

## **BASIS FOR CONCLUSIONS Joint Policy Statement Concerning Communications with Law Firms Regarding Claims and Possible Claims in Connection with the Preparation and Audit of Financial Statements**

**April 2016**

This Basis for Conclusions has been prepared by the staffs of the Auditing and Assurance Standards Board (AASB) and the JPS Review Committee of The Canadian Bar Association (CBA Committee). It relates to, but does not form part of, the "Joint Policy Statement Concerning Communications with Law Firms Regarding Claims and Possible Claims in Connection with the Preparation and Audit of Financial Statements" (Statement), which is appended to CAS 501, *Audit Evidence — Specific Considerations for Selected Items*.

### **Purpose of this Basis for Conclusions**

This Basis for Conclusions provides a brief summary of the AASB's and the CBA Committee's public exposure and approval steps for this project and how the AASB and the CBA Committee dealt with significant matters arising from comments received in response to their Exposure Draft of the proposed Statement (ED-JPS). This information is set out below.

### **Background**

In November 2014, the AASB and the CBA Committee issued ED-JPS, proposing that the revised Statement replace:

- (a) the existing Statement, with the same title; and
- (b) ASSURANCE AND RELATED SERVICES GUIDELINE AuG-46, Communications with Law Firms under New Accounting and Auditing Standards (often known to lawyers as the "interim guidance").

There were 15 respondents to ED-JPS (identified below). In addition to the written responses, input was collected through webinars held by the AASB and the CBA Committee in early 2015.

The AASB approved the revised Statement, and conforming amendments to CAS 501, in October 2015. The Auditing and Assurance Standards Oversight Council concluded that the AASB followed due process in developing this Statement prior to its issuance in the CPA Canada Handbook – Assurance.

The CBA Council approved the revised Statement in February 2016.

### **Significant Matters Arising from Comments in Response to ED-JPS Affecting the Statement**

#### **Terminology**

1. ED-JPS used the term "third party" throughout when referring to a person other than management, the auditor, or the law firm. One respondent noted that this term has a specific meaning in the litigation context that is different from the ways it is used in the Statement, which may lead to confusion.
2. The AASB and the CBA Committee agreed with the respondent and replaced references to the term "third party" with other appropriate terms (for example, other persons, another person, and entity).

#### **Purpose and Scope**

##### *Applicability of the Statement*

3. One respondent expressed the view that the introductory paragraph of ED-JPS reads as if communications with law firms is always required, rather than a decision the auditor makes based on the circumstances. The respondent suggested that the Statement be amended to incorporate the wording of paragraph 10 of CAS 501, which describes the circumstances where the auditor is required to communicate with the law firm.
4. The AASB and the CBA Committee decided not to make the suggested amendment. The auditors' responsibilities in this regard are set out clearly in CAS 501 and it is appropriate to assume that auditors are familiar with them. Nonetheless, as a point of clarification, the AASB and the CBA Committee decided to further emphasize in paragraph 1 of the Statement that the Statement applies if the auditor has determined that such communication is required.

##### *Applicability of the Statement to Notaries in the Province of Quebec*

5. Two respondents suggested that the scope of the Statement be expanded to apply to notaries who are members of the Chambre des Notaires du Québec on the basis that they often act in a legal capacity in entities.
6. The AASB and the CBA Committee decided not to make the suggested amendment. Quebec notaries are governed by the Notaries Act, which establishes an authorized scope of service and standards of professional practice different from lawyers. Also, the Statement offers guidance only; it does not impose mandatory protocols on lawyers as the CBA does not have that authority. If it is determined by the Chambre des Notaires du Québec that the protocols of the Statement

are appropriate for its members to follow when in receipt of an audit inquiry, it can adopt the protocols as a standard of professional practice.

#### *Applicability of the Statement to Foreign Jurisdictions*

7. One respondent suggested that the Statement be amended to also address the responsibilities of auditors and law firms in circumstances where Canadian companies have operations in foreign jurisdictions.
8. The AASB and the CBA Committee decided not to make the suggested amendment. The Statement is written in the context of the responsibilities of auditors and law firms in the Canadian environment, which may differ from those in other jurisdictions. The law and protocols within the foreign jurisdiction must be assessed to determine the correct process, although aspects of the Statement may be helpful in that assessment.

