

# SOUTH AFRICAN AUDITING PRACTICE STATEMENT 4

## Enquiries Regarding Litigation and Claims

October 2005\*

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Appendix: Example of a request for an attorney's representation letter  
regarding litigation and claims

This South African Auditing Practice Statement (SAAPS), *Enquiries regarding litigation and claims* should be read in the context of the *Preface to Standards on Quality Control, Auditing, Assurance and Related Services as Adopted for Issue by the Auditing and Assurance Standards Board*, which sets out the application and authority of SAAPSs.

#### **Warning to Readers**

*Registered auditors are alerted to the fact that the practice statement has not been updated for amendments to ISA 501, Audit Evidence – Specific Considerations for Selected Items which is effective for audits of financial statements for periods beginning on or after 15 December 2009.*

\* On 1 January 2005 the Auditing and Assurance Standards Board adopted the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants for use in South Africa. South African Auditing Standard (SAAS) 502, *Enquiries regarding litigation and claims* was developed locally specifically for auditors making enquiries regarding litigation and claims in South Africa and does not form part of the ISAs. Accordingly, SAAS 502 is reissued as a South African Auditing Practice Statement (SAAPS) as it contains guidance for auditors in South Africa. The guidance contained in this SAAPS was taken directly from SAAS 502.

Consequently, SAAS 502, *Enquiries regarding litigation and claims* issued in December 2002 is withdrawn with the issue of this SAAPS.

## ENQUIRIES REGARDING LITIGATION AND CLAIMS

### INTRODUCTION

1. The purpose of this practice statement is to provide guidance on obtaining sufficient appropriate audit evidence regarding litigation and claims affecting the entity. In particular, this practice statement identifies the appropriate method of communication with an attorney in connection with litigation and claims by or against the entity. For purposes of this practice statement a reference to “attorneys” will include independent attorneys and/or employee legal advisors of the entity as the context requires.
2. This practice statement does not establish new requirements for, or exemptions from, the requirements of the international standards and is issued as additional guidance to the requirements of the International Standard on Auditing (ISA) 501, *Audit Evidence – Additional Considerations for Specific Items*.
3. The auditor considers obtaining sufficient appropriate audit evidence regarding:
  - whether all material litigation and claims have been identified,
  - the probability of any material revenue or expense arising from such matters and the estimated amount thereof, and
  - the adequacy of the accounting treatment of such matters including their disclosure in the financial statements.

### MANAGEMENT RESPONSIBILITIES

4. It is the responsibility of management of an entity to adopt policies and procedures to identify, evaluate, record and report on the outcome of any material litigation or claim. Since the factors that would be considered in the accounting for and reporting of litigation and claims are within the direct knowledge and control of the management of an entity, management is the primary source of information. However, the auditor may need to obtain evidence from different sources to corroborate management assertions if material litigation and claims are identified or if the auditor believes they may exist.

### AUDIT PROCEDURES

5. The audit procedures which the auditor performs to identify litigation and claims affecting the entity may include the following:
  - Review and discuss with management the procedures within the entity’s internal control structure for identifying and recording litigation and claims and bringing them to the attention of management.
  - Review and discuss with management the procedures within the entity’s internal control structure for identifying, controlling and recording legal expenses and associated revenues and expenses in appropriate accounts.
  - Obtain and discuss with management:

- a list of litigation and claims, including a description of the matters and an estimate of their likely financial consequences, and
  - an analysis identifying legal expenses.
  - Review relevant documents, for example, correspondence with attorneys.
  - Obtain written representations regarding the completeness of material outstanding litigation and claims from management.
6. The auditor's examination may also include other audit procedures which may be undertaken for different purposes, but which might also disclose litigation and claims. Such procedures include:
- examining contracts, loan agreements, leases, insurance policies and claims and other correspondence,
  - reading minutes of meetings of the governing body, directors, the audit committee, shareholders and appropriate committees,
  - obtaining information from bank confirmations concerning guarantees,
  - developing a knowledge of the essential characteristics of the entity's business operations, including an understanding of the potential involvement in litigation and claims, and
  - enquiries of management and other employees of the entity.
7. The procedures outlined in paragraphs 5 and 6 are the principal means whereby the auditor can identify both material litigation and claims and the attorneys who have been consulted by the entity. However, these procedures may not necessarily provide the auditor with sufficient appropriate audit evidence concerning the existence of and likely outcome of litigation and claims, or indicate whether the information provided by management is complete. Furthermore, the auditor ordinarily may not possess the skills necessary to make legal judgements concerning management's assessment of the likely outcome of litigation and claims.

