal concepts and doctrines also play a substantial role. Auditors have more narrowed, specific regulations set forth by the FASB that dictate the treatment of contingent liabilities. Granted their relatively recent implementation, these provisions have only made a culpable impact on the accounting profession in the past few decades. As a result, longevity and tradition create a clear distinction between the motivating factors behind lawyers' and auditors' "duties" to handle contingent liabilities. Whereas lawyers can be said to rely on customary industry procedures to mandate their decisions, auditors are perceived to base their actions on recently implemented and strictly enforced rules. As these interviews will reveal, though, the professions share the same end goal: adopting a "customer-first" mentality to prioritize the best interests of their clients.

Incorporating the viewpoints of professionals in both the legal and financial reporting fields on their respective governing bodies is imperative to fully examining the roots of the contingent liability conflict. These professional opinions provide insight into a wide variety of issues that currently plague lawyers and auditors as they attempt to ensure the fair and accurate disclosure of contingencies. This chapter covers opinions on both sides of the conflict; however, there is a notable difference in how comprehensive

[10] Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. (April 1976), as referenced in Chapter 1.

each profession's opinions are. Namely, there is a much more thorough review of the legal perspective on contingent liabilities than that of the auditing side. This discrepancy occurs because, as one might imagine, a lawyer's main responsibilities concentrate primarily on handling litigation. Conversely, auditors only rarely deal with companies that report contingent liabilities arising from claims, assessments, and litigation. Regardless, each professional brings up crucial points in his or her commentary on contingent liabilities, providing tips and solutions toward alleviating the tension between lawyers and auditors.

THE LEGAL SIDE

As previously stated, a lawyer's mentality hinges largely on precedent. Policies and procedures mandated by the ABA, its internal regulatory bodies, as well as state bar associations give rise to the commonly accepted practices from which precedents arise. As an example, to formally delineate the extent of lawyers' disclosure requirements to auditors, the aforementioned *ABA Statement of Policy* provides the following basis:

> *Response may be Limited to Material Items.* In response to an auditor's request for disclosure of loss contingencies of a client, it is appropriate for the lawyer's response to indicate that the response is limited to items which are considered individually or collectively material to the presentation of the client's financial statements.[11]

A number of these provisions exist within the *ABA Statement of Policy* to help direct lawyers on how to address contingency losses. In worst-case scenarios, lawyers can pinpoint these clauses as defenses for their actions if they happen to be challenged by

[11] Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. (April 1976). American Bar Association. Retreived from americanbar.org.

auditors. As the professional attorney interview will reveal, though, it is rare for lawyers to automatically default to written guidance as a decision-making framework. Rather, when it comes to the way that legal culture impacts lawyers' actions, it is the well-known, customary doctrines that oversee the profession.

For the most part, the way attorneys approach lawsuits is primarily dictated by two of the industry's most ubiquitous standards: the attorney-client privilege and the work-product doctrine. These principles are fundamental attributes of the so-called legal culture, mainly because they epitomize lawyers' social function: to protect, serve, and defend their clients.

At its core, the aim of the attorney-client privilege is to preserve due process of law by facilitating candid and honest interactions between clients and their lawyers. By ensuring "that one who seeks advice or aid from a lawyer should be completely free of any fear that his secrets will be uncovered," lawyers are given full access to essential details of the case while clients, often defendants, are protected from self-incrimination (*United States v. Grand Jury Investigation*). The attorney-client privilege is a central consideration for lawyers when they are asked to respond to inquiries regarding the occurrence and value of contingent liabilities. Particularly when it comes to corporate lawsuits, companies' financial assets, market positions, and industry reputations are highly at stake. In this context, the attorney-client privilege is more prized than ever. An attorney representing a company undergoing litigation can expect to be called upon "to preserve not only his clients' *confidences—i.e.,* privileged material—but his *secrets,* matter which the client has asked 'be held inviolate' or as to which disclosure would be ‘embarrassing’ or ‘detrimental’ to the client” (Hooker, “Lawyers’ Responses”, 1022). Because lawsuits entail such significant implications pertaining to a company’s operative and often ethical practices, this privilege will likely be at the forefront of a lawyer’s mind when considering how to disclose matters involving contingent liabilities to auditors.

Equally critical to the legal profession is the work-product doctrine. It serves a purpose similar to that of the attorney-client privilege by shielding pertinent case information from outside parties. Broadly speaking, work product can be defined as "documents and other tangible things…prepared in anticipation of litigation or for trial" (Sawaya, “The Work-Product Privilege”, 32). Like the attorney-client privilege, lawyers are grateful for this medium through which they can extract all beneficial details of the lawsuits from their clients for open discussion. Conceivably, the work-product doctrine can absolve lawyers from the obligation to report contingent liability estimates to auditors. Since statistical and financial estimates of future legal outcomes hinge on lawyers’ “work” toward building a defense, they can argue that these disclosures would violate privacy. Lawyers, however, must carefully lconsider what items actually fall under the umbrella of “work.” Georgetown University Professor of Law Sherman L. Cohn asserts “a party's mental information is not protected by the work-product doctrine, even if that information was obtained by means that would normally fall under work-product protection” (Cohn, “The Work-Product Doctrine”, 923). Therefore, the lawyer’s use of this doctrine to avoid disclosure is highly dependent on each respective jurisdiction’s definition of work. Still, both the work-product doctrine and attorney-client privilege are not only prevailing standards in the legal practice, but they both serve a particularly significant purpose in terms of preserving lawyers' litigation strategies.

Lawyers, therefore, depend on both mandated regulations as well as time-tested legal doctrines in handling contingent liability disclosure with auditors. In essence, they refer to stated rules to steer their decisions as to how they should handle auditors' requests. They then rely on deeply engrained customs of the legal profession to justify the extent and manner of their contingent liability disclosures.

AN INTERVIEW WITH JOHN MACKIE

To gain insight on how lawyers apply these legal doctrines to their interactions with auditors, I interviewed Attorney at Law John G. Mackie. Mr. Mackie is Co-founder and Partner of Carle, Mackie, Power & Ross LLP, an independent law firm in Santa Rosa, California. He serves as the firm's Managing Partner and chairs the Transactional Practice Group as well as the Wine and Food Group. Prior to the interview, Mr. Mackie confirmed that the firm "handles many audit letters," including a number that require him and his staff to "carefully craft" responses. The following interview occurred on April 13, 2015.

Question: *What general procedures do you typically follow when handling auditors' requests for information pertaining to contingent liabilities?*

J. Mackie: "We get a lot of requests every year for audit letters, usually from companies' CFOs. However, our responses are almost always directed back to companies' audit teams. We do our best to cover any liabilities of which we are aware, ranging from legal fees to litigation. Litigation is the most difficult kind of liability to handle because it requires careful discretion over what to say and what not to say. Litigation does become a file of public record, though, so at some point anybody can look at a complaint filed. Also, we don't just serve clients defending cases. Companies can be plaintiffs or defendants. The bigger issue, obviously, is when they're defendants, which is also statistically more likely.

"Our goal is to try to be as factual as possible regarding the current status of the case. We stick with what has been filed, and we avoid talking about strategy. Auditors will often speculate about damages and possible liability. In these cases, we will usually say something along the lines of 'we believe the company has defenses and counterclaims against the defendant, and we plan to defend the case rigorously.' Another typical response we will give is simply 'we believe we have a strong defense' in order to avoid hurting our own defense in the process. When it comes to auditors' requests for an estimate of financial value, we will report what is given to us. Complaints usually have some sort of dollar amount attached to it—what we call 'substantial damages.'"

