

DOCUMENT RETENTION POLICIES

INTRODUCTION

One of the many focal points surrounding the collapse of Enron is the revelation that a team of up to 80 partners, managers and administrative staff of the Big Five accounting firm, Arthur Andersen LLP, wrongfully shredded their files. News reports reveal the following timeline¹:

October 12, 2001

Enron executives sent Andersen partner David Duncan a draft of the press release announcing plans to “restate” third quarter 2001 earnings including more than \$1 billion in charges “against income” on an after-tax basis.

October 12, 2001

Andersen attorney Nancy Temple e-mails to Andersen partner Michael Odom referring him to the firm’s “document retention policy” (which permits the destruction of documents), and asking that he circulate the policy to the Enron engagement team.

October 15, 2001

Duncan memo to Odom and Temple regarding Enron’s draft press release regarding its intention to restate its 2001 third quarter earnings.

October 16, 2001

Temple e-mail to Duncan and Odom suggesting the deletion of certain parts of Duncan’s memo regarding Enron’s press release, specifically any comments suggesting that Andersen thought the release was misleading. Temple also noted that she would consult with counsel on Andersen’s liability and potential 10 (A) securities violations.

October 24, 2001

Andersen manager Kimberly Latham sends e-mail on Enron team’s “initiative” to ensure Andersen “compliance” with the firm’s document retention guidelines. The note stated that employees were expected to work “on an overtime basis” to carry this out.

October 31, 2001

The Securities and Exchange Commission announces that it has upgraded its informal inquiry into Enron to a formal investigation.

The public disclosure of this document destruction was quickly followed by Arthur Andersen’s termination of David Duncan, its partner in charge of the Enron account, the public disclosure of the accounting firm’s document retention policy, Congressional hearings, court

hearings, efforts to recreate the extirpated evidence and Arthur Andersen's empowerment of former Federal Reserve Board Chairman Paul Volcker to investigate and impose changes on the firm's governance and policies.

The episode left many observers wondering how such an act could have occurred and questioning why an accounting firm would or could ever destroy documents pertinent to its performance of professional services. Unbeknownst to the public, the accounting profession has for years been evaluating and adopting stringent document retention policies, for reasons set out below. Indeed (and ironically), in January, 2002, the Auditing Standards Board of the AICPA issued new professional standards for the documentation of audit and attest engagements, both of which will become effective later this year.² This article will discuss these new standards, describe the perspective of the accounting profession toward document retention and summarize the law concerning the preservation of evidence.

OVERVIEW

This article deals with an increasingly important economic and policy issue facing accountants: the retention of client files. Do accountants have a duty to retain client files? If not, should client files be retained anyway? How long should client files be kept? What types of files should be destroyed, if any?

Importantly, this section does not address issues pertaining to the retention of files other than client files, including the business, corporate, personnel, financial, and tax records generated in the course of operating an accounting practice. Instead, this discussion is limited to the retention of files generated by an accountant in the course of performing professional services for clients, such as audit workpapers, tax return preparation files, research and consulting files, and the like.

As an initial matter, mention should be made of records typically generated by an accountant which reflect or materially relate to professional services rendered to clients, but which are not usually physically included in the files maintained for clients, or conceptually considered to be within the rubric: *client file*. These include:

- Personal calendars, daytimers, and diaries;
- Daily time records;
- Work-in-process records;
- Client billing, disbursements, and payment records;
- Personal correspondence; and
- Personal (or "stash") files.

ECONOMIC CONSIDERATIONS

The primary reason that accountants are focusing on the client file retention issue is economic. Accountants face ever-increasing costs to retain client files. These costs include:

- Storage space;
- Maintaining security for files;
- Organizing, indexing, and cataloging stored files;
- Transporting files to and from storage; and
- Equipment to organize files, such as file shelving.

Emerging technologies, including microfiche, electronic, and magnetized storage media, have not developed to the point of providing cost-effective solutions to the retention dilemma, in many cases.

