

## Assurance and Related Services Guideline

AuG-46

### Communications with law firms under new accounting and auditing standards

This Guideline is to be read in conjunction with the Preface to the CICA Handbook – Assurance.

August 2010

#### TABLE OF CONTENTS

#### Paragraph

<b>Scope and Purpose</b>	1
<b>Introduction</b>	3
<b>Financial statements prepared in accordance with IFRSs</b>	5
Evaluation of the likelihood of loss in the inquiry letter under the Joint Policy Statement	6
Estimation	9
Measurement	10
Factors taken into account by the client	11
Disclosures	14
<b>Dating of the inquiry and response letters under the CASs</b>	16
<b>Appendix</b>	

#### SCOPE AND PURPOSE

1. This Guideline provides interim guidance to assist financial statement preparers (clients), auditors and law firms to communicate with respect to claims and possible claims in circumstances outside the scope currently contemplated by the “Joint Policy Statement Concerning Communications with Law Firms Regarding Claims and Possible Claims in Connection with the Preparation and Audit of Financial Statements” appended to Canadian Auditing Standard (CAS) 501, “Audit Evidence — Specific Considerations for Selected Items.” These circumstances are as follows:

- a. when the financial statements are prepared in accordance with International Financial Reporting Standards (IFRSs), including in particular International Accounting Standard (IAS) 37 *Provisions, Contingent Liabilities and Contingent Assets* in Part I of the CICA Handbook – Accounting; or
  - b. when the auditor is conducting the audit in accordance with the CASs and, therefore, must follow the requirements for dating the auditor’s report in CAS 700, “Forming an Opinion and Reporting on Financial Statements,” paragraph 41, that will affect the dating of the inquiry and response letters sent under the Joint Policy Statement.
2. In these circumstances, communications with law firms continue to be governed by the Joint Policy Statement, taking into account the additional matters discussed in this Guideline. In all other circumstances, communications with law firms continue to be governed by the Joint Policy Statement in its current form. Inquiry letters to law firms and responses from law firms should continue to reference the Joint Policy Statement and indicate whether or not this Guideline applies.

## **INTRODUCTION**

3. CAS 501, “Audit Evidence — Specific Considerations for Selected Items,” paragraph 10, requires the auditor to seek direct communication with the entity’s external legal counsel if the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures indicate that other material litigation or claims may exist. CAS 501, paragraph CA25a, indicates that the communication between auditors and the entity’s external legal counsel with respect to claims and possible claims is conducted in accordance with the Joint Policy Statement. The process set out in the Joint Policy Statement ensures that, as far as possible, confidentiality and privilege of solicitor-client communications is protected. It was drafted based on financial statements prepared in accordance with the Canadian generally accepted accounting principles, including CONTINGENCIES, Section 3290 in Parts II and V of the CICA HANDBOOK – ACCOUNTING, and audited in accordance with the Canadian generally accepted auditing standards, in effect when the Joint Policy Statement was issued. Changes to these principles and standards are occurring,

including the introduction of a variety of financial reporting frameworks in Canadian accounting standards, continuing changes to underlying accounting standards, and changes to auditing standards resulting from the adoption of International Standards on Auditing as Canadian Auditing Standards (CASs).

4. The Auditing and Assurance Standards Board is working with the Canadian Bar Association to revise the Joint Policy Statement to address these changes while continuing to protect the confidentiality and privilege of solicitor-client communications. Since a revised Joint Policy Statement will not be in place prior to the implementation of many of these changes, this Guidance is an interim measure.

#### **FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH IFRSs**

5. The Guideline identifies in the Appendix some significant differences between CONTINGENCIES, Section 3290, and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* that may affect communications with law firms. However, this Guideline does not amend or override accounting standards Section 3290 and IAS 37, and reading this Guideline is not a substitute for considering the accounting standards in their entirety.

#### **Evaluation of the likelihood of loss in the inquiry letter under the Joint Policy Statement**

6. The threshold for recognizing claims and possible claims is lower under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* than under CONTINGENCIES, Section 3290, and involves one additional consideration than under Section 3290. Accordingly, the client's description in the inquiry letter of the evaluation of the claim or possible claim under IAS 37 may need to refer to the likelihood that an obligation exists and the likelihood that there will be an outflow of economic resources. This reference would differ from the likelihood of loss cited in Joint Policy Statement, paragraph 16(a), that reflects Section 3290 requirements, and should instead reflect the discussion in paragraphs 11-13 of this Guideline.

