

ASA 508

(April 2006)

Auditing Standard ASA 508
Enquiry Regarding Litigation
and Claims

Issued by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

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CONTENTS

PREFACE

AUTHORITY STATEMENT

	<i>Paragraphs</i>
Application.....	1-2
Operative Date	3
Introduction.....	4-6
Audit Implications	7
Audit Procedures.....	8-10
Requests for Representation Letters from Lawyers	11-17
<i>Employee and/or Third Party Lawyers</i>	18-21
<i>Lawyer's Response</i>	22-25
<i>Lawyer's Inability to Respond Comprehensively or Limitations in a Response</i>	26-30
<i>Audit Reporting Considerations</i>	31-32
Related Procedures.....	33-37
Conformity with International Standards on Auditing.....	38
Appendix 1: Example of a Request for a Representation Letter to a Lawyer for an Audit Client	

PREFACE

Reasons for Issuing Auditing Standard ASA 508 *Enquiry Regarding Litigation and Claims*

The Auditing and Assurance Standards Board (AUASB) issues Auditing Standard ASA 508 *Enquiry Regarding Litigation and Claims* due to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001*, as from 1 July 2004. Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislative Instruments Act 2003*.

Main Features

The purpose of this Auditing Standard is to establish mandatory requirements and provide explanatory guidance on obtaining sufficient appropriate audit evidence regarding legal matters affecting the entity.

This Auditing Standard:

- (a) requires the auditor to obtain sufficient appropriate audit evidence regarding the identification of legal matters;
- (b) requires the auditor to request management to obtain a representation letter from the entity's lawyers as a means of acquiring sufficient appropriate audit evidence for the identification and existence of litigation by or against the entity; and
- (c) includes additional follow up procedures, which the auditor ordinarily pursues, when a lawyer's response to a representation letter is either not received or the response is incomplete.

Operative Date

This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from AUS 508 (July 2002 *Inquiry Regarding Litigation and Claims*)

The main differences between this Auditing Standard and the Auditing Standard issued by the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, AUS 508 (July 2002) *Inquiry Regarding Litigation and Claims*, are that in this Auditing Standard:

1. The word 'shall', in the **bold-type** paragraphs, is the terminology used to describe an auditor's mandatory requirements, whereas an auditor's degree of responsibility is described in AUS 508 by the word 'should'.
2. The explanatory guidance paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, whereas in AUS 508 some obligations are implied within certain explanatory paragraphs. Accordingly, these paragraphs have been amended to clarify that these matters form part of the explanatory guidance.
3. This Auditing Standard includes explanatory guidance, not included in AUS 508, regarding circumstances when it may be difficult to either obtain a representation letter or be provided with information about legal matters from the entity's lawyers, and alternative audit procedures that the auditor may consider in such circumstances (paragraphs 27 and 28).

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standard 508 *Enquiry Regarding Litigation and Claims* as set out in paragraphs 1 to 38 and Appendix 1, pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with the *Preamble to AUASB Standards*, which sets out the intentions of the AUASB on how the Auditing Standards are to be understood, interpreted and applied.

The mandatory requirements of this Auditing Standard are set out in **bold-type** paragraphs.

Dated 28 April 2006

M H Kelsall
Chairman - AUASB

AUDITING STANDARD

Enquiry Regarding Litigation and Claims

Application

- 1 **This Auditing Standard applies to:**
 - (a) **an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the *Corporations Act 2001*; and**
 - (b) **an audit of a financial report for any other purpose.**
- 2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Operative Date

- 3 **This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.**

Introduction

- 4 The purpose of this Auditing Standard is to establish mandatory requirements and provide explanatory guidance on obtaining sufficient appropriate audit evidence regarding legal matters affecting the entity. In particular, this Auditing Standard identifies the appropriate method of communication with the entity's lawyers in connection with litigation by or against the entity.
- 5 **The auditor shall obtain sufficient appropriate audit evidence regarding:**
 - (a) **whether all material legal matters have been identified;**
 - (b) **the probability of any material revenue or expense arising from such matters and the estimated amount thereof; and**
 - (c) **the adequacy of the accounting treatment of such matters including their disclosure in the financial report.**

- 6 “Legal matters” means matters referred to lawyers by an entity relating to pending or potential litigation which may result in actual or contingent liabilities, and other matters referred to the entity’s lawyers which may affect the financial position or the results of the entity’s operations.

Audit Implications

- 7 It is the responsibility of those charged with governance of an entity to adopt policies and procedures to identify, evaluate, record and report on the outcome of any material legal matter. However, since the factors that would be considered in the accounting for and reporting of legal matters are within the direct knowledge and control of the management of an entity, management is the primary source of information. Ordinarily, the auditor would seek audit evidence from different sources to corroborate management assertions.