Question: *How well-versed in auditing/financial terminology do you have to be to respond to audit letters?*

J. Mackie: "Rather than speculate an abstract number, we make an estimate in a statement along the lines of 'we think there could be damages up to ____ [blank].' If we are truly strained for an estimate, we will report 'damages to be determined.' Oftentimes when there is a claim, we will state a factual claim and then counter it with a different estimate based on our own analysis. In general, though, it is rare to have to give a specific amount."

Question: *What are your biggest considerations/precautions when you are drafting responses to audit letters?*

J. Mackie: "Though we obviously adhere to ABA guidelines, we recognize that the standards are always changing. We also consider that the auditor is judged on a 'probity of investigation,' meaning that the team is reluctant to be held accountable for projection of potential for loss. This places less pressure on us to get it right, which is good because as lawyers, we are very cautious to be definitive since we have a greater probity of investigation. Sometimes, though, if auditors are not satisfied with a vague, non-definitive answer, they will send the letter back and ask for more detail because their main concern, as is ours, is materiality."

Question: *Which hinders your ability to communicate with auditors more (if at all): ABA Regulations or FASB Regulations?*

J. Mackie: "As the Opinion General, I abide mostly by the ABA or State Bar of California when I look to guidance. However, I don't usually look at guidance because most times, we receive a 'fill in the blank' form, if you will. This helps clarify the auditor's expectations of us within their regulatory framework as well."

Question: *Have you ever received backlash from auditors after responding that you cannot provide any information?*

J. Mackie: "Most times when there is backlash, it comes as a phone call because it is an urgent matter. The auditor will say, 'we need that letter' if for whatever reason it got tied up in the office. Other than that, we do on occasion receive the 'not enough information' complaint, to which we counter that we are constrained by confidentiality. A lot of times, though, our phone calls from auditors have to do with something called a 'date down,' which comes as a call the day they want to issue their letter and confirm the date of the letter. These issues are handled by paralegals in our office who deal with the details since this is a defined and time-sensitive process. These calls don't always have to do with litigation, though. For example, we recently handled a letter from a private equity firm transitioning from a Delaware Corp to Delaware LLC, and our job was to maintain equivalency."

Question: *What do you wish auditors knew about your profession prior to drafting audit letters?*

J. Mackie: "There isn't necessarily anything that auditors need to know. We consider ourselves fellow professionals, and we try our best to understand one another."

(End of Interview)

On the whole, this interview with Mr. Mackie illustrates several key insights into how lawyers work with auditors to disclose contingent liabilities, and specifically, how they respond to audit letters. As can be inferred from his comments on "carefully crafting" audit letters, not only are lawyers highly constrained by strict regulations, but they also exercise a great deal of caution for the sake of their firm's reputation when issuing information to auditors. Furthermore, he discusses how lawyers are frequently asked to make financial estimates when, in most cases, there is simply no way for lawyers to know any better than auditors what the monetary value of a claim or lawsuit will be. However, on a positive note, Mr. Mackie's description of this issue does not allude to any sort of negative tension between lawyers and auditors in terms of personal interactions. His emphasis on the mutual understanding that both parties are "fellow professionals" shows that there is plenty of opportunity for lawyers and auditors to collaborate toward solutions.

THE AUDITING SIDE

Like lawyers, auditors have their own set of considerations in mind when dealing with contingent liabilities. However, unlike lawyers, auditors rely on much less of an industry "culture" around general doctrines and practices that apply to the entire auditing profession. Instead, they tend to apply individual principles set forth by GAAP as well as separate pronouncements within the FASB framework. Simply put, auditors refer to regulatory literature to handle issues on a case-by-case basis. Therefore, when it comes to contingent liabilities, auditors default to FAS 5 and SAS 12, of which the specific mandates can be referred back to in Chapter 2.

The most basic problem with the two professions' divergent treatment of contingent liabilities is this difference in the big-picture approach that lawyers take as opposed to the red-line procedures that auditors follow. With regard to working with auditors on contingent liability disclosure, many lawyers agree "that the rules in the guidelines are confusing, and many of the law review articles or other statements concerning the audit letter process interpret the rules in an inconsistent manner" (Trainor, "The Ethical Playing Field", 2). It is important, then, to examine firsthand the auditor's main priorities and foci when dealing with contingent liabilities in order to reconcile this difference between the auditor's and the lawyer's mentalities. The following statements capture the practical considerations from the auditor's side of the issue.

STATEMENT BY KEITH REDMOND

Keith Redmond is a retired CPA who, prior to serving as CFO to a number of corporations, began the first seven years of his career as an auditor at Ernst & Young. At the time Mr. Redmond was working for E&Y a Senior Auditor, the company was one of the Big 6 Accounting firms. Upon being asked about his experiences with auditing companies undergoing litigation, he provided the following statement:

> Back when I was doing that sort of thing some 30 years ago, I don't recall having much trouble with the lawyers' disclosure under FAS 5 (yes, it was in effect back then), but I was auditing mostly privately held companies where everyone had their arms around most of the potential exposure items. Later at Ernst, I was involved in the audits solely from a tax accrual perspective, and the related accrual of contingencies of exposure items there.[12]

Though Mr. Redmond does not report any experiences with conflicting interests between lawyers and auditors, his comment referring to privately held companies has noteworthy implications. It provides that without having to adhere to PCAOB standards, auditors are much more capable of accessing information on contingent liabilities that are crucial to the audit. This type of visibility allowed by private companies is crucial to

[12] Keith Redmond, email message, April 6, 2015.

considering how auditors can retrieve this information from public companies. Perhaps this example suggests the need for another party to gain access to legal information rather than the auditor. This idea feeds into one of the steps pertaining to third-party involvement toward solving the tension between lawyers and auditors, which will be discussed later in Chapter 5.

STATEMENT BY VENISA IBARRA

Venisa Ibarra is also a licensed CPA who has served as a Partner at Deloitte & Touche's Los Angeles practice for the past 18 years. Her response to the same question posed to Mr. Redmond reveals additional considerations in terms of the different types of legal counsel that auditors interact with:

> In my experience, there is usually a reluctance by Companies regarding disclosures, including in-house counsel. I have rarely found tension with their external counsel, however, external counsel letters rarely provide much in the way of likelihood of outcome of the cases or financial impact. There is usually sufficient detail regarding the legal matter but very little in the way of likely outcome, etc.[13]

Likely due to her role and experiences as a Partner, Mrs. Ibarra's response specifically addresses the tension between lawyers and auditors. She discusses the auditor's struggle to not only extract information from lawyers, but also the difficulty with which they make estimates relying on limited facts. Both of these points offer steps toward solutions to the conflict. For one, auditors may need to differentiate their requests between companies' "in-house" and external legal counsel to gain more thorough information on claims and litigation. Additionally, Mrs. Ibarra hints to the fact that auditors must understand that lawyers have very little additional material available to

[13] Venisa Ibarra, email message, April 6, 2015.

them, making them no more capable of producing an accurate statement than auditors would be able to. This comment ties back to Mr. Mackie's assertion that lawyers simply do not have enough information nor the legal means to reveal any sort of definitive estimate of financial impact. Again, this major point of contention will also be addressed later in Chapter 5.

