**Chapter 9**

**CONFIDENTIALITY**

**Exercises**

*Identifying Confidential Information*

1. Your client is a gun manufacturer. Due to the tragic nature of gun violence, many citizens have threatened to protest against your client. However, your client’s manufacturing plant is located in rural Montana, so protesters cannot conveniently get there to stage a public protest.

In preparing an SEC filing for this client, you disclosed the addresses of its Montana manufacturing plant and its company headquarters in downtown Seattle. Over 80 top company executives work at company headquarters. Your disclosure led to a large protest rally in downtown Seattle that created adverse publicity for your client. Your client now is upset because, historically, it only disclosed the address of its rural Montana plant in public filings. The SEC form, however, clearly required that a company’s “principal places of business” be disclosed.

Did you violate the duty of confidentiality?

SOLUTION for Exercise 9-1: No. Disclosure of your client’s headquarters location was harmful to your client, but the company did not have a reasonable expectation that the location of its headquarters would remain undisclosed. You provided information required by the SEC. Furthermore, the location of the Seattle headquarters previously may have been publicly known because the company maintained a substantial workforce there.

1. A manufacturing client hired you to prepare a property tax report. During the course of your discussions, the client told you that it made certain improvements to its production facilities without obtaining required construction permits. In valuing the client’s property, you disclosed in your report that the property deserved a lower valuation for tax purposes because “substantial sums would have to be spent to bring the property in compliance with local Construction Code requirements.” Did you violate the duty of confidentiality?

SOLUTION for Exercise 9-2:No. Your disclosure implies that the client failed to obtain a construction permit and violated construction codes. This fact is not widely known and may cause your client to incur substantial fines.

However, in valuing property, it is necessary to identify all costs that might impair an asset’s value. As a result, the nature of your duties suggests that your client did not have a reasonable expectation that you would keep this fact secret.

1. Your former accounting professor recently contacted you because she knows that you currently work for an accounting firm that performs compilation services for several privately held mining companies. The professor requested data concerning whether your firm’s clients capitalize or expense certain environmental clean-up costs. Your clients discuss their accounting policies openly with you, but do not disclose these policies to outsiders. Your professor has agreed in writing to keep your clients’ accounting policies confidential. The professor is a member of the AICPA, and she will not achieve any financial gain. May you disclose the requested information to the professor?

SOLUTION for Exercise 9-3: No. You may not disclose confidential client information. It is irrelevant that the professor is a member of the AICPA, will not benefit financially, and has promised to keep the information confidential.
2. Your client, a French pharmaceutical manufacturer, is about to release a blockbuster new drug that inhibits the growth of certain tumors. While auditing this company, you happened to overhear research scientists openly discussing with marketing personnel this drug’s benefits and anticipated sales revenues. You are aware that this pharmaceutical manufacturer carefully guards this information from competitors as well as the general public.

Based on the information you overheard, you believe that pharmaceutical patents held by an unrelated United States client will now become worthless. Under generally accepted accounting principles, intangible assets must be recorded at “lower of cost or market” when an impairment of value occurs. Should you consider the impact of this new French drug in valuing the patents of your United States client?

SOLUTION for Exercise 9-4: No. The upcoming release of this new French drug clearly is relevant in valuing the patents of your United States client. However, the information that you overheard while visiting your French pharmaceutical client is confidential.

If you utilize information learned from your French client in valuing patents held by your United States client, you action might alert competitors or regulators about the French client’s new drug, causing the French client harm. Therefore, your use of information overheard at your French client would be an improper “disclosure” of confidential information to others. Accordingly, notwithstanding the obvious relevance of the French company’s new drug, you must value patents held by United States client as if you had no knowledge whatsoever about the French client’s activities. In short, the French company’s secret must remain confidential, even though the prohibition on you using information learned from that client diminishes the accuracy of the patent valuation performed for your United States client.

1. During his lifetime, a famous pop star was rumored to have abused his children by repeatedly spanking them with a hard leather belt.

In a recent TV interview, this celebrity’s accountant stated on a TV interview that she had “kept her mouth shut while Mr. Bigshot Superstar was alive, but now that he is dead, I want you to know that he confided in me on two occasions that he physically struck his children.”

