No. 16-1466

IN THE

Supreme Court of the United States

MARK JANUS,

Petitioner,

v.

AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES, COUNCIL 31, *et al.,*

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICI CURIAE* IN SUPPORT OF NEITHER PARTY

VIRGINIA A. SEITZ*
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000
vseitz@sidley.com

Counsel for Amici Curiae

* Counsel of Record

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INTEREST OF *AMICI CURIAE*[1]

Amici curiae are public accounting firms employing certified public accountants. *See* Appendix (listing firms). Each firm specializes in attestation services for labor unions, including conducting *Hudson* audits. *See Chicago Teachers Union Local No. 1 v. Hudson*, 475 U.S. 292, 307 n.18 (1986). These established firms have each been in existence for decades and amongst them have been performing *Hudson* audits since this Court's decision in 1986. Together, the *amici* firms have performed hundreds of *Hudson* audits for local and international unions throughout the country, including affiliates of respondent here.

Amici have a strong interest in judicial decisions involving *Hudson* audits to the extent those decisions describe and rest on assumptions and potentially misunderstandings about the role of the independent auditor on such engagements. The purpose of this brief is to assist the Court in understanding the role that an independent auditor plays in performing a *Hudson* audit, to inform the Court of the professional and ethical standards that govern the auditor on such engagements, and to address how those standards affect the auditor's conduct of a *Hudson* audit.

SUMMARY OF ARGUMENT

In *Hudson*, this Court held that a public sector union's allocation of expenses that may be charged to

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[1] Pursuant to Supreme Court Rule 37, *amici curiae* state that no counsel for any party authored this brief in whole or in part, and that no entity or person other than *amici curiae* and their counsel made any monetary contribution toward the preparation and submission of this brief. All parties filed blanket consents with this Court.

objecting nonmembers requires "verification by an independent auditor." *Id.* at 307 n.18. In *Knox v. SEIU, Local 100*, 567 U.S. 298 (2012), the Court stated that in assessing whether a particular expense is chargeable, the "auditors take the union's characterization for granted" and merely perform the "simple accounting function" of ensuring that the union-claimed expenditures were actually made for the claimed expense. *Id.* at 318-19. The Court wrote that if a union "believes that supporting sympathetic political candidates is chargeable and bases its classification on that view – the auditors will classify these political expenditures as chargeable." *Id.* at 319.

As explained in detail below, however, the ethical and professional standards that govern independent auditors do not permit them to take the union's chargeability characterizations "for granted." The *amici* accounting firms are governed by a Code of Conduct and Auditing Standards established by the America Institute of Certified Public Accountants. The Code and Standards require the auditor to provide assurance that the union's chargeability characterizations are fairly presented to a potential objector, and to question the union when those characterizations are materially misstated or contrary to settled law. Put differently, if a union were to misclassify expenses under settled law or to fail to acknowledge a questionable chargeability classification, the auditor would not be permitted to passively accept those characterizations. For example, were a union to attempt to classify political expenses as chargeable, the auditor, absent a union correction, would either issue a modified opinion or withdraw from the audit engagement. An auditor would not

issue a "clean" or unmodified opinion in this situation.[2]

Moreover, the independent auditor's role involves substantive analytical procedures and testing of the union's expenses to confirm not only that union-claimed expenditures were actually made for the specific claimed expenses, but further that the allocation of those expenses to the chargeable or nonchargeable category is fairly presented. In other words, the auditor reviews and verifies the union's chargeable and nonchargeable characterizations based on the auditor's knowledge of the settled lines that the Court and others have drawn in this area in order to provide assurance that the statements are fairly presented for all users, including potential objectors.

ARGUMENT

I. THE INDEPENDENT AUDITOR PROVIDES ASSURANCE THAT THE UNION'S CHARGEABILITY CHARACTERIZATIONS ARE FAIRLY PRESENTED TO POTENTIAL OBJECTORS

A. The Court's Decisions Concerning The Role Of The Independent Auditor

In *Hudson*, this Court held that public sector unions must adopt "[p]rocedural safeguards" to ensure that objecting nonmembers are assessed only the fair-share fees properly chargeable to them. 475 U.S. at

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[2] An auditor's unmodified opinion is one that concludes that the client's financial statements are presented fairly in all material respects. A "modified" opinion is one that concludes that the financial statements are materially misstated or that the auditor is unable to obtain sufficient evidence to conclude that the financial statements are free from material misstatement. *See infra* pp. 9-11, 13-15.