## **REQUESTS FOR ATTORNEYS' REPRESENTATION LETTERS**

8. In terms of ISA 501, when material litigation and claims have been identified or when the auditor believes they may exist, the auditor should seek written representation from the entity's attorneys. A written request may be sent to attorneys where the auditor has identified material litigation and claims or believes they may exist, and would not simply be sent as a matter of course. These written representations are obtained in order to evaluate the reasonableness of management's estimates of the likely financial consequences of litigation and claims, and to corroborate the completeness of the litigation and claims identified by management. The completeness of the response obtained is likely to depend on the individual attorney, the size of the attorney's firm and the complexity of the particular matter, and it may be necessary for further audit procedures to be undertaken in order to obtain sufficient appropriate audit evidence on which to base the audit opinion.

## ENQUIRIES REGARDING LITIGATION AND CLAIMS

9. The written request for the attorney's representation letter, prepared by management and sent by the auditor, requests the attorney to communicate directly with the auditor. The letter, which is prepared on the entity's letterhead, and is sent by the auditor to the attorney only when the auditor is satisfied, by virtue of the procedures outlined in paragraphs 5 and 6, that such letter has been properly completed by management.
10. The matters that may need to be covered in a request for an attorney's representation letter include, but would not necessarily be limited to, the following:
  - identification of the name, and the end of the reporting period, of the entity and all other entities to which the enquiry relates, such as subsidiaries and incorporated joint ventures,
  - a list prepared by management which names each entity which is a party to material litigation or a material claim or claims of a class and describes the nature of such litigation and claims, the amount claimed and its status or management's assertion that no such matters exist,
  - management's estimate of the financial exposure (inclusive of costs and disbursements) for each litigation matter and claim in respect of which the attorney has been engaged by the entity,
  - a request that the attorney advise whether the items are properly described and whether management's evaluations are reasonable as well as a request to provide the auditor with further information if the list is considered by the attorney to be incomplete or incorrect,
  - a request for comment on those litigation matters and claims on which the attorney disagrees with management,
  - a request for a list of any other litigation matters and claims dealt with by the attorney in relation to the entity, where the attorney has taken the opportunity to bring to the auditor's attention further material litigation and claims of which the attorney is aware,
  - an indication of the amount below which litigation matters and claims are not considered to be material for the purposes of the enquiry regarding litigation and claims and need not be considered by attorneys when attorneys take the opportunity of bringing further litigation and claims, of which they are aware, to the attention of the auditor,
  - a request that the response address events as at and subsequent to the financial year-end of the entity/entities and that it be provided as close as possible to the expected date of the audit report, and
  - a request that the nature of and reasons for any limitation on the response be advised.
11. An example of a request for an attorney's representation letter is included as an Appendix to this practice statement.
12. An auditor may in some cases request that management send a request for an attorney's representation letter to attorneys who are not identified as currently handling the entity's

litigation and claims. For example, when the entity has changed attorneys on a particular matter, or an attorney engaged by the entity has withdrawn from the matter, the auditor would consider the need for enquiries concerning the reasons for the change or withdrawal.

### **Employee legal advisors**

13. In circumstances where legal advisors who are employees of the entity, or another entity within the group, have the primary responsibility for litigation and claims and are in the best position to corroborate management's representations, a request for an attorney's representation letter seeking information similar to that sought from an independent attorney may be obtained from such employee legal advisors.
14. Before relying on the opinion of either an employee legal advisor or an independent attorney, care may need to be exercised to ensure that conditions prevail which would make such reliance reasonable. For guidance on using the work of an expert, refer to the ISA 620, *Using the Work of an Expert*.
15. If both employee legal advisors and independent attorneys are involved in advising on the same litigation and claim, the auditor may seek a written representation from the employee legal advisor or independent attorney with the primary responsibility for that matter. However, there may be circumstances where the employee legal advisor has primary responsibility, but the matter has involved substantial participation by an independent attorney, and is of such significance that the auditor may need to consider obtaining a written representation from such attorney that his or her opinion does not differ materially from that of the employee legal advisor.
16. In circumstances where both employee legal advisors and independent attorneys have devoted substantial attention to a litigation matter or claim and primary responsibility rests with the independent attorney, evidence obtained from an employee legal advisor may not be considered an adequate substitute for any information that an independent attorney may refuse to furnish, in which case the procedures outlined in paragraphs 17 to 25 would be followed.