Did this accountant violate her duty of confidentiality?

SOLUTION for Exercise 9-5: Yes. The duty of confidentiality applies to former clients even once they are dead.

FOLLOW UP: Once a client is deceased, how would this type of disclosure harm a celebrity, such as Michael Jackson? It would hurt his estate’s income from record sales, memorabilia, song placement in movies, etc. Also, it would hurt his family, including his children, who are people that the deceased would want to protect from humiliation or keep out of the limelight.

1. The Commodities Futures Trading Commission, or CFTC, is a respected federal agency that oversees trades in futures contracts for commodities such as wheat and cotton. You have several clients in Iowa that hedge their production costs by trading futures contracts.

The CFTC has asked you to voluntarily attend a hearing that they are conducting concerning allegedly improper futures contract trades by one of your clients. You have no information or knowledge about any of these trades, and you believe that your public reputation will be tarnished if the business community discovers that you refused to attend the hearing of a respected governmental agency.

Should you attend the hearing?

SOLUTIONfor Exercise 9-6:You could perhaps attend the hearing, but you should not answer any questions about your client’s business or conduct. You owe a strict duty of confidentiality to your client, unless it consents to you attending the hearing and answering questions that relate to its conduct. If that agency wants to obtain your testimony, they should issue a valid subpoena to you because the duty of confidentiality is overridden when a subpoena is issued to an accountant.

1. A CPA wants to entice a small cable television company to become a client. During the course of their discussions, the CPA mentioned that he is very familiar with the communications industry because his firm is the auditor for a well-known, publicly traded cable television company. Did the CPA violate his duty of confidentiality?

SOLUTION for Exercise 9-7: No. The existence of this accountant-client relationship is already widely known because public companies disclose the name of their auditor in their SEC filings. Therefore, the CPA’s auditing relationship with this public company is not confidential and may be disclosed.

1. During the course of auditing a telecommunication hardware company, you learned a great deal about typical credit terms and profit margins in that industry. You now have been hired by a small supplier of component parts to the telecommunications industry. This supplier has asked you to prepare its financial projections. In preparing these projections, you intend to assume that credit terms and projected profit margins will be similar to others in the same industry. By doing so, are you violating your duty of confidentiality to the large telecommunications hardware company?

SOLUTION for Exercise 9-8: Probably not. A CPA is allowed to use the expertise and knowledge acquired from conducting professional activities in rendering services to subsequent clients. A CPA, however, should not disclose specific details learned from one client to another client. It sometimes can difficult to draw a clear line between disclosing specific confidential information and merely relying on general industry knowledge. In this case, the CPA firm is using basic industry averages that likely are widely known in the industry. As long as the CPA firm does not disclose specific details learned from another client, it does not violate its duty of confidentiality.

*Required Disclosures*

1. During the course of preparing budgeting projections in a consulting engagement, you learned that your client might be engaged in illegal price-fixing with its distributors and franchisees. The client is a closely held family-run corporation and you are not the client’s auditor. Do you have a duty to disclose this activity to government authorities?

SOLUTION for Exercise 9-9: No. You generally must protect confidential client information, even if you suspect that illegal business activities have occurred. You should disclose this client information only if a valid subpoena requests it, a regulatory body demands it, or a law compels it.

1. Your audit client recently suffered a huge loss when a large customer discontinued doing business with your client after receiving defective merchandise. Due to this loss, your client is struggling to survive.

Your client does not want other customers to find out about its production and financial difficulties. However, in accordance with accounting standards, you are required to disclose that client you have a substantial doubt about this client remaining a viable going concern.

Your client has threatened to hold you responsible if you base your “going concern” disclosure on confidential information about its liquidity that you learned during the course of the audit. Would disclosure of this client’s financial condition violate your duty of confidentiality?

SOLUTION for Exercise 9-10: No. An accountant’s duty to comply with generally accepted accounting principles supersedes a client’s desire to keep this information secret.