LITIGATION ENVIRONMENT

Another factor has led some members of the profession to assess the desirability of permanently retaining client files: the litigation environment. Because the plaintiff in any malpractice claim has the burden of proving an accountant's negligence, some have voiced the opinion that retaining client files for unnecessarily long intervals only makes it easier for plaintiffs to prove their claims.

Advocates of this school of thought cite examples of cases where plaintiffs were able to prove claims only because of evidence obtained from an accountant's own workpapers or client files. Here are some hypothetical examples:

- The only evidence of an auditor's failure to perform a sales cutoff test that would have detected the over-reporting of sales is supplied by the absence of audit workpapers on the test.
- The only evidence that the auditor was aware of checking account irregularities that should have led to the discovery of defalcation are the "tic marks" on an audit workpaper.
- The only way the plaintiff can show that a tax return preparer knew that the corporate taxpayer had set up the wrong type of retirement account for its CEO is some scribbling by a staff accountant on a note stuffed into the client's tax file.

In short, there is some support for the proposition that retaining client files for shorter time intervals will minimize the possibility of the accounting firm's being hoisted by its own petard.

Just as persuasively, others maintain that the premature extirpation of client files will leave an accountant defenseless against a claim of malpractice at least as often as it produces a bad result due to retention of documents. This camp asserts that it is not possible to make a generalized prediction about whether a good or bad litigation result will follow from the adoption of a truncated client file retention policy. Examples of claims for which an accountant might need to refer to a client file to successfully defend a malpractice claim include these:

- When an audit client's management contends that the accountant knowingly participated in overstatement of the company's financial position, but the audit workpapers fully exonerate the accountant.
- In *Frymire-Brinoti v. KPMG Peat Marwick*, 2 F.3d 183 (7th Cir. 1993), the absence of workpapers showing that an auditor checked out issues later identified as "red flags" was cited as evidence that the CPA acted with reckless indifference to the rights of others
- When a tax client asserts that the accountant failed to take advantage of the insolvency exception to the recognition of income due to a reduction in indebtedness, but the accountant's file on the engagement shows that the client supplied a financial statement showing a positive net worth.

Exponents of discarding client files sooner, rather than later, have advocated the adoption of a policy to discard client files as quickly as 12 months after termination of the accountant-client relationship. Even advocates of longer retention periods believe that files should never be stored with any documents that are not in final form or are incomplete. This school of thought concedes that client files should be discarded after the statute of limitations applicable to the engagement can reasonably be expected to have expired.

In rebuttal, proponents of short retention schedules posit that the mere disclosure of the fact of destruction of old files to a claimant or plaintiff's attorney, pursuant to a reasonable and good faith document retention policy, will deter an unscrupulous claimant from asserting a claim in the hope of discovering some basis for recovery in the accountant's records.

LEGAL REQUIREMENTS

Broadly speaking, an accountant has no express legal duty to maintain client files at all, or for any particular time interval. Even the old bromide that everyone has to keep tax records for seven years has been exposed as a myth.³ In some respects, it would be simpler and much more reassuring if a definite period of time were specifically and affirmatively established by law. Instead, accountants and other business operators must work through a confusing and complicated set of statutes and regulations governing records retention. Any accountant considering the establishment of a records retention policy should consult the following resources to determine whether any particular state or federal statute or regulation must be accommodated:

- Office of the Federal Register, *Guide to Record Retention Requirements in the Code of Federal Regulations*, published with annual supplements;

- Skupsky, ed., *Legal Requirements for Business Records: Federal and State*, a four-volume looseleaf; and
- Hancock, ed., *Guide to Records Retention (1986)*.

