

Protecting Internal Audit Workpapers From Discovery

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Abstract

Access to internal audit workpapers is increasingly being requested or demanded by parties external to the entity. To protect workpapers from discovery, internal auditors may take proactive measures. Such measures include developing comprehensive job descriptions, having workpaper policies and a corporate charter, and conducting investigations under the direction of an attorney. Despite proactive measures, sensitive information may still be petitioned. To shield confidential information, internal auditors may invoke the attorney-client privilege, the work-product privilege, or other, less well-known doctrines.

Introduction

The preparation of workpapers is critical to the internal audit function. Workpapers are developed to document the planning of the work, the procedures performed, and the conclusions reached. The workpapers provide support for the findings and the recommendations reported.

Parties outside the organization have increasingly come to realize the usefulness of internal audit workpapers. In several instances, internal audit workpapers have been the focus of court proceedings.¹

As external parties seek to obtain copies of internal audit workpapers, the preparers of those documents, the internal auditors, have become increasingly concerned. Allowing external parties access to workpapers undermines the usefulness of the internal audit function. Auditees, fearing disclosure of sensitive information, may not be forthright and open with the internal auditors. Also, if auditees believe confidential information will be revealed, they may view internal auditors as adversaries, rather than as helpful consultants.

To aid internal auditors struggling with protecting the sensitive information in workpapers, this article examines professional guidance provided by the Institute of Internal Auditors (IIA) regarding workpapers. Suggestions are provided regarding proactive measures internal auditors might take to protect workpapers. Recommendations on procedures to follow in reaction to requested workpapers are also offered and issues regarding workpapers which may surface in the future are discussed.

Workpapers And Professional Pronouncements

Several IIA pronouncements provide guidance relevant to internal audit workpapers.

The Code of Ethics notes that members of the IIA and Certified Internal Auditors (CIAs) must "exhibit loyalty in all matters pertaining to the affairs of their organization . . ." (Section II, 1988). Further, the Code states that members and CIAs should be "prudent in the use of information" obtained during the engagement and should not use information in a way which is "contrary to law or detrimental to the welfare of their organization" (Section VIII). Because the workpapers contain information about the organization, internal auditors are obligated to protect the workpapers from scrutiny by external parties.

The Statement of Responsibilities of Internal Auditing (1990), in defining internal auditing, notes that internal auditing operates as a service to the organization. The Statement comments that members of the entity who are assisted by internal auditing includes management and the board of directors. The workpapers are developed to aid internal auditors as they gather information to serve management and the board.

The Standards for the Professional Practice of Internal Auditing, which provide more specific guidance than the Statement of Responsibilities, reiterate the concept that internal auditors should exhibit loyalty to the organization (Section 240.01, 1978).

Two Statements on Internal Auditing Standards (SIASs) specifically address issues related to workpapers. SIAS 6, "Audit Working Papers," (1987) and SIAS 11, "1992 Omnibus Statement," include guidelines regarding ownership, custody, and retention of workpapers. The Statements emphasize that internal audit workpapers are the property of the organization and that internal audit departments should control access to the documents. Management and other members of the organization may occasionally request copies of internal audit workpapers in order to follow-up on findings. Also, external auditors might ask for copies of specific workpapers. In both instances, the requests should be approved by the director of internal audit. If other external parties request internal audit workpapers, the director should consult with senior management and/or the entity's attorney.

The IIA published its "Report of Subcommittee on Access to Internal Auditing Work Products" (1992) to alert internal auditors to issues related to demands by external parties (other than external auditors) for access to workpapers. The Report notes that the type of proceeding may affect the accessibility of internal audit workpapers. External parties are more successful in obtaining workpapers in criminal and tax proceedings than in civil actions or regulatory or governmental contract reviews. Also, courts are more likely to grant access to workpapers if the documents are closely connected to the issue at hand. If the court views the request for workpapers as a "fishing expedition," it is less likely to agree to the request. Further, the courts often attempt to differentiate between facts gathered by the internal auditors and their opinions; facts are more readily discoverable than opinions.