302-03. The union must provide the nonmember with "sufficient information to gauge the propriety of the union's fee" so that the nonmember has a basis to determine whether to object to paying the full fee or to challenge a fair-share fee calculation. *Id.* at 306. Among other "[p]rocedural safeguards," this Court held that adequate disclosure requires "verification by an independent auditor." *Id.* at 307 n.18. The "purpose of requiring the verification" is to give the "nonmembers some prior assurance that the . . . fee was properly calculated"; and when "nonmembers do not receive that assurance, their constitutional rights are violated" under *Hudson*. *Otto v. Pa. State Educ. Ass'n – NEA*, 330 F.3d 125, 131 (3d Cir. 2003) (quoting *Hohe v. Casey*, 956 F.2d 399, 415 (3d Cir. 1992)).

In *Lehnert v. Ferris Faculty Association*, 500 U.S. 507 (1991), the Court held that chargeable activities are those (1) germane to collective-bargaining activity, (2) justified by the government's vital policy interest in labor peace and avoiding free-riders, and (3) not significantly adding to the burdening of free speech.[3] *Id.* at 519. More than two decades later, in *Knox* and *Harris v. Quinn*, 134 S. Ct. 2618 (2014), the Court stated that because "of the open-ended nature of the *Lehnert* test, classifying particular categories of expenses may not be straightforward." *Harris*, 134 S. Ct. at 2633; *see also Knox*, 567 U.S. at 318-19.

Relevant here, the Court wrote that determining the chargeable "breakdown is problematic" in part because "auditors typically do not make a legal determination as to whether particular expenses are

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[3] In general, chargeable expenses include those undertaken to advance the representational interests of the collective bargaining unit as a whole whereas nonchargeable expenses are those for political or ideological projects. *E.g.*, *Knox*, 567 U.S. at 303.

chargeable." *Knox*, 567 U.S. at 318. Specifically, the Court expressed its belief that "auditors take the union's characterization for granted" and merely perform the "simple accounting function" of ensuring that the union-claimed expenditures were actually made for the claimed expense. *Id.* at 318-19; *see Harris*, 134 S. Ct. at 2633 ("auditors do not themselves review the correctness of a union's categorization"). The Court continued, "if a union takes a very broad view of what is chargeable – if, for example, it believes that supporting sympathetic political candidates is chargeable and bases its classification on that view – the auditors will classify these political expenditures as chargeable." *Knox*, 567 U.S. at 319. Respectfully, as we explain below, these statements rest on a misunderstanding of the independent auditor's role in a *Hudson* audit.

B. *Hudson* Audits Must Be Conducted In Accordance With Auditing Standards Set Forth By The American Institute Of Certified Public Accountants, As Well As With Its Code Of Professional Conduct

Certified public accountants ("CPAs") are licensed by the state or states in which they practice, and are bound by the Code of Professional Conduct ("Code") issued by the American Institute of Certified Public Accountants ("AICPA"). The AICPA also issues Auditing Standards (denominated "AU-Cs" or "Auditing Standards") that similarly govern the conduct of CPAs who perform audits.[4] All audits, including

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[4] The Code and Auditing Standards can be located on the AICPA's website. *See* https://www.aicpa.org/research/standards/codeofconduct.html (Aug. 31, 2017); https://www.aicpa.org/research/standards/auditattest.html (last visited Dec. 4, 2017). AU-C stands for Clarified Auditing Standard.

Hudson audits, must be conducted in compliance with the generally accepted auditing standards in the United States ("GAAS"), as specified in the AU-Cs. *See Ferriso v. NLRB*, 125 F.3d 865, 871 (D.C. Cir. 1997) ("Federal and state authorities and professional associations have devoted considerable effort to developing standards of independence and professionalism for audits of businesses, employee benefit plans, and the like; potential objectors to agency fees should not be required to rely on an audit that does not meet the prevailing standards for audits ….").