Citing the Federal Paperwork Reduction Act of 1980 and the Uniform Preservation of Private Business Records Act, one leading authority argues that there is a “presumption” that businesses ought to retain records for three years, but that they have no duty to keep them thereafter.⁴ The uniform law or its equivalent has been adopted by these states:

- Colorado
- Georgia
- Illinois
- Maryland
- New Hampshire
- North Dakota
- Oklahoma
- Texas⁵

This authority concedes that this presumption is rebuttable, and should at best be viewed only as a rule of thumb for guidance in setting a records retention policy.

PROFESSIONAL ACCOUNTING STANDARDS

Naturally, accountants (and now the general public) are especially keen to know the extent of any duty they may have to retain audit workpapers. This is because the exposure of the accounting firm to ruinous damages awards derives substantially from claims arising out of alleged “failed audits.” Moreover, accountants perceive that the combination of “perfect” hindsight with the complexity of performing and documenting audits, and the pervasiveness of professional judgment involved in performing an audit, makes audit workpapers the number one vehicle for unfairly targeting the profession for legal liability.

In *Statement on Auditing Standards*, “Audit Documentation” (SAS No. 96), the accounting profession adopted its most specific set of professional standards for the retention of audit workpapers. Under SAS 96, an auditor has the following duty:

The auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor

in the engagement. The quantity, type and content of audit documentation are matters of the auditor's professional judgment.

Additional guidance is provided with respect to the required content of audit workpapers, including documentation sufficient to enable members of the audit team and their supervisors to understand what was done, who performed the work and that accounting records are consistent with the financial statements. Auditors are also required to document audit findings or "issues" that are deemed to be "significant" and "the basis for the final conclusions reached."

Unhelpfully, the professional standards provide little guidance about the length of time that an auditor is required to retain workpapers, noting only:

The auditor should adopt reasonable procedures to retain audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention.

Accountants might be guided on the time required to maintain audit workpapers by the functions that audit working papers are intended to serve, which include:

- Providing "principal support" for the audit report;
- Demonstrating that work has been adequately planned and supervised;
- Evidencing the auditor's understanding of the audit client's internal control structure and to substantiate the nature, timing, and extent of substantive testing performed; and
- Establishing that the auditor obtained "sufficient competent evidential matter" to support the audit report.⁶

In addition, certain working papers prepared by an auditor may sometimes serve as a useful reference source for the client.⁷ Working papers also provide information needed for SEC reports, tax returns, and reports to other government agencies, and may serve as a continuing source of information for succeeding audits.⁸

In fashioning a client file retention policy, the CPA would also be well advised to consider the implications of the protocol governing the transition between predecessor and successor auditors, including:

The successor auditor should request the client to authorize the predecessor [auditor] to allow a review of the predecessor's working papers. It is customary in such circumstances for the predecessor auditor to make himself available to the successor auditor for consultation and to make available for review certain of his working papers. The predecessor and successor auditors should agree on those working papers that are going to be made available for review and those that may be copied. Ordinarily, the

predecessor should permit the successor to review working papers relating to matters of continuing accounting significance, such as the working paper analysis of balance sheet accounts, both current and non-current, and those relating to contingencies. Valid business reasons, however, may lead the predecessor auditor to decide not to allow a review of his working papers.⁹

As for client tax records, one school of thought holds that such records should be retained for the current year plus three year, citing Treasury Regulation § 31.600 1-1(e).¹⁰

LIABILITY FOR DOCUMENT DESTRUCTION

An accountant who destroys or discards client files on an *ad hoc* basis may face serious and adverse legal consequences. The destruction or failure to retain such documents pursuant to a neutral, evenly applied, and formal document retention policy can effectively minimize the risk of these consequences.