STATEMENT BY PAULA REDMOND

Paula Redmond is another licensed CPA who works as an independent consultant for finance projects. Before entering consulting, she also launched her career in the Big 6 with Ernst & Young, where she spent four years and became a Senior Auditor. Reflecting on her experience in the auditing profession, Ms. Redmond provided a number of points that explore the pragmatic application of contingent liability disclosure procedures:

> 1. The request needs to be in writing to both internal and external Counsel teams. This is an important point and gets the internal team engaged in the accuracy and completeness of the external business law firm's response.
>
> 2. The response also needs to be in writing from both teams. The accounting firm is issuing requests and gaining responses to get the facts, issues and conclusions individually assessed. They then also need to look at the issues individually and in the aggregate to determine if the internal accountants' assessments of financial risk are fairly stated.
>
> 3. On large multi-national clients, I have only seen success when developing a "consistent quarterly process" and engaging the general counsel (internal legal team) to review all responses from external counsel in a defined timeframe. My opinion is that the mailing process should be controlled by the external accountant, but the reviewing the responses for accuracy and completeness requires input from internal teams.
>
> 4. The General Counsel's office and business leaders should be required to certify to the 10K/10Q. A consistent quarterly process includes leaders in the business

and lawyers to "sign-off' in a formal manner that they have read the 10K/10Q and their area of expertise is fairly stated. Without an internal sign-off process, people tend to believe that the accountants are the only sign-off necessary.

5. Education as to the facts being gathered and a consistent quarterly process with defined timelines and deliverables is the best practice. The education should be in the ranks of the accounting firm as well as at the client.[14]

Ms. Redmond's input highlights her own slant on how to be scrupulously attentive in working with lawyers to gain information on contingent liabilities yet still ensure that each party enjoys the same benefits from the interaction. Her first two points bring up an issue that has yet to come up in this discussion: the need for timely and thorough documentation. By insisting that both parties self-impose strict standards of record-keeping, this point ensures that there is not only a viable reference for lawyers and auditors to come back to, but also that there is a mutual commitment between the two sides to operate ethically and professionally. Furthermore, with her third point, Ms. Redmond re-emphasizes the internal and external counsels' alternative functions, as Ms. Ibarra previously mentions. This consideration is vital to approaching communication strategies with each group differently. In a prime example of why this distinction is important, Ms. Redmond discusses in her fourth point how auditors must recognize, both for the sake of efficiency as well as to maintain positive interactions with legal advisors, which parties are required to approve of various financial matters.

As an appropriate summary of this section, Ms. Redmond's final point advocates education, knowledge, and familiarity in the contingent liability reporting process between the two sides. Though these essentials cannot be defined or tangibly measured, they capture the theme behind the changes that need to be made to how the professions

[14] Paula Redmond, email message, April 16, 2015.

handle these matters. With the prominence of education and open collaboration between the two sides in mind, the next chapter will explore the current regulatory movement toward reconciling the two professions' objectives. Conjunctively, these considerations will help construct a workable framework in the final chapter.

CHAPTER 4: THE CURRENT MOVEMENT TOWARD A MIDDLE GROUND

In response to disagreements between lawyers and auditors pertaining to the disclosure of contingent liabilities, professionals in each field have recently proposed a number of solutions to mediate the conflict. These measures have focused on lessening regulatory barriers, enhancing communication, and improving education between the two sides. While they provide valuable insight into how the professions can work together, most of these tactics fall short in their theoretical nature. Specifically, these suggestions for improvement come from only one of the polarized sides of the conflict, they demand significant changes in each profession's approach to litigation, and they rely on grand-scale reform that obstructs preexisting regulatory structures. Taken as a whole, the current movement behind encouraging auditors and lawyers to coincide on the treatment of contingent liabilities accurately identifies the deficits in the system. However, both professions still need concrete plans to amend regulation in order to elicit a tangible impact.

Arguably the most momentous step toward opening up communication channels between the industries occurred in 2009 when lawyers and accountants convened for the FASB Roundtable on Contingent Liability Disclosure. The roundtable assembled in order to build off the momentum of the previous year's FASB exposure draft, which sought to make litigation information on both the auditor and lawyer side more readily accessible. One of the greatest benefits of this meeting was the vast array of representatives from all parties involved in the mediation process. Members of the Chamber of Commerce, the ABA, and the defense bar were present to defend the legal perspective on the issue. To represent the auditor's interests, all members of the FASB partook in the discussions, and select individuals from the Securities and Exchange Commission (SEC), the Public Companies Accounting Oversight Board (PCAOB), and the International Accounting Standards Board (IASB) took part as well. The public interest also had advocates through individual company representatives and general users of financial statements. Achieving this diversity of opinions and viewpoints was a crucial component of the roundtable's goal toward far-reaching, unbiased reform for the system of disclosing contingent liabilities.

The first item on the roundtable's agenda was identifying areas to improve the reporting landscape. Members acknowledged that the current system of disclosing contingent liabilities on financial statements does not adequately inform investors on companies' positions in litigation proceedings (Lewis, "Report Back from FASB Roundtable"). This argument prevailed for obvious reasons. One of the more prominent points highlighted that only a specialized group of users of financial statements actually know and understand the intricacies of reporting contingent liabilities. For example, the simple inclusion or omission of disclosure in and of itself signifies a liability's likelihood, financial burden, and degree of impact. Without knowing that the accounting treatment of these items depends on probability and estimatability, the average investor might not realize that the absence of litigation costs on a financial statement does not mean it is immaterial. In fact, this inadequate disclosure calls for further investigation into financial statement footnotes and disclosures just to know whether a company is undergoing litigation in the first place.

However, this criticism pertaining to insufficient disclosure did not resonate as well with representatives from the legal profession. With confidentiality in mind, especially concerning the attorney-client privilege, lawyers failed to see a better alternative to reporting contingencies; they advocated that they already hand over all of the information they are legally permitted to disclose. In spite of this difference of opinion, the roundtable ultimately concluded that the inadequacy of current disclosures is the foundation of the issue behind visibility in reporting contingent liabilities.

Identifying this substantial deficit in contingent liability reporting laid the foundation for the roundtable's first proposal to amend the process. Members largely agreed that the *probable, reasonably possible, and remote* principle is too vague and gives companies undue flexibility in choosing whether or not to report liabilities. This issue results in insufficient information provided to users of financial statements. To alleviate this pain, the roundtable suggested a refinement to the *remote* standard as a first step toward definition and specificity. Representatives advocated that "if a liability is viewed by a company as 'remote' but the consequences could be severe, then disclosure should be required regardless of the timeline on which the liability would be resolved" (Lewis, "Report Back from FASB Roundtable").

This change would significantly improve reporting on both the legal and financial sides. For lawyers, the ability to disclose case information on remotely likely liabilities, irrespective of the liability's "timeline", is less demanding of their limited ability to perform financial forecasting. It relieves them of the hassle of predicting how litigation expenses should be allocated across multiple reporting years. On the auditor side, this suggestion strengthens the focus on materiality within the financial reporting industry. In essence, this proposition prioritizes economic substance over unpredictable odds. By arguing that all contingent items with potentially severe consequences should be disclosed, even those that are unlikely to occur, this amendment upholds GAAP's emphasis on conservatism[15] in financial statement reporting. In other words, severely consequential liabilities are presumably material, and the purpose of the audit is to ensure that all material items are duly noted in the financial statements. Therefore, this recommended practice assists with the auditor's goals toward financial statement accuracy as well as the lawyer's goals toward providing comprehensive and accurate information.