Audit Procedures

- 8 To identify legal matters affecting the entity, the auditor ordinarily performs the following procedures:
- reviews and discusses with management the procedures within the entity’s internal control structure for identifying and recording legal matters and bringing them to the attention of management;
 - reviews and discusses with management the procedures within the entity’s internal control structure for the identification, control and recording of legal expenses and associated revenues and expenses in appropriate accounts;
 - obtains and discusses with management:
 - (i) a list of legal matters, including a description of the matters and an estimate of their likely financial consequences; and
 - (ii) an analysis identifying legal expenses;
 - reviews relevant documents, for example correspondence with the entity’s lawyers; and

Auditing Standard ASA 508 *Enquiry Regarding Litigation and Claims*

- obtains from management an assurance that the information obtained regarding material outstanding legal matters is complete.
- 9 Audit procedures that are undertaken for different purposes might also disclose legal matters. Such procedures include:
- examining contracts, loan agreements, leases, insurance policies and claims, and other correspondence;
 - reading minutes of meetings of the governing body, the audit committee, shareholders and appropriate committees;
 - obtaining information concerning guarantees from bank confirmations;
 - developing a knowledge of the essential characteristics of the entity's business operations, including an understanding of the potential involvement in legal matters; and
 - enquiries of management and other employees of the entity.
- 10 The procedures outlined in paragraphs 8 and 9 of this Auditing Standard are methods whereby the auditor can identify both material legal matters and the lawyers who have been consulted by the entity. However, these procedures may not necessarily provide the auditor with sufficient appropriate audit evidence concerning the likely outcome of legal matters, or indicate whether the information provided by management is complete. Furthermore, the auditor ordinarily does not possess the skills necessary and is not in a position to make legal judgements concerning the likely outcome of legal matters.

Requests for Representation Letters from Lawyers

- 11 **When legal matters have been identified or when the auditor believes they may exist, the auditor shall endeavour to obtain written representations from all lawyers with whom management has consulted on material legal matters.**
- 12 Written representations are obtained from the entity's lawyers in order to evaluate the reasonableness of management's estimates of the likely financial settlement of legal matters, and to corroborate the completeness of the legal matters identified by management. The completeness of the response obtained is likely to depend on the individual lawyer and the size and complexity of the lawyer's firm, and it may be necessary for further audit procedures to be

Auditing Standard ASA 508 Enquiry Regarding Litigation and Claims

undertaken in order to obtain sufficient appropriate audit evidence on which to base the audit opinion.

13 The auditor shall request management to prepare the representation letter to the entity's lawyers, with a request that the lawyers respond directly to the auditor. The auditor shall send the representation letter to the entity's lawyers.

14 The representation letter would ordinarily be prepared on the entity's letterhead.

15 The matters that would ordinarily be covered in the representation letter to the entity's lawyers 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, for example subsidiaries and incorporated joint ventures;
- a list prepared by management which names each entity subject to a legal matter, describes the nature of each legal matter and its status;
- management's evaluation of the probable outcome and estimate of the financial settlement (inclusive of costs and disbursements) for each legal matter in respect of which a lawyer has been engaged by the entity;
- a request that the entity's lawyers advise whether the items are properly described and the evaluations are reasonable;
- a request for comment on those legal matters on which the entity's lawyers disagree with management;
- a list of open files maintained by the entity's lawyers in relation to the entity;
- a request that the response be provided on a specified date which would be as close as possible to the expected date of the audit report; and
- a request that the entity's lawyers advise the nature of and reasons for any limitation on the response.

16 An example representation letter to a lawyer is included in Appendix 1.

Auditing Standard ASA 508 *Enquiry Regarding Litigation and Claims*

- 17 An auditor may in some cases request that management send a request for a representation letter to the entity's lawyers who are not identified as currently handling the entity's legal matters. For example when the entity has changed lawyers on a particular matter, or when a lawyer engaged by the entity has resigned, the auditor would consider the need for enquiries concerning the reasons for the change or resignation.

Employee and/or Third Party Lawyers

- 18 **Where lawyers who are employees of the entity have the primary responsibility for legal matters and are in the best position to corroborate management's representations, the auditor shall endeavour to obtain a representation letter, seeking information similar to that sought from a third party lawyer, from those employees.**
- 19 Before relying on the opinion of either an employee lawyer or a third party lawyer, care must be exercised to ensure that conditions prevail which would make such reliance reasonable. For the applicable mandatory requirements and explanatory guidance on using the work of an expert, refer to ASA 620 *Using the Work of an Expert*.
- 20 If both employee and third party lawyers are involved in advising the entity on the same legal matter, the auditor would ordinarily seek a written representation letter from the lawyer with the primary responsibility for that matter. However, there may be circumstances where the employee lawyer has primary responsibility, but the matter has involved substantial participation by a third party lawyer, and is of such significance that the auditor would consider obtaining a written representation letter from the third party lawyer that their opinion does not differ materially from that of the employee lawyer.
- 21 In circumstances where both employee and third party lawyers have devoted substantial attention to a legal matter involving the entity and primary responsibility rests with the third party lawyer, evidence obtained from an employee lawyer is not an adequate substitute for any information that a third party lawyer may refuse to furnish, in which case, the procedures outlined in paragraphs 22 to 30 would ordinarily be followed.

