

Report on Audit Response Timing Issues

By the Audit Responses Committee, ABA Business Law Section*

INTRODUCTION

A law firm’s delivery of an audit response letter confirming certain information about loss contingencies, such as pending or threatened litigation or claims (an “audit response”), is a part of the process for the external audit of a client’s financial statements.

This Report discusses the meaning and applicability of various dates or time periods relevant to audit responses and is based on the existing literature and guidance and the practices that have developed under the American Bar Association Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information (the “ABA Statement of Policy”).¹

1. GETTING STARTED—DATE OF THE CLIENT AUDIT INQUIRY LETTER

A law firm’s audit response is provided to a client’s external auditors pursuant to the client’s specific written request (the “client audit inquiry letter”) that identifies the relevant entities to be covered and the fiscal period being audited.²

Generally, the client audit inquiry letter is prepared by the auditors in coordination with the client and subsequently sent to the law firm at a time chosen by the auditors in advance of completion of the audit. The date of the client audit inquiry letter is relevant only for purposes of identifying the letter in the law firm’s audit response³ and does not otherwise have any bearing on the substance of the response.

* Editor’s Note: This Report is published in the form approved by the Audit Responses Committee on April 21, 2021. It has not been approved by formal action of the American Bar Association or the Council of the Business Law Section, and it therefore does not constitute an official position of either. It does, however, represent the views of the Audit Responses Committee.

1. *Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information*, 31 BUS. LAW. 1709 (1976), reprinted in ABA BUS. LAW SECTION AUDIT RESPONSES COMM., AUDITOR’S LETTER HANDBOOK 1 (2d ed. 2013) [hereinafter AUDITOR’S LETTER HANDBOOK].

2. The discussion in this Report also applies to audit responses in connection with a review by auditors of interim period financial statements. For convenience, this Report only refers to audits.

3. See ABA Statement of Policy, *supra* note 1, at 1733–34 (*Illustrative Form of [Audit Response] Letter for Use by Outside Practitioner or Law Firm*) [hereinafter Illustrative Audit Response].

2. END-DATE OF FISCAL PERIOD OF FINANCIAL STATEMENTS UNDER AUDIT

The client audit inquiry letter establishes the scope of information to be provided in the audit response by identifying the fiscal period under audit and its end-date. The ABA's illustrative client audit inquiry letter opens with the following language:

In connection with an examination of the . . . financial statements of . . . [the "Company"] . . . at [insert balance sheet date] and for the [insert fiscal period under audit] then ended, our auditors . . . have asked that we request you to furnish them with information concerning certain contingencies⁴

The balance sheet date is the end-date of the fiscal period under audit.⁵ This date will be relevant in determining the date or period as of which loss contingencies exist that may require accrual or footnote disclosure, though events occurring or discovered after the balance sheet date may also affect the accruals or disclosures when the financial statements are finally issued. The balance sheet date may also serve as a reference date in identifying the lawyers of the firm who will be polled to provide information, as discussed below.

3. DETERMINATION OF AUDIT RESPONSE DELIVERY DATE

The Illustrative Audit Inquiry does not expressly speak to the date on which the audit response should be delivered. In the absence of an express request for delivery on or as of a particular date, it may be inferred that the client is requesting delivery of the audit response within a reasonable time after receipt of the client audit inquiry letter by the law firm.

In part because of current requirements in accounting and auditing standards, the client audit inquiry letter will often request delivery of the audit response on a specified date, so that the client's financial statements can be ready when they are needed, with language such as the following:

Our auditors expect to complete their audit work on or about [date]; *please deliver your response on or about [audit completion date minus one or two business days].*

Applicable auditing standards provide that the date of the audit response should be as close to the date of the auditors' report as is practicable.⁶ Accordingly, the auditors may request an update if they believe the length of time

4. *Introductory Analysis and Guides to Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 BUS. LAW. 1737, 1743 (1976) [hereinafter *Illustrative Audit Inquiry*], reprinted in *AUDITOR'S LETTER HANDBOOK*, *supra* note 1, at 35.

5. The fiscal period end-date is usually the last day of the month of the annual or quarterly period under audit. Occasionally, the client audit inquiry letter will indicate a date other than the last day of a month when a company prepares its financial statements using a 52/53-week fiscal year or in connection with the closing date of a corporate transaction or securities offering. See also *supra* note 2.