Though the previous point specifically aids investors in supporting their rights to ample and accurate information, the roundtable also took into account companies' rights to release and withhold financial information. On this point, the roundtable collectively agreed that the FASB should protect companies from reputational and financial damages. In order to ensure equal treatment between the two sides, the group advocated for "a balance between providing better information to investors, while not requiring disclosure of information that would prejudice cases being defended by companies, and therefore might actually lead to an increase in the costs of those liabilities" (Lewis, "Report Back from FASB Roundtable"). While this goal seems rather obvious, there are worrisome repercussions for companies disclosing litigation information in the event that lawyers and auditors do not properly sustain this balance. As the roundtable members pointed out, in amending the current process and forming new regulations for reporting contingent

[15] The principle of conservatism mandates that if a company could equally use more than one accounting method, the company should use the one that affects the financial statements in the least favorable way. nDefined by Wiley, in "GAAP and the FASB."

liabilities, the FASB must be careful not to hold companies responsible for disclosing information that would unduly influence the outcome of the case. The most important consideration is avoiding forced self-incrimination; that is, placing companies in a position of unnecessarily reporting harmful evidence against their cases, which would only result in heightened litigation costs.

Agreement on these two issues in the contingent liability reporting framework came easily to the roundtable since the proposed solutions benefitted both lawyers and auditors. The amendments also made practical sense without suggesting any radically unrealistic reform measures. However, when it came to addressing the conflict in its entirety, it became clear that there was a fundamental discrepancy between the two sides' viewpoints. That is, lawyers and auditors had different opinions on who bears the responsibility of accurate and transparent reporting. As a result, the solutions proposed by each side were vastly different.

On the legal side of the roundtable, the defense bar aired toward a more liberal solution to contingent liability reporting. This perspective placed the burden of evaluating and determining the extent of litigation impact on the investing public. The defense bar proposed that companies undergoing litigation should "provide shareholders with access to [such] contentions and public documents and then allow investors to do their own assessment as to the level of potential liability" (Lewis, "Report Back from FASB Roundtable"). This solution made theoretical sense for lawyers and auditors in terms of saving both parties time and other economic resources as well as reducing their liability to accurately estimate litigation figures. It also allowed investors to formulate their own opinions on the likelihood and value of the litigation rather than be immediately subjected to financial statement disclosures containing inevitable biases toward the company.

The FASB side, however, identified issues in this approach, declaring that it was a large disservice to general users of financial statements. Auditors argued that under this framework, smaller investors would bear an unfair burden of performing their own assessments on a company's litigation position. Not only does this approach disregard the fact that most investors have little to no insight on individual companies' legal situations, but even if investors had unlimited access to this information, it is painfully inefficient from a market perspective. The FASB pointed out that there would be "added cost[s] and inefficiencies posed to the broader investing community if everybody has to do their own assessments of the magnitude of these liabilities" (Lewis, "Report Back from FASB Roundtable").

In short, it simply does not make sense for every party investigating a company's legal proceedings to make their own judgments on financial effects. For a vast array of companies, this strategy is not just redundant, but it wastes one of their most valuable economic resources: time. Accordingly, the defense bar's proposition has important implications in terms of fostering independent financial evaluations of companies from diverse viewpoints. This benefit, though, is far outweighed by the abundance of time and other economic resources that this practice demands.

Alternatively, representing the financial reporting side of the conflict, the FASB issued a proposal that called for heightened regulation of contingent liability reporting through an entirely different party. This solution supported the idea that rather than assign the responsibility of evaluating contingent liabilities to any number of individuals in the general public, it should designate this task to a clearly defined group of experts. In essence, the FASB favored creating a requirement that companies involved in legal cases should "pay for and disclose a third-party assessment of the range of potential costs, akin to what an insurance company would do." Proponents of this solution theorized that these evaluations would be based on the public record so as to avoid jeopardizing the attorney-client privilege (Lewis, "Report Back from FASB Roundtable"). Similar to the defense bar's suggestion, this proposal has the advantage of reducing bias in determining the extent and value of legal costs by employing independent opinions. Simultaneously, it mitigates the concern that assessors of these liabilities lack appropriate knowledge, experience, and insight into contingent legal proceedings. This reassurance occurs through the expectation that the hired third parties will have a certain level of expertise.

In spite of these strengths, this proposal also falls short of a comprehensive solution. While the idea to establish these independent third parties is hypothetically sound, it does not seem possible to create an entirely new profession that could completely dismiss itself of regulatory liability. With so much at stake in litigation, even if it were possible to form completely unbiased entities to evaluate the likelihood and value of a lawsuit, these entities would still need to be held accountable to some standards of regulation within the ABA and the FASB. In this case, it once more seems economically inefficient to install a standard requiring evaluation and subsequent disclosure from these firms.

Furthermore, this proposal requires that the arbitrary line between what can and cannot be disclosed on the public record be set and clearly delineated. However, in the absence of any sort of definite conclusion as to what information should be made available to the public, this proposal is unrealistic and without any sort of regulatory framework to fall back on, it is not feasible. It became evident at the conclusion of the FASB roundtable discussions that the lawyer and auditor sides of the conflict failed to fully convene under ideologically divergent perspectives. A general lack of a realistic basis as to how these proposals would be implemented in the first place was to blame.

The FASB Roundtable signifies the one unique circumstance under which representatives from both industries actually met to discuss and seek out various means of mediation. For progress toward a solution to continue, lawyers and auditors need to keep seeking out opportunities to assemble and formally converse on how to transcend the obstacles currently in place. Fortunately, in spite of only a few isolated events under which the two sides have had the opportunity to meet, there is an array of research and literature that specifically addresses the need for a resolution. Though this work tends to take on theoretical solutions, research proposals have the advantage of considering the intricacies behind the minute details of the regulations that govern each profession. Therefore, they provide a stable foundation from which to build realistic, applicable solutions.

Taking a broad perspective on the issue of contingent liability reporting, a 2009 study in the Fordham Law Journal proposed some basic solutions as a starting point for how auditors can bridge the communication gap with lawyers to issue accurate financial reports. According to the authors, one method of maneuvering communication obstacles presented by the attorney-client privilege involves "reeducating" attorneys, auditors, and the courts under new provisions (Koprowski, Arsenault, & Cipriano, "Financial Statement Reporting", 455). Their concept of reeducation implies that within each practice, professionals should employ additional up-to-date tactics to the preexisting regulations within each of their respective fields to improve the reporting environment.

This platform calls first for attorneys to revise the *ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* to "make it less hostile to the process" of reporting contingent liabilities on financial statements (Johnson, "The Accountable Attorney", 33-34). This issue draws from the need for the professions to work on establishing a more open, collaborative environment in general, rather than continuing to work under the isolated, self-interested relational pretenses that currently exist. Auditors, then, should seek reeducation by broadening, improving, and refining the nature of the audit inquiry letter. The authors discuss how focusing on expanding the reach of the audit inquiry letter might not only help auditors gain more information from lawyers, but it might also provide clarity to lawyers with regard to what specifically the auditors seek expert opinion on. For lawyer and the courts, the authors vaguely advocate a change in mentality pertaining to precedents already set by the treatment of contingent liabilities. They acknowledge, however, that with little idea as to how court mentality needs to change as well as lawyers' limited control over judges' and juries' opinions, this change would occur slowly and likely only have a minimal impact.

Taken as a whole, it seems as though the only component of this three-pronged solution that would propagate any sort of tangible impact would be the call for an amendment to the *ABA Statement of Policy*. The problem with even this potentially influential solution, though, is that it actually manifests into a change more on the audit side than on the legal side. In practice, though, it is unreasonable to assume that lawyers should demand sway over the auditor's operations.

