



# New rules and guidelines

## Assessing your client's outstanding claims for audit purposes

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*On January 1, 2011, certain organizations will begin using International Financial Reporting Standards (IFRS) as the basis for preparing their financial statements. In this article we examine the implications of IFRS for lawyers and the Interim Guidance that will help lawyers comply with recent changes to Canadian and international accounting and auditing standards.*

*This morning's mail brings an inquiry letter from your client. The auditor is reviewing the company's financial statement and the client wants your input. The letter lists several outstanding claims involving your client and asks you to confirm that the claims are properly described and that the evaluations of loss or gain are reasonable. Your client is also asking you to review the list to see if any other claim should have been included.*

*Red flags: What period of time does the audit cover?*

*What approach should you use to assess the outstanding claims?*

*How can you preserve solicitor-client privilege?*

*By when does your client need your reply?*

It is the responsibility of a corporation's management team to prepare financial statements. Auditors then review those statements

to confirm that they reasonably reflect the corporation's financial status. During this process, corporate clients may ask their lawyers to confirm corporate information about current claims and possible claims. None of this is new. What is new are different accounting rules that some corporations will begin to use in 2011.

As of January 1, 2011, publicly accountable, for-profit corporations, government business enterprises, and other enterprises which

### Comments?

The joint Canadian Bar Association and Auditing and Assurance Standard Board Working Group welcome input on the Interim Guidance. Write to [epii@cba.org](mailto:epii@cba.org)



choose to do so will begin using International Financial Reporting Standards (IFRS) as the basis for preparing their financial statements. Corporations have been getting ready for this conversion for some time. Their lawyers need to be ready too, as IFRS also changes the ground rules for them.

The IFRS have different rules for reporting “contingencies” or uncertain items, including unresolved legal claims. These rules differ in some important ways from the current Canadian Generally Accepted Accounting Principles (GAAP), found primarily in Section 3290 “Contingencies,” which Canadian auditors, clients, and lawyers have been following.

The IFRS contingency rules are found in International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37). IAS 37 has been in place for over ten years, but is being revised with the date of a finalized new version expected to be in 2012 – at the earliest.

In the meantime, lawyers with clients subject to IFRS will have to respond to inquiries about unresolved legal claims following the

existing IAS 37 rules. Since these rules differ in some important ways from the current GAAP, the Canadian Bar Association and the Auditing and Assurance Standards Board have been working together to provide lawyers and auditors with immediate guidance on audit-related inquiries about unresolved legal claims.

The *Interim Guidance (Assurance and Related Services Guidance AuG-46)* is intended to bridge the gap between January 1, 2011 and the date on which a revised *Joint Policy Statement on Audit Inquiries* (JPS) comes into effect, reflecting a revised IAS 37.

The Interim Guidance takes as a starting point the JPS prepared by the Canadian Bar Association and the Canadian Institute of Chartered Accountants in 1978. The JPS sets out what lawyers and auditors can “properly expect of the other in connection with the audit inquiry process.”

The JPS guides lawyers on how to answer audit inquiries to meet “meaningful disclosure” audit standards while preserving their obligations to their client, including the protection of privilege.

## Reporting on contingencies, including unresolved legal claims – simplified

### GAAP approach

#### INCLUDING A POTENTIAL CLAIM:

- likely
- “non-determinable” a possible entry in a report

#### ESTIMATING LIABILITY:

- reasonable estimate

#### NOT DISCLOSING:

- OK to omit if significant adverse effect

#### TIMING:

- substantial completion approach with effective date of response the date of completion of auditor’s field work

### IFRS approach

#### INCLUDING A POTENTIAL CLAIM:

- more likely than not

#### ESTIMATING LIABILITY:

- best estimate

#### NOT DISCLOSING:

- justification for non-disclosure rare – has to be seriously prejudicial and some information still required

#### TIMING:

- tighter turnaround – effective date of response five days before auditor’s report date



It recognizes that clear expectations and good communication between a lawyer and client and between the client and auditor are essential to avoiding a qualified audit report and its potential prejudicial impact on a client's business.

The JPS will continue to apply when clients follow current GAAP and not IFRS. The JPS will also apply to IFRS clients when the Interim Guidance is silent on a matter. Be sure you and your clients know which rules to apply.

### Interim Guidance for lawyers with IFRS clients

The *Assurance and Related Services Guideline – Communications with Law Firms Under New Accounting and Auditing Standards (AuG-46)* was adopted by CBA and AASB in August 2010. Its main topics are:

- the threshold for identifying a claim
- the approach to estimating the expected value of a claim
- disclosures
- the dates that apply to a letter of inquiry and a response.

### The threshold for identifying a claim

IAS 37 uses a wider net than the current rules when identifying claims which must be considered – financial statements should recognize a present obligation that arises out of a past event when it is probable that a payment will have to be made to settle the legal or constructive obligation.

This is a “more likely than not” approach. In contrast, GAAP's Section 3290 rule requires reporting when it is “likely,” i.e. the chance is high, that a future event will confirm that payment is required. While there is no official interpretation of these phrases, one way to think about this would be to say that under the IFRS approach, a corporation would be expected to report claims when there is a greater than 50 per cent chance that a payment might have to be made. Under the GAAP approach, “likely” is viewed as a higher hurdle, so a corporation might only report legal claims that are estimated to have a 70 per cent or greater likelihood of being settled against the corporation. These percentages are a rough guide, not hard and fast rules.

Section 3290 also says that claims do not have to be included when there is insufficient or conflicting evidence upon which to determine amounts. Only amounts that can be reasonably estimated (“determinable”) have to be included.

IAS 37, on the other hand, recognizes that using estimates does not undermine the reliability of a financial statement and that in almost all cases an estimate is possible. “Not determinable” will not likely appear on financial statements under IAS 37.