6. Codification of Statements on Auditing Standards, AU Section 9337.05 (Am. Inst. Certified Pub. Accountants 1977) (clarified and recodified at Codification of Statements on Auditing Standards, AU-C Section 501.A53 (Am. Inst. Certified Pub. Accountants 2013)); Interim Auditing Standards, AU Section 9337.05 (Pub. Co. Acct. Oversight Bd. 2007) (recodified at AI 17: Inquiry of a

between the delivery date of the audit response and the completion date of the audit is significant.⁷ If the audit response includes substantive information regarding a matter, the auditors may need extra time to review the information and make determinations as to any necessary accruals or disclosures.

4. DETERMINATION OF AUDIT RESPONSE EFFECTIVE DATE

The ABA Statement of Policy anticipates that the law firm will indicate the date as of which information is disclosed in the audit response (the “effective date”) and provides that it is appropriate to disclaim any undertaking to advise the auditors of changes in the information disclosed after such effective date.⁸ The Illustrative Audit Response anticipates that an audit response will state its effective date, or that such date will be implied to be the date of the audit response itself.⁹

Although not prescribed by the Illustrative Audit Inquiry,¹⁰ often the client audit inquiry letter will contain language along the following lines:

“Please state the effective date of your response if other than the date thereof.”

Alternatively, although also not prescribed by the Illustrative Audit Inquiry,¹¹ often the client audit inquiry letter will request a particular effective date for the audit response so that the audit response does not become “stale” before issuance of the financial statements, with language along the following lines:

[P]lease deliver your response on or about [audit completion date minus one or two business days] with an effective date no earlier than [audit completion date minus two or three business days].

Frequently, upon receipt of the client audit inquiry letter, the law firm will reach out to the auditor and client contact persons to confirm its receipt of the client audit inquiry letter and to clarify the scheduled delivery date and effective date of the audit response.

As a matter of practice, the law firm and the auditors may agree to advance or delay delivery of the audit response within a reasonable time around a delivery date specified in the client audit inquiry letter, without preparing an amended letter. In such case, client consent to the change from the client audit inquiry letter is presumed if no objection is raised by the client to the change.

The Illustrative Audit Response contemplates that the effective date of the audit response will be linked to the timing of the law firm’s preparation of the audit response:

Client’s Lawyer Concerning Litigation, Claims and Assessments: Auditing Interpretations of AS 2505, at 2.05 (Pub. Co. Acct. Oversight Bd.).

7. See generally *Statement on Updates to Audit Response Letters*, 70 BUS. LAW. 489 (2015).

8. ABA Statement of Policy, *supra* note 1, at para. 2.

9. Illustrative Audit Response, *supra* note 3, at 1734.

10. Illustrative Audit Inquiry, *supra* note 4.

11. *Id.*

The information set forth herein is [as of the date of this letter] [as of *(insert date)*], the date on which we commenced our internal review procedures for purposes of preparing this response¹²

5. UNDERSTANDING THE “LOOK-BACK PERIOD”; TIMING OF MATTERS TO BE DISCLOSED

The ABA Statement of Policy and the Illustrative Audit Response address the issue of what is the relevant date or period for considering whether there exist loss contingencies that may require audit response disclosure (the “look-back period”).

Paragraph 2 of the ABA Statement of Policy provides that:

Unless the lawyer’s response indicates otherwise, (a) it is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon¹³

The Illustrative Audit Response mirrors the treatment of the look-back period of the ABA Statement of Policy, but provides additional detail in identifying the matters to be covered in the audit response:

[W]e advise you that since [*insert date of beginning of fiscal period under audit*] we have not been engaged to give substantive attention to, or represent the Company in connection with, [*material*] loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:¹⁴

Two approaches have developed in practice for dealing with the look-back period—the “Entire Period Approach” and the “Snapshot Approach.” The Committee believes that either approach is acceptable so long as the audit response reflects the basis of the firm’s reply.

Entire Period Approach

Under one common reading of the ABA Statement of Policy, emphasis is given to the foregoing language of the Illustrative Audit Response (“since [*insert the date of beginning of fiscal period under audit*]”) to report matters that existed *at any time* during the period (the “Entire Period Approach”).

The Entire Period Approach results in disclosure of matters that arose or remained pending during the look-back period even if such matters were settled or otherwise disposed of during the look-back period, and therefore are not “contingencies existing” as of the relevant balance sheet date, including matters that under ASC 450 would not require accrual or disclosure as loss contingencies in the financial statements as at the end of the fiscal period. Under this

12. Illustrative Audit Response, *supra* note 3, at 1734.

13. ABA Statement of Policy, *supra* note 1, at para. 2.

14. Illustrative Audit Response, *supra* note 3, at 1733.

approach, a matter pending or threatened during the look-back period would be reported whether or not it had been finally disposed of.