CPAs take seriously their duty to comply with the Code and Standards. Violations of either could subject the CPA and/or his or her firm to sanctions by, or expulsion from, the AICPA, monetary sanctions from the CPA's State Board of Accountancy, or in extreme circumstances the loss of the CPA's license to practice public accountancy. Compliance with the Code and Standards, in other words, is of the utmost importance to CPAs.

The Code. The Code broadly defines the professional and ethical obligations of CPAs in all aspects of the accounting profession. It recognizes that as professionals, CPAs "should exercise sensitive professional and moral judgments in all their activities." Code § 0.300.020.01. It obligates them to "serve the public interest" and "to honor public trust," noting that a "distinguishing mark" of CPAs is their "responsibility to the public." *Id.* §§ 0.300.030.01, 0.300.030.02. The "public" extends far beyond the CPA's client – it includes all "others who rely on the objectivity and integrity of *members* to maintain the orderly functioning of commerce." *Id.* § 0.300.030.02.

CPAs must act with the "highest sense of integrity," *id.* § 0.300.040.01, which requires them to "observe both the form and the spirit of technical and ethical

standards; circumvention of those standards constitutes subordination of judgment." *Id.* § 0.300.040.04. They also must "maintain objectivity and be free of conflicts of interest" and should be "independent in fact and appearance when" conducting an audit. *Id.* § 0.300.050.01. This objectivity requirement "imposes the obligation to be impartial, intellectually honest, and free of conflicts." *Id.* § 0.300.050.02.

CPAs must exercise due care, meaning they are required to "observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of [their] ability." *Id.* § 0.300.060.01. In other words, they must be competent and diligent and have "mastery of the common body of knowledge" required for their work. *Id.* § 0.300.060.03.

The Auditing Standards. The Auditing Standards universally apply when a CPA is conducting an audit, including a *Hudson* audit. Those Standards provide that the "purpose of an audit is to provide financial statement users with an opinion by an auditor on whether the financial statements are *presented fairly*, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users can place in the financial statements." AU-C § 200.04 (emphasis added); *id.* §§ 200.12; 200.A1. The auditor must "obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error." *Id.* § 200.06. Misstatements are material if "they could *reasonably be expected to influence the economic decisions of users* that are taken based on the financial statements." *Id.* § 200.07 (emphasis added); *see id.* § 320.02 (same).

A material misstatement may exist for the overall financial statement or for "classes of transactions, account balances and disclosures." *Id.* § 200.A38. Moreover, a misstatement may result from fraud or error, including from "judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate." *Id.* § 450.A1(e).

GAAS require that auditors "exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit," including based "on an understanding of the entity and its environment, including the entity's internal control[s]." *Id.* § 200.08; *see also id.* §§ 200.15, 200.17, 200.18. Exercising professional judgment means "application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of an audit engagement." *Id.* § 200.14. Professional skepticism means an "attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence." *Id.*

Auditors must also act in the "public interest" and "be independent of the entity subject to the audit." *Id.* § 200.A17. The independence must be in both "fact" and "appearance." *Id.*

Critically here, the auditor's opinion will also "depend upon the applicable financial reporting framework and any applicable law or regulation." *Id.* § 200.09; *see id.* §§ 200.A3, 800.07e ("logical, reasonable criteria" applicable to items reviewed in a *Hudson* audit). This includes the "legal and ethical environ-

ment, including statutes, regulations, [and] court decisions," as well as general and "industry practices widely recognized and prevalent." *Id.* § 200.A6. *See also id.* § 250.04 (auditor responsible for "identifying material misstatement . . . due to non-compliance with laws").

When the auditor identifies a misstatement, the auditor will communicate it to the client and request that the client "correct" the misstatement. AU-C § 450.07. If the client "refuses to correct" some or all of the misstatement, the auditor should understand the reasons for not making the correction and take those reasons "into account when evaluating whether the financial statements as a whole are free from material misstatement." *Id.* § 450.09. In determining whether the uncorrected misstatement is material, the auditor shall make such determination "based on the auditor's understanding of the *user needs and expectations*," including potential objectors in the *Hudson* audit context. *Id.* § 450.A18 (emphasis added); *see infra* p. 11 (citing Code § 0.300.030.02).