#### **Definitions**

##### *Definition of "Applicable Financial Reporting Framework"*

9. One respondent suggested that the examples of financial reporting frameworks contained within the definition of "applicable financial reporting framework" in the Statement should be removed in order to avoid singling out some frameworks when there are others that may be used.
10. The AASB and the CBA Committee decided not to remove the examples of financial reporting frameworks. The financial reporting frameworks listed in paragraph 6(a) of the Statement are not meant to be all encompassing, but rather focus on the financial reporting frameworks that are most commonly encountered in Canada. The AASB and the CBA Committee believe that these examples are helpful in assisting lawyers' understanding of the term "applicable financial reporting framework" when reading the Statement.

##### *Definitions of "Claim" and "Possible Claim"*

11. Respondents suggested some amendments to the definitions of "claim" and "possible claim" in the Statement. One respondent suggested clarifying that a matter involving the entity that is, or may become, litigious includes regulatory or other administrative proceedings. Another respondent suggested that in order to protect any privileged legal advice provided to the entity, these definitions should be expanded to encompass any other matters where a law firm is advising the entity.
12. The AASB and the CBA Committee agreed to amend the definitions of "claim" and "possible claim" to make clear that litigious matters include regulatory or other administrative proceedings. However, the AASB and the CBA Committee decided that these definitions should not be expanded beyond litigious matters as auditors in the context of the Statement would only seek information from an entity regarding matters that are or may become litigious, resulting in contingencies that need to be evaluated.

##### *Differentiating between a Claim and Possible Claim*

13. A claim and possible claim were distinguished in the ED-JPS by whether or not a demand or an indication of a demand has been communicated to or by the entity. Two respondents indicated that differentiating between the two terms is difficult without defining the phrase "demand or indication of a demand."
14. The AASB and the CBA Committee decided not to define the phrase "demand or indication of a demand" as its interpretation depends on the circumstances and any attempt to define it may create confusion and be unduly restrictive. In situations where the client is unclear whether a demand or indication of a demand exists, the entity's lawyer will likely be consulted.

##### *Definition of "Law Firm"*

15. ED-JPS indicated that the Statement is for use by auditors and law firms in Canada. It defined the term "law firm" as "A sole practitioner, two or more lawyers practicing together in a partnership, corporation or other entity, or in-house legal counsel who acts in a legal capacity by performing a role that commonly would be performed by external legal counsel." One respondent indicated that the description of the role of in-house legal counsel as it applies to the Statement inappropriately suggests that their work within the entities is limited to traditional legal work when in fact their range of work might be more extensive. Another respondent suggested that, for enhanced clarity, a description of the role of in-house legal counsel as it applies to the Statement should be included within the definition of "in-house legal counsel" rather than within the definition of "law firm".
16. The AASB and the CBA Committee agreed with the respondent that the work performed by the entity's in-house legal counsel can be more extensive than traditional legal work and, accordingly, it amended the definition of "law firm" in paragraph 6(h) of the Statement as follows: "A sole practitioner, two or more lawyers practicing together in a partnership, corporation or other entity, or in-house legal counsel who is representing or advising the entity with respect to claims and possible claims."
17. The AASB and the CBA Committee decided to retain the description of the role of in-house legal counsel as it applies to the Statement within the definition of "law firm." The definition of "in-house legal counsel" in paragraph 6(g) of the Statement is meant to be broad as the term "in-house legal counsel" is used in its generic sense in paragraphs 4(c), 9, and 10 of the Statement.

#### **Confidentiality and Privilege**

18. A few suggestions were made to amend content in the Statement regarding litigation privilege and solicitor-client privilege by:
  - (a) removing this guidance as it is not helpful to the communication process under the Statement, and the guidance may change in the future and prematurely date the Statement;
  - (b) removing guidance that directs the law firm to review the notes to the financial statements regarding claims and possible claims as it should be the subject of a separate mandate between the lawyer and the client outside the scope of the Statement;
  - (c) recognizing circumstances where auditors are allowed to disclose to their regulatory oversight authority, where required by statute, information obtained from the law firm without a waiver of privilege;
  - (d) clarifying that litigation privilege protects communications related to anticipated litigation, as well as for the dominant purpose of litigation; and
  - (e) clarifying that privilege, both solicitor-client and litigation, can apply to communications with in-house legal counsel or with external legal counsel.
19. The AASB and the CBA Committee decided not to remove guidance relating to litigation privilege and solicitor-client privilege, set out in paragraph 9 of the Statement. This guidance is a useful reminder for lawyers, and provides auditors with some appreciation of the nature and significance of privilege. The CBA Committee believes that this guidance is unlikely to prematurely date the Statement given the general nature of its content.
20. The AASB and the CBA Committee agreed with the respondent's view that the Statement should not impose an obligation on the law firm to review the notes to the financial statements and, accordingly, replaced the wording "when requested to do so, the law firm will review ..." with "the law firm may be requested by management to review ..." in paragraph 14 of the Statement.
21. The AASB and the CBA Committee decided not to amend the Statement to recognize circumstances where auditors may, where required by statute, disclose information obtained from the law firm to their regulatory oversight authority without waiving privilege, for the following reasons:
  - (a) the legitimacy of disclosure of information required by law or regulation is subject to judicial determination;
  - (b) the communication process under the Statement is already designed to avoid waiver of privilege; and
  - (c) including a discussion of disclosure of information required by statute would add unnecessary complexity to the Statement.
22. The AASB and the CBA Committee agreed that guidance with respect to litigation privilege and solicitor-client privilege should be clarified. Accordingly, paragraph 9 of the Statement makes clear that:
  - (a) litigation privilege protects communications for the dominant purpose of litigation, as well as anticipated litigation; and
  - (b) both solicitor-client and litigation privilege can apply to communications with in-house legal counsel or with external legal counsel.