Koprowski, Arsenault, and Cipriano suggest a second solution to ease the tension between lawyers and auditors that has to do with inventing a new principle to jointly govern the auditor's and lawyer's operations. They pose a relatively simple, obvious suggestion: that the ABA and FASB create an Accountant/Auditor-Client Privilege. This doctrine would ensure that clients are entitled to confidentiality in disclosing legal information to those handling their financial statement disclosures (455-456). A few states already acknowledge this privilege, or at least some variation of it, for auditors and accountants in their interactions with clients. However, the first issue with this standard is that it is only recognized on a state-by-state basis. Without the ability to establish uniformity throughout the entire U.S. GAAP framework, this measure may only complicate lawyers' and auditors' interactions. Secondly, there appears to be no chance that this privilege would receive regulatory support because the PCAOB has already issued a public statement to clarify that it would not recognize it. The effort to create an auditor/accountant-client privilege, then, would appear futile. In addition, with auditors already subject to professional standards that ensure confidentiality in their proceedings with clients, this standard appears redundant and unnecessary.

Keeping with the popular advocacy of third-party involvement in the lawyer-auditor disclosure conflict, Koprowski, Arsenault, and Cipriano's last proposal argues for reporting by an independent third-party counsel. The idea behind this measure is to maintain expertise on the attorney side in terms of evaluating the merit of claims while still avoiding obstruction of the attorney-client privilege. This precaution is substantial because information gathered from the client's attorneys would never be disclosed to outside legal counsel (456-457). Again, the demand for some form of third-party involvement between these two professions is heightened by this argument, further pushing the need to establish these entities.

However, Koprowski et al.'s particular claim does not clearly delineate how the participation of third parties circumvents the attorney-client privilege. In fact, adding this third-party counsel would fundamentally violate the attorney-client privilege since it demands that an attorney on the case disclose litigation information to the counsel. In essence, without this forwarding of information from the legal side, this proposal really only adds another name to the list of individuals who approve of the "fair representation" of financial statements. It does little by means of adding substance to financial accuracy. This suggestion for third-party involvement therefore overlooks the fact that the hypothetical counsel would not perform any function that lawyers and auditors do not already achieve.

Various other sources of literature on contingent liabilities propose narrow, specialized solutions to the disclosure issue in particular. A prominent example of this approach comes from Karen Hennes, who theorizes that the best solution to this tension is to keep the current system in place. She argues that the most efficient solution lies in simply allowing investors to make their own judgments as to what the financial disclosure/nondisclosure of contingent liabilities signifies. As alluded to earlier, this approach, which allows investors to critically evaluate the probability and magnitude of loss on their own, is a popular alternative for those who believe that proper evaluation requires investors to arrive at their own conclusions. Hennes points out how "statements (or lack thereof) regarding the accrual status of the contingency, the potential materiality of the loss, and the firm's willingness to settle can all be used to form a meaningful prediction of the likelihood of loss in a given suit" (Hennes, "The Reporting of Contingent Legal Liabilities", 30). Ideally, investors and users of financial statements would be able to look into a company's 10K statements, even within statements in sections such as Management Discussion and Analysis (MD&A), to gain independent financial insight on a company's litigation proceedings.

Relying particularly on firms' own reports, though, once more raises the issue of the degree of subjectivity with which these reports on contingent liabilities are being presented. However, Hennes' study acknowledges this inherent bias and tests how large of a role it actually plays in practice. Surprisingly, she found that investors, even with their lack of knowledge on contingent legal liabilities as well as potentially being primed by MD&A bias, were still able to arrive at accurate estimates. In fact, her study shows that "predicted probability of loss derived from the financial statements is correlated with the market's expected probability of loss, which is consistent with the market using the SFAS 5 disclosures or similar information" (30). In other words, investors' predicted outcomes were consistent with the outcomes that auditors working under FAS 5 and other regulations would have arrived at. These predictions were also consistent with what actually took place in the market.

With this study, there is a strong argument to be made that investors are fully capable of doing their own homework and accurately making their own estimates regarding contingent liabilities. As was discussed in prior evaluations of this technique, though, the issue of economic efficiency still exists. Further, it is difficult to draw conclusions as to the experience and knowledge of the people making predictions in Hennes' study and whether the group was proportionally representative of the whole investing population. Even so, the research instills confidence in the general public's ability to project contingent liability occurrences, which seems promising with regard to upholding financial accuracy.

With a strong theoretical framework based on some form of communication between the two professions, these proposed solutions certainly add to the discourse surrounding the contingent liability dispute. However, the strongest, most sustainable recommendations for improvement have a realistically sound basis and do not call for groundbreaking reform in either industry. Accordingly, drawing from each of these studies' conclusions, there is potential for a collective structure to form that would help ease the tension between auditors and lawyers.

CHAPTER 5: A THREE-STEP SOLUTION TO RESOLVING THE TENSION

When it comes to creating an environment through which lawyers and auditors can work collaboratively to report contingent liabilities, two main obstacles prevail. For one, the issue of accuracy both from an occurrence standpoint as well as a financial valuation standpoint inhibits the two professions. With little experience in making financial projections, lawyers struggle to appease auditors' requests for accurate estimates. Adding to this strain, they must also judiciously report their assessments under the umbrella of client confidentiality. The auditor, on the other hand, must rely on the limited information disclosed by lawyers to calculate financial statement impact. This component of the audit is a major source of stress for auditing firms since they are liable for any inaccuracies or inconsistencies that may appear.

The second obstacle, addressed in Chapter 1, deals with each side's strict and unwavering regulatory guidelines. Though the rules of each profession effectively polarize the two sides, it is difficult and unreasonable to demand that one or both sides initiate sweeping reforms to their respective regulatory frameworks. Therefore, the primary solution to this stalemate rests on some method of establishing new communication channels to allow professionals on both sides to openly collaborate. Supposing that this two-way pipeline would be able to connect the professions, it would ease the foregoing tension by allowing lawyers and auditors to continue adhering to their own strict regulations while simultaneously working within the other side's rules.

Lawyers and auditors can address these focal issues by implementing three new measures to help standardize and simplify the process of reporting contingent liabilities.

First, they should categorize contingent liabilities in accordance with their impact on financial statements. Recognizing that it is too difficult to apply a singular rule to a wide range of contingent liabilities, this solution proposes a classification system which would group contingencies based on their financial consequences to companies. Second, the FASB should work conjunctively with the ABA to refine the *probable, reasonably possible, and remote* decision matrix. A revamped method of estimating the likelihood and estimatability of a contingent liability would not only be more strictly defined, but it would also apply to regulations governing both lawyers' and auditors' practices. The final—and likely most pervasive—measure calls for the creation of a third-party system to strengthen and clarify communications between the two sides. This component, as delineated above, would help combat bias between lawyers and auditors as well as disperse responsibility. Taken as a whole, these three solutions can drastically change the entire reporting landscape for contingent liabilities.

STEP 1: CREATING A CLASSIFICATION SYSTEM

For both lawyers and auditors to understand how to distinguish between types of contingencies, given their obscure differences, they must categorize them based on their financial statement treatment. The FASB already has a general outline for three types of loss contingencies: collectability of receivables, pending or threatened litigation, and possible claims and assessments (AICPA, SAS No.12). These groupings serve as an important starting point to assigning the likelihood of a liability occurring as well as the value of the liability once it is realized.

With regard to the collectability of receivables, these items do not fall under the proposed solution in this paper because they do not lead to recording contingent liabilities. Such loss contingencies include bad debts and product warranties; in other words, losses that companies are fairly certain will occur but can only estimate their financial impact based on historical data. Even though they represent loss contingencies, their accounting treatment deviates significantly from the treatment of pending litigation and claims. In order to recognize a loss contingency related to bad debts and uncollectible accounts, accountants record a contra-asset to serve as a deduction to a receivable account, whereas contingent losses from litigation are simply accrued as liabilities. Accordingly, these items do not qualify for the same treatment as contingent liabilities and should be left out of this framework. Instead, the following solutions are aimed at helping companies report liabilities associated with legal proceedings.

