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The broad summoning power of the Internal Revenue Service [IRS] which enables it to examine any documents related to a taxpayer’s liability was challenged in United States v. Arthur Young & Co. The major issue of the proceedings was whether tax accrual workpapers, prepared by a taxpayer’s independent auditor during the course of an annual audit, were subject to disclosure to the IRS pursuant to a summons under section 7602 of the Internal Revenue Code of 1954. In reaching its holding, the Supreme Court had to determine whether tax accrual workpapers were relevant to an IRS inquiry within the meaning of section 7602. In addition, if the workpapers were found to be relevant, the Supreme Court had to decide whether the workpapers would be protected from disclosure in order to preserve the integrity of the securities market or because a privilege or immunity attaches to the workpapers.

Tax accrual workpapers contain the auditor’s evaluation of the sufficiency of the reserve for tax contingencies within the taxpayer’s financial statement. The workpapers also contain the auditor’s projection as to the tax consequences of a potential IRS audit. Arthur Young’s major concern was that the workpapers would give the IRS a “roadmap” of the taxpayer’s most aggressive interpretation of the Internal Revenue Code. Such disclosure would inhibit communication between the client and accountant. The IRS argued on the other hand that the self-assessment taxation system requires full disclosure of questionable positions for effective revenue collection. The Supreme Court held that the tax accrual workpapers must be disclosed to the IRS pursuant to a section 7602 summons subject to only the traditional privileges and limitations. The result of this decision is that ultimately the tax accrual workpapers can be obtained by the IRS subject to general requirements to be introduced in

3. Also known as tax accrual account, noncurrent tax account, or tax pool. Id. at 1500.
4. I.R.C § 7602.
5. Young, 104 S. Ct. at 1498.
6. Id. at 1501.
7. Id. at 1502.
9. Id.
11. Id.
12. Young, 104 S. Ct. at 1497.
this note. The decision may appear to be unfair and constitute an enormous in-
vansion of the taxpayer's privacy.

FACTS

In 1975, pursuant to a routine audit of Amerada Hess Corp., the IRS
discovered questionable payments to foreign countries from a special disburse-
ment account. Immediately the IRS instituted a criminal investigation of the
tax returns. As part of the investigation, the IRS issued a summons pursuant
to section 7602 of the Internal Revenue Code to Young who audited
Amerada's financial statements annually and signed its federal income tax
return. The summons directed Young to produce over a quarter of a million
pages of documents including the tax accrual workpapers. Amerada directed
Young not to comply with the summons. The IRS commenced an enforce-
ment action against Young. Amerada intervened in the proceedings. The
crucial issue that the district court faced was whether Young's audit program
and audit workpapers, which included the tax accrual workpapers, should be
protected from disclosure to the IRS. As the case filtered through the lower
courts, this main issue was reduced at the Supreme Court to whether the tax
accrual workpapers must be disclosed in response to an IRS summons.

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13The largest corporations in the country are audited annually. See Commissioner Jerome Kurtz and Panel,
Meeting of Section of Taxation, American Bar Association, Discussion on Questionable Positions, 32 TAX
14Young, 496 F. Supp. at 1154.
15Young, 104 S. Ct. at 1498.
16Id. Section 7602 of the Code provides in relevant part:
For the purpose of ascertaining the correctness of any return, making a return where none has been
made, determining the liability of any person for any internal revenue tax or the liability at law or in
equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting
any such liability, the Secretary is authorized —
(1) To examine any books, papers, records, or other data which may be relevant or material to such
inquiry;
(2) To summon the person liable for the tax or required to perform the act, or any officer or employee
of such person, or any person having possession, custody, or care of books of accounts containing
entries relating to the business of the person liable for tax or required to perform the act, or any
other person the Secretary may deem proper, to appear before the Secretary at a time and place
named in the summons and to produce such books, papers, records, or other data, and to give such
testimony, under oath, as may be relevant or material to such inquiry.
I.R.C. § 7602.
17United States v. Arthur Young & Co., 677 F.2d 211, 214 (2d Cir. 1982).
18Id. at 215.
19Under § 7609 of the Internal Revenue Code, the taxpayer under investigation is entitled to receive notice
of the summons to a third party. In addition, the taxpayer may stay compliance of the summons and in-
trive in any enforcement action brought against the third party. I.R.C. § 7609 (1982).
20Section 7604 of the Internal Revenue Code gives the person from whom the documents are summoned
substantial protection by allowing him to challenge the § 7602 summons by appearing in court at a show
21See I.R.C. § 7609.
22Young, 496 F. Supp. at 1154.
23Young, 104 S. Ct. at 1498.
The primary reason why a company such as Amerada employs an independent public accounting firm is to meet the requirements mandated by the Securities and Exchange Commission. Young’s most significant duty concerning the present case was its annual audit of Amerada’s financial statements. The auditor will issue an unqualified opinion as to a client’s financial statements when the auditor considers them to be fairly presented in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Current and potential investors rely upon these audited financial statements as a primary source of information to guide their investing decisions.