#### **Withholding Information from the Auditor**

23. One respondent was concerned that guidance in ED-JPS might suggest that protecting privilege is an acceptable reason for withholding information about claims or possible claims from auditors. Two other respondents sought clarification regarding management's responsibility to inform the auditor about possible claims.
24. The AASB and the CBA Committee determined that additional guidance is not needed. Paragraph 15 of the Statement specifies that withholding information from auditors, on the basis that it is privileged, may result in insufficient evidence to support the auditor's opinion without reservation. Paragraph 18(a) of the Statement states that management is responsible for identifying claims and possible claims. In addition, the auditing standards require the auditor to request management to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

#### **Communication with In-house Legal Counsel**

25. One respondent expressed the view that the guidance in ED-JPS was unclear about the communication process when in-house legal counsel both assists management in drafting the inquiry letter and responds to the inquiry letter in the position of the law firm. The respondent suggested that the Statement prescribe a modified communication process to be followed in these circumstances.
26. The AASB and the CBA Committee decided not to prescribe a modified communication process with respect to in-house legal counsel. The Statement is workable in the circumstances noted by the respondent. In-house legal counsel assisting management to draft the inquiry letter and then responding to the same letter is no different than the client asking external legal counsel for assistance in drafting the inquiry letter (which is encouraged in the Statement). Further, the CBA Committee is of the view that in-house legal counsel are aware of the potential conflict between their role as legal advisors and their role in management, if any, and the importance of meeting their professional obligations as lawyers.

#### **Evaluating the Outcome of Claims and Possible Claims**

27. ED-JPS included examples of factors that management might consider in making its evaluation of claims and possible claims. One respondent suggested that these examples be removed as they may be mistaken as prescriptive, rather than examples, and lead to incorrect application of the applicable financial reporting framework.
28. The AASB and the CBA Committee decided not to remove the examples of factors. These examples can be considered by management irrespective of the applicable financial reporting framework and provide context to the guidance regarding the propriety of referencing factors considered by management in the inquiry letter.

#### **Acknowledgment of Receipt of the Inquiry Letter**

29. ED-JPS specified that the inquiry letter include a request that the law firm acknowledge receipt to management and the auditor of the inquiry letter. One respondent suggested that the law firm's acknowledgment of receipt of the inquiry letter should be made more explicit by incorporating into the law firm's responsibilities section of the Statement.
30. The AASB and the CBA Committee decided not to make the suggested amendment. A request that the law firm acknowledge receipt to management and the auditor of the inquiry letter is appropriately positioned in paragraph 50(g)(i) of the Statement as an element to be included in the inquiry letter and it is unnecessary to repeat it or make it more explicit elsewhere in the Statement.

#### **Matters that May Be Excluded from the Inquiry Letter**

31. One respondent suggested that the Statement be amended to instruct management to include in the inquiry letter all claims and possible claims, unlimited by a quantitative threshold. This is because there may be individual small claims or possible claims where the quantitative amount is below the threshold, but in aggregate could materially impact the financial statements. Alternatively, a claim may be incorrectly estimated by management to be under a specific quantitative threshold and inappropriately excluded from the inquiry letter.
32. The AASB and the CBA Committee did not agree that the Statement should instruct management to include all claims and possible claims, unlimited by a quantitative threshold. The exclusion of claims and possible claims below specific quantitative thresholds aligns with the auditing standards where there is an expectation for the auditor to communicate with the law firm in circumstances where the auditor assesses a risk of material misstatements regarding identified litigation or claims, or when audit procedures performed indicate that other material litigation or claims may exist. This optional exclusion would be agreed between the auditor and management.