Ruling out this category of contingency losses, the two remaining groups that form the basis of this classification system include liabilities arising from possible claims and assessments, and alternatively, liabilities arising from threatened litigation. These categories deviate namely by a company's level of fault. On one hand, when a company reports possible claims and assessments, it assumes most of the fault by agreeing to pay a certain amount in settlement. By immediately recognizing the damages, the company displays that it would prefer to pay up to the defendant to reconcile the charges rather than potentially incur hefty legal fees. Conversely, reporting threatened litigation indicates that the company will enter into a lawsuit to push back against charges. Its willingness to engage in long and financially burdensome legal proceedings signifies a company's belief that, in some capacity, the claims made against it may be invalid. The company in this case assumes significantly less fault. With different criteria pertaining to the defending company's perceived levels of culpability, these two groups of liabilities must be categorized and treated separately.

The first category is comprised of possible claims and assessments, which includes torts, destruction of property, liquidated damages, and other claims that constitute impairments to a company's assets. As previously mentioned, the occurrence of these contingent liabilities is fairly imminent by nature of the claims that are brought against them. Consequently, I propose that companies accrue a liability and disclose the litigation in full on the financial statements in order to reflect the likely material impact that they will have. Full disclosure would require both the liability listed with its monetary estimation on the balance sheet as well as a footnote disclosure describing the legal proceedings.

Because this method automatically forces a company to incur a less favorable financial statement impact, it reinforces conservatism under GAAP and falls under best practices for reporting. In addition, these contingent liabilities do not heavily rely on a lawyer's assessment because they consist of charges being brought directly against companies. Since this solution upholds methodologies that already dominate the accounting profession, it is practical to require that companies follow a standard of immediately reporting and footnoting possible claims and assessments on their financial statements.

With regard to the second category, which groups together all forms of threatened litigation, the proposed method of treatment is slightly more complicated given the unique nature of each individual case. In general, threatened litigation encompasses lawsuits that deal with a wide variety of charges: from environmental liabilities, to injuries and/or damages caused by products sold or services provided, and even to regulatory violations such as trademark infringements and malpractice suits. Considering the large scope of threatened litigation, it is necessary to further break down this category into smaller groups according to, once again, financial statement impact. In this case, I propose utilizing an operating versus non-operating approach to differentiate these groups for purposes of financial statement simplicity and clarity.

The rationale behind this methodology follows a similar process to the justification for dividing the statement of cash flows between operating, investing, and financing activities. Cash inflows and outflows provide users of financial statements with more insight into a company's successes and failures in these three different fields. Likewise, by applying this technique to reporting contingencies, investors can derive more information based on whether or not these contingent losses pertain to a company's operating activities (Schroeder, Clark, & Cathey, "Financial Accounting Theory and Analysis," 23). Essentially, investors would be able to discern whether a company's primary method of income generation, that being through its main operations, are at stake. Under this theory, I propose that when contingent litigation pertains to a company's operating activities, companies must accrue a liability and footnote the litigation accordingly. Alternatively, some suits may have no relation to income-generating practices, in which case investors would place less weight on the threat that the litigation poses to the company's performance. Therefore, only a footnote disclosure would be necessary.

Based on this proposed classification framework, auditors as well as users of financial statements would find greater ease in determining whether companies properly reported contingent losses. For example, injuries and damages arising from a product sold or service provided to a customer would directly relate to operations and therefore require both balance sheet accrual and footnote disclosure. On the other hand, regulatory violations would likely fall into the non-operating category because a company's general adherence to legal guidelines does not automatically impact its operating activities. In these circumstances, companies would not need to apply a liability to the balance sheet. Instead, they would only need to footnote the disclosure.

The classification of contingent liabilities as operative or non-operative is not always so clear-cut. In a more unique circumstance, environmental liabilities might fall into either the company's operating or non-operating categories. The classification would depend on the extent to which a company utilizes natural resources in its operations. Thus, an oil drilling company that creates a large spill in the Atlantic would have to treat the impending lawsuit as an operative contingent loss and incur both a balance sheet and footnote liability. This treatment occurs because the oil spill relates directly to an oil-drilling company's main revenue stream. However, if a local bakery were to catch fire, and if this fire happened to spread to the nearby forest and become a wildfire, the resulting lawsuit on the bakery's financial statement would fall into the non-operative category. Since the bakery's operations have little relation to the surrounding environment that was unfortunately damaged, the bakery would only have to footnote the liability in its financial statements. Either way, breaking threatened litigation down into these categories gives users of financial statements a better grasp of how lawsuits will impact a company's future economic performance, so long as its main income-generating activities derive from operations.

On the whole, it appears that even if this classification system begins by only vaguely dividing contingent liabilities into these categories and subcategories, it will begin a movement toward more narrowly defining contingencies to fall in line with their imminence. For the most part, this classification system would impact the auditing side of handling of contingent liabilities, as auditors are responsible for interpreting how financial items impact a company's operations. They also bear the burden of estimating the monetary value of the litigation as it requires balance sheet disclosure. However, this system would significantly assist auditors in determining the scope of their inquiries to lawyers.

Lawyers would also have a better idea of the extent of detail that auditors require for financial statement disclosure. Under this system, they could help auditors differentiate between the nature of claims and assessments and that of threatened litigation to determine which details of the case are absolutely necessary to disclose. According to Mr. Mackie[16], "any sort of guide would be helpful" as lawyers and auditors look to determine the treatment of contingent liabilities. Therefore, both professions need a starting point to identify the different types of liabilities and help point them in the right direction regarding their treatment. Even if this classification system does not directly impact the current tension between lawyers and auditors, at the forefront, it at least clarifies the objective of reporting separate contingencies.

[16] Interview referenced previously in *Chapter 3: Professional Opinions*.

STEP 2: ENHANCING ACCURACY THROUGH SPECIFICITY

The next stage in improving contingent liability disclosure between lawyers and auditors has to do with refining the matrix between probability and estimatability, which determines whether a contingent liability requires disclosure or not. For reference, a synopsis of this matrix is available on page 13 of this report.

Currently, probability is first determined by the *probable, reasonably possible, and remote* likelihood measure. As a reminder, this system determines events that are likely to occur as *probable*, those that have only a slight chance of occurring as *remote*, and all events in between these two criteria as *reasonably possible*. These vague definitions of likelihood reinforce the principles-based nature of GAAP by giving companies the flexibility to determine potential future events according to their projections of future legal outcomes. At the same time, they also grant lawyers the ability to make reasonable estimates of a company's financial damages without violating ABA guidelines pertaining to confidentiality.

The second element of the decision matrix, estimatability, is much simpler. Auditors determine whether or not the monetary value of the contingent liability can be reasonably estimated. However, the same issues that arise in differentiating the likelihood measures also apply to estimatability, stemming from the fact that the ability to *reasonably* estimate the costs associated with litigation is highly subjective and arbitrary. Arguably, the imprecise boundaries around contingent liability valuation are even more dangerous to the estimation process. Once a liability is present on the balance sheet, its financial worth may be used by investors or other parties to run projections and other computations pertaining to a company's future performance.