If the auditor determines that it cannot offer reasonable assurance that the financial statements are free from material misstatement, the auditor must either issue a modified opinion or withdraw from the engagement (where possible). *See id.* §§ 200.13, 705.02, 705.05, 705.07(b).[5] If the auditor does not

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[5] In *amici*'s experience, an auditing firm's standard engagement letter will warn the client about the possibility of a modified opinion by stating, for example: "We cannot provide assurance that an unmodified opinion will be expressed. Circumstances may arise in which it is necessary for us to modify our opinion or add an emphasis-of-matter or other-matter paragraph. If our opinion is other than unmodified, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not

withdraw from the engagement but instead issues a modified opinion, it will be either a qualified opinion, an adverse opinion, or a disclaimer of opinion. *Id.* §§ 705.02, 705.05, 705.07(b). The auditor should issue a "qualified opinion" where there is sufficient appropriate audit evidence,[6] and the misstatements are "material but not pervasive," *id.* § 705.08(a), and an "adverse opinion" where the misstatements are "material and pervasive." *Id.* § 705.09. The auditor should disclaim an opinion where there is not sufficient audit evidence on which to base an opinion *and* the auditor concludes that the possible effects of undetected misstatements could be both material and pervasive. *Id.* §§ 705.10, 705.13. When an auditor issues a modified opinion, it should "include a paragraph in the . . . report that provides a description of the matter giving rise to the modification." *Id.* § 705.17.

Moreover, even if the opinion is unmodified, an auditor retains discretion to insert an "emphasis-of-matter" or "other-matter" paragraph. *Id.* § 706. An auditor may insert such a paragraph when it is "necessary," in the auditor's professional judgment, to bring to the user's attention a matter of "such importance that it is fundamental to the users' understanding of the financial statements," or "relevant to the users' understanding of the audit, the auditor's responsibilities, or the auditor's report." *Id.* § 706.04.

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formed an opinion, we may decline to express an opinion or withdraw from this engagement."

[6] "Audit evidence" is defined as "[i]nformation used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information." AU-C § 500.05.

C. The Independent Auditor Does Not Take The Union's Chargeability "Characterization For Granted," But Evaluates The Characterization To Assure That It Is Presented Fairly And Not Materially Misstated

Independent auditors conducting a *Hudson* audit of a union have two audiences: the union's governing body, and potential objectors and/or challengers. *See*, *e.g.*, Code § 0.300.030.02 (auditor must serve all "others" who rely on the objectivity and integrity of the audit). The very purpose of the audit is to ensure that "potential objectors be given sufficient information to gauge the propriety of the union's fee" and thus to determine whether to object or to challenge the union's calculation of the reduced fair share fee. *Hudson*, 475 U.S. at 306.

With that latter user in mind, the auditor has a duty to offer assurance that the union's allocations of chargeable expenses and nonchargeable expenses are "presented fairly" and without "material misstatement." AU-C § 200.04, 200.06. The potential objector must be provided with an appropriate "degree of confidence" in the statements. *Id.* § 200.04. And, although classification of a particular expense as chargeable is a legal determination, the auditors who perform these audits are fully versed in the legal requirements of *Hudson* and its progeny, and they review those classifications (and underlying definitions) with professional skepticism in light of "any applicable law," including "court decisions" and "industry practices." *See id.* §§ 200.09, 200.A6; *see also id.* § 250.A5 (while noncompliance of law is a matter for legal determination, "the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognize that some

acts coming to the auditor's attention may constitute noncompliance with laws").

Auditors thus do not – and indeed, may not – take the union's chargeability characterizations "for granted." *Knox*, 567 U.S. at 318. Instead, they subject them to scrutiny to verify that the statement as a whole is fairly presented to the potential objectors or challengers. For example, if a union "believes that supporting sympathetic political candidates is chargeable and bases its classification on that view," the auditor most certainly will *not* "classify these political expenditures as chargeable." *Id.* at 319. Instead, because of their training, expertise, and knowledge of the "applicable law" and "court decisions" about *Hudson* chargeability issues, *see* AU-C §§ 200.09; 200.A6, the auditors would not accept such a classification, which is contrary to settled law. *E.g.*, *Locke v. Karass*, 555 U.S. 207, 210 (2009) ("political expenditures" are not chargeable); *see supra* pp. 8-9. Such a classification would constitute a material misstatement resulting in an unfair presentation to potential objectors.[7] A CPA confronting such a situation and determining whether to issue an unqualified opinion would be required by governing professional standards to ask: "Am I doing what a person of integrity would do? Have I retained my integrity?" Code § 0.300.040.04. The answer would be "no."