As part of the audit, the independent certified public accountant is required to determine whether the reserve account for contingent tax liabilities is sufficient. This evaluation assures that all potential loss contingencies arising from an increased tax liability due to an IRS audit are disclosed. There are many gray areas in the Code which require judgment such as the characterization of the gain on a sale of an asset or the determination whether certain cash received is immediately subject to taxation. As a result of an IRS audit, the taxpayer may be assessed additional taxes for incorrectly interpreting a gray area. In addition, the tax accrual workpapers also take into account the taxpayer’s position on a particularly questionable item. For example, the taxpayer may reveal to his outside auditor that if a particular deduction is contested by the IRS, he will not dispute it. By examining the tax accrual workpapers, the IRS becomes aware of the taxpayer’s defenses and is more likely to contest

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2 The term “audit” means an examination of financial statements by an independent certified public accountant in accordance with generally accepted auditing standards for the purpose of expressing an opinion. 17 C.F.R. § 210.1-02(d) (1983).

3 See generally A. ARENS & J. LOEBBECKE, AUDITING: AN INTEGRATED APPROACH 18-21 (2d ed. 1980). Professor Arens and practitioner Loebbecke state:

Whenever sufficient evidence has not been accumulated or the results of the tests lead the auditor to believe the statements are not fairly presented, it is necessary to issue some type of report other than an unqualified report. Three primary types of audit reports are issued under these conditions: a qualified report, an adverse opinion, and disclaimer of opinion.

Id. at 21.

7 Young. 104 S. Ct. at 1499.

9 Id. at 1500.

10 The Financial Accounting Standards Board provides:

An estimated loss from a loss contingency shall be charged if (a) it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements and (b) the amount of the loss can be reasonably estimated. Disclosure is required for loss contingencies not meeting both those conditions if there is a reasonable possibility that a loss may have been incurred.

2 FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS § C59 (1982).

11 See Young. 104 S. Ct. 1500, n. 9.
such a deduction which is normally left alone. Furthermore, tax accrual workpapers contain the outside auditor's prediction as to the total amount of additional taxes resulting from an IRS audit. This amount may determine the extent of the IRS investigation. For example, an IRS agent may uncover no questionable positions after a brief review of the taxpayer's records. However, after the agent compares his conclusions with an auditor's large prediction of additional taxes, the agent may decide to conduct further tests on the taxpayer's records to uncover the hidden questionable positions.

Pursuant to section 7601 of the Internal Revenue Code, the IRS may audit any person, including a corporation, that may be liable for an internal revenue tax. The IRS's primary investigative tool is the section 7602 summons. The scope of section 7602 was tested in *Arthur Young* when the Supreme Court determined whether the tax accrual workpapers prepared by Young were protected from disclosure in response to the summons.

**FINDINGS OF THE LOWER COURTS**

Relying on *United States v. Powell,* the district court held that Young must make the tax accrual workpapers available for inspection by the IRS. The tax accrual workpapers met the relevance requirement of section 7602 as presented in *Powell.* The audit program and other audit workpapers were not ordered to be disclosed because they were less relevant to the IRS investigation of Amerada's tax returns, "standing many steps removed from the question of actual tax liability."