Lawyer's Response

- 22 **If a response from the entity's lawyers contains a material disagreement with management's original evaluation of a**

particular matter, the auditor shall seek discussions with management and the entity's lawyers, unless management subsequently agrees with the lawyers' evaluation.

- 23 If the disagreement is resolved after discussions, the auditor would ordinarily request that the entity's lawyers confirm in writing to the auditor the reasonableness of the details as resolved.
- 24 If the disagreement is not resolved, the auditor would ordinarily prepare a memorandum of the discussion and seek written confirmation from management and the entity's lawyers that it is an accurate record of the discussion. In conjunction with evidence from other audit procedures, the auditor, under ASA 701 *Modifications to the Auditor's Report*, needs to consider the effect of such disagreement on the auditor's report.
- 25 If the response from the entity's lawyers contains information that requires clarification, the auditor would ordinarily make further enquiries of management and the entity's lawyers, as appropriate, and request clarification in writing.

Lawyer's Inability to Respond Comprehensively or Limitations in a Response

- 26 If a response is not received from the entity's lawyers, or the response received is incomplete, the auditor would ordinarily consider:
- (a) requesting management to contact the entity's lawyers to either seek a complete answer to the original request, or an explanation for the lack of, or limitation in, a response, which ought to be sent directly to the auditor; or
 - (b) making arrangements to discuss with management or the entity's lawyers the reasons for the lack of, or limitation in, a response.
- 27 Due to the following circumstances it may be difficult to either obtain a representation letter or be provided with information about legal matters from the entity's lawyers:
- (a) If the entity is involved in litigation, or litigation is anticipated or contemplated, relevant information about legal matters may be subject to legal professional privilege. Disclosure of this information in the representation letter, directly to the auditor for the purposes of the audit of the entity's financial report, is not privileged. This may cause legal professional privilege attaching to the entity's

Auditing Standard ASA 508 Enquiry Regarding Litigation and Claims

- communications with its lawyers to be compromised, as information in the representation letter might become discoverable in litigation proceedings.
- (b) Factors influencing the outcome of a legal matter may sometimes not be within the lawyers' 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.
- (c) Due to material uncertainties, the entity's lawyers may be unable to form a conclusion to corroborate management's representations regarding outstanding legal matters.
- 28 Where the auditor has not obtained sufficient appropriate audit evidence as to a material financial report assertion regarding legal matters, under *ASA 330 The Auditor's Procedures in Response to Assessed Risks*, the auditor needs to consider whether alternative audit procedures can provide further audit evidence. Alternative audit procedures may include:
- (a) further enquiries of management or those charged with governance, about for instance the processes, procedures and assumptions they implement, adopt or make to ensure legal matters are recognised and disclosed in accordance with the applicable financial reporting framework;
- (b) where possible, making arrangements to discuss legal matters with management and the entity's lawyer;
- (c) reviewing documents in management's possession concerning legal matters, including the entity's board minutes; and
- (d) examining accounts rendered by the entity's third party lawyers.
- 29 The auditor may also consider any relevant legislation to assist in obtaining information about legal matters, including:
- Section 310 of the *Corporations Act 2001* for example, entitles the auditor to a right of access at all reasonable times to the books of a company registered scheme and disclosing entity, and may require from any officer information, explanations and other assistance for the purposes of the audit or review.

Auditing Standard ASA 508 *Enquiry Regarding Litigation and Claims*

- When the entity is a disclosing entity, whether disclosure of any legal matters has been made in accordance with the continuous disclosure requirements under section 674 or 675 of the *Corporations Act 2001*.
- 30 Under ASA 230 *Audit Documentation*, the auditor needs to prepare sufficient appropriate audit documentation regarding the alternative audit procedures performed.

Audit Reporting Considerations

- 31 A limitation on the scope of the auditor's work exists when:
- (a) management refuses to respond to the auditor's request that they prepare the representation letter to the entity's lawyers;
 - (b) management does not allow the auditor to communicate with the entity's lawyer; or
 - (c) the auditor has been unable to obtain sufficient appropriate audit evidence from performing alternative audit procedures.

Accordingly, under ASA 701 *Modifications to the Auditor's Report*, the auditor needs to consider the effect on the auditor's report.