7. Unlike CONTINGENCIES, Section 3290, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* does not include guidance on when the chance of occurrence (or non-occurrence) of the future event(s) cannot be determined. Therefore, if, for example, there is conflicting or insufficient evidence, the client would have to decide whether an obligation exists and the probability of an outflow of resources in accordance with IAS 37 based on all available information. Under IAS 37, a client cannot classify a claim or possible claim as not determinable. IAS 37 indicates that in rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the end of the reporting period by taking into account all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence:
- a. where it is more likely than not that a present obligation exists at the end of the reporting period, the entity recognizes a provision (if the recognition criteria are met); and
  - b. where it is more likely that no present obligation exists at the end of the reporting period, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.
8. In some cases, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* may require that a provision be recognized when, given the same facts and circumstances, CONTINGENCIES, Section 3290 may not require the accrual of a contingent loss. Therefore, on changeover to IFRSs, clients and auditors may need to reassess claims or possible claims previously assessed under Section 3290.

### **Estimation**

9. In estimating a provision required under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, clients would be expected to be able to determine a reliable estimate of the amount, rather than assessing whether the amount can be reasonably estimated under CONTINGENCIES, Section 3290, as reflected in Joint Policy Statement, paragraph 16(b). IAS 37 indicates that, except in extremely rare cases, an entity will be able to

determine a range of possible outcomes and, therefore, can make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision. In the extremely rare case where no reliable estimate can be made (which may include a lawsuit), a liability exists that cannot be recognized. IAS 37 requires that liability to be disclosed as a contingent liability.

## **Measurement**

10. Depending on the nature of the claim or possible claim, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* may require the client to perform more complex measurement calculations, and take different factors into account, than required under CONTINGENCIES, Section 3290.

## **Factors taken into account by the client**

11. It is the client's responsibility to prepare and present financial statements that are in accordance with International Financial Reporting Standards and, in particular IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The client may evaluate a claim or possible claim under IAS 37 using factors such as those listed below: in assessing whether an obligation for a claim or possible claim exists; in assessing whether there will be an outflow of economic resources; and in performing measurement calculations. The following are examples of factors that the client may use in making its evaluation:

- a. management's, and others', previous experience with similar claims or possible claims;
- b. how management intends to respond to the claim or possible claim (for example, whether it intends to contest the matter vigorously or to seek an out-of-court settlement);
- c. the possible different outcomes of the claim or possible claim and the risks and uncertainties associated with them; and
- d. the likelihood of the possible cash flows associated with each possible different outcome and their timing.

12. Because the evaluation of a claim or possible claim under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* may be different from that under CONTINGENCIES, Section 3290, it may be appropriate to seek confirmation of the reasonableness of the client's conclusions relating to one or more of the factors the client used in making its evaluation through communication between the client and the law firm, rather than seeking the form of confirmation under the Joint Policy Statement. In such a case, the client should determine the factors for which it is appropriate to request the law firm to confirm the reasonableness of its conclusions, taking into account the nature of its relationship with the law firm and the extent of the law firm's involvement in the matter. If the client is uncertain which factors are appropriate to include in the inquiry letter, the auditor should encourage the client to discuss the matter with the law firm. Consultation between the client and the law firm is an important part of the process to ensure that the law firm can provide the requested confirmation and that the client appreciates the associated cost.
13. To protect solicitor-client privilege in this respect:
- a. the consultation referred to in paragraph 12 should be between the client and the law firm and should not include or otherwise be disclosed to the auditor; and
  - b. the client should restrict the information in the letter to a brief description of the factors and the conclusions for which the client is requesting the law firm to confirm the reasonableness.

## **Disclosures**

14. Joint Policy Statement, paragraph 23, states that the law firm should be prepared to review the proposed wording of any note to the financial statements regarding claims and possible claims on which it has been consulted. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* has more extensive disclosure requirements than CONTINGENCIES, Section 3290.
15. Because of the more extensive required disclosures, clients may consult with law firms on more aspects of the proposed wording of financial statement disclosures of claims and possible claims under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* than they would for financial statement disclosures under CONTINGENCIES, Section

3290. Similarly, clients and auditors may seek evaluation by law firms of the reasonableness of those disclosures through communications under the Joint Policy Statement.

### **DATING OF THE INQUIRY AND RESPONSE LETTERS UNDER THE CASs**

16. CAS 700, "Forming an Opinion and Reporting on Financial Statements," sets out the requirements for dating the auditor's report. This will normally be a later date than the date of substantial completion, which is the concept used in the Joint Policy Statement when dealing with the timing of the inquiry and response letters. Because of this, the process for preparing inquiry letters and receiving response letters from law firms in the Joint Policy Statement may need to be amended. The following presents a practical approach to the process that reflects the needs of all three parties:

- a. The inquiry letter may specify an effective date for the response letter ("the effective date of response"), which will normally be not more than five business days before the anticipated audit report date. The inquiry letter should also specify the expected date when the response letter from the law firm is required ("the response date"). The inquiry letter would be received by the law firm at least three weeks in advance of the effective date of response.
- b. The response letter would take into consideration developments up to the effective date of response. The time lag in reviewing the law firm's records, together with the time required to prepare the response letter, may result in the response letter not being received by the client and the auditor until at least five business days after the effective date of response.
- c. When a response letter will not be available by the response date specified in the inquiry letter, the law firm would advise the client of the date when it would be available. The auditor would then discuss with the client whether the prospective date of the audit report that this entails is acceptable. If it is not, the auditor would request that the client and the law firm have a discussion to determine a mutually agreeable solution to the timing problem.