### **Attorney's response**

17. If the response from the attorney contains a material disagreement with management's original evaluation of a particular matter, the auditor should seek to resolve the disagreement through discussions with management and the attorney, or through alternative audit procedures, unless management subsequently agrees with the attorney's evaluation.
18. If the disagreement is resolved after discussions, the auditor may request that the attorney confirm in writing to the auditor the reasonableness of the details as resolved.
19. If the disagreement is not resolved, the auditor may need to prepare a memorandum of the discussion and may seek written confirmation from management and the attorney that it is an accurate record of the discussion. In conjunction with evidence from other audit

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procedures, the auditor may need to consider the effect of such disagreement on the audit report.

20. If the response from the attorney contains information that requires clarification, the auditor may make further enquiries of the client and attorney, as appropriate, and may request clarification in writing.

### **Attorney's failure to respond comprehensively or limitations in a response**

21. If a response is not received from the attorney, or the response received is incomplete or indicates a limitation on the attorney's response, the auditor may need to request that management contact the attorney instructing that a complete answer to the original request, or an explanation for the lack of or limitation in a response, be sent directly to the auditor.
22. Arrangements may need to be made to discuss with management and the attorney the reasons for the lack of or limitation in a response. Information obtained from such discussions may need to be documented, a copy sent to the attorney, and the attorney requested to confirm the accuracy thereof.
23. If, in the judgement of the auditor, the reasons given by the attorney are unacceptable, or if a response is not obtained, the auditor may need to determine whether alternative audit procedures can provide sufficient appropriate audit evidence. Alternative procedures might entail, for example, further enquiries of management, a more detailed review of documents in management's possession concerning litigation and claims or examining accounts rendered by independent attorneys.
24. The auditor may also need to consider any relevant legislation to assist in this regard. For example, section 281 of the Companies Act 1973, entitles the auditor to a right of access at all times to the accounting records and all books and documents of a company, and it also entitles the auditor to require from the directors or officers of the company such information and explanations necessary for the purposes of the audit. Where an attorney refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative procedures, the auditor may need to consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.
25. An attorney may be unable to include in a response an opinion concerning the likelihood of the outcome of a litigation matter or claim or the amount or range of any potential revenue or expense because of inherent uncertainties. Factors influencing the outcome may sometimes not be within an attorney's competence to judge, for example where there is no relevant or historical experience of the entity or other entities in similar matters, or where the litigation is at an early stage. Where, due to significant uncertainties, an attorney is unable to come to a conclusion to corroborate management's representation, the auditor, after pursuing all reasonable alternative means of obtaining sufficient appropriate audit evidence, may need to issue a modified audit report. In circumstances where the auditor considers that the disclosure of the significant uncertainty in the financial statements is adequate the auditor may need to consider modifying the audit report with an emphasis of matter paragraph. If in the auditor's opinion the disclosure of

the uncertainty is inadequate or unreliable, a qualified opinion may need to be expressed on the basis of a disagreement with management.

## **RELATED PROCEDURES**

26. The auditor enquires of management as to new matters referred to an attorney subsequent to the date of the attorney's representation letter and prior to signing the audit report. If any such matters exist which may have a material effect on the financial statements, the auditor requests management to prepare a request for an attorney's representation letter with respect to the matter.
27. If the audit procedures lead to the discovery of matters of a legal nature not previously identified by management, the auditor considers the impact of each of the matters on the financial statements. Management needs to be informed and requested to address further enquiries to, or arrange a meeting with, the attorneys or other relevant experts, at which the auditor would be present. The auditor ordinarily extends the audit procedures to ensure that sufficient appropriate audit evidence on which to form an opinion has been obtained. If, however, having regard to all the circumstances, the auditor is unable to obtain satisfaction that all the information required for the purposes of the audit has been received, the audit opinion may need to be qualified.
28. If information comes to the auditor's attention that may indicate the existence of material liabilities resulting from matters of a legal nature on which management has not sought advice, the auditor may need to discuss the matter with management. Depending on the circumstances, refusal by management to seek advice may be considered to be a limitation in the scope of the auditor's work.