1. Your tax advisory client is an active securities trader. She just told you she intends to spread a rumor that a Middle Eastern sheik is planning to buy a controlling interest in Technotrilogy stock. Your client believes that if she spreads this false rumor, the stock price will increase and she will “make a fortune.”
2. May you disclose her plans to government authorities?
3. May you disclose her plans to news reporters?
4. If a court issues a subpoena for you to testify about this conversation, may you refuse to testify based on the duty of confidentiality?

SOLUTION for Exercise 9-11:

1. No. The duty of confidentiality prevents you from disclosing your client’s plan, unless you are ordered to do so by a court subpoena.
2. Same answer as above.
3. No. A court subpoena supersedes the duty of confidentiality.
4. You work for a CPA firm that sends tax returns to India for processing. The Indian company to which these processing duties are outsourced solely employs Chartered Accountants, and its personnel have extensive training in U.S. taxation. The CPA firm does not tell its clients that portions of their tax returns are being processed in India. None of the information contained in these tax returns has ever been disclosed to the public. Does your CPA firm violate the Confidential Client Information Rule?

SOLUTION for Exercise 9-12: Yes. If a CPA firm wishes to outsource professional services to others, client consent should be obtained.

1. At your high school reunion, you saw someone you used to date, but *dumped* you for someone else. While chatting with him and two of his old football teammates, you tried to impress him by telling him you “made partner” at a prestigious CPA firm. You also mentioned that you specialize in personal financial planning for several prominent clients in the entertainment industry, including a well-known movie actor whose name you practically shouted at him.

Did you violate the duty of confidentiality?

SOLUTION for Exercise 9-13: No. The mere fact that someone is your client usually would not be embarrassing or harmful to him or her.

FOLLOW UP: What types of services might an accountant provide that would make disclosure of a client’s name potentially embarrassing to the client? Bankruptcy accounting, divorce-related work, criminal tax defense work, forensic accounting investigations of misconduct such as embezzlement, bribery, or fraud.

1. You recently become a partner in a local CPA firm. Your firm provides a wide range of professional services, but your firm is best known in the business community for its expertise in loan workouts, debt restructuring, and bankruptcy accounting. The general public, including most of your family and friends, is not aware of your firm’s expertise in these areas.

The firm wants to grow and they think that you are the right person to help because you have an excellent commitment to marketing. As part of your marketing efforts, you are giving speeches on the accounting profession to various industry groups. You also want to mention during your introduction that your CPA firm represents some well-known members of the local business community, including two prominent banks.

May you reveal the names of your clients during the course of giving these presentations?

SOLUTION for Exercise 9-14: Probably not. Disclosure of client names usually is merely a fact and not “confidential information.” However, your firm’s prominence in the field of troubled company restructurings and bankruptcy might make members of the audience listen to you become concerned that your clients are in financial distress. That could be devastating to some of you clients, especially the banks.

The fact that the general public is unaware of your expertise is irrelevant. The participants in the audience likely know of your expertise and they are the relevant market segment that is hearing your comments.

1. Under GAAP, contingent liabilities have to be accrued on a company’s balance sheet if they are “probable and “can be reasonably estimated.” During the course of performing a company’s annual audit, you discovered facts that make it highly likely that a pending lawsuit against the company will be successful. You estimate that the company will lose $30 million. The client is attempting to settle this case for a small amount. They also have told you that their adversary has not discovered this vital fact and the company “wants to keep it that way.”

What should you do?

SOLUTION for Exercise 9-15: Under GAAP, this liability is probable and reasonably estimable, so it must be accrued on the company’s balance sheet. A CPA’s duty to follow GAAP and GAAS supersedes its duty of confidentiality.

You should insist that the client consent to an accrual of this liability. If the client does not consent, you should inform it that you will not be able to issue an unqualified audit opinion on its financial statements. The opinion would have to be qualified or adverse. If the lawsuit could make the company insolvent, a “going concern” disclosure might be required as well.

FOLLOW UP: You may want to use this question as an opportunity to review the rules on contingent liabilities accruals and disclosures, including those that that are “reasonably likely” and “remote.” It also gives you an opportunity to discuss the significance of reading qualitative disclosures, such as those related to contingent liabilities and “going concern” doubts.

Also, you might want to review the rules on contingent gain disclosures.

