

BASIS FOR CONCLUSIONS AuG-46, Communications with Law Firms under New Accounting and Auditing Standards

August 2010

This Basis for Conclusions has been prepared by staff of the Auditing and Assurance Standards Board (AASB). It relates to, but does not form part of, ASSURANCE AND RELATED SERVICES GUIDELINE AuG-46, Communication with Law Firms under New Accounting and Auditing Standards.

Background

Canadian Auditing Standard (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 Appendix to CAS 501, which contains the Joint Policy Statement Concerning Communications with Law Firms Regarding Claims and Possible Claims in Connection with the Preparation and Audit of Financial Statements (JPS).

The JPS was drafted based on financial statements prepared in accordance with Canadian generally accepted accounting principles, including CONTINGENCIES, Section 3290 in Parts II and V of the CICA Handbook – Accounting, and audited in accordance with Canadian generally accepted auditing standards, in effect when the JPS 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 CASs.

In September 2009, the AASB commenced a project to revise and replace the Appendix to CAS 501. In undertaking this project, the AASB is working with the Canadian Bar Association (CBA). In January 2010, in response to urgent issues identified during the course of the project, the AASB decided to develop AuG-46.

The AASB approved AuG-46 in June 2010. The Auditing and Assurance Standards Oversight Council confirmed that the AASB followed due process in developing AuG-46 prior to its issuance in the CICA Handbook – Assurance.

Purpose of this Basis for Conclusions

This Basis for Conclusions provides a brief summary of the AASB's objectives in issuing AuG-46, the significant matters addressed and exposure considerations. This information is set out below.

AASB's Objectives in Issuing AuG-46

The AASB's objectives in issuing AuG-46 included the following.

- (a) Provide interim guidance to assist financial statement preparers (clients), auditors and law firms while the AASB continues its project to revise the JPS

For entities whose financial statements are prepared in accordance with International Financial Reporting Standards (IFRSs), the accounting standard they will use with respect to contingencies will be International Accounting Standard (IAS) 37 *Provisions, Contingent Liabilities and Contingent Assets* in Part I of the CICA Handbook – Accounting, which is quite different from Section 3290. IAS 37 is undergoing revision. The AASB concluded that changing the JPS to reflect IAS 37 and then changing it again a short time later to reflect the revisions to IAS 37 would be inefficient and perhaps confusing to users of the JPS. Further, the AASB believed that the nature of the revisions to IAS 37 prevented the AASB from using a one-step approach that would result in a JPS that could be effectively applied regardless of whether existing or revised IFRSs were used in preparing the financial statements.

The AASB concluded that it should provide interim guidance in the form of AuG-46 to assist clients, auditors and law firms to communicate using the JPS when financial statements are prepared in accordance with existing IFRSs, including IAS 37. The AASB will continue to work with the CBA to revise the JPS to enable communications when financial statements are prepared in accordance with IFRSs, including the revised accounting standard.

- (b) Provide guidance in the context of the JPS.

The process set out in the JPS ensures that, as far as practicable, confidentiality and privilege of solicitor-client communications are protected. The AASB's objective is that the interim guidance will be used in the context of the existing JPS so as to maintain this protection.

- (c) Provide guidance that will assist clients develop inquiry letters to which law firms can respond.

There are some significant differences between Section 3290 and IAS 37. Because of these differences, the form and content of inquiry letters under the Joint Policy Statement will be different for contingencies under IAS 37. The

AASB considered it important to highlight the significant differences between the two accounting standards and provide guidance that would assist clients when preparing inquiry letters with respect to contingencies under IAS 37.

- (d) Provide guidance on the dating of inquiry and response letters under the CAs.

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 JPS 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 JPS may need to be amended.

Significant Matters Addressed

Providing guidance with respect to different financial reporting frameworks

1. The JPS provides guidance on the evaluation made by a client of claims and possible claims when preparing the financial statements, based on Section 3290. In future, financial statements may be prepared using one of several possible financial reporting frameworks depending on the type of entity and other factors. These financial reporting frameworks may contain different requirements with respect to accounting for contingencies. The AASB and CBA considered two possible approaches to revising the JPS to reflect these different financial reporting frameworks:
 - (a) Provide guidance with respect to the accounting requirements and the evaluation that would be reflected in the client's inquiry letter for each different financial reporting framework. The AASB and CBA rejected this approach because it would require readers of the JPS to become familiar with each financial reporting framework and the related communications.
 - (b) Provide generic guidance that can be adapted for use with a variety of financial reporting frameworks. The AASB and CBA preferred this approach because it would not require readers of the JPS to be familiar with each financial reporting framework. It would also promote consistency in communications.
2. The AASB and CBA are in the process of jointly developing a revised JPS using the latter approach, but are awaiting finalization of proposed changes to IAS 37. As an interim measure, because of the urgent need to deal with matters in existing IAS 37, the AASB has developed AuG-46 that focuses on the factors that the client might consider when evaluating a claim or possible claim under that IAS. It is the client's responsibility to understand and apply the accounting requirements of the financial reporting framework and determine the factors for which it is appropriate to request the law firm to confirm the reasonableness of the client's conclusions.

Developing a practical approach to the process for preparing inquiry letters and receiving response letters

3. In developing a practical approach to the process for preparing inquiry letters and receiving response letters, the AASB and CBA considered the following:
 - (a) Law firms require a period of time in order to review their records and prepare the response letter. Accordingly, the inquiry letter should be sent to the law firm sufficiently in advance of the expected date when the response letter is required.
 - (b) The effective date of the response letter will generally be as close as possible to the auditor's report date but it will usually not be as of the date of the auditor's report because of the time it takes for the law firm to review its records and prepare a response letter.
 - (c) Because the effective date of the response letter will be before the date of the auditor's report, the auditor will need to use professional judgment in determining whether to obtain further audit evidence, such as further inquiry of management or obtaining updated information from the client's external legal counsel.
 - (d) When the auditor decides that a further written inquiry of the law firm is necessary for the purpose of updating the original response letter, the updated response letter will normally be prepared following the same process as was used for the original response letter.

Exposure Considerations

4. The AASB is not required to expose proposed Assurance and Related Services Guidelines for public comment, although it may decide that exposure is appropriate in certain circumstances. With respect to the AuG-46, the AASB decided that exposure was not required for the following reasons:
 - (a) AuG-46 contains comparisons between Section 3290 and IAS 37, which is factual information.
 - (b) The remaining guidance in AuG-46 with respect to the accounting standards either provides an assessment of the impact of the differences between the two standards, or provides limited guidance on factors that might be considered by the client in preparing an evaluation. The guidance with respect to dating of the inquiry and response letters is reflective of the practical implications of the change to the auditing standards. As such, the AASB considered it unlikely that readers would raise any significant concerns with AuG-46.
 - (c) The CBA supported the AASB's decision. It believed that issuing AuG-46 in final form as quickly as possible would encourage its early use and permit experience to develop.

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