The legal risks of document destruction include:

- Criminal sanctions, fines, or penalties for obstruction of justice or hindering law enforcement;¹¹
- Contempt of court for failure to comply with subpoena;¹²
- Court-ordered judgment by default for money damages in a civil case;¹³
- Discovery sanctions, including awards of costs and attorneys' fees incurred by an opposing litigant to discover, investigate, and take remedial action as a result of document destruction;¹⁴
- Instruction of jury that an adverse inference can be drawn to the effect that destroyed documents would either have favored the plaintiff or harmed the legal position of the defendant, for purposes of rendering a verdict; and
- Civil liability for tort of spoliation of evidence.¹⁵

Because these litigation risks typically ensue only when documents have been destroyed in the face or imminent threat of a criminal investigation, subpoena, or civil litigation, the adoption and successful implementation of a good faith, even-handed, and reasonable document retention policy can immunize an accountant from these bad outcomes.¹⁶

RETENTION POLICY

As just illustrated, the destruction of client files should not occur randomly or sporadically. Instead, documents should be discarded only pursuant to a formally adopted, written retention policy.

To be successful, a records retention policy should meet these objectives:

- Provide evidence that client files have not been retained pursuant to a good faith, evenly applied practice in the ordinary course of running a professional and profitable professional service organization. Conversely, avoidance of litigation or adverse litigation consequences should *not* be a goal of such a policy, and should not be mentioned or referenced in the written policy.
- Assure that only documents intended to be destroyed are destroyed, and provide a record of exactly what was destroyed, when, and by whom.

Creating a document retention policy requires some time and effort. During the planning process, the accountant should give consideration to the unique nature and circumstances of his or her practice which must be met in any document retention policy. For example, practitioners who retain original client tax documents would probably be well advised not to discard such files, under any circumstances, until the time for the government to challenge a return has expired. Practitioners who conduct compliance audits for government agencies might also be subject to unique document retention constraints. Because all of these variables might be affected by the state in which the accountant practices, the retention of a lawyer practicing in the state where the accountant practices is recommended.

The elements of a suitable client file retention policy include:

- The program must be documented;
- The program must be broad enough to cover all copies and functional equivalents of the documents to be destroyed;
- A schedule of document extirpation should be published;
- Written approvals should be obtained from all appropriate management levels;
- Records should be destroyed systematically as specified by the program, not in a selective or haphazard way;
- Documentation of the development, implementation, and operation of the program must be maintained.¹⁷

EFFECT OF EXISTING, IMMINENT, FORESEEABLE LITIGATION

To avoid adverse legal consequences from the destruction of client files, the accountant's document retention policy must clearly provide that documents will not be destroyed when they are pertinent or likely to become pertinent to existing or even potentially imminent litigation. Controls must be built into a document retention policy sufficient to safeguard against even the unintended or accidental destruction of such documents.¹⁸

Thus, the retention policy should clearly provide that no pertinent document will be destroyed once the accounting firm has received any notice or reason to believe that litigation over the subject matter of the client's files is imminent or even potentially likely to occur. Proceeding with destruction of the files in the face of threatened litigation, merely because no

process has actually been served, is almost certain to be regarded by the courts as a distinction that makes no difference to the imposition of adverse legal consequences.

One important court has even gone so far as to hold that the destruction of documents which the business owner should merely have appreciated would be relevant to reasonably foreseeable litigation was enough to justify an adverse inference in litigation, even though the documents had been destroyed years before the commencement of litigation pursuant to a good faith policy adopted and implemented in the ordinary course of business.¹⁹ According to this court, a plaintiff could be entitled to benefit from the adverse inference doctrine for documents destroyed pursuant to a longstanding document retention policy, depending on these factors:

- Whether the retention policy was reasonable for the particular documents to be destroyed;
- Whether lawsuits concerning the destroyed records had been previously filed or complaints made;
- Whether the retention policy was instituted in bad faith.

ONE-TIME DOCUMENT DESTRUCTION

Many professional service organizations, particularly smaller organizations, cannot afford to implement, maintain, or follow a document retention policy calling for frequent or even regularly scheduled destruction of client files. Can such organizations safely discard documents as a part of a one-time destruction program?

Although such a program might be viewed with more suspicion by the courts, it can be done in a way that minimizes the risk of adverse legal consequences. If the organization destroys the documents as a part of a good faith, reasonable practice in the ordinary course of business, the organization should be safe (provided that no client files are destroyed if litigation is pending, threatened, imminent, or reasonably foreseeable).