The *Powell* court set forth the substantive requirements to obtain enforcement of an IRS summons. The required showing is "that the investigation will be conducted pursuant to a legitimate purpose," that the inquiry may be relevant to the purpose, that the information sought is not already within the

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1. See *Young,* 677 F.2d at 217.
2. *Young,* 496 F. Supp. at 1155. When determining whether the reserve for these contingent taxes is adequate, the auditor must:
   
   engage in speculation as to the positions that might be taken by the IRS and taxpayer, theoretical analysis, and opinions bearing on the fairness and reasonableness of the parties' positions (as distinguished from factual transactional data), which if revealed to the IRS, could seriously prejudice the taxpayer in negotiations with it.

3. *Young,* 677 F.2d at 217.
8. *Young,* 496 F. Supp. at 1157. A committee report was protected from disclosure under the work product doctrine. The IRS was to examine the documents at Young's office and bear the cost of reproduction. *Id.* at 1160.
10. The investigation will be considered conducted pursuant to a legitimate purpose if the summons is issued before the IRS recommends that a criminal prosecution be undertaken and the summons authority is exer-
Commissioner's possession, and that the administrative steps required by the Code have been followed." Young's major arguments were that the tax accrual workpapers were not relevant under the second requirement of Powell and that they should be protected from disclosure by an indirect auditor-client privilege. The other three requirements of Powell were not contested. As to the privilege argument, the district court noted that the Supreme Court had refused to recognize such an auditor-client privilege.

In analyzing the relevency requirement of Powell, the district court focused on "whether the summons seeks information which might throw light upon the correctness of the return." The request does not have to be particularized under section 7602. Furthermore, the IRS is not required to make a showing that there is probable cause to suspect a Code violation exists. The requested documents, however, must have a purpose beyond that of making the investigation convenient. Nevertheless, it appears that the primary result of an IRS summons of tax accrual workpapers is a more efficient audit of a taxpayer. The IRS could ultimately uncover questionable positions and obtain complete answers to questions even without the aid of an outside auditor's tax accrual workpapers. However, duplicative work would be required resulting in wasted audit hours. The definition of relevance has been narrowed further in United States v. Harrington to whether the "might" in the standard "might throw light" represents a realistic expectation that something might be discovered.

The IRS has shown some concern for the privacy of the taxpayer by providing guidelines in the Internal Revenue Manual to be followed by its agents when requesting tax accrual workpapers. However, the fourth requirement

40 41 42 43 44 45 46 47 48 49 50 51 52 53 54 55 56 57 58 59

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of Powell — adherence to administrative steps established by the Code — is not violated when evidence is obtained without following the Manual's procedures. The evidence is still admissible since the Internal Revenue Manual is not part of the Internal Revenue Code.32

Once the Powell test is met, the burden shifts to the taxpayer to show that enforcement of the summons would act as an abuse of the summons process.33 Such an abuse would be present if the IRS did not issue the summons in good faith with regard to the particular investigation.34

The appellate court modified the district court's decision by finding that all of the audit workpapers including the tax accrual workpapers were relevant to Amerada's actual tax liability.35 The majority was concerned, however, that the reliability of the independent auditing process would suffer if independent auditors were required to disclose their tax accrual workpapers.36 The appellate court noted that a review of these workpapers by the IRS would leave open the auditor's and taxpayer's positions.37 The court was concerned that the taxpayer would become so vulnerable to attack that he would not be totally candid with the auditor.38 The majority noted that any holding involving the tax accrual workpapers would create a collision between important congressional policies.39 The first policy involves safeguarding investors.40 Allowing the tax accrual workpapers to be obtained by the IRS may harm the investing public through reliance on inaccurate financial statements.41 The second important congressional policy involves revenue collection.42 Nondisclosure of the workpapers would hamper the IRS in its enforcement of the revenue laws.43

The appellate court struck the balance in favor of nondisclosure by

7602 summons to the independent auditor. When the workpapers are obtained, the examination should consist only of those portions of the workpapers believed to be relevant or material to the investigation. See INT. REV. MANUAL — AUDIT Chpt. 4024.4 (CCH 1981).