#### **Effective Date of Response and the Response Date**

33. ED-JPS specified that the inquiry letter be provided to the law firm at least three weeks in advance of the effective date of response and that the law firm will normally require five business days after the effective date of response to prepare the response letter. A few respondents commented on these timelines, suggesting that:
  - (a) the delivery of the inquiry letter to the law firm at least three weeks before the effective date of response should be shortened to one week on the basis that lawyers are not able to start their internal searches for claims and possible claims until the effective date of response and, events can develop during that period that would not be reflected in the inquiry letter; and
  - (b) allowing the law firm five business days after the effective date of response to respond to the inquiry letter is either too long or too short a timeframe.
34. The AASB and the CBA Committee decided not to amend the timelines. The delivery of the inquiry letter to the law firm at least three weeks before the effective date of response provides the law firm with sufficient time to circulate the inquiry letter within the law firm and address any issues in the inquiry letter that may be identified. Further, allowing the law firm five business days to respond to the inquiry letter provides the law firm with sufficient time to prepare the response letter and the auditors with relevant, up-to-date information before dating the auditor's report. The AASB and the CBA Committee noted that nothing in the Statement prevents the law firm from responding to the inquiry letter in less than five business days if it is able to do so.

#### **Auditor Review of the Inquiry Letter Prior to Sending It to the Law Firm**

35. One respondent disagreed with the guidance that directed the auditor to review the inquiry letter prior to sending it to the law firm on the basis that it weakens privilege. Another respondent indicated that the wording used to describe the auditor's involvement in reviewing the inquiry letter is not aligned with the wording used in other parts of ED-JPS.
36. The AASB and the CBA Committee decided not to remove guidance relating to auditor review of the inquiry letter. Paragraph 34 of the Statement sets out the aspects of the inquiry letter that the auditor should consider in its review – specifically, whether management has provided an evaluation of the outcome of claims and possible claims in a manner appropriate to the applicable financial reporting framework and whether the form and content of the inquiry letter complies with the Statement. From a practical perspective, such a review by the auditor is necessary for the communication process to work effectively and efficiently among management, the auditor and the law firm. It ensures that the law firm receives an inquiry letter that is acceptable to the auditor and complies with the Statement, allowing the law firm to focus on assessing the reasonableness of the evaluation based on its legal expertise.
37. In response to the comment that the wording used to describe the auditor's involvement in reviewing the inquiry letter is not aligned with the wording used in other parts of ED-JPS, the AASB and the CBA Committee amended paragraph 35 of the Statement to align with the wording in paragraph 34 of the Statement by specifying that the auditor's responsibility is to review the inquiry letter, rather than monitor the quality of the inquiry letter.

#### **Sending the Inquiry Letter to the Law Firm**

38. ED-JPS specified that once the inquiry letter has been finalized with management, the auditor will send the inquiry letter directly to the law firm with a copy to management. One respondent expressed concern that privilege is weakened by the auditor, rather than management, sending the letter to the law firm. The respondent also questioned what is gained by the auditor sending the letter directly to the law firm.
39. The AASB and the CBA Committee decided not to make an amendment in this regard. Auditing standards require the auditor to send the inquiry letter directly to the law firm to ensure the reliability of the audit evidence.

#### **Confirming the Reasonableness of Management's Evaluation**

40. ED-JPS directed the law firm to confirm the reasonableness of management's evaluation of claims and possible claims in the inquiry letter. One respondent expressed the view that confirmation of the reasonableness of management's evaluation by the law firm could inappropriately suggest that the law firm is expressing an opinion or had done a substantial analysis of the claims or possible claims. Accordingly, the respondent suggested that the Statement be amended to qualify the law firm's confirmation of the reasonableness of management's evaluation by indicating that it neither means that the law firm agrees with the evaluation nor that it has formed an opinion nor provided an analysis or legal assessment of the claims or possible claims.
41. The AASB and the CBA Committee decided not to make the suggested amendment. The qualifying language suggested by the respondent could have the unintended effect of downplaying the importance of the response letter. Further, paragraph 39 of the Statement already makes clear that when a law firm confirms the reasonableness of management's evaluation, the law firm is not expressing a conclusion as to the ultimate outcome of claims and possible claims, or as to whether management has provided its evaluation in a manner appropriate to the applicable financial reporting framework. Rather, the law firm is providing the benefit of its professional insight based on its experience in litigation and settlement of claims and possible claims applied in the context of the facts and circumstances of the identified claims or possible claims.