In such a circumstance, the auditor would confer with union management and/or legal counsel and request that the union correct the misstatement. AU-C § 450.07. In *amici*'s experience, an auditor in that

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[7] It would be akin to a union's attempting to classify legal bills as "rent" by stating in a definition that "legal bills shall constitute rent." Plainly, an auditor would not accept such a mischaracterization.

situation would emphasize that a failure to correct will result in a modified opinion or withdrawal from the engagement. And, again in the experience of *amici*, when faced with these possible consequences, unions are responsive to the auditor's criticisms and agree to the correction. If the union does not agree, however, the auditor will either issue a modified opinion to make the disagreement clear, or withdraw from the engagement if the modification is deemed insufficient. *Id.* §§ 200.13, 705.05. Issuing an unmodified opinion in such a circumstance would be contrary to the Code and standards described above. Thus, while auditors do not have authority to make a binding legal determination or otherwise to compel a union to change its classifications of expenses, they may not issue an unmodified opinion on a *Hudson* audit that is inconsistent with settled law.[8]

Even in areas of unsettled law, the auditor would take action if it were to discover during the course of the audit that the union is making a potentially questionable chargeability classification. For example, litigation expenses incidental to the union's negotiation or administration of the collective bargaining agreement or other litigation normally conducted by an exclusive representative are chargeable, whereas litigation expenses lacking such a connection to collective bargaining are not chargeable. *See Locke*, 555

[8] Although the chargeability decision itself is a legal determination, *Tierney v. City of Toledo*, 917 F.2d 927, 936 n.7 (6th Cir. 1990), auditors must follow their professional standards and ensure that union chargeability definitions and classifications are presented fairly to potential objectors in accordance with governing law. *See supra* pp. 8-9. Moreover, auditors are aware that they may be called as witnesses, whether at an arbitration, in court, or at a state labor board, and thus must be able to explain under oath to an impartial decision maker why the opinion is defensible. *See Hudson*, 475 U.S. at 307.

U.S. at 215; *Ellis v. Bhd. of Ry., Airline & S.S. Clerks*, 466 U.S. 435, 453 (1984) (holding non-chargeable litigation expenses related to protecting the rights of employees generally during bankruptcy proceedings as too attenuated from collective bargaining). If a union were to attempt to take a questionable position and define as chargeable a litigation with only an attenuated relationship to collective bargaining, the auditor would not merely "take the union's characterization for granted." *Knox*, 567 U.S. at 318. Rather, after questioning the union about the basis for and reasonableness of the classification, the auditor would ensure that the user – the potential objector – understands the union's position and the unsettled nature of the question, so that he or she can make an informed decision about whether to challenge the classification.

For example, in such a situation the auditor could issue a qualified opinion in which the auditor opines that the *Hudson* statements are presented fairly in all material respects *except* for the one particular classification decision. AU-C §§ 705.08, 705.17, 705.18. The auditor would then include a paragraph describing for the user the basis of the reasons for the modified opinion and explaining why the particular classification decision is not presented fairly to permit the objector to understand the nature of the position. *Id.* § 705.17.

Alternatively, the auditor may conclude that the classification position does not rise to the level of a material misstatement, but is nevertheless "fundamental to [the potential objector's] understanding of the financial statements." *Id.* § 706.01. In this situation, the auditor would either require that the definitional notes to the *Hudson* financial statements be made explicit in describing the expense as a chargea-

ble one, or would insert an "emphasis-of-matter" paragraph in the opinion letter explaining the unsettled nature of the position. *Id.* In these circumstances, the auditor would provide an unmodified opinion, but would nevertheless draw the attention of the potential objector to the relevant classification decision. It would describe both the classification and the auditor's position on the classification in detail. In this manner, it would permit the potential objector to make an informed decision with "sufficient information" about whether to challenge the classification before an impartial decision maker, be it an arbitrator, a state labor board, or a court. *Hudson*, 475 U.S. at 307; *see Airline Pilots Ass'n v. Miller*, 523 U.S. 866, 877-78 (1998) (objectors need not exhaust union procedures and may proceed directly to court); *Robinson v. New Jersey*, 806 F.2d 442, 450 (3d Cir. 1986) (challenging classifications before a state labor board).[9]