Snapshot Approach

Under another common reading of the ABA Statement of Policy, read together with the Illustrative Audit Inquiry, the loss contingencies to be disclosed in the audit response are treated as those described solely in Paragraph 5(a) of the ABA Statement of Policy (the “Snapshot Approach”). The related Commentary to Paragraph 5 of the ABA Statement of Policy provides that:

The term loss contingencies and the categories relate to concepts of accounting accrual and disclosure specified . . . in Statement of Financial Accounting Standards No. 5 (“FAS 5”) issued by the Financial Accounting Standards Board [now recodified at FASB ASC 450-20]¹⁵

Under the Snapshot Approach, the relevant time for identification of reportable loss contingencies refers to the probability “that an asset had been impaired, or a liability had been incurred *at the date of the financial statements*.”¹⁶ Support for this approach can also be found in the Illustrative Audit Inquiry:

Your response should include matters your firm was handling at [insert balance sheet date] as well as new engagements undertaken during the period from that date to the date of your response.¹⁷

Audit response disclosure of a matter arising or discovered after the balance sheet date is requested because financial statement accrual or disclosure may be necessary if the circumstances giving rise to the loss contingency were in existence at the balance sheet date or constituted a material subsequent event, or if qualification of the auditors’ opinion on the financial statements may be required in the case of certain post-balance-sheet date events.¹⁸ For example, a lawsuit filed after the balance sheet date that involves claims arising from events that occurred before the balance sheet date would be covered by the audit inquiry letter.

For clarity, some law firms following the Snapshot Approach choose to vary the language of the Illustrative Audit Response to refer to the balance sheet date instead of referring to the entire look-back period using language such as:

15. ABA Statement of Policy, *supra* note 1, at 1719 (citing STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5 (Fin. Acct. Standards Bd. 1975) (recodified at FASB ACCOUNTING STANDARDS CODIFICATION 450-20 (2009))).

16. ABA Statement of Policy, *supra* note 1, at 1720.

17. Illustrative Audit Inquiry, *supra* note 4, at 1744. Some lawyers who follow the Entire Period Approach believe that this language could be read as being consistent with that approach by emphasizing the need for subsequent events to be disclosed.

18. ABA Statement of Policy, *supra* note 1, at 1729–30 (quoting STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5, at paras. 34–36 (Fin. Acct. Standards Bd. 1975)); Codification of Statements on Auditing Standards, AU Section 560 (Am. Inst. Certified Pub. Accountants 1972) (clarified and recodified at Codification of Statements on Auditing Standards, AU-C Section 560 (Am. Inst. Certified Pub. Accountants 2013)).

[W]e advise you that [as of] [*insert balance sheet date*], and from such date to the date hereof, we have not been engaged to give substantive attention to, or represent the Company in connection with, [*material*] loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter ((i.e., pending or threatened claims in existence as of the date of the financial statements or subsequently)), except as follows¹⁹

Under the Snapshot Approach, the principal date for determination of the existence of disclosable loss contingencies is the end-date of the fiscal period under audit (i.e., the balance sheet date). Accordingly, under this approach, previously disclosed matters that have been settled or otherwise finally disposed of prior to the fiscal end-date are no longer treated as pending or threatened loss contingencies at such date and would not be reportable. Similarly, matters that arose during the look-back period but which were disposed of prior to the fiscal end-date would not be reportable. However, all such matters would be reportable under the Entire Period Approach.

Although under the Snapshot Approach matters that are no longer pending or threatened loss contingencies as of the fiscal end-date are generally not treated as reportable, some firms follow the practice of reporting the resolution of matters disclosed in earlier audit responses.

The following is an example of such an “exit” description:

In our [earlier response dated ____] (our “previous response”) we described a matter pending in the [court, docket number].²⁰ Since the effective date of our previous response, the matter was settled on or about [date], and the court dismissed the action on or about [date].

6. TREATMENT OF “STALE” THREATENED CLAIMS

Paragraph 5 of the ABA Statement of Policy provides that loss contingencies consisting of overtly threatened litigation should be disclosed:

[I]f a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote.²¹

Occasionally a demand letter or other communication of a claim that results in an audit response disclosure is resolved or abandoned without such disposition coming to the attention of the lawyers preparing a subsequent response.