You might ask: Would your answer be different if the company had a contingent gain? For example, what if your client has a great opportunity to succeed in an antitrust lawsuit, but it does not want to tip off the future defendant yet for tactical reasons. A gain would not be “embarrassing” to the company, but disclosure might be harmful to its ability to win and obtain the maximum amount of damages. As a further follow-up, you might want to point out the asymmetry in accounting rules concerning “probable and reasonably estimable” litigation outcomes. The probable loser must accrue its losses due to the conservatism principle, but the probable winner may not accrue the gain from its probable victory due to the revenue realization principle.

1. You discovered material errors in your client’s audited statements for prior years. The CPA firm that performed the audit was reckless, in your opinion. You would like to disclose this other firm’s incompetence to the state board of accountancy and to the AICPA Professional Ethics Division. Your client is concerned that, if the investment community learns of these errors, the investing public will lose faith in the accuracy of its financial statements. What should you do?

SOLUTION for Exercise 9-16: You do not need your client’s permission to disclose this alleged malpractice to appropriate investigatory bodies. You can assure your client, however, that these investigatory bodies cannot disclose any communications that you have with them. Therefore, the information shared by you should remain confidential and unavailable to the general public.

1. A former client just sued you for malpractice. Fortunately, you have malpractice insurance, so the costs of defending this legal action and any possible costs of settlement or liability will be borne by the insurance company.

According to your malpractice policy, you have a duty to “promptly notify” them about any actual or threatened lawsuit. Further, you must “fully assist” them in aggressively defending you in the lawsuit. The insurance company now has asked you to provide to them with all documents that relate to your professional engagement with this former client. You are concerned that some of these documents contain information that the former client considers to be confidential and, indeed, marked in bold red letters “HIGHLY CONFIDENTIAL.” You certainly do not want to face another lawsuit from this same client for breaching your duty of confidentiality. What should you do?

SOLUTION for Exercise 9-17: The duty of confidentiality does not prevent you from using otherwise confidential information in your defense. Therefore, you should feel free to convey these documents to the insurance company that is defending you.

1. Toby, CPA is representing his client in a critical, time-sensitive negotiation. Toby had expected his client to attend a meeting with Dunbart, the opposing party, but Toby’s client called him to say that he could not make the meeting due to a sudden illness. When Toby canceled the meeting at the last minute, Toby sensed that Dunbar was disturbed by the last-minute cancellation and doubted that Toby’s client had any interest in finishing this deal. To reassure Dunbar of his client’s strong commitment to the negotiation, Toby truthfully told Dunbar that his client was “deathly ill, vomiting with horrible diarrhea” and “could not get out of bed” to attend the meeting.

Did Toby breach his duty of confidentiality?

SOLUTION for Exercise 9-18: No. Although some clients would consider their “extreme diarrhea” to be embarrassing, Toby knew that his client really wanted to consummate a deal with Dunbar. Also, Toby’s client was too sick to give his specific consent and Toby, under the circumstances, did not want to disturb him.

In short, Toby’s actions were impliedly authorized by his client, even though “specific” consent technically was not obtained from the client.

1. A 19-year-old staff member at your accounting firm went into your computer system and copied the names, addresses, and identifying numbers of clients who pay by your firm by credit card. As a result of this identity theft, your clients lost thousands of dollars.

When you first hired this young staff member, you did not investigate whether this staff member had a criminal record. If you had, you would have learned that this staff member had been arrested and convicted once in the past when he was younger for “Driving Under the Influence.” Some of your clients who suffered losses now claim that you violated your duty of confidentiality. Did you?

SOLUTION for Exercise 9-19: Probably not. A CPA has a duty to use reasonable care to ensure that confidential client information is protected. Credit card numbers obviously are very sensitive client information.

However, your duty is to exercise “reasonable” care. If you had performed a criminal background check, it would not have yielded meaningful information that could have prevented this misconduct. You and your client were the victims of this employee’s misconduct, but his conduct was a crime that you likely could not reasonably have prevented through the exercise of additional screening efforts.

FOLLOW UP: Due to the duty of confidentiality, should an accounting firm always perform background checks on professional employees before it hires them? What about administrative employees, such as IT professionals and file clerks?

