ABA COMMITTEE ON AUDIT RESPONSES

Statement on Effect of FIN 48 on Audit Response Letters

On July 13, 2006, the Financial Accounting Standards Board issued Interpretation No. 48 ("FIN 48") on Accounting for Uncertainty in Income Taxes, which is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, issued in 1992. It applies to issues involving federal, state, local or foreign income taxes. FIN 48 is effective for public companies for fiscal years beginning after December 15, 2006 and generally is effective for non-public companies for fiscal years beginning after December 15, 2007, although FASB has proposed a deferral for non-public companies to 2008. FIN 48 provides that its guidance governs with respect to accounting for such tax contingencies in place of FASB Statement No. 5, Accounting for Contingencies ("FAS 5"). As discussed below, the Committee on Audit Responses (the "Committee") of the American Bar Association’s Section of Business Law believes that the issuance of FIN 48 does not change the standards under which a lawyer should respond to an auditor’s request for information regarding such contingencies. The Committee further believes that, although FIN 48 can affect the way a lawyer advises his or her client when income tax matters are involved, it does not alter the lawyer’s professional responsibility to provide that advice when that is required within the scope of the lawyer’s engagement.

Handling Loss Contingencies under the "Treaty"

In 1975 the Board of Governors of the American Bar Association, following approval by the Section on Corporation, Banking and Business Law (now known as the Section of Business Law), approved a Statement of Policy (the "ABA Statement") regarding lawyers’ responses to an auditor’s request for information that had been previously approved by the Auditing Standards Executive Committee of the AICPA. The AICPA also approved in parallel Statement of Auditing Standards No. 12 recognizing the ABA Statement. This so-called "Treaty" between the legal and accounting professions has operated successfully for over 30 years pursuant to the following ground rules:

- A lawyer will only furnish information in an audit response letter with respect to "loss contingencies" as defined in FAS 5 that may result in incurrence of a liability or impairment of an asset, if the lawyer has devoted substantive attention to and consulted with the client with respect to the following loss contingencies:
  - overtly threatened or pending litigation, whether or not specified by the client;
  - contractually assumed obligations that the client has specifically identified and upon which the client has specifically requested comment to the auditor; and
  - unasserted possible claims or assessments that the client has specifically identified and upon which the client has specifically requested comment to the auditor.
• A lawyer will not express any opinion in the audit response letter on the outcome of a loss contingency or the extent of possible exposure unless the lawyer concludes that liability is either probable or remote.

• A lawyer should not be requested to comment on unasserted claims unless the client has determined that it is probable (i.e., likely to occur) that a possible claim will be asserted, that there is a reasonable possibility that, if asserted, the outcome will be unfavorable, and that a resulting liability will be material to the financial condition of the client.

• A lawyer should confirm, as contemplated by the Treaty (see Paragraph 6 of the ABA Statement), that, when the lawyer, within the scope of his or her engagement, has formed a professional judgment that the client must disclose or consider disclosure of a possible claim in its financial statements, the lawyer will so advise the client and consult with the client regarding such disclosure. The auditor may assume that in these circumstances the lawyer has advised the client regarding disclosure of unasserted claims that may call for financial statement disclosure. If the lawyer’s advice regarding disclosure is disregarded by the client, the lawyer, as a matter of professional responsibility, may need to consider withdrawal from the engagement or other remedial action.

Just as a lawyer should be familiar with FAS 5 in responding to auditor’s requests for information about loss contingencies and advising the client on its disclosure obligations, a lawyer should be familiar with FIN 48 when that is relevant to the lawyer’s engagement.

The adoption of FIN 48 raises a number of issues with respect to audit response letters.

Dealing with FIN 48’s “more likely than not” requirement

FIN 48 requires the client to account in its financial statements for income tax loss contingencies (FIN 48 speaks in terms of “income tax uncertainties”) based on the client’s assessment under a two-step process: first, determining whether it is more likely than not that its position will be sustained upon examination, and second, if so, measuring and recognizing the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. The unrecognized tax benefit is a liability and, if the client cannot reach the “more likely than not” conclusion, the entire tax liability must be recognized. In making the determinations under FIN 48, the client may choose to seek legal assistance regarding its tax position, but the required assessment and corresponding measurement is that of the client, as the Treaty specifically recognizes that a lawyer is not required to make determinations of what should be disclosed in financial statements.

For purposes of preparing an audit response letter, a lawyer should continue to follow the usual practice under the Treaty regarding whether or not to comment on the expected outcome of asserted and unasserted claims disclosed in the audit response letter under the “probable” or “remote” standard, leaving it to the client to determine for financial reporting purposes whether its position will be sustained and the amount of the tax benefit, including whether the “more
likely than not” determination can be made. Accordingly, because it would be a departure from the ABA Statement, a lawyer, if requested to do so, may appropriately decline to comment in the audit response letter on the determinations required to be made under FIN 48.

**Dealing with unasserted income tax claims**

Paragraph 38 of FAS 5 (which is quoted in the Commentary to the ABA Statement) discusses when assertion of an unasserted claim is to be considered probable, and leaves to the client to determine whether assertion of the claim is probable (i.e., likely to occur). If the client determines that assertion is not probable, then no accrual or disclosure is required under FAS 5, and so long as the lawyer believes the client has a reasonable basis for its determination, the lawyer may deliver an audit response letter without the unasserted claim being disclosed.

FIN 48 has made Paragraph 38 of FAS 5 inapplicable to income taxes, and proceeds on the assumption that, in assessing whether the client satisfies the “more likely than not” criterion for success, it is to be presumed that the client’s tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information (see Paragraph 7a of FIN 48). Thus, the client’s judgment that a claim is not likely to be asserted by a taxing authority ceases to be applicable in determining what the client may need to disclose in the financial statements with respect to unasserted contingencies relating to income taxes. In cases where the lawyer has rendered substantive advice to the client with respect to a material unasserted contingent liability relating to income taxes, the lawyer, in responding to the auditor’s request for information, should be aware of FIN 48, and if the lawyer has concluded that financial statement disclosure of the income tax contingency is required but is not satisfied that the auditor has been or will be made aware of the contingency, the lawyer should consider what action is appropriate as a matter of professional responsibility. Such action might include, depending on the circumstances, refraining from providing the audit response letter and possibly withdrawing from the engagement.

**Addressing asserted income tax claims**

Overtly threatened and pending income tax claims should continue to be handled in the audit response letter pursuant to the Treaty, as summarized above.

**Effect of FIN 48’s amendment of FAS 5 on the Treaty**

The last paragraph of the standard form of audit response letter included in the ABA Statement indicates that it is limited by, and in accordance with, the ABA Statement, and confirms that whenever a lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning an unasserted possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure “and the applicable requirements of Statement of Financial Accounting Standards No. 5.” Notwithstanding that FIN 48 makes Paragraph 38 of FAS 5 inapplicable to unasserted claims for incomes taxes, the Committee believes, as indicated above, that this change to FAS 5 does not alter the professional responsibility of a lawyer to advise its client on financial statement disclosure with respect to income tax matters when that is required in connection with the lawyer’s engagement.