

STATEMENT 3.234

AUDITING GUIDELINE

**CONTINGENT LIABILITIES ARISING FROM
PENDING LEGAL MATTERS**

Introduction

1. Paragraph 7 of Auditing Standard No. 3.101 "Audit Approach" states that:

"The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom."

This Auditing Guideline gives guidance on how that statement may be applied to the audit of contingent liabilities arising from pending legal matters. It is supplementary to, and should be read in conjunction with, auditing standards and related guidelines.

2. This Guideline relates primarily to company audits but the considerations outlined apply equally to other audits which involve auditors in expressing an opinion on the truth and fairness of the view given by the financial statements.

Background

3. This Auditing Guideline has been prepared after discussions with the Council of the Law Society of Hong Kong and consideration of the statement published by the English Law Society entitled "Information by solicitors for company audit purposes", which has been adopted in Hong Kong.
4. It is the duty of directors to ensure that proper account is taken of all liabilities, including contingent liabilities in the preparation of company financial statements. From the audit viewpoint, pending lawsuits and other actions against the company may present problems both of ascertainment and appraisal.

Procedures

5. The following audit procedures are suggested for the verification of the existence of such claims though they will not necessarily provide the auditor with adequate information of the likely amounts for which the company may ultimately be responsible:

- (a) reviewing the client's system of recording claims and the procedure for bringing these to the attention of the management or board;
 - (b) discussing the arrangements for instructing solicitors with the official(s) responsible for legal matters (for example the head of the legal department (if any) or the company secretary);
 - (c) examining the minutes of the board of directors and/or executive or other relevant committee for references to, or indications of, possible claims;
 - (d) examining bills rendered by solicitors and correspondence with them, in which connection the solicitors should be requested to furnish bills or estimates of charges to date or to confirm that they have no unbilled charges;
 - (e) obtaining a list of matters referred to solicitors from the appropriate director or official with estimates of the possible ultimate liabilities; and
 - (f) obtaining a written assurance from the appropriate director or official that he is not aware of any matters referred to solicitors other than those disclosed.
6. In appropriate circumstances, auditors may decide to obtain written confirmations from third parties of certain representations made by directors; for example, the identification and appraisal of contingent liabilities. In the field of legal actions the normal and proper source of such confirmations is the company's legal advisers.
7. Requests for such confirmations should be kept within the solicitor-client relationship and should thus be issued by the client with a request that a copy of the reply should be sent direct to the auditors.
8. In order to ascertain whether the information provided by the directors is complete, auditors (especially in certain overseas countries) may decide to arrange for solicitors to be requested to advise whether they have matters in hand which are not listed in the letter of request, and to provide information as to the likely amounts involved. When considering such a non-specific enquiry, auditors should note that the Council of the Law Society of Hong Kong has advised solicitors that it is unable to recommend that they comply with requests for information which are more widely drawn than the specimen form of wording set out in paragraph 9 below.

9. In these circumstances, the enquiry should normally list matters identified as having been referred to the company's legal advisers in accordance with paragraph 5(e) above. The following form of wording, appropriate to specific enquiries, has been agreed with the Council of the Law Society of Hong Kong as one which may be properly addressed to and answered by solicitors:

“In connection with the preparation and audit of our accounts for the year ended the directors have made estimates of the amounts of the ultimate liabilities (including costs) which might be incurred, and are regarded as material, in relation to the following matters on which you have been consulted. We should be obliged if you would confirm that in your opinion these estimates are reasonable.

Matter	Estimated liability including costs”
--------	--------------------------------------

10. The Council of the Hong Kong Society of Accountants understands the reasons for the view of the Council of the Law Society of Hong Kong regarding non-specific enquiries, but nevertheless believes that there may be circumstances in which it is necessary as an audit procedure for an enquiry of a general nature to be addressed to the solicitors in order to confirm that the information provided by the directors is complete in all material particulars.
11. If the outcome of the enquiries set out in paragraphs 5 and 8 above appears satisfactory, auditors would not normally regard the absence of a corroboration of the completeness of a list of legal matters as a reason in itself for qualifying their report. If the enquiries lead to the discovery of significant matters not previously identified, the auditors will wish to extend their enquiries and to request their clients to address further enquiries to, or arrange a meeting with, the solicitors, at which the auditors will wish to be present. If, however, having regard to all the circumstances, the auditors are unable to satisfy themselves that they have received all the information they require for the purpose of their audit, they must qualify their report.