In sum, the independent auditor has a professional obligation to assure that the *Hudson* statement is "presented fairly" in all material respects to a potential objector. If a union were to take the position that political expenditures were chargeable or some similarly questionable classification position, the auditor would not simply issue an unmodified opinion. Rather, the auditor would request that the union correct the misstatement, and, absent a correction, would take steps to ensure that a potential objector would become aware of an aggressive position, whether through a modified opinion, expanded disclosure in the notes to the financial statements, or an "emphasis-of-matter" paragraph. If, due to the significance of the positions in question, the auditor deemed the

[9] By challenging the classification before a court or state labor board, the challenger may transform an unsettled area of law with respect to chargeability into a settled area of law.

modifications to the opinion or financial statement insufficient, the auditor would withdraw from the engagement.

D. The Independent Auditor Rigorously Evaluates And Tests The Expense Allocation For Material Misstatement

The independent auditor does not perform a rote, unquestioning, "simple accounting function" on a *Hudson* audit. *See Knox*, 567 U.S. at 318. Instead, the independent auditor plays a significant role in assuring not only the accuracy of the union's expenses, but also their allocation to chargeable and non-chargeable categories. The audit firm must do so in order to comply with its professional obligations and to ensure that the *Hudson* statements are fairly presented to potential objectors or challengers. We set forth below the steps an independent auditor takes with respect to a *Hudson* audit.

As a preliminary matter, an auditor can provide three levels of verification with respect to financial statements: a compilation, a review, or an audit. A compilation involves preparing a financial statement in which the auditor expresses "no assurance of accuracy, completeness or conformity with generally accepted accounting principles." *Prescott v. Cty. of El Dorado*, 177 F.3d 1102, 1106 (9th Cir. 1999), *vacated on other grounds*, 528 U.S. 1111, *reinstated in relevant part*, 204 F.3d 984 (9th Cir. 2000). An accountant performing a compilation need not "verify or corroborate" the financial statement information. *Otto*, 330 F.3d at 133.

A review involves an intermediate level of scrutiny and results in an expression of only "limited assurance" because the auditor relies on representations of management that there are no material modifications

that need to be made. *Prescott*, 177 F.3d at 1106-07; *Otto*, 330 F.3d at 133. In conducting a review, the auditor makes a limited, not a comprehensive, "inquiry into client management, accounting practices, internal control structure, and analytical procedures." *Otto*, 330 F.3d at 133.

By contrast, an audit "consists of sufficient independent examination to express an opinion on the fairness, in all material respects, of the financial statement." *Prescott*, 177 F.3d at 1107. It provides the "highest level of assurance on financial statements," and "provides *verification* of the financial statements' claims and assertions." *Otto*, 330 F.3d at 133. It requires "the accountant to assess the organization's internal control procedures" and "examine evidence supporting the amounts in the financial statement using an appropriate sampling frequency." *Prescott*, 177 F.3d at 1107.

The courts of appeals that have directly confronted the issue have held that only a "true audit" meets the verification requirement of *Hudson*. *Prescott*, 177 F.3d at 1108; *see also Otto*, 330 F.3d at 134 ("local unions, regardless of their size, are required to obtain audits of their financial statements"). And, in *amici*'s experience, they perform audits to verify the allocation of expenses by public sector unions.[10] *Prescott*, 177 F.3d at 1107. An audit is the highest level of verification that auditors can provide.

Moreover, the independent auditor's verification is substantive, extensive, and complex. A *Hudson* audit

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[10] The Ninth Circuit has held that there is a limited exception to the true audit requirement for small local unions with under $50,000 in estimated revenue. *Harik v. Cal. Teachers Ass'n*, 326 F.3d 1042, 1047 (9th Cir. 2003). The Third Circuit has rejected this position. *Otto*, 330 F.3d at 132.

engagement begins with the planning process. *See* AU-C § 300. During planning, the independent auditors perform preliminary analytical procedures,[11] *see id.* § 520 (describing analytical procedures in detail), to determine what further testing will be done during the engagement, assess risks, and formulate an audit strategy. By way of example, this may entail examining each line item of expenditures from the prior year and comparing the expenditures in the current year to what the auditor, based on the auditor's knowledge of the union and its environment, *id.* § 315, expected the expenditures to be. In 2016, a Presidential election year, for instance, the auditor would expect the amount of political expenditures to have increased. If they had not, the auditor would mark for increased testing and analysis expenditures in the political realm.