The IIA's Report also discussed the possibility that internal auditors may be able to protect their work using the attorney-client privilege. For the privilege to apply, the internal auditors must be working under the direct supervision of an attorney. The courts attempt to differentiate work performed in the ordinary course of internal auditing from that conducted during an investigation directed by counsel. The latter is afforded much more protection from discovery than the former.

Being Proactive

Internal auditors must be proactive regarding third-party accessibility to workpapers. Anticipating demands for workpapers may help protect the organization's confidential information.

Job Descriptions

Job descriptions may aid internal auditors in addressing requests for workpapers. Job descriptions should include

the many and varied duties internal auditors perform. A job description aids not only internal auditors in understanding the scope of their work, but also helps external parties in comprehending the duties of internal auditors. Because the Standards for the Profession Practice of Internal Auditing and the Statements on Internal Auditing Standards assist in understanding the function of internal auditing, both should be referred to or included in an internal auditor job description.

Policies

Besides job descriptions, internal auditors should also develop a set of policies regarding the operation of the department. Policies concerning the handling of investigations should be included.

Workpaper policies should specify the content and format of the documents. When demanding internal audit workpapers, plaintiffs have been more successful at obtaining objective, rather than subjective, information. Therefore, the internal audit department may consider establishing a policy that objective data are to be recorded on separate workpapers from subjective evaluations, opinions, and conclusions. This procedure may protect the more critical aspects of internal audit work from later discovery.

Workpaper policies should also indicate how review notes are to be handled. Some internal audit departments require that review notes be retained as a record of issues raised and subsequent resolutions. Other departments, perhaps anticipating that third-parties might use review notes to identify risky audit areas, expect that review notes will be destroyed.

The retention of workpapers should also be addressed by department policies. The length of time workpapers are to be kept is governed not only by the needs of the organization, but also by legal requirements. Policies regarding workpapers should set forth who in the organization controls access to the documents and how requests for access are handled. The confidentiality of workpapers should be stressed.

Another area which internal audit policies should address is investigations. Internal auditors need guidance on when an ordinary internal audit warrants a metamorphosis into an investigation. The professionals also need assistance in determining their role (if any) in the ensuing investigation.

Depending on the nature and severity of the problem under investigation, the internal auditors may wish to report the issue to the audit committee, to consult legal

counsel, and/or to an appropriate governmental agency. To protect against allegations of whistle-blowing, situations in which internal auditors are required to communicate with the audit committee or other parties should be clearly specified. Policies should indicate who to notify and which workpapers and other evidence to make available.

Of critical importance in any investigation is prompt notification to the director of internal auditing. An early warning system helps ensure that sensitive matters are handled appropriately.

Internal audit policies should not remain static; rather, they should evolve and be updated as changes occur in both the organization and in statutory and case law impacting workpapers and internal auditors.

Corporate Charter

Every entity should have a corporate charter in place. Included in the scope of the charter are the significant functions internal auditors perform. Of particular importance is for the charter to require internal auditors to report fraud to the audit committee. Employees who voluntarily notify upper management of possible wrongdoing may be characterized as whistleblowers and fired. Many states allow hiring and firing at will, thereby granting little protection to employees who are wrongfully discharged for reporting suspected wrongdoing. Requiring internal auditors, through the charter and internal auditing policies, to report fraud helps ensure that the professionals will not lose their jobs for performing the duties they are trained and hired to perform.

Investigations

When the director of internal audit is informed of a possible fraud, defalcation, or illegal act, a decision must be made whether to proceed with an investigation. If an investigation is warranted, it must be carefully handled in a manner most beneficial to the organization. One way for the director to address the situation is to hire an attorney. The attorney may conduct the investigation or may direct the work of others, perhaps internal auditors. The advantage of having a lawyer head the investigation is that communication between the attorney and the client is protected by the attorney-client privilege and workpapers developed for the investigation are covered by the work-product privilege.