- 32 In those circumstances where, due to material uncertainties, the entity's lawyers are unable to form a conclusion to corroborate management's representation, under ASA 701 the auditor needs to consider the effect on the auditor's report arising from the extent of disclosure of the material uncertainty in the financial report. Under ASA 701:
- (a) where the auditor considers that the disclosure of the material uncertainty in the financial report is adequate the auditor needs to include an emphasis of matter section; or
 - (b) if in the auditor's opinion the disclosure of the material uncertainty is inadequate or unreliable, a modified opinion needs to be expressed on the basis of a disagreement with management.

Related Procedures

- 33 **The auditor shall enquire of management about new legal matters referred to the entity's lawyers subsequent to the date of the request for a representation letter to the entity's lawyers and prior to signing the auditor's report.**
- 34 Under paragraphs 13 and 33 of this Auditing Standard, when new legal matters have been referred to the entity's lawyers, subsequent to sending the representation letter to the entity's lawyers and prior to signing the audit report, which may have a material effect on the financial report, the auditor needs to request management to prepare an additional representation letter to the lawyer regarding the new legal matters.
- 35 **If audit procedures lead to the discovery of matters of a legal nature not previously identified by management, the auditor shall consider the impact of each of the matters on the financial report.**
- 36 When legal matters are discovered, which were not previously identified by management, the auditor would ordinarily inform management and request they address further enquiries to, or arrange a meeting with, the entity's lawyers or other relevant experts, at which the auditor would be present. In addition, under paragraph 5 of this Auditing Standard, the auditor needs to extend the auditor's 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 needs to be modified under ASA 701.
- 37 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 ordinarily discusses the matter with those charged with governance. 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.

Conformity with International Standards on Auditing

- 38 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 501 *Audit Evidence – Additional Considerations for Specific Items Part C: Procedures*

Auditing Standard ASA 508 *Enquiry Regarding Litigation and Claims*

Regarding Litigation and Claims, issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. The differences between this Auditing Standard and ISA 501 are:

- This Auditing Standard includes mandatory requirements and explanatory guidance dealing with the:
 - ◆ receipt of an incomplete response from a lawyer in response to a representation letter, or where the lawyer's response contains a material disagreement with management's evaluation of particular legal matters (paragraphs 31 and 32);
 - ◆ identification of legal matters subsequent to obtaining the representation letter (paragraphs 33-37); and
 - ◆ obtaining of audit evidence about legal matters where the entity's employee lawyers have primary responsibility for legal matters (paragraphs 18-21).
- The Appendix to this Auditing Standard is not included in ISA 501.

Compliance with this Auditing Standard enables compliance with ISA 501.

APPENDIX 1

EXAMPLE OF A REQUEST FOR A REPRESENTATION LETTER TO A LAWYER FOR AN AUDIT CLIENT

(Letterhead of Client)

(Date)

(Name and Address of Lawyer)

Dear ...

In connection with the preparation and audit of the financial report of the company (and the following subsidiaries and/or divisions) for the reporting period ended (date) we request that you provide to this company, at our cost, the following information,

- 1 Confirmation that you are acting for the company (and the above-named subsidiaries and/or divisions) in relation to the matters mentioned below and that the directors' description and estimates of the amounts of the financial settlement (including costs and disbursements) which might arise in relation to those matters are in your opinion reasonable.

Name of Company (subsidiary or division)	Directors' Description of Matter (including current status)	Directors' Estimate of the Financial Settlement (inclusive of costs and disbursements)
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- 2 Should you disagree with any of the information included in 1 above, please comment on the nature of your disagreement.
- 3 In addition to the above, a list of open files that you maintain in relation to the company (and the above mentioned subsidiaries and/or divisions).
- 4 In relation to the matters identified under 2 and 3 above, we authorise you to discuss these matters with our auditor (name and address), if requested, and at our cost.

Auditing Standard ASA 508 Enquiry Regarding Litigation and Claims

It is understood that:

- (a) the company (and the above-named subsidiaries and/or divisions) may have used other lawyers in certain matters;
- (b) the information sought relates only to information relating to legal matters 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;
- (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 matters referred to you as lawyers for the company (and the above-mentioned subsidiaries and/or divisions), not on those within your knowledge solely because of the holding of any office as director, secretary or otherwise of the company (and the above-mentioned subsidiaries and/or divisions) by a consultant, partner or employee of your firm; and
- (e) your reply is sought solely for the information of, and assistance to, this company in connection with the audit of, and report with respect to, the financial report of the company (and the above-mentioned subsidiaries and/or divisions) and will not be quoted or otherwise referred to in any financial report or related documents of the company (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. If you are unable to confirm or provide the information requested above, please advise us and our auditor the reasons for any limitation or impediment to fulfilling this request.

Would you please forward a signed copy of your reply directly to our auditors, (name) at (address), by (date).

Yours faithfully,

(Signature of client)