Clearly, these criteria for interpreting the possibility that a company incurs a contingent liability are too vague. For one, each of these components is a function of the other so that they jointly determine a contingent liability's financial statement treatment. In other words, these definitions on their own hold very little meaning; for example, likelihood estimations still require estimatability considerations such as monetary value, materiality, and operative impact, and vice-versa. Additionally, the inexplicit meanings behind "probable", "reasonably possible", and "remote," as well as those behind "estimable" and "non-estimable" impart very little confidence to users of financial statements since there are essentially no concrete points to differentiate between the terms. Given the need for a more specific and conclusive method of expressing contingent liability probabilities, the FASB must establish a new measurement system that relies on historical precedents rather than inconclusive approximations.

First, the probability measures need specificity. For purposes of consistency, simplicity, and retaining as much of the preexisting standard as possible, this suggested solution would still use the same "probable", "reasonably possible", and "remote" terms. However, I propose an amendment to further define these terms by assigning percentages to each level of likelihood. As a basic example, the FASB could specify that a probable outcome corresponds with an 80-99% chance of occurrence, a reasonably possible outcome would have anywhere from 21-79% odds, and a remote outcome would have a 0-20% probability. In terms of how a company would numerically estimate the odds of incurring its contingent liabilities, it would base these percentages on data pertaining to outcomes of previous lawsuits. These precedents would derive either from within the company itself, if it has a statistically relevant history of incurring legal liabilities, or from within the industry that the company operates to reasonably contrive estimates from similar entities.

Companies that find themselves in the midst of litigation would greatly benefit from this heightened specificity as an addition to the generic, principles-based system. Particularly, the requirement that companies adhere to precedents set by industry standards would not only help investors and customers gain insight into the risks of the company's operations, but it would also help companies protect themselves from risky activities. The Investor Environmental Health Network (IEHN), for example, investigated how companies handle contingent litigation resulting from product toxicity. They observed that "most companies rely on boilerplate statements on compliance, while providing little or no specific information on risks and opportunities presented to the particular company" (Lewis et al., "Toxic Stock Syndrome", 1). Assigning percentage values to the preexisting GAAP probability measures would help curb this issue by making data on companies' risk liabilities more apparent to other companies and users of financial statements.

Even further, this standard would pressure companies to preemptively report and record contingencies immediately upon realizing that they may be liable for damages in the future, reinforcing the GAAP conservatism principle. On this note, the IEHN also determined that without regulations that require proactively recording contingent liabilities, manufacturing firms would irresponsibly neglect to disclose risks. The report found that although "information was available to industry insiders in the years prior to

2007 to suggest that products sourced from China could contain lead paint," companies failed to include this information in their financial statements (Lewis et al.). The stark contrast between the substantial need to report contingencies and the lack of reporting in practice thus calls for specificity in estimating percentage of likelihood. This way, companies can maintain an accurate grasp of the financial impact of contingent liabilities.

Placing a numeric value on the likelihood that a company will incur legal liabilities also gives auditors, lawyers, and users of financial statements a foundation from which to base their assessments of a company's performance and investment value. This idea holds especially true when it comes to how these parties view uncertain financial statement matters, of which contingent liabilities are especially prominent. Mark Nelson and William Kinney conducted a study on how ambiguity affects loss contingency reporting judgments, revealing that levels of probability are key determinants of such judgments. Their research indicates that "both auditors and users of financial statements react conservatively to ambiguity at low levels of probability and unconservatively to ambiguity at high levels of probability." In other words, probability significantly dictates investor reactions. Similarly, "auditors 'cross over' from a conservative to an unconservative reaction to ambiguity at a lower probability than do users," which is especially crucial in conducting reliable audits (Nelson and Kinney, "The Effect of Ambiguity", 269). Clearly, requiring that companies disclose the percentage of likelihood that they incur contingent liabilities would be highly beneficial to users of financial statements since probability is a crucial element of decision-making.

With the strong deterministic relationship that exists between the probability that a contingent legal liability will occur and the estimated value of the legal liability, the aforementioned reforms would have important implications for the estimatability component of the contingent liability disclosure process. Presumably, a higher computed likelihood that a contingent liability will occur indicates that there is more information available to the auditor to assess this probability. Conversely, a low likelihood of occurrence would likely accompany very little information through which an auditor would be able to compute a reasonable estimate. This pattern means that the preexisting decision matrix still holds value: probable and estimable liabilities should be disclosed on the balance sheet, whereas remote and non-estimable liabilities should only require footnotes. All that is acquired in addition to the current framework is to assign concrete percentages to the *probable, reasonable possibly, and remote* likelihood measures. Determining the exact value of these percentages, on the other hand, requires much more extensive market research than is possible to explore in this study, though it is an immensely vital area for future exploration of this topic.

Again, this step in the solution toward resolving lawyer and auditor disclosure conflicts does not fully solve the issue of future obscurity in making financial estimates. However, at the very least, it removes an element of uncertainty in financial reporting by more clearly delineating regulatory guidelines. Once more, this measure places a large burden on the financial side of the conflict by requiring that FASB regulations change the way in which auditors interpret contingent liabilities. Still, it is important to consider the positive impact that this reform would have on lawyers. By clarifying the degrees of probability that contingent liabilities occur, lawyers would be able to more effectively perform on their end by providing the appropriate and applicable disclosure information. Mr. Mackie, for example, comments that maintaining a method of "standardization" is pivotal to determining the probability that contingent liabilities will culminate on financial statements (Mackie). This method enhances the regulation process by assigning more meaning to each probability measure. These sorts of measures are within the FASB's and ABA's jurisdiction, which is important to recognize in light of the fact that most issues pertaining to the ambiguity of contingent liabilities are out of enforceable control. Therefore, these regulatory bodies must take advantage of all possible opportunities to hone in on areas that they exercise control over. By requiring companies to specifically reference historical data on contingent liabilities to determine their probability and then to report their likelihood based on a numerical value, they can move toward more accurate financial statement estimates.

STEP 3: INVOLVING THIRD PARTIES

The third and final step toward relieving the tension between lawyers and auditors over reporting contingent liabilities involves the establishment of a third-party counsel to mediate between the two professions. In the previous examination of the FASB Roundtable on the disclosure of contingent liabilities, a collaborative effort between the legal and financial accounting professions, the participants suggested this system as a potential solution. Koprowski et al. also alluded to this solution as a mitigating step. Third-party involvement ensures that a high level of expertise, a range of different opinions, and candid interactions still exist in the process of assessing contingent liabilities.

However, this step in the solution process is an expansion of the previous literature's suggestions. Instead of requiring professional services firms to examine contingent liabilities as the third-party contributors, which the roundtable recommended, I propose that government-sponsored entities review contingent liabilities for public companies. Requiring the government to provide this system of third-party counsel is a far more feasible and realistic solution than forcing clients to pay additional fees for professional service firms to handle contingent liabilities. With regard to the substantial legal and audit fees that clients already have to pay during litigation proceedings, Mr. Mackie comments that third-party involvement would be "a bad idea because clients would hate having to contribute even more capital to the process" (Mackie). Thus, requiring the government to supply a counsel to public companies would alleviate this painstaking issue for companies undergoing litigation.

Providing third-party counsel to assess contingent liabilities addresses issues on both the lawyer and the auditor side of reporting contingent liabilities. First, for the lawyers, it would help them submit more information to assist the audit team without defying the client's right to confidentiality. Traditionally, as previously discussed, lawyers are extremely limited in the scope of their disclosures. This means that for lawyers, "the audit inquiry letter has become a necessary evil…the response that is eventually received [by the auditor] may not actually be that useful to the accountant in evaluating loss contingencies. Most responses only result in verifying claims that the client has already disclosed to the auditor" (Anderson, "Talkin' 'Bout My Litigation", 144). Inserting a third party into the discourse between lawyers and auditors, though, can ease communications by allowing the government counsel to relay information to auditors that lawyers would not otherwise be able to reveal.

