

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

This Joint Policy Statement of January 1978 has been approved by The Canadian Bar Association¹ and by the Auditing Standards Committee of The Canadian Institute of Chartered Accountants [currently the Auditing and Assurance Standards Board].

Application and Definitions

1. For purposes of this Statement:
 - (a) "law firm" includes an individual practicing alone;
 - (b) "auditor" means an individual unless he is a partner or member of a firm in which case it means his firm, where the context requires;
 - (c) "claim" means a matter involving the client which is or may become litigious with respect to which (i) the law firm has been engaged to represent or advise the client and (ii) a demand or indication of demand has been communicated to or by the client, carrying with it the possibility of future loss or gain; accordingly, claims include those against third parties as well as those by third parties;
 - (d) "possible claim" means a matter involving the client which is or may become litigious with respect to which the law firm has been engaged to represent or advise the client but a demand or indication of demand has not been communicated to or by the client;
 - (e) "records" means the method or system used by the law firm to record services given to the client and may, but shall not necessarily, consist of claims registers, time-charge records or docket entries.
2. When a request from a client to a law firm for confirmation of claims and possible claims in connection with the preparation and audit of financial statements (the "inquiry letter") and the law firm's letter of response (the "response letter") are stated to be made in accordance with this Statement, they are deemed to be governed by and interpreted in accordance with this Statement as if it were part of both letters.
3. This Statement does not apply to:
 - (a) legal opinions sought by the auditor;
 - (b) audit inquiries which may be made of a lawyer who is an employee of the client or of a lawyer in his capacity as a director of the client; and
 - (c) audit inquiries which may be made of law firms in respect of such items as trust funds, unpaid accounts, unbilled charges and contractual obligations and commitments of the client.

Form of Inquiry Letter and Response Letter

4. The inquiry letter shall be substantially in the appropriate version of the forms illustrated in Schedule A and be signed by the client. The response letter shall be substantially in the appropriate version of the forms illustrated in Schedule B and be signed by a partner of, or in the name of, the law firm. The law firm is not expected to respond to a general inquiry.

Routing the Inquiry Letter and the Response Letter

5. The inquiry letter shall be addressed to the law firm. The response letter, marked "Privileged and Confidential", shall be addressed to the client with a separate signed copy sent directly to the auditor.

Timing of Inquiry Letter and Response Letter

6. Although the inquiry letter relates to financial statements for a particular fiscal period, the client, in preparing the financial statements, and the auditor, in reporting on them, have to consider events which occur up to the date the financial statements are finalized, which would generally coincide with the date of completion of the auditors' field work. The inquiry letter will therefore specify the date as of which the response letter will take effect ("the effective date of response") which will normally be the date on which the auditor's field work will be completed. The inquiry letter should be sent to the law firm at least three weeks in advance of the effective date of response.
7. The response letter should take into consideration developments up to the effective date of response. In most instances, the normal time-lag in keeping the law firm's records, together with the time required to prepare the response letter, will result in the response letter not being available until some time after the effective date of response. Accordingly, the law firm will require a reasonable time after the effective date to prepare the response letter.
8. As there is usually a lapse of about two weeks between the completion of the auditor's field work and the release of his report, the receipt of the response letter within two weeks after the effective date specified in the inquiry letter will normally be satisfactory. Where, however, a response letter will not be available within two weeks from the specified effective date, the law firm should advise the client of the date when it will be available. The client and the auditor will then consider whether the prospective date of release of the audit report which this entails is acceptable. If it is not, the client, the law firm and the auditor should have a discussion to determine a mutually-agreeable solution to the timing problem.
9. 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.

Preparation of the Inquiry Letter

10. The responsibility rests with the client to list in the inquiry letter the claims and possible claims. However, particularly in smaller enterprises, the client may wish to discuss the description and evaluation of these matters with the law firm prior to preparing the inquiry letter.
11. The inquiry letter may relate to other entities which are also clients of the law firm (where, for example, the client is preparing consolidated financial statements) in which case every entity to which the inquiry relates shall be named therein and the inquiry letter shall be signed on behalf of each listed entity.
12. The inquiry letter may be limited by stating that it excludes:
 - (a) matters of an identified type (for example, collections);
 - (b) matters involving amounts that aggregate less than a stated dollar amount.