*Accountant-Client Privilege*

1. Should there be an accountant-client privilege in every state? Discuss the pros and cons.

SOLUTION for Exercise 9-20: For discussion.
The accountant-client privilege would lead to greater candor between accountants and their clients, and would reflect the same policy considerations that underlie the attorney-client privilege. However, it would impede civil and criminal investigations of wrongdoing, which might result in more wrongdoing going undetected.

FOLLOW UP: Would you favor the accountant-client privilege for all types of communications other than potential criminal wrongdoing?

FOLLOW UP: What groups might lobby against the creation of this privilege in your state? Organizations of securities lawyers, tax lawyers, government prosecutors, class action lawyers who represent plaintiffs?

1. You are a skilled and experienced tax advisor. Under what circumstances, if any, should you encourage a client to utilize the services of a tax attorney?

SOLUTION for Exercise 9-21: A tax attorney should be retained on matters involving tax fraud and other tax crimes because of the broad attorney-client privilege.

*Tax Return Disclosure*

1. Your clients applied to the Portland Housing Authority to obtain a government-subsidized apartment and were approved. As part of the approval process, your clients submitted a statement of income and personal expenses. The Portland Housing Authority now has requested that the couple supply a copy of their last two years’ tax returns. Your clients did not respond. The Housing Authority decided to obtain a subpoena for their tax return after receiving an anonymous tip you’re your clients’ income was much higher than they originally reported. Your clients do not want to have to submit their tax returns. Do they have to produce these tax returns to the Housing Authority?

SOLUTION for Exercise 9-22: Probably. The discovery of tax returns is usually barred in litigation unless a party’s income is at issue in the matter and alternative means of discovering their income are unavailable. In this case, your clients’ income is relevant to whether they qualified as low-income residents and alternative proof of their income is not likely available.

**Comprehensive Problems**

1. Injured workers have filed numerous workers’ compensation claims against your audit client. In reviewing medical exams filed in connection with these claims, you noticed that one of these former employees has a life-threating disease. This disease can be cured by surgery, but the former employee does not know about his disease or about his need for surgery.

You asked your client for permission to inform this former employee about his life-threatening condition, but your client refused. During the course of your discussion, the client told you bluntly that “we will save a small fortune if the former employee has a short life span because, frankly, we will pay out fewer workers’ compensation checks.”

Should you reveal information to this former employee concerning his life-threatening disease?

SOLUTION for Exercise 9-23: Yes. Technically, the Code of Conduct expressly forbids you from disclosing this confidential information without your client’s consent. Nevertheless, from a moral or ethical perspective, you should act to save the life of this former employee. It is unimaginable that you would be sanctioned in this situation, despite the Code of Conduct’s mandates.

1. While you were at client’s production facility, you noticed that factory personnel were taking hazardous chemicals and dumping them in a forest area behind the facility. Based on a microbiology class you took in college, you strongly suspect that these chemicals will seep into the groundwater and eventually cause severe neurological damage to those who drink that water. According to your Internet research, these chemical will not necessarily affect everyone who drinks the poisoned water and the adverse effects, although extreme, will not be observable for many years into the future.

What should you do?

SOLUTION for Exercise 9-24: The chemical dumping is confidential client information whose disclosure would be extremely harmful to your client’s reputation and financial position. You could ask your client to disclose this information voluntary, but that effort likely would be futile.

According to the AICPA rules, you must first obtain the client’s specific consent.

A CPA is required to disclose information if there is a law or regulation that requires disclosure. You might wish to inquire of the Environment Protection Agency or an environmental lawyer to see if there is a law that requires disclosure or that would protect you against professional discipline or client retaliation.

As an alternative, you could resign as the client’s auditor in protest, which might embarrass your client into action. However, you may not disclose the reason for your resignation, under the AICPA rules.

Alternatively, you could ignore the AICPA rules and take action based on the compelling public policy of protecting the health of innocent bystanders. That could, however, subject you to AICPA discipline or client legal action This question is based on an actual case, cited as Spaulding v. Zimmerman, 116 N.W. 2d 704 (Minn. 1962).

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