To justify a one-time client file destruction program, the accountant should keep the following elements in mind:

- A written expression of the adoption of the program, its procedures, and neutral and valid business reasons therefor should be prepared and maintained;
- All files within a category or classification of records should be destroyed, with the exception of files that have already become litigation-sensitive;
- Records of the personnel who destroy the files, the dates of destruction, and the exact contents destroyed should be prepared and maintained.

CONCLUSION

As demonstrated by the foregoing, the adoption and execution of a document retention policy can be highly perilous, especially for CPAs. In the aftermath of Enron, it can be expected that the accounting profession will take a careful look at its approach to document retention.

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- ¹ 78 *Banking Report*, No. 4 (BNA, Jan. 28, 2002), p. 132.
 - ² *Statement on Auditing Standards No. 96* (effective May 15, 2002); *Statement on Standards for Attestation Engagements No. 11* (effective December 15, 2002).
 - ³ Skupsky, *Recordkeeping Requirements* 69 (1988).
 - ⁴ 1 *Legal Requirements for Business Records: Federal Requirements* 020-1050-00 (1990), citing 44 U.S.C. §§ 3501-3520 and 13 Uniform Laws Annotated (1985).
 - ⁵ *Colorado*: Colo. Rev. Stat. § 6-17-101; *Georgia*: Ga. Code Ann. § 10-11-1; *Illinois*: Ill. Ann. Stat. ch. 116, ¶ 59; *Maryland*: Md. Ann. Code 1957, art. 15B, § 1; *New Hampshire*: N.H. Rev. Stat. Ann. § 337-A:1; *North Dakota*: NDCC. §§ 31-07.1-04; *Oklahoma*: 67 Okla. Stat. Ann. §§ 251-256; *Texas*: Tex. Bus. & Com. Code § 35.47.
 - ⁶ *Statement on Auditing Standards No. 96* (effective May 15, 2002); *Statement on Standards for Attestation Engagements No. 11* (effective December 15, 2002).
 - ⁷ *Statement on Auditing Standards No. 96* (effective May 15, 2002); *Statement on Standards for Attestation Engagements No. 11* (effective December 15, 2002).
 - ⁸ O'Reilly, Hirsch, Defliese & Jaenicke, *Montgomery's Auditing* 156 (John Wiley & Sons, 11th ed. 1990).
 - ⁹ AICPA Professional Standards at AU § 315.09.
 - ¹⁰ Skupsky, *Some Considerations Related to Records Retention Requirements for Tax Records*, in *Guide to Records Retention* 2001 (Hancock ed. 1986).
 - ¹¹ 18 U.S.C. §§ 1503, 1505 and 1510, and state law analogues.
 - ¹² Skupsky, *Recordkeeping Requirements* 28 (1988).
 - ¹³ *Carlucci v. Piper Aircraft Corp.*, 102 F.R.D. 472 (S.D. Fla. 1984).
 - ¹⁴ *Wm. T. Thompson v. General Nutrition Corp.*, 593 F. Supp. 1443 (C.D. Cal. 1984).
 - ¹⁵ *Federated Mut. Ins. Co. v. Litchfield Precision Components, Inc.*, 456 N.W.2d 434 (Minn. 1990).
 - ¹⁶ *Vick v. Texas Employment Comm'n*, 514 F.2d 734 (5th Cir. 1975); *Coates v. Johnson & Johnson*, 756 F.2d 524 (7th Cir. 1985).
 - ¹⁷ 1 *Legal Requirements for Business Records: Federal Requirements*, at 020-1030-00.
 - ¹⁸ Hancock, ed., *Guide to Records Retention* 131 (1986).
 - ¹⁹ *Lewy v. Remington Arms Co.*, 836 F.2d 1104 (8th Cir. 1988).