
Federal Financial Accounting and Auditing Technical Release 1: Audit Legal Representation Letter Guidance

Status

Issued	March 1, 1998
Effective Date	For fiscal periods beginning after September 30, 1997
Interpretations and Technical Releases	Interpretation 2, <i>Accounting for Treasury Judgment Fund Transactions: An Interpretation of SFFAS 4 and SFFAS 5</i>
Affects	None.
Affected by	None.

Summary

Management of the Federal reporting entity is responsible for adopting policies and procedures to identify, evaluate and account for litigation, claims and assessments as a basis for the preparation of financial statements, including those handled by outside legal counsel. Management is responsible for reporting loss contingencies in accordance with the requirements of Statement of Federal Financial Accounting Standards No.5. This may require consultation by management and its legal department with DOJ, as well as other outside legal counsel.

The auditor should request that management send a letter of audit inquiry to legal counsel with whom management has consulted concerning litigation, claims and assessments. Management of the Federal reporting entity and its legal department are responsible for providing the auditor with a legal representation letter.

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Issue:

Who should be the source of audit legal representation letters in cases where Department of Justice attorneys are handling legal matters on behalf of other Federal reporting entities?

Background:

This issue was raised by the Department of Justice (DOJ) in relation to Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions*, issued by the Federal Accounting Standards Advisory Board (FASAB), however it is applicable to any situation where outside legal counsel is handling legal matters on behalf of a Federal reporting entity.

FASAB Interpretation No. 2 states that "the Federal entity's management, as advised by the Justice Department, must determine whether it is probable that a legal claim will end in a loss for the Federal entity and the loss is estimable." DOJ is concerned that the language in the Interpretation will lead agencies to conclude that DOJ is the sole source of audit legal representation letters in cases where DOJ attorneys are handling legal matters on behalf of other Federal reporting entities.

Recommended Implementation Guidance

Management of the Federal reporting entity is responsible for adopting policies and procedures to identify, evaluate and account for litigation, claims and assessments as a basis for the preparation of financial statements in accordance with the requirements of the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. These include litigation, claims and assessments handled by legal counsel outside of the Federal reporting entity's legal department.

Management of the Federal reporting entity is responsible for ensuring that loss contingencies, including those arising from litigation, claims and assessments, are presented in the financial statements in accordance with the requirements of Statement of Federal Financial Accounting Standards No.5, *Accounting for Liabilities of the Federal Government*. This may require consultation by management and its legal department with DOJ, as well as other outside legal counsel, to ensure the accuracy and completeness of the presentation of matters related to litigation, claims and assessments in the Federal reporting entity's financial statements. Such consultation may include requesting a list of pending litigation, claims and assessments from DOJ or other outside legal counsel.

A representation letter from legal counsel to the auditor, in response to a letter of audit inquiry from management to legal counsel, is the auditor's primary means of corroborating the information furnished by management concerning the accuracy and completeness of litigation, claims and assessments. The auditor should request that management send a letter of audit

inquiry to legal counsel with whom management has consulted concerning litigation, claims and assessments. A materiality limit for the legal representation letter is generally established in the letter of audit inquiry, based on an understanding between management and the auditor.

Management of the Federal reporting entity and its legal department are responsible for providing the auditor with a legal representation letter. The legal representation letter should cover all litigation, claims and assessments pertaining to the Federal reporting entity, including matters handled by DOJ or other outside legal counsel on behalf of the Federal reporting entity.

The legal representation letter provided to the auditor by the Federal reporting entity's legal department, or "inside counsel", may provide sufficient evidential matter for the auditor. In certain circumstances the auditor may also need supporting legal representation from outside counsel. Section AUI 337.26 of the AICPA Codification of Statements on Auditing Standards provides the following guidance for situations where inside counsel is handling litigation, claims and assessments either exclusive of or in conjunction with outside counsel:

Audit inquiry letters should be sent to those lawyers, which may be either inside or outside lawyers, who have the primary responsibility for, and knowledge about, particular litigation, claims and assessments. If inside counsel is handling litigation, claims and assessments exclusively, their evaluation and response ordinarily would be considered adequate. Similarly, if both inside and outside lawyers have been involved in the matters, but inside counsel has assumed primary responsibility for the matters, inside counsel's evaluation may well be considered adequate. However, there may be circumstances where litigation, claims and assessments involving substantial overall participation by outside lawyers are of such significance to the financial statements that the auditor should consider obtaining the outside lawyers' response that they have not formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation, even though inside counsel may have primary responsibility.

In those circumstances where the auditor determines that a legal representation letter is needed from DOJ, or other outside legal counsel, to support the Federal reporting entity's legal representation letter, the Federal reporting entity's management, in conjunction with its legal department, would request such representation in a letter of audit inquiry. The Federal reporting entity would provide DOJ with its description and evaluation of the possible outcome of the case in question, and request that the DOJ lawyer respond directly to the auditor. If the Federal reporting entity is not sufficiently knowledgeable of the case to provide a description and evaluation, the DOJ lawyer would be requested to provide a description and evaluation directly to the auditor. Such requests to DOJ should be case specific and directed to the lead DOJ lawyer handling the case. To meet the reporting deadlines for audited financial statements, there should be early coordination between the auditor and the Federal reporting entity's management and legal department to determine whether supporting legal representations will be needed from DOJ.

The legal representation letter provided to the auditor by the legal department of the Federal reporting entity requires an assertion as to the completeness of the list of litigation, claims and assessments, including matters handled by DOJ or other outside legal counsel on behalf of the Federal reporting entity. The auditor's consideration of this completeness assertion is based primarily on the assessed effectiveness of the Federal reporting entity's internal control structure for identifying, evaluating and accounting for litigation, claims and assessments. The auditor also may need to request additional information from the Federal reporting entity, or DOJ or other outside legal counsel, to obtain evidence about the completeness assertion. Such requests to DOJ or other outside legal counsel should be made through management of the Federal reporting entity. Further, the auditor should consider whether the audit scope is limited by the inability to obtain sufficient competent evidential matter regarding the completeness assertion for litigation, claims and assessments.

References

Interpretation of Federal Financial Accounting Standards No. 2, *Accounting for Treasury Judgment Fund Transactions*

Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*

AICPA Codification of Statements on Auditing Standards, AU Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments*; and Auditing Interpretations of AU Section 337