Mr. Mackie stressed the importance of confidentiality issues such as the attorney-client privilege and the work-product doctrine in developing third party counsels to contingent liability disclosures. He emphasized how privacy " is not just about the potential to reveal litigation strategy," but rather that literally in disputes, lawyers and their clients "want to have communications protected from depositions and discovery" by means of the attorney-client and work-product doctrines (Mackie). As an example, Mr. Mackie referenced a massive litigation case that he defended which had to do with arsenic levels in his client's wine. In these kinds of cases, he said, in order to preserve the secretive details of the case but still provide a reasonable projection of the losses the company would incur, his firm hires external aid. These hired-on parties are often accountants unrelated to the case or experts in financial reporting. They are crucial consultants in these procedures because the contingent liabilities need discussion and clarification but are also considered work product. Attorneys, therefore, already have their "third-party" confidants, but Mr. Mackie points out that auditors do not have this assistance due to the inherent arms-length nature of the transaction with their clients (Mackie). This limitation serves as the reason why this solution entails impartial government involvement and provisions: so that auditors can also take advantage of the benefits of third-party counsel.

Thus, the importance of a third-party involvement derives from a delicate balance between communications on both the auditor and lawyer sides of the interactions. For example, Mr. Mackie points out how easy it is just in the normal course of communication for lawyers to make private information "discoverable" and thereby render the work product doctrine obsolete. Lawyers, then, must leverage these confidentiality principles for purposes of client interactions as well as external third-party collaboration. In terms of auditing, though he does not identify a specific area of improvement for the lack of third-party counsel available on the financial side, Mr. Mackie stresses the importance of each field's awareness of what is being required of its counterparts. He places an emphasis on properly educating professionals so that "lawyers and CPAs are clearer on the other side's responsibilities in each scenario" (Mackie). Revisiting this concept from Chapter 1, it is clear that when it comes to improving the contingent liability disclosure landscape, the starting point is developing mutual understanding and cooperation through education.

From the auditor's perspective, this third-party solution would create more transparency in reporting what contingent liabilities a company may face. The current barrier to an auditor's ability to enhance visibility in financial reporting is that "auditors' requests for information at the time of an annual audit can threaten to invade areas otherwise protected by the attorney-client privilege and the work product protection" (Greenwald, "Transparency in Financial Reporting", 39). Again, the intervention of a government entity that is legally permitted to extract this information from attorneys solves this issue. Essentially, incorporating a third party counsel into contingent liability disclosure allows each side to carefully navigate regulations that protect the rights of the client, but which also inconveniently hinder professional communications.

The obvious issue with this third-party solution is the government's ability to raise ample capital and provide enough resources for these third party regulatory bodies to operate. With this dilemma in mind, the government, taxpayers, and users of financial statements, all of which are overlapping interest groups, must decide whether the extra cost of providing this resource outweighs the benefits of greater financial statement transparency and accuracy. An added incentive of pursuing this option is that only public companies would receive these government services because they are required to undergo yearly financial statement audits, unlike private companies. Still, this third solution presents the most obstacles in terms of realistic implementation because it requires not only government involvement, but also the creation of an entirely new entity in the contingent liability evaluation process. Alternatively, out of all three steps within this suggested solution, it has the potential to contribute the most positive impact toward easing the tension between lawyers and auditors. Once more, this element of the proposal can be tested on the basis of its future conceivability and effectiveness with further research outside the realms of this study.

CONCLUSION

The need to accurately and fairly report contingent liabilities has been a source of conflict between lawyers and auditors for decades. Most of this tension derives from the staunchly different regulations that govern each profession, namely those set forth by the FASB and the ABA. In essence, neither body sought to collaborate with the other on how to ensure that proper financial statement disclosure occurs on both ends, which gave the two parties little to no room to work together. As a result, with each side prioritizing the need to abide by its own rules first, they both fail to provide leeway and flexibility to one another in terms of recognizing the other side's constraints to reporting contingent liabilities.

Ironically, though, these same regulatory bodies that created the tension between the legal and financial accounting professions are also the parties through which a solution can emerge. This paper relies on historical application of the rules delegated by the FASB and the ABA, recent attempts at reconciling each regulatory framework, and future projections as to how to continue amending these rules. The goal is to come up with a set of solutions to serve as a starting point toward allowing these professions to interact in a cooperative manner rather than in an adversarial manner. The first step within the comprehensive solution in this paper offers clarity to the process of reporting contingent liabilities. By requiring that contingent liabilities be treated based on their categorization both according to FASB literature as well as their impact on company operations, it becomes easier to decide how they are recorded in line with their financial effects. The second step of the solution provides specificity within a vague, principles-based accounting system. The final step establishes a platform for cross-professional cooperation by combining originally oppositional areas of expertise into one entity that can discern the essential elements of each profession.

However, this paper is not meant to present the end-all resolution to how lawyers and auditors should use one another's expertise to report contingent liabilities. In fact, these solutions hardly scratch the surface of the issue. For example, the first step that has to do with classifying contingencies makes no tangible impact on the process of reporting at all, yet it is a basic first step toward improvement. As a result, the movement toward answering the question as to how lawyers and auditors can work together to disclose contingent liabilities relies very much on trial and error. Unfortunately, this process propagates a slow learning curve which depends on the hope that one method will be effective. Only then can the industries move on and refine the next stage in the process.

Considering that basically neither party has taken action toward making amends to its criteria for reporting contingent liabilities, there are a number of opportunities in addition to those described within the research to conduct further studies in this field. To take a proactive approach on investigating the failures of collaboration, research on the successes and failures of previous attempts of the FASB and ABA to interact with each other, or even with other regulatory bodies, on any topic of contention would be beneficial. Specifically, this kind of research would seek out general obstacles to collaboration, or areas where either the FASB or ABA refuse to budge, in order to achieve a firmer grasp on what is possible to amend and what is not. Secondly, expanding this research to an international stage—in other words, how IFRS handles contingent liabilities with legal parties—would provide more inspiration to developing other solutions to the conflict. Using preexisting methodologies, even if they are only slightly more operative than the U.S. GAAP system, might encourage policymakers to explore new alternatives and even contribute to the movement toward lawyer-auditor convergence. Finally, the last area for future research pertains specifically to the second solution in this paper which deals with creating definitive categories for probable, reasonably possible, and remote probabilities. This proposal would involve empirical studies that examine the determinants of litigation outcomes; that is, whether any preliminary factors within a company tend to lead to victory or defeat in lawsuits. Examining any of these topics would greatly contribute to closing the communicative gap between lawyers and auditors.

The lengthy debates and discussions that have already taken place to address this issue of contingent liability disclosure between lawyers and auditors exemplify the complex nature of the conflict at stake. They serve as proof that in order for both sides to come to an agreement, there needs to be action. However, there cannot be action simply on one side or the other. Rather, both sides need to initiate the process of laying a foundation to serve as a platform for lawyers and auditors to collaborate. After all, as Isaac Asimov points out, one side might already know the key to solving the other side's problem. Recognizing this irony, therefore, is the first step toward building a mutually beneficial relationship between lawyers and auditors.

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Figure 1: Buchman, Tetlock, and Reed (see above).

Figure 2: J. David Spiceland, James F. Sepe, and Mark W. Nelson (see below).

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