The attorney-client privilege shields communication between the attorney and the client from disclosures to outsiders. The privilege allows the client to disclose relevant information to the attorney without fear that it will be further revealed. The objective of the privilege is

to allow the attorney to be fully informed of facts relevant to rendering legal advice.

The work-product privilege protects documents prepared to aid the attorney from disclosure. The documents may be prepared by the attorney, staff personnel, investigators, internal auditors or others working under the direction of counsel.

Both the attorney-client privilege and the work-product privilege are predicated on a relationship in which the client is seeking legal advice from the attorney. A discussion or analysis of general business affairs will not invoke the protection. Thus, it is imperative that the client and attorney agree that the purpose of their communications and preparation of working papers is to facilitate the rendering of legal advice. To clarify the attorney-client relationship and aid in invoking the privileges, the director of internal auditing should prepare a retention letter explicitly requesting legal advice from the attorney based on the investigation.

Responding To Requests For Workpapers

When confidential information from the internal auditors is requested, the director must be prepared to respond appropriately. Requests for confidential information are to be processed strictly according to the procedures set forth in the internal auditing policies. Because the auditee may provide valuable input, the policies may include a procedure to notify the affected audit unit upon receipt of a request.

In handling a request, the director wants to understand the reason for the request and consider the party making it.

For example, if the external auditors ask for copies of workpapers detailing cyclical inventory observations, the director would normally be able to quickly provide the documents. However, if a group of shareholders asks for the same workpapers, the director may elect to first seek the advice of the audit committee and legal counsel.

Attorney-Client Privilege

The director of internal audit may determine that, for a particular request, consulting with an attorney is warranted. The ensuing communications are normally protected from disclosure by the attorney-client privilege. Four elements must be present for the privilege to apply.

The first is communication. A communication between the attorney and the client must take place. The communication may be verbal, as in a conversation, or nonverbal, such as printed information or gestures.

The second element is that the communication must be between privileged parties, i.e., the attorney and client. Agents for either party are included within the scope of the privilege. To be protected, the agent must be working under the direct supervision and control of the privileged party. For example, the communications of paralegals, secretaries, and investigators, all acting in the capacity of agents for the attorney, are protected. The third element of the attorney-client privilege deals with confidentiality. The privileged communications must take place in confidence by parties who do not expect that its contents will be revealed to anyone outside the attorney-client privilege.

The final element relates to the purpose of the communication. The objective of the communication must be to seek legal assistance for the client.

Although understanding the four elements of the attorney-client privilege is important, comprehending matters which are not protected by the privilege is also significant. Certain matters, not covered by the attorney-client privilege, are discoverable. These include the identity of the client, the fact that a communication took place, and the nature of the services requested of the attorney.

Work-Product Privilege

Besides the attorney-client privilege, the work-product privilege may prove useful when attempting to protect confidential information from disclosure to third parties. The work-product privilege affords protection to products prepared in anticipation of litigation. Internal audit workpapers may be covered by the privilege if the auditors are working under the direct supervision of an attorney.

There are three elements of the work-product privilege. The first addresses which items are and are not included in the privilege. Some matters may be protected by other means, such as the attorney-client privilege. If the item is not covered by another privilege, the question of whether the matter falls within the bounds of work-product arises. The work-product privilege applies to memos, computer-generated data, diagrams, photographs, or other items.

The second element of the work-product privilege specifies that the work-products must be used by the attorney in anticipation of litigation. It is not necessary that a lawsuit be filed for the client and attorney to anticipate litigation. Because the reason for the creation of some work-products may be questioned later, it is

advisable to note on the face that the purpose of each document is to document information in anticipation of litigation.

The final element of work-product privilege relates to the party preparing the work-products. Nonlawyers, acting under the direction of the attorney, prepare numerous work-products to be used by the attorney. Such work products are protected from discovery.

Work-products developed before the attorney-client relationship commences are not covered by the work-product privilege. That is, delivering documents or other items to an attorney does not bring the products under the cloak of the work-product privilege (or attorney-client privilege).