## **PUBLIC SECTOR PERSPECTIVE**

29. The guidance contained in this practice statement applies to the audit of financial statements in the public sector.

**EXAMPLE OF A REQUEST FOR AN ATTORNEY'S REPRESENTATION LETTER REGARDING LITIGATION AND CLAIMS**

(Letterhead of Client)

(Date)

(Name and Address of Attorney)

Dear .....

In connection with the preparation and audit of the financial statements of the entity (and the following subsidiaries and/or divisions) for the reporting period ended (date) we request that you provide to our auditors, (name) at (address), by (date), at our cost, the following information regarding litigation and claims:

- 1 Confirmation that you are acting for the entity (and the above-named subsidiaries and/or divisions) in relation to the matters set out in the attached schedule and that management's description and estimates of the amounts of the financial exposure (including costs and disbursements) which might arise in relation to those matters, are in your opinion reasonable.
- 2 Should you disagree with any of the information included in the attached schedule, please comment on the reasons for your disagreement.
- 3 In addition to the above, you are afforded the opportunity (but without assuming any duty to do so) to bring to the attention of our auditors further litigation and claims, of which you are aware, in relation to the entity (and the above-named subsidiaries and/or divisions), which are not dealt with in the attached schedule.
- 4 In considering litigation and claims to be brought to the attention of our auditors, litigation and claims not exceeding R..... are not considered material and need not be considered, unless you are aware of actions of a class which in aggregate may exceed the aforementioned amount.
- 5 In relation to the matters identified under 2, 3 and 4 above, we authorise you to discuss these matters with our auditor (name and address), if requested, and at our cost.

It is understood that:

- (a) the entity (and the above-named subsidiaries and/or divisions) may have used other attorneys in certain matters,
- (b) the information sought relates only to litigation and claims referred to your firm (including branches or subsidiaries) which were current at any time during the above-mentioned reporting period, or have arisen since the end of the reporting period and up to the date of your response, which response is to be provided as close as possible to (expected date of audit report),
- (c) unless separately requested in writing, you are not responsible for keeping the auditors advised of any changes after the date of your reply,



- (d) you are only required to respond on litigation and claims referred to you as attorneys for the entity (and the above-mentioned subsidiaries and/or divisions), not on those matters within your knowledge solely because of the holding of any office as director, secretary or otherwise of the entity (and the above-mentioned subsidiaries and/or divisions) by a consultant, partner or employee of your firm, and
- (e) your reply represents legal advice and is sought for the information of, and assistance to, this entity and will not be quoted or otherwise referred to in any financial statements or related documents of the entity (and the above-mentioned subsidiaries and/or divisions), nor will it be furnished to any governmental agency or other person, subject to specific legislative requirements, without the prior written consent of your firm. Your prompt assistance in this matter will be appreciated.

Would you please forward a signed copy of your reply to us.

Yours faithfully,

(Signature of client)

**ENQUIRIES REGARDING LITIGATION AND CLAIMS**

**Schedule to a request for an attorney’s representation letter regarding litigation and claims<sup>1</sup>**

Name of entity .....

Financial year-end .....

Litigation and Claims <sup>2</sup>			
Name of entity (subsidiary or division)	Management’s description of matter (including current status and amount claimed as well as attorney’s reference if known)	Management’s estimate of the financial exposure (inclusive of costs and disbursements)	Attorney’s remarks

We confirm that we are acting for the entity (and the above-named subsidiaries and/or divisions) in relation to the above-mentioned litigation and claims and that management’s description and estimates of the amounts of the financial exposure (including costs and disbursements) which might arise in relation to those matters are in our opinion reasonable.

OR<sup>3</sup>

The management of the above named entity has advised that there are no pending material litigation or claims which have been referred to us as attorneys which would involve financial exposure (including costs and disbursements). We advise that we are/are not in a position to confirm management’s above mentioned representation.

In addition to the above matters we wish to bring to your attention the following litigation and claims exceeding R..... of which we are aware in relation to the entity (and the above-named subsidiaries and/or divisions).

.....

Date: .....

Attorneys: .....

<sup>1</sup> Attorneys are under no obligation to respond to such request where the attached schedule has not been completed.

<sup>2</sup> Where no litigation and claims exist management should state this fact.

<sup>3</sup> Delete as appropriate.