33Wyatt, 637 F.2d at 300.

4For example, a bad faith purpose would exist if the summons was issued solely to "harass the taxpayer or to put pressure on him to settle a collateral dispute." Powell, 379 F.2d at 58. See also Bisceglia, 420 U.S. at 146. In Young, the district court specifically noted that the purpose of the summons issued to the IRS was not to oppress or harass Young. Young, 496 F. Supp. 1155, n. 5.

43Young, 677 F.2d at 212. "It is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw 'light upon' the correctness of the return." Id. at 219.

44Id. at 214.

45Id. at 220.

46Id.

47Id.

48Id.

49Id.

50Id.

51Id.
fashioning an accountant work-product privilege analogous to the attorney work-product privilege recognized in Hickman v. Taylor. A work-product privilege would protect the investing public from the "grave dangers of inaccuracy and untrustworthiness." Only upon a sufficient showing of need would the IRS be able to review tax accrual workpapers. In this case, the IRS failed to meet that burden. Accordingly, Young was not required to disclose the tax accrual workpapers to the IRS.

Justice Newman dissented to the portion of the appellate decision concerning the work-product privilege. He contended that any decision creating a privilege for an accountant's workpapers should be created by Congress and not a court. Justice Newman noted that since 1979, when the IRS successfully summoned Arthur Andersen's tax accrual workpapers, Congress had been aware that the IRS was obtaining tax accrual workpapers through section 7602 summonses. Because Congress is conscious of the IRS practice, Justice Newman apparently believed that Congress indirectly allows the IRS to grasp tax accrual workpapers via section 7602. Congress has had numerous opportunities to specifically legislate against requesting tax accrual workpapers but has failed to do so. Furthermore, Justice Newman stated that disclosures required by a tax summons were "subject to the traditional privileges and limitations." Federal law fails to recognize an accountant privilege. Finally, Justice Newman doubted that the integrity of the securities market would suffer if tax accrual workpapers could be readily subpoenaed by the IRS. Justice Newman's dissent set the foundation for the Supreme Court's holding.

THE SUPREME COURT DECISION

The Supreme Court granted certiorari to resolve the specific issue that had filtered its way through the lower courts: whether tax accrual workpapers would be subject to disclosure pursuant to a section 7602 summons. In agree-

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"Id. at 221. Hickman v. Taylor, 329 U.S. 495 (1947).
"Young, 677 F.2d at 221.
"Id.
"Id. The summons under § 7602 does not violate the fourth amendment as an unreasonable search and seizure. "The mere fact that the summons encompasses a large volume of relevant materials does not render it unreasonable." Arthur Andersen, 474 F. Supp. at 331.
"Young, 677 F.2d at 221 (Newman, J., dissenting).
"Id.
"Arthur Andersen, 474 F. Supp. at 322.
"Young, 677 F.2d at 221 (Newman, J., dissenting).
"Young, 677 F.2d at 221.
"Id. at 223.
"Young, 104 S. Ct. at 1497.
ment with the lower courts, the Supreme Court held that the tax accrual workpapers were relevant to the IRS investigation. The court reiterated the test employed by the lower courts and noted that the relevancy requirement is not equivalent to the standard used to admit evidence.

The Supreme Court stated that the relevancy requisite is not a technical test. The court noted that section 7602 is an important discovery tool for the IRS in performing its investigative and enforcement functions. The Court further noted that section 7602 grants the IRS broad powers to obtain potentially relevant information. Apparently, Congress granted the IRS such broad powers to promote effective enforcement of the revenue laws. Accordingly, the word “relevant” under section 7602 is given an expansive interpretation. Section 7602 permits the IRS to investigate a taxpayer upon a mere suspicion that the Internal Revenue Code has been violated. This power is considered inquisitorial in nature and analogous to that of a grand jury investigation. The IRS agent does not have to guarantee that the requested documents will be relevant. However, section 7605 limits the IRS’s broad statutory power by requiring that the IRS agent follow special procedures if he investigates an entity more than one time per year. Furthermore, an IRS summons can be enforced only by the courts. Finally, the Supreme Court held that the summoned items can be those not used in the actual preparation of the tax return.