- d. Because the effective date of response will be before the date of the auditor's report, the auditor may need to consider obtaining further audit evidence for the period between the effective date of response and the audit report date. The longer this period, the greater the likelihood that the auditor would need to obtain further audit evidence. The nature and extent of this audit evidence is a matter for the professional judgment of the auditor, taking into account factors such as the nature and status of current litigation and the materiality of the items involved. It might be obtained, for example, by inquiry of management (including in-house legal counsel) responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the client's external legal counsel. Where circumstances require, a further written inquiry may be sent to the law firm for the purpose of updating all or part of the original response letter. These inquiry and response letters would be prepared in accordance with the Joint Policy Statement (amended as necessary for the guidance in this Guideline). Because the law firm would normally follow the same process for preparing an updated response letter as for the original response, an updated response letter may require as much time to prepare as the original response letter.

**Significant differences between CONTINGENCIES, Section 3290, and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets***

<b>CONTINGENCIES, Section 3290 (unless otherwise indicated)</b>	<b>IAS 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i></b>
<b>Evaluation of the likelihood of loss</b>	
<p>Under paragraph 3290.12, one of two conditions (both of which must be met) when a contingent loss is required to be accrued is when it is likely that a future event will confirm that an asset had been impaired or a liability incurred at the date of the financial statements.</p> <p>Paragraph 3290.06 describes the term “likely” as the chance of the occurrence (or non-occurrence) of the future event(s) is high. Further, paragraphs 3290.06 and 3290.14 do not require recognition of a contingent loss when the chance of occurrence (or non-occurrence) of the future event(s) cannot be determined (for example, if there is conflicting or insufficient evidence on which to base a decision as to the outcome of a contingent loss).</p>	<p>Under IAS 37 paragraph 14, two of three conditions (all three of which must be met) when a provision is required to be recognized are when:</p> <ul style="list-style-type: none"> <li>(a) an entity has a present obligation (legal or constructive) as a result of a past event; and</li> <li>(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.</li> </ul> <p>IAS 37 paragraphs 15 and 23 indicate that a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists, and an outflow of resources or other event is regarded as probable if the event is more likely than not to occur.</p>

### Estimation

Under paragraph 3290.12, the second of two conditions when a contingent loss is required to be accrued is when the amount can be reasonably estimated.

Under IAS 37 paragraph 14, the third of three conditions when a provision is required to be recognized is when a reliable estimate can be made of the amount of the obligation.

IAS 37, paragraph 25, indicates that the use of estimates is an essential part of the preparation of the financial statements and does not undermine their reliability. Further, it indicates that, except in extremely rare cases, an entity will be able to determine a range of possible outcomes and, therefore, can make an estimate of the obligation that is sufficiently reliable to use in recognizing a provision.

### Measurement

Paragraph 3290.13 indicates that the estimate of the amount of a contingent loss to be accrued may be based on information that provides a range of the amount of the loss. When a particular amount within such a range appears to be a better estimate than any other, that amount would be accrued; however, when no amount within the range is indicated as a better estimate than any other, the minimum amount in the range would be accrued.

IAS 37, paragraph 36, requires that the amount recognized as a provision be the best estimate of the expenditure required to settle the present obligation. IAS 37, paragraph 40, indicates that where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower

	<p>amount. Where the provision being measured involves a large population of items, IAS 37, paragraph 39, indicates that the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is “expected value.” Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used. IAS 37, paragraph 45, indicates that where the effect of the time value of money is material, the amount of a provision is required to be the present value of the expenditures expected to be required to settle the obligation.</p>
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<b>Disclosures</b>	
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<p>MEASUREMENT UNCERTAINTY, paragraph 1508.08, indicates that the recognized amount of the item subject to measurement uncertainty should be disclosed, except when disclosure of the amount would have a significant adverse effect on the entity. When the recognized amount is not disclosed, the financial statements should indicate the reasons for non-disclosure.</p>	<p>IAS 37 has more disclosure requirements than Section 3290. Some of these additional required disclosures, as set out in IAS 37, paragraphs 84 and 85, include:</p> <ul style="list-style-type: none"> <li>(a) movements in the provisions account for each class of provision;</li> <li>(b) a description of the nature of the obligations and contingent liabilities;</li> <li>(c) information about the uncertainties regarding the amount or timing of cash flows; and</li> <li>(d) the possibility of any reimbursement.</li> </ul> <p>IAS 37, paragraph 92, indicates that, in extremely rare cases, disclosure of some or all of the required information can be expected to prejudice seriously the position of the entity in a dispute with other parties on</p>
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	<p>the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.</p>
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