When appropriate, such circumstances can be handled with language along the following lines:

In our previous audit response dated _____, we reported a matter involving a claim against the Company by [name of claimant]. Since the effective date of our

19. Compare *supra* text accompanying note 14.

20. Law firms typically do not go into detail regarding the terms of settlements, which the parties often agree to keep confidential.

21. ABA Statement of Policy, *supra* note 1, at para. 5.

earlier response, we have not become aware of any material developments in connection with such claim, and you should communicate with the Company as to the current status thereof if you have not done so already.

When such language might be appropriate to be included in audit responses depends upon the circumstances.

7. LOOK-BACK PERIOD COVERED FOR NEW ATTORNEYS AND TREATMENT OF FORMER ATTORNEYS

An important aspect of preparing audit responses is identifying the attorneys in the firm most likely to have relevant information concerning loss contingencies. Paragraph 2 of the ABA Statement of Policy provides that:

(a) [The firm's audit response] is properly limited to matters which have been given substantive attention by the lawyer[s] [currently in the firm] in the form of legal consultation and, where appropriate, legal representation since the beginning of the period or periods being reported upon . . . [i.e., the first day of the fiscal period under audit].²²

The application of the look-back period, insofar as it refers to “matters which have been given substantive attention by [the lawyers currently in the firm] in the form of legal consultation [or] legal representation since the beginning of the period . . . being reported upon²³ [until the effective date of the audit response]”²⁴ is limited to “lawyers currently in the firm . . . who have performed [such] services for the client since the beginning of the fiscal period under audit.”²⁵ This would include a lawyer currently at the firm who arrived after the beginning of the look-back period, but is understood only to apply to matters handled while at the firm. On the other hand (except as discussed in the next section), an attorney who was at the firm during the look-back period but who is no longer at the firm as of the effective date of the audit response would not be included. In either case, no specific mention need be made of either circumstance in the audit response.

8. AUDIT RESPONSES FOR FORMER CLIENTS, NEW CLIENTS, AND CHANGES OF COUNSEL ROLES

When clients engage new counsel, or follow their existing counsel to a new firm, the question arises as to who has responsibility to provide the auditors with information concerning loss contingencies that were handled by both firms. The Commentary to Paragraph 2 of the ABA Statement recognizes that:

22. ABA Statement of Policy, *supra* note 1, at para. 2.

23. *Id.*

24. See Illustrative Audit Inquiry, *supra* note 4, at 1744.

25. In practice, it is unnecessary to identify the exact date during the look-back period when the new lawyer arrived. Attorneys who left the firm are excluded from the law firm's review process as they are no longer “currently in the firm.” Additionally, some law firms further limit their response by excluding from their internal review process lawyers currently on a leave of absence.

[T]he appropriate lawyer to respond as to a particular loss contingency is the lawyer having charge of the matter for the client (e.g., the lawyer representing the client on a litigation matter and/or the lawyer having overall charge and supervision of the matter), and that the lawyer not having that kind of role with respect to the matter should not be expected to respond²⁶

Accordingly, the ABA Statement of Policy and related Commentary anticipate that only one counsel is the appropriate counsel to disclose a matter in the audit response. The new or transferee counsel, if assuming a “lead counsel” role, is the counsel who should respond, even if the former or transferor law firm still has some involvement.

For reasons similar to those behind the use of an “exit description” as discussed above, former counsel whose involvement otherwise makes delivery of an audit response appropriate (e.g., such counsel is handling other matters for the client or served as counsel during at least some of the look-back period) might include a statement along the following lines:

In our [earlier response dated ____ (our “previous response”)], we described a matter involving the Company pending in the [court, docket number]. Since the effective date of our previous response, the matter has been transferred to the law firm of [name of firm], and you should communicate with such firm as to the status thereof if you have not done so already.

When a client audit inquiry letter is received that could involve a matter where there has been such a change of lead counsel, responding counsel may wish to communicate with the client or the other law firm to confirm which law firm should cover the matter in its audit response. Similarly, if a firm receives an audit inquiry letter with respect to a former client, it may simply correspond with the auditor that it will not be providing a response since the inquiry involves a former client.

9. CONCLUSION

In providing audit responses, lawyers should be aware of the dates and time periods relevant to those responses because they can affect both the process and substance of the response. With respect to the coverage of the audit response, there are two approaches used in practice: the Entire Period Approach and the Snapshot Approach. The Committee believes that either approach is acceptable so long as the audit response reflects the basis of the response.

26. ABA Statement of Policy, *supra* note 1, at 1717.