The Supreme Court ultimately addressed the issue as to whether the requested tax accrual workpapers should be protected from disclosure due to the work-product doctrine adopted by the appellate court. Following the ra-

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77Id. at 1501.
78That the requested documents might throw light upon the correctness of the taxpayer’s return. Wyatt, 637 F.2d at 300.
79Young, 104 S. Ct. at 1501.
80Id.
81Id.
82Id.
83See generally United States v. Euge, 444 U.S. 707, reh’g denied, 446 U.S. 913 (1980). (The respondent was required to appear before the IRS pursuant to a § 7602 summons to execute handwriting exemplars of certain signatures on a bank signature card).
84Wyatt, 637 F.2d at 299.
85Id.
86Ackers, 325 F. Supp. at 862. In United States v. Richards, 631 F.2d 341, 345 (4th Cir. 1980), the court stated: “We recognize this relevancy standard to be minimal for a higher threshold might unduly interfere with the service’s ability to detect violations of federal revenue law.”
87I.R.C. § 7605(b) (1982). This section provides in relevant part: “No taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer’s books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.” Id.
88Bisceglia, 420 U.S. at 146; See I.R.C. § 7604(b).
89Young, 104 S. Ct. at 1500. See also United States v. Noall, 587 F.2d. 123, 126 (1978), cert. denied, 441 U.S. 923 (1979); Shlom, 420 F.2d at 265; Ackers, 325 F. Supp. at 863.
90Young, 104 S. Ct. at 1502.
tionale of Justice Newman in his dissenting opinion, the Court noted that, absent Congressional direction otherwise, section 7602 is subject to only the traditional limitations and privileges. The Court said the broad powers of the IRS are essential to this country's self-assessment reporting system. Relying on Bisceglia, the court noted that the alternatives to the present system could involve far less tolerable invasions of the taxpayer's privacy.

The Supreme Court stated that no confidential accountant relationship exists under federal law. Accordingly, Justice Burger stated that the court of appeals' work-product doctrine for accountants was misplaced and conflicted with the clear intent of Congress. The taxpayer does not have a legitimate expectation of privacy. It is presumed that a taxpayer is aware that any disclosures to his auditor that are noted in the auditor's tax accrual workpapers may be the subject of a section 7602 summons. Therefore, the taxpayer could not rationally expect his disclosures to be completely confidential.

The Supreme Court distinguished Hickman's attorney work-product doctrine by noting that the accountant's role is different than that of an attorney. The independent certified public accountant is the public watchdog with a responsibility transcending any relationship with the client/taxpayer. In terms of the audit function, the independent accountant owes ultimate allegiance to the investing public. Allowing a work-product doctrine for the accountant's workpapers would destroy an auditor's crucial role as a disinterested analyst of financial statements.

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91 "Id. "Furthermore, this Court has consistently construed Congressional intent to require that if the summons authority claimed is necessary for the effective performance of Congressionally imposed responsibilities to enforce the tax Code, that authority should be upheld absent express statutory prohibition or substantial countervailing policies." Euge. 444 U.S. at 711.
92 Young. 104 S. Ct. at 1502.
93 420 U.S. at 146.
94 Young. 104 S. Ct. at 1502. In Bisceglia, the Supreme Court upheld an IRS "John Doe" summons issued to a banker to help uncover the identity of a potential delinquent taxpayer. Bisceglia, 420 U.S. at 142.
95 Young. 104 S. Ct. at 1503. See Couch 409 U.S. at 335; Thompson Co. v. General Nutrition Corp., 671 F.2d 100, 103 (3d Cir. 1982).
96 Young. 104 S. Ct. at 1503. See generally Couch, 409 U.S. at 335.
97 Young. 104 S. Ct. at 1503.
98 "Id. This argument is similar to that presented in the dissent of the appellate court by Justice Newman that "in preparing and certifying such statements, he is not retained to defend his client in complying with government obligations to inform the investing public." Young, 677 F.2d at 224 (Newman, J., dissenting).
99 This allegiance overrides the somewhat limited fiduciary duty to the client as stated in the American Institute of Certified Public Accountants Professional standards. The relevant ethical principle states: As a professional person, the CPA should serve his clients with competence and with professional concern for their best interests. He must not permit his regard for a client's interest, however, to override his obligation to the public to maintain his independence, integrity, and objectivity. This discharge of dual responsibility to both clients and the public requires a high degree of ethical perception and conduct.
AICPA PROFESSIONAL STANDARDS, ET § 54.01 (CCH, 1982).
100 Young, 104 S. Ct. at 1504, n. 15.
The Supreme Court stated that the integrity of the securities market would not suffer because corporate officers could not afford to withhold information from the auditors concerning tax contingencies.\(^{102}\) If the auditor had reason to believe that the corporate officers were withholding relevant information, he would not issue an unqualified report.\(^{103}\) This would immediately send a negative signal to the investing public, creditors, and shareholders.\(^{104}\) Furthermore, the Court noted that if the auditor believes his client is not being perfectly candid, the auditor has the duty to make further investigations for himself.\(^{105}\)