The auditor that performs the union's *Hudson* audit is also often the same auditor that audited the union's basic financial statements (which, when prepared in accordance with GAAS, reflect the financial position, results of operations, and cash flows for the year). Those financials, too, would have been subjected to testing, including on the internal controls of the union concerning, for example, cash disbursements, payroll, and employee benefits. The auditor thus is generally able to use its knowledge of the union's operation and the nature of its expenses, learned during the audit of the financial statements,

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[11] Analytical procedures are "[e]valuations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount." AU-C § 520.04.

to aid in the evaluation of the reasonableness of the union's definitions and methodologies in its *Hudson* allocations.

The next step is for the independent auditor to request supporting documentation of relevant expenses for the year on a sample basis. *See* AU-C § 530. The auditor will request supporting documentation for a subset of items that are considered necessary to test based on the preliminary analytical procedures described above. The auditor then would spend significant time reviewing documentation of the expenses, confirming not only that the union made the expenditures claimed, but also that the allocation between chargeable and nonchargeable expenses has been made in accordance with the definitions and methodologies outlined in the notes to the *Hudson* statements, and, as discussed in Part I.C, ensuring that the definitions and methodologies are reasonable and in accordance with the law.

For example, the printing and distribution costs of a union publication such as its newsletter are chargeable to the extent the articles in the publication concern chargeable activity. *Ellis*, 466 U.S. at 451. Allocation of expenses in this setting is typically done on the basis of the square inches of the publication devoted to chargeable versus nonchargeable activity. The auditor will not only re-measure the articles to ensure that the union's measurements resulting in the allocation percentage are accurate, but will also review each article to verify that the content of the article itself is properly characterized as chargeable or nonchargeable. If the union attempted to classify an article taking a position on the preferred candidate in a gubernatorial election, for instance, as chargeable, the auditor not would simply accept that characterization, but would instead ask the union to

correct the allocation and treat the article as non-chargeable.

As another example, with respect to union meetings or conferences, the auditor reviews the agenda of the meeting or the minutes of the meeting to verify the percentage of the meeting spent on chargeable versus nonchargeable activities.[12]

Once the auditor concludes the testing, the audit evidence gathered and tested goes through a multi-level quality control review process within the audit firm. Various levels of internal staff (such as a field supervisor, a partner in charge, and quality control partner) review the audit to assure that the auditor has conducted procedures sufficient to verify the *Hudson* statements. Moreover, every three years the audit firm is itself subject to a peer review by an independent qualified third-party accounting firm. The peer reviewer analyzes the audit firm's accounting and auditing process, and it may select for review any *Hudson* audit conducted in the time period subject to review. The AICPA established the peer review program almost forty years ago, and participation is required for all AICPA member firms with an accounting and auditing practice.

Finally, once the auditor has performed all necessary procedures and tests on a sufficient and appropriate amount of audit evidence, the auditor will issue an opinion on the *Hudson* statements. The auditor will issue an unmodified opinion only if the auditor determines that the statements are presented fairly, in all material respects, including for the actual expenses of the union and the allocation of those

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[12] Other tests performed include review and verification of employee salaries, review of employee time and activities, and review of travel expenses and the purpose of those expenses.

expenses between chargeable and nonchargeable on the basis of the definitions and significant factors and assumptions in the statements.

CONCLUSION

For the foregoing reasons, *amici* respectfully request that this Court rest its judgment on a complete and accurate understanding of the role and work of an independent auditor conducting a *Hudson* audit.

Respectfully submitted,

VIRGINIA A. SEITZ*
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000
vseitz@sidley.com

Counsel for Amici Curiae

December 6, 2017

* Counsel of Record

APPENDIX

LIST OF *AMICI CURIAE*

Buchbinder Tunick & Company LLP

Calibre CPA Group PLLC

Legacy Professionals LLP

Lindquist LLP

Novak Francella LLC, CPAs

WithumSmith+Brown, PC