Claims Omitted from the Inquiry Letter

13. The law firm shall specify in the response letter any claim identified in its records which is outstanding and which is omitted from the inquiry letter.

Possible Claims Omitted from the Inquiry Letter

14. It is in the public interest that the confidentiality of lawyer-client communications be maintained. Accordingly, the law firm will not indicate in the response letter any possible claims which are omitted from the inquiry letter.

15. It is also in the public interest that the financial statements contain all adjustments and disclosures required for fair presentation in accordance with generally accepted accounting principles. Accordingly, the law firm will discuss with the client possible claims identified in the law firm's records but omitted from the inquiry letter with a view to ensuring that the client is informed of his responsibility to inform the auditor and to make any appropriate adjustment of, or disclosure in, the financial statements.

Evaluations

16. In order to make decisions required in the preparation of its financial statements the client evaluates:
 - (a) whether loss (or gain) ultimately resulting from each particular claim and possible claim is likely, unlikely or not determinable; and
 - (b) the amount of ultimate loss (or gain) if reasonably estimable.
17. When a law firm confirms the reasonableness of evaluations made by the client, it is not expressing a conclusion as to the ultimate outcome, but is providing the benefit of its professional insight based on considerations which in its experience are generally relevant to the litigation and settlement of claims and which may be helpful to the client in arriving at a decision on the appropriate financial statement treatment and to the auditor in his consideration of that decision.
18. The amounts which are recorded or the information which is disclosed in the client's financial statements are not attributable to the law firm but reflect the decisions reached by the client by reference to generally accepted accounting principles, taking into account all relevant information including the comments of the law firm.
19. One of the factors which a law firm is expected to consider in determining whether it can confirm the reasonableness of the client's evaluations is the extent of its own knowledge of the matter. While there are instances where the law firm will be unable to assess the likelihood of loss (or gain) or make a reasonable estimate of the ultimate amount thereof, it is in the client's interest that the law firm make a reasonable effort to do so.
20. While another factor considered by the law firm in reviewing the estimated amount of ultimate loss (or gain) is the probable legal costs of the claim, no separate mention need be made in the response of a normal accumulation of unbilled fees and disbursements.
21. When the law firm disagrees with the client's evaluation, the response letter should not include an evaluation but should request that the client arrange a conference (which may be by telephone) at which the client, the law firm and the auditor will discuss the matter. The law firm should endeavour to bring such a disagreement to the client's attention as soon as possible as the financial statements or auditor's report may be affected thereby. If the client and the law firm agree on an evaluation at the conference, the law firm will be in a position to confirm this in writing to the auditor. If the client and the law firm still disagree on an evaluation following the conference, the auditor will usually prepare a memorandum of the discussion and request the client and the law firm to confirm its accuracy.

Confidentiality

22. Every lawyer has a duty to hold in strict confidence all information acquired in the course of the professional relationship concerning the business and affairs of a client and may not divulge any such information unless expressly or impliedly authorized by the client or required by law to do so. The client has the privilege of denying third parties access to communications between the client and the client's law firm. The response letter is a

privileged and confidential communication requested by the client and given to the client and the client's auditor in connection with the preparation and audit of the financial statements.

23. The auditor's professional responsibility not to divulge information concerning a client's affairs without the client's consent applies to the response letter. It must not be quoted from or referred to in the financial statements or be furnished in whole or in part to any other party without prior written consent of the law firm. 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.

