

EXPOSURE DRAFT

ED 27/05
(December 2005)

Proposed Auditing Standard: Inquiry Regarding Litigation and Claims (Re-issuance of AUS 508)

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



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be forwarded so as to arrive by 31 January 2006. Comments should be addressed to:

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A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au.

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PREFACE

Reasons for Issuing ED 27/05

The Auditing and Assurance Standards Board (AUASB) is proposing to re-issue Auditing Standard (AUS 508) *Inquiry 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 will be legislative instruments under the *Legislative Instruments Act 2003*.

Main Proposals

This proposed Auditing Standard:

1. requires the auditor to obtain sufficient appropriate audit evidence regarding the identification of legal matters;
2. 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
3. includes additional follow up procedures, which the auditor is required to pursue, when a lawyer's response to a representation letter is either not received or the response is incomplete.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 1 July 2006.

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(*Re-issuance of AUS 508*)**

Main changes from existing AUS 508 (July 2002)

The main differences between this proposed Auditing Standard and the Auditing Standard issued by the former Auditing & Assurance Standards Board of the Australian Accounting Research Foundation that it supersedes, AUS 508 (July 2002), is that in this proposed 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 was previously described by the word 'should'; and
2. the explanatory paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, whereas previously some obligations were implied within certain explanatory paragraphs. Accordingly, such paragraphs have been redrafted to clarify that the matter forms part of the explanatory guidance.

A Table of Proposed Changes is provided as an attachment to the Exposure Draft.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of Auditing Standard (AUS 508) *Inquiry Regarding Litigation and Claims* by 31 January 2006. The AUASB would prefer that respondents express a clear overall opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on any matter. The AUASB regards both critical and supportive comments as essential to a balanced review of the proposed Auditing Standard.

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(*Re-issuance of AUS 508*)

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standards << >> *Inquiry Regarding Litigation and Claims* as set out in paragraphs 1 to 36 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.

AUDITING STANDARD

Inquiry 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 a third party lawyer 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.**

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- 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 lawyers which may affect the financial position or the results of the entity’s operations.

Audit Implications

- 7 It is the responsibility of the governing body of an entity to adopt policies and procedures to identify, evaluate, record and report on the outcome of any material legal matter. 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. However, the auditor would ordinarily 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:
- (a) review and discuss 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;
 - (b) review and discuss 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;
 - (c) obtain and discuss 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;
 - (d) review relevant documents, for example correspondence with lawyers; and

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- (e) obtain from management an assurance that the information obtained regarding material outstanding legal matters is complete.
- 9 The auditor's examination ordinarily includes certain other audit procedures which may be undertaken for different purposes, but which 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
 - inquiries 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 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,

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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.

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

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 inquiry 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 lawyer advise whether the items are properly described and the evaluations are reasonable;
- a request for comment on those legal matters on which the lawyer disagrees with management;
- a list of open files maintained by the lawyer 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 lawyer advise the nature of and reasons for any limitation on the response.

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- 16 An example representation letter to a lawyer is included in Appendix 1.
- 17 An auditor may in some cases request that management send a request for a representation letter to 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 inquiries concerning the reasons for the change or resignation.

Employee and/or Third Party Lawyers

- 18 In circumstances 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, a request for a representation letter seeking information similar to that sought from a third party lawyer shall be obtained 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 guidance on using the work of an expert, refer to Auditing Standard AUS 606 *Using the Work of an Expert*.
- 20 If both employee and third party lawyers are involved in advising 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 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.

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Lawyer's Response

- 22 **If the response from the lawyer contains a material disagreement with management's original evaluation of a particular matter, the auditor shall seek discussions with management and the lawyer, unless management subsequently agrees with the lawyer's evaluation.**
- 23 If the disagreement is resolved after discussions, the auditor would ordinarily request that the lawyer 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 lawyer that it is an accurate record of the discussion. In conjunction with evidence from other audit procedures, the auditor is required, pursuant to AUS 702 Part B *Modifications to the Independent Auditor's Report*, to consider the effect of such disagreement on the audit report.
- 25 If the response from the lawyer contains information that requires clarification, the auditor would ordinarily make further inquiries of the client and lawyer, as appropriate, and request clarification in writing.