The Supreme Court held that the IRS does not have an unfair advantage by possessing the power to summon tax accrual workpapers.\(^{106}\) The Court noted that both a private plaintiff in securities litigation and the Securities and Exchange Commission could obtain the workpapers.\(^{107}\) The Securities and Exchange Commission is empowered to summon documents relevant to any inquiry.\(^{108}\) The Federal Rules of Civil Procedure allow the parties to discover materials, not privileged, relevant to the subject matter of the litigation.\(^{109}\) Accordingly, due to the broad language and objective of section 7602, the Court stated that the IRS should not have lesser authority than the Securities and Exchange Commission.\(^{110}\) Furthermore, the Supreme Court noted that the IRS has shown some concern for the auditor by tightening its own controls for the issuance of summonses directed towards tax accrual workpapers.\(^{111}\) The controls consist of guidelines that provide for the summoning of tax accrual workpapers only in unusual circumstances and only of those portions of the workpapers believed to be pertinent to the investigation.\(^{112}\)

CONCLUDING NOTES

Both the Supreme Court and appellate court focused their main arguments on the important Congressional policies of providing the investing public with accurate financial statements and promoting the effective enforcement of the revenue laws by equipping the IRS with a broad summoning power. The opinions recognized the conflicts between these policies. The ap-
pellate court desired to avoid any potential for inaccurate financial statements, viewing the choice between real investment losses by the public or the loss of convenience on the part of the IRS.\textsuperscript{113}

The Supreme Court did not believe there was a realistic expectation of increased economic loss due to its decision. Apparently, the Supreme Court had much confidence in the independent auditing process. The Court seemed to believe that ultimately nothing can be hidden from the independent auditor. In reality, auditing consists of statistical sampling predominantly in those areas where errors or irregularities are believed to exist. Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness of certain representations\textsuperscript{114} is reasonable. The Supreme Court noted that the auditor must make further investigations if he believes that his client is not being perfectly candid.\textsuperscript{115} However, it is always possible that the auditor may not be aware of a client's misrepresentation. Therefore, an auditor would have no duty to make further investigations. As a result, the investing public would suffer real economic losses through reliance on inaccurate financial statements.

In terms of the audit, the auditor's main responsibility is to follow generally accepted auditing standards. Adhering to these standards does not guarantee that the financial statements will be accurate. The Supreme Court appeared to have an idealistic view of the audit process, implying that nothing could or would be hidden from the auditor. Auditing consists mostly of sampling transactions and verification procedures which do involve much uncertainty. Many errors and irregularities are never uncovered due to time and money constraints.\textsuperscript{116} If the competing Congressional policies noted in this case carry equal weight, the the Supreme Court should carefully review the rationale of its opinion and its implications. The possibility of an increasing number of inaccurate financial statements due to client misrepresentations is realistic.

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\textsuperscript{113}Young, 677 F.2d at 221.
\textsuperscript{114}The representation may possibly pertain to the subject of contingent tax liabilities.
\textsuperscript{115}Young, 104 S. Ct. at 1503.
\textsuperscript{116}See AICPA Professional Standards, AU § 350.07 (CCH, 1982).