Although the work-product privilege affords valuable protection, the doctrine does have limitations. One is that, in some cases, adversarial parties have been able to pierce the protection of work-product. If there is a substantial need for information that is essential to the case, the court may order the work-products produced. Also, if the information is not otherwise available without undue hardship, the court may require the work-products to be released. The latter may occur, for example, if a witness previously giving testimony to one party in litigation is now deceased.

Courts are less likely to allow access to work-products which include the attorney's thought processes or strategies for litigation. Protection of "opinion work-product" is stronger than that for documents which are merely compilations of facts or "ordinary work-products."

For work-products which are afforded some protection by the privilege, certain matters related to work-products are not covered by it and are discoverable. These items include the name of the author, the recipients of the document, and the purpose of its development. Although the work-products themselves are not released, these pieces of information must be.

Internal Audit Workpapers

Internal audit workpapers prepared in the normal course of performing internal audits are not afforded protection under either the attorney-client privilege or the work-product privilege. Thus, ordinary internal audit workpapers are generally not protected from discovery. However, the courts are beginning to temper broad, absurd demands for sensitive information. Requests for internal

audit workpapers should relate to specific documents which are relevant and closely connected to the issue. Broad requests, used in fishing for evidence, are not normally granted.

Self-evaluative Privilege

The self-evaluative privilege is another way in which internal auditors may seek protection from disclosure of sensitive information. The doctrine recognizes that work conducted during a self-analysis by a company should be kept confidential. The privilege holds that self-evaluations benefit not only the company, but ultimately, society in general. If companies fear disclosure of sensitive data through documents detailing internal analyses, they may be less likely to scrutinize operations.

The work of internal auditors would seem to fit neatly within the protection of the self-evaluative privilege. However, because the doctrine is not yet well-defined and has not received widespread acceptance, internal auditors should not rely exclusively on it. Still, if internal auditors cannot utilize the attorney-client or work-product privilege, the self-evaluative privilege may prove beneficial.

Providing Workpapers

When internal auditors agree or are required to produce workpapers, they should carefully prepare the documents to be turned over.

Only those specific workpapers requested should be released. Further, only workpapers which record facts are provided. Workpapers which contain opinions and recommendations are not released. Also, documents that provide evidence of the attorney's thought processes or strategies should not be revealed.

Only copies of the pertinent workpapers should be given to the requesting party; originals are not released. This is especially important if the workpapers are prepared in pencil. If the court requires originals, the internal audit department must retain copies. Each workpaper released should be labeled as confidential. Also, a notation on each document should indicate that secondary distribution is not permitted without the approval of the director of internal auditing.

Other Issues

Besides primary concerns regarding the attorney-client and work-product privileges, other, peripheral issues related to internal auditors' work are also worthy of consideration.

Shareholders vs Management

According to the Statement of Responsibilities, internal auditing is an independent appraisal function established to perform a service to the organization. Questions may arise as to who the organization is or who in the organization the internal auditors serve. I.E., do the internal auditors serve the shareholders, management or another party? This dilemma may become especially significant if, for example, the shareholders make allegations against management and request relevant internal audit workpapers to support their claims.

External Auditors

Another issue regarding confidentiality of information relates to the work of external auditors. Both the internal and external auditing literature recommend that the two functions coordinate work to achieve maximum audit coverage in the most efficient manner. SIAS 5, "Internal Auditors' Relationships with Independent Outside Auditors" (1987), provides guidance to the internal auditor in such situations; SAS 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (1991) aids the external auditor. Both Standards encourage the two sets of auditors to exchange workpapers.

A legitimate concern of either the external or internal auditors relates to the treatment of copies of one party's workpapers which are in the possession of the other. For example, the internal auditors may provide copies of workpapers detailing cyclical inventory counts. The external auditors may decide to rely on the work and include the copies in their workpaper files. If the external auditors are then subpoenaed or the external auditors are deposed, is the information provided by the internal auditors discoverable?