#### **Inquiry Letters**

42. ED-JPS specified that the inquiry letter will include an addressee that is the responsible lawyer within the law firm. One respondent suggested that guidance be provided as to whom the responsible lawyer within a law firm would be.
43. The AASB and the CBA Committee decided not to provide such guidance. The AASB and the CBA Committee believe that it is not practicable to define the term "responsible lawyer" with precision as it may vary depending on the circumstances. The AASB and the CBA Committee noted that identifying the responsible lawyer may involve a discussion between the auditor and management.

#### **Updated Response Letters**

44. One respondent suggested that additional guidance be provided with respect to the scope and timing of requests for updated response letters. The respondent also expressed the view that there is insufficient time to circulate the request for an updated response to the entire firm and, therefore, such response letters should indicate that the information provided is to the best of the responding lawyer's knowledge.
45. The AASB and the CBA Committee agreed with the respondent that additional guidance would be helpful regarding requests for updated response letters, but disagreed that such guidance should state that the information provided in the updated response letter is to the best of the responding lawyer's knowledge. The AASB and the CBA Committee added guidance regarding updated response letters in paragraph 58 of the Statement, explaining that the law firm will normally require five business days after the effective date of response to prepare the updated response letter, but recognizing that there may be circumstances where the auditor may request a response date that is less than five business days from the effective date of response. The guidance encourages communications among management, the auditor and the law firm in determining a mutually agreeable response date for updated response letters.

#### **Illustrative Examples**

46. A few respondents suggested that the Statement include the following additional illustrative examples:
  - (a) an inquiry letter and related response when there are no claims or possible claims listed; and
  - (b) an illustration of management's evaluation of claims and possible claims in an inquiry letter when it is determined that a loss is not likely to occur in the case where the entity's financial statements are prepared in accordance with accounting standards for private enterprises.
47. The AASB and the CBA Committee agreed with the respondents and added examples in relevant Schedules of the Statement. Also, guidance was added in paragraph 51 of the Statement explaining when a no-claim inquiry letter may arise.

#### **Significant Matters Arising from Comments in Response to ED-JPS Affecting Auditing Standards**

##### **Terminology**

48. ED-JPS used the terms "claim" and "possible claim" whereas CAS 501 uses the terms "litigation" and "claim". One respondent questioned why the terms "litigation" and "claim", referred to in CAS 501, are not used, or referenced in ED-JPS. The respondent expressed the view that this difference in terminology between CAS 501 and the Statement would create application challenges.

49. The AASB and the CBA Committee decided to retain the terms "claim" and "possible claim" in the Statement. These terms are well known and understood, and have long-standing definitions in the Statement, while the terms "litigation" and "claim" are not defined within CAS 501. Paragraph CA25a of CAS 501 includes wording to acknowledge these terminology differences.

**Interrelationship between CAS 501 and the Communication with In-house Legal Counsel under the Statement**

50. Two respondents expressed concern that the interrelationship between CAS 501 and the communication with in-house legal counsel under the Statement is unclear.
51. The AASB agreed with the respondents and included new application material in paragraph CA25b of CAS 501 to clarify the interrelationship between CAS 501 and communications with in-house legal counsel under the Statement.

**Using Communication with In-house Legal Counsel as Audit Evidence**

52. A few respondents sought clarification about which standard is to be applied by the auditor when evaluating the objectivity, legal expertise and competence of in-house legal counsel when using their communication as audit evidence.
53. The AASB added paragraph CA25c of CAS 501 to indicate that when communication from legal counsel is to be used as audit evidence, the auditor is to consider the relevance and reliability of the information upon which it is based. The reader is directed to CAS 500, *Audit Evidence*, as the appropriate standard that establishes requirements and provides guidance in this regard.

**List of Respondents to ED-JPS \***

BDO LLP

Bennett Jones, Barristers & Solicitors LLP

Deloitte LLP

Ernst & Young LLP

John Kelly, FCPA, FCA

Ordre des comptables professionnels agréés du Québec

Office of the Auditor General of Canada

Office of the Provincial Auditor of Saskatchewan

PricewaterhouseCoopers LLP

Raymond Chabot

Grant Thornton LLP

Richard J. Berrow, Richard Berrow Law Corporation

Sam Black, Lawyer The member firms of Nexia Canada

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## Footnotes

\*. 2 other respondents requested confidentiality

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