Schedule A

(Inquiry Letter) ⁱⁱ1

Version 1 — when there are claims or possible claims to be listed

(On client letterhead)

(To law firm)

(Date)

Dear Sir(s):

In connection with the preparation and audit of our financial statements for the fiscal period ended (date), (which include the accounts of the following entities), ⁱⁱⁱ2 we have made the following evaluations of claims and possible claims with respect to which your firm's advice or representation has been sought:

Description	Evaluation
(name of entity, name of other party, nature, amount claimed and current status)	(indicate likelihood of loss (or gain) and estimated amount of ultimate loss (or gain), if any; or indicate that likelihood is not determinable or amount is not reasonably estimable)

Would you please advise us, as of (effective date of response), on the following points:

- (a) Are the claims and possible claims properly described?
- (b) Do you consider that our evaluations are reasonable?
- (c) Are you aware of any claims not listed above which are outstanding? If so, please include in your response letter the names of the parties and the amount claimed.

This inquiry is made in accordance with the Joint Policy Statement of January 1978 approved by The Canadian Bar Association and the Auditing Standards Committee of The Canadian Institute of Chartered Accountants.

Please address your reply, marked "Privileged and Confidential", to this company and send a signed copy of the reply directly to our auditor, (name and address of auditor).

Yours truly,

c.c. (name of auditor)

(Inquiry Letter) ^{iv}1

Version 2 — when there are no claims or possible claims to be listed

(On client letterhead)

(To law firm)

(Date)

Dear Sir(s):

In connection with the preparation and audit of our financial statements for the fiscal period ended (date), (which include the accounts of the following entities), ^v2 we have determined that there are no claims or possible claims with respect to which your firm's advice or representation has been sought and which are outstanding.

Please confirm that there are no claims which are outstanding as of (effective date of response). If you are aware of any such claims, please include in your response letter the names of the parties and the amount claimed.

This inquiry is made in accordance with the Joint Policy Statement of January 1978 approved by The Canadian Bar Association and the Auditing Standards Committee of The Canadian Institute of Chartered Accountants.

Please address your reply, marked "Privileged and Confidential", to this company and send a signed copy of the reply directly to our auditor, (name and address of auditor).

Yours truly,

c.c. (name of auditor)

Schedule B

(Response Letter)

Version 1 — responding to Inquiry Letter Version 1

Privileged and Confidential

(To client)

(Date)

Dear Sir(s):

This reply to your inquiry letter of (date) is made in accordance with the Joint Policy Statement referred to in that letter.

We confirm, based on an examination of our records, that as of (effective date of response) the claims and possible claims referred to in your letter:

- (a) have been properly described (except for the following: ^{vi}1)
- (b) have been reasonably evaluated (except for the following with respect to which we request that you arrange a conference at which our (identify individual) will discuss the matter with you and your auditor: ^{vii}1)
- (c) include all claims which are outstanding (except for the following:
Parties Amount Claimed ^{viii}1)

This letter should not be quoted from or referred to in your financial statements or in dealings with third parties without our prior written consent.

Yours truly,

c.c. (Signed copy to auditor)

(Response Letter)

Version 2 — responding to Inquiry Letter Version 2

Privileged and Confidential

(To client)

(Date)

Dear Sir(s):

This reply to your inquiry letter of (date) is made in accordance with the Joint Policy Statement referred to in that letter.

We confirm, based on an examination of our records, that as of (effective date of response) there are no claims which are outstanding.^{ix} 1

This letter should not be quoted from or referred to in your financial statements or in dealings with third parties without our prior written consent.

Yours truly,

c.c. (Signed copy to auditor)

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- i 1. and by the Council of the Bermuda Bar Association.
- ii 1. The letter should be appropriately modified if the client advises that certain matters have been excluded in accordance with paragraph 12 of the Joint Policy Statement.
- iii 2. Delete if inapplicable. If applicable, refer to paragraph 11 re signing of the inquiry letter.
- iv 1. The letter should be appropriately modified if the client advises that certain matters have been excluded in accordance with paragraph 12 of the Joint Policy Statement.
- v 2. Delete if inapplicable. If applicable, refer to paragraph 11 re signing of the inquiry letter.
- vi 1. Delete if inapplicable.
- vii 1. Delete if inapplicable.
- viii 1. Delete if inapplicable.
- ix 1. Delete if inapplicable and substitute the following:
We have identified in our records the following claim(s) which is (are) outstanding as of (effective date of response):
Parties Amount Claimed