Similarly, the external auditors may provide sensitive information to the internal auditors. If the internal audit workpapers are requested, can or should the data, analyses, and conclusions supplied by the external auditors be revealed?

These are questions which could be significant as internal and external auditors continue to strive to coordinate their work. Both sets of auditors may consider including in their departmental workpaper policies procedures to limit secondary access to the documents.

Internal Auditor-Auditee Privilege

Internal auditors have labored for many years to overcome the negative images denoted in labels such as

"snitch," "audigator," and "bean counter." Now, internal auditors are often seen as "advisors," "co-workers," and "communicators." If internal auditors are forced to reveal sensitive information, auditees will not be as open and cooperative as they have been; they will naturally be less communicative. Such reactions would adversely impact the internal audit function.

To guard against such consequences, the profession should consider advocating an internal auditor-auditee privilege. The privilege would protect internal auditor-auditee communications and related workpapers. Such a privilege would allow the auditee to confide in the internal auditor without fear of external retribution.

Conclusion

The courts and other third parties have increasingly noted the significance of the internal auditing function within an organization. In particular, these parties have recognized the usefulness of internal auditors' workpapers and testimony. While internal auditors are naturally pleased with the attention, they are also understandably concerned about revealing sensitive information.

To help internal auditors struggling with issues of disclosing corporate information, the IIA, through its Code of Ethics, Statement of Responsibilities, Standards for the Professional Practice of Internal Auditing, and SIASs, offers some guidance. Also, there are proactive measures internal auditing departments should take to prevent later problems. These include having complete job descriptions for internal auditors, developing workpaper policies, having a corporate charter which addresses workpaper issues, and conducting investigations under the direction of an attorney. If, despite the existence of proactive measures, sensitive information is requested or demanded, internal auditors may be shielded by the attorney-client privilege, the work-product privilege, or other, less well-known doctrines.

While understanding professional guidance, taking proactive measures, and reacting appropriately to requests for information are of more immediate significance, internal auditors should also consider other issues related to the disclosure of sensitive information. These include the possibility of shareholders making allegations against management, internal and external auditors sharing workpapers, and investigating the feasibility of an internal auditor-auditee privilege.

This article has touched on numerous issues related to confidential auditee information acquired by internal auditors. One article (or one journal or even one book) cannot cover all the situations which may arise in every

organization. Therefore, armed with an understanding of the issues, internal auditors are advised to consult with counsel. An attorney can help draft job descriptions, policies, and the corporate charter. The attorney can be ready to direct an investigation, thus protecting information under the attorney-client privilege and/or the work-product privilege. Finally, having attorneys familiar with internal auditor concerns for confidentiality helps ensure that quick, appropriate responses are made if sensitive information is demanded.

Suggestions For Future Research

Future work in the area of the protection of internal audit workpapers should examine the results of court cases. Cases which focus on the confidentiality of internal audit workpapers are naturally of interest. Also, cases which involve functions other than internal audit may also be germane. For example, the impact of decisions in which a third-party is demanding information gathered by management in anticipation of reporting on internal control may be relevant to internal auditors. ☐

*** Footnotes ***

1. See Fargason, "Internal Auditors and the Law," *Internal Auditor*, August 1993, pp. 42-46, for a review of cases involving access to internal audit workpapers.

*** References ***

1. AICPA, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (SAS 65), 1991.
2. Fargason, J.S., "Internal Auditors and the Law," *Internal Auditor*, August 1993, pp. 42-46.
3. IIA, "Standards for the Professional Practice of Internal Auditing," 1978.
4. IIA, "Internal Auditors' Relationships with Independent Outside Auditors" (SIAS 5), 1987.
5. IIA, "Audit Working Papers" (SIAS 6), 1987.
6. IIA, "Code of Ethics," 1988.
7. IIA, "Statement of Responsibilities of Internal Auditing," 1990.
8. IIA, "Report of the Subcommittee on Access to Internal Auditing Work Products," 1992.
9. IIA, "Omnibus Statement" (SIAS 11), 1992.