For those enterprises reporting under IFRS, clients and auditors may need to re-assess claims previously categorized under

# Resources for lawyers

## ABOUT THE JPS

The *Joint Policy Statement on Audit Inquiries (JPS)* was written by the Canadian Bar Association and the Canadian Institute of Chartered Accountants. In place since 1978, it provides guidance to lawyers who are asked to respond to questions about a client's unresolved legal claims in the context of an audit.

The rules for reporting on contingencies will change for some Canadian enterprises in 2011 when they convert to the International Financial Reporting Standards (IFRS).

The JPS has therefore been enhanced by the *Interim Guidance (Assurance and Related Services Guidance AuG-46)* to assist lawyers advising clients who are now following the IFRS. The JPS will be revised once International Accounting Standards for reporting on contingencies are finalized.

Find out more about the *Joint Policy Statement on Audit Inquiries (JPS)* and *Interim Guidance (Assurance and Related Services Guidance AuG-46)* at <http://www.cba.org/CBA/jointpolicystatement/main/default.aspx>

## NEW ACCOUNTING STANDARDS IN CANADA

The CICA Handbook – Accounting has been restructured to move away from the single financial reporting framework currently in place under Canadian Generally Accepted Accounting Principles (GAAP). The revised Canadian GAAP has five financial reporting frameworks:

- Part I – International Financial Reporting Standards (IFRS)
- Part II – Accounting standards for private enterprises
- Part III – Accounting standards for not-for-profit organizations
- Part IV – Accounting standards for pension plans
- Part V – Canadian GAAP prior to the adoption of Parts I, II, III or IV (Pre-changeover accounting standards)

There are no changes to the way to account for contingencies, including unresolved legal claims, for entities covered by Parts II to V. Entities that fall under Part I will follow IFRS accounting standards which have a different accounting approach for reporting on contingencies.



Section 3290 rules, because claims or potential claims previously excluded may now need to be included under the IAS 37 rules.

### The approach to estimating the expected value of a claim

IAS 37 expects clients to be able to give a reliable estimate of the amount that might be owing. The expected value is to be included as an accrual. In the rare situations where no reliable estimate is possible, for example in some lawsuit situations, the liability is to be disclosed as a contingent liability.

The IAS 37 rules require a “best estimate,” a higher standard than Section 3290’s “reasonable estimate” approach. To make a “best estimate,” the IAS 37 “may require the client to perform more complex measurement calculations, and take different factors into account, than required under “Contingencies” Section 3290. (paragraph 10). Factors may include previous experience with similar claims, management’s intentions regarding an out-of-court settlement or trial, the range of possible outcomes, and the likelihood of cash flows relating to the possible outcomes (paragraph 11).

Clients may wish to confirm their analysis of the factors that led to their conclusions with their lawyers. The Interim Guidance says that to protect privilege, the client should communicate directly with the law firm without disclosing the communication to the auditor. The audit inquiry letter, once prepared, should provide only a brief description of the factors the client considered and their conclusions, and ask the law firm to confirm the reasonableness of the client’s conclusions (paragraph 13).

### Disclosures

IAS 37 has more extensive disclosure requirements than Section 3290. Section 3290 allows for information to be omitted if there might be a significant adverse effect to the client. IAS 37 only allows omissions that would be seriously prejudicial and then requires the financial statement to include a general description of the nature of the dispute and the reasons why the information is not being disclosed.

The Interim Guidance (paragraph 15) foresees that “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 ... than they would for financial statement disclosures under ... Section 3290.”

### The dates that apply to a letter of inquiry and a response

The JPS uses a substantial completion approach, requiring that the contingency information should be accurate up until the

date of the completion of the auditor’s field work. It anticipates that a law firm will receive an inquiry letter three weeks before the auditor’s field work is to be completed and that there will be a two-week time lag between the completion of the auditor’s field work and the issuance of the auditor’s report.

IAS 37 shortens the period between the effective date of a law firm’s response and the anticipated audit report date to five days. It anticipates that a law firm will receive an inquiry letter three weeks before the effective date for the response. The inquiry letter should include a date by which a response is required.

The Interim Guidance recognizes that law firms may have trouble meeting the deadlines and says that the law firm should advise the client if it is unable to meet the response date. The client would then bring this to the auditor’s attention to see if the extension of the response date deadline is acceptable. If not, the auditor would ask the client and the law firm to find a “mutually agreeable solution to the timing problem” (paragraph 16[c]).

Both the Interim Guidance (paragraph 16[d]) and the JPS (section 09) foresee the possibility of the client having to ask the lawyer to update information at the request of the auditor.

### To preserve solicitor-client privilege

Clients are likely to call on their lawyers to advise them on the application of the IFRS to claims and possible claims in respect of their enterprise. To preserve solicitor-client privilege, lawyers should:

- Keep consultations between the client and lawyer.
- Avoid becoming involved with the auditor – the client should be the point of contact.
- Resolve with the client any disagreements that arise with the client. Only if no resolution is possible should the matter then be raised among the lawyer, the client and the auditor.
- In response to audit inquiry letters, only confirm or deny the reasonableness of the client’s descriptions and estimates and do not provide explanations or your reasoning. If further discussion is required, it should be with the client only, at least until it is clear no resolution can be reached.

### The value of clear communication

The JPS and the Interim Guidance both attempt to balance the need for lawyers to hold client information in strict confidence with the need for meaningful disclosure of claims and possible claims in a client’s financial statements. The documents set out the parameters of a lawyer’s obligation to respond to a client’s audit inquiry letter and, to the benefit of all, promote clarity of communications between clients, their lawyers, and auditors.