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

- 26 If no response is received from the lawyer, or the response received is incomplete, the auditor would ordinarily request that management contact the lawyer 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.
- 27 Arrangements would ordinarily be made to discuss with management and the lawyer the reasons for the lack of or limitation in a response. In addition, pursuant to AUS 208 *Audit Documentation*, information obtained from such discussions would be documented, and the lawyer requested to advise in writing of any inaccuracies.
- 28 If, in the judgement of the auditor, the reasons given by the lawyer are unacceptable, or if no response is obtained, the auditor would ordinarily consider whether alternative audit procedures can provide sufficient appropriate audit evidence. Alternative procedures might entail, for example, further inquiries of management, reviewing documents in management's possession concerning legal matters or examining accounts rendered by third party lawyers.

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- 29 The auditor would also consider any relevant legislation to assist in this regard, for example section 310 of the *Corporations Act 2001* 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. If sufficient appropriate audit evidence cannot be obtained, the lack of or limitation in a response would be considered to be a limitation on the scope of the auditor's work and the auditor is required to consider, pursuant to AUS 702 Part B *Modifications to the Independent Auditor's Report*, whether a qualification or a disclaimer form of audit opinion would be expressed.
- 30 A lawyer may be unable to include in a response to a representation letter an opinion concerning the likelihood of the outcome of a legal matter or the amount or range of any potential revenue or expense because of inherent uncertainties. Factors influencing the outcome may sometimes not be within a lawyer'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 material uncertainties, a lawyer is unable to form a conclusion to corroborate management's representation, the auditor is required, after pursuing all reasonable alternative means of obtaining sufficient appropriate audit evidence, pursuant to AUS 702 Part B, to issue a modified opinion. In those circumstances, pursuant to AUS 702 Part B, where the auditor considers that the disclosure of the uncertainty in the financial report is adequate the auditor would include an emphasis of matter section. If in the auditor's opinion the disclosure of the uncertainty is inadequate or unreliable, a qualified opinion would be expressed on the basis of a disagreement with management.

Related Procedures

- 31 **The auditor shall inquire of management about new legal matters referred to a lawyer subsequent to the date of the request for a representation letter to the entity's lawyers and prior to signing the audit report.**
- 32 Pursuant to paragraphs 13 and 31 of this Auditing Standard, when new legal matters have been referred to a lawyer, 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 is required to request management to prepare an additional representation letter to the lawyer regarding the new legal matters.

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- 33 **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.**
- 34 When matters of a legal nature are discovered, which were not previously identified by management, the auditor would ordinarily inform management and request they address further inquiries to, or arrange a meeting with, the entity's lawyers or other relevant experts, at which the auditor would be present. The auditor would ordinarily extend 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 would be qualified, pursuant to AUS 702 Part B.
- 35 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

- 36 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 501 *Audit Evidence - Additional Considerations for Specific Items Part C: Inquiry Regarding Litigation and Claims*, issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. The difference between this Auditing Standard and ISA 501 are the inclusion of mandatory requirements and explanatory guidance dealing with the :
- (a) 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 a particular legal matter;
 - (b) identification of legal matters subsequent to obtaining the representation letter; and
 - (c) obtaining of audit evidence about legal matters where the entity's employee lawyers have primary responsibility for legal matters.

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The Appendix to this AUS is additional to 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 A COMPANY 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)
------------------------------------------------	-------------------------------------------------------------------------	----------------------------------------------------------------------------------------------------

- 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.

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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.

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

Yours faithfully,

(Signature of client)

Table of Proposed Changes from AUS 508 <i>Inquiry Regarding Litigation and Claims</i>

Base standard

Auditing Standard (AUS 508) *Inquiry Regarding Litigation and Claims* (July 2002) was used as the base standard for re-drafting this proposed Auditing Standard. The table below indicates proposed changes from this standard.

Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
1, 2	Requirement / Guidance	New application paragraphs.
3	Requirement	Re-positioned Operative date paragraph.
5, 11, 13, 18, 22, 31, 33	Requirement	Replaced “should” with “shall” to indicate mandatory requirement.
7, 14 15, 21,23, 24, 25, 26 27, 28, 34, 35	Guidance	Inserted “ordinarily,” to remove the effect of an implied obligations
24, 27, 29, 30, 32, 34	Guidance	Inserted: “pursuant to... the auditor is required to”