Significant areas, litigation and claims

MODULE 4 | 4.1.1 | STUDENT COMPANION

Completion is the auditor's last check that nothing important has slipped through. Three **significant areas** get a final look: accounting estimates, related parties and fraud. **Litigation and claims** must be searched for, and in Australia the rules are in **ASA 502**. Where the auditor assesses a risk of material misstatement, it sends the entity's external lawyers a **letter of enquiry** that management has drafted, and they reply directly to the auditor. Each legal matter is then tested against the accounting rules: a **provision**, a **contingent liability** disclosure, or nothing at all.

Three significant areas: a final look

Accounting estimates	Related parties	Fraud
• Review the final figures and their disclosures • Use evidence from events after year end, up to the date of the report • Ask whether management's judgements, taken together, show a pattern of bias	• Check that every relationship and significant transaction identified is properly disclosed • Get management's written confirmation that all related parties have been disclosed	• Do the analytical procedures near the end point to a fraud risk not recognised before? • Could any misstatement found be a sign of fraud? • Must anything be raised with the board, the audit committee or others?

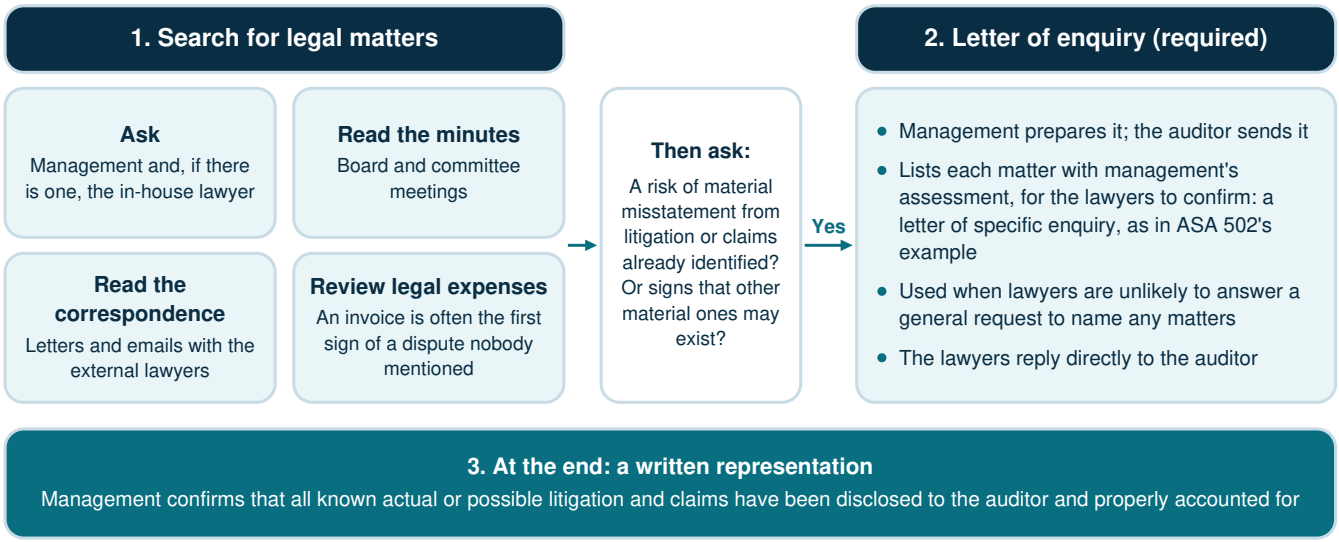
At Voltana, that last point is live. The June revenue journals and the undisclosed related party were already being treated as possible fraud; the completion work confirms that the extended journal testing found no further problems.

Estimates. Events after year end often settle an estimate: a claim paid in July, or stock sold in August below its carrying amount. Bias is judged across the estimates as a whole. If every judgement leans the same way, say towards higher profit, each one may look reasonable on its own while the pattern doesn't. Signs of possible bias aren't misstatements in themselves, but they colour the auditor's view of the statements as a whole and of the risk of fraud.

Related parties. The auditor checks that the relationships and significant transactions it has found are properly accounted for and disclosed, and obtains written representations that management has disclosed every related party, relationship and transaction it knows of (ASA 550).

Fraud. Final analytical procedures can reveal a fraud risk that wasn't recognised before. A misstatement that may be fraud is never judged on its size alone: the auditor reconsiders the reliability of management's representations and the evidence generally, tells management at the right level, and those charged with governance, and considers any duty to report outside the entity (ASA 240).

Searching for litigation and claims



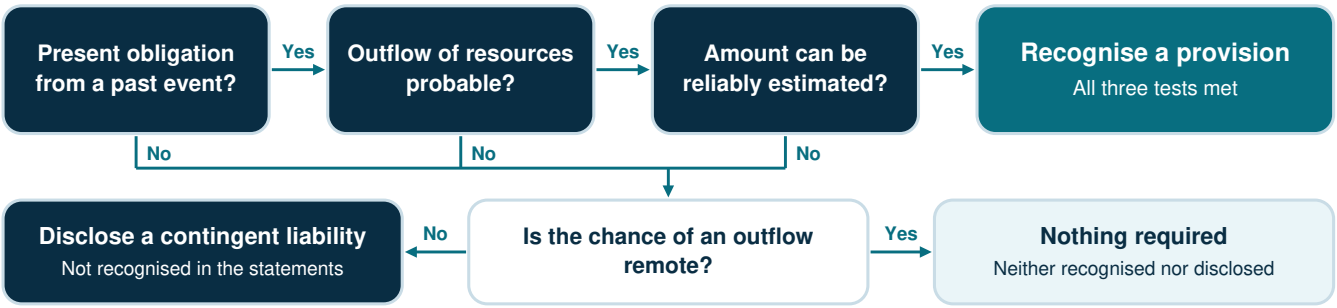
The Australian standard. ASA 502 Audit Evidence - Specific Considerations for Litigation and Claims sets these requirements; ASA 501 now deals only with inventory and segment information. (Internationally, ISA 501 covers all three.) The letter of enquiry isn't optional: when the trigger is met, the auditor must seek direct communication with the external lawyers through a letter that management prepares and the auditor sends.

Two kinds of letter

	General enquiry	Specific enquiry
What it asks	The lawyers list any litigation and claims they know of, with their view of the outcome and an estimate of the financial effect, including costs	The letter lists each matter with management's assessment and estimate; the lawyers confirm whether those are reasonable and say if the list is incomplete or wrong
When it's used	Where the lawyers can be expected to answer an open request	When lawyers are unlikely to answer a general request, for example because their professional body discourages it. ASA 502's example letter takes this form

Further ASA 502 requirements. If an in-house lawyer has primary responsibility for litigation and is best placed to corroborate management, the auditor tries to obtain a similar letter from them. If a lawyer's reply materially disagrees with management's evaluation, the auditor discusses it with management and the lawyers. For a matter that is a significant risk, complex or disputed, the auditor may also meet the lawyers, normally with management's permission and a representative of management present.

Provision, contingent liability or nothing?



Contingent liability VOLTANA

Class action (Federal Court, May 2026)

Customers say batteries lost capacity faster than the marketing promised. Lawyers: early stage; liability possible, not probable; no reliable estimate yet. Disclose its nature and, where practicable, an estimate of its financial effect and the uncertainties.

Provision VOLTANA

Overseas cell supplier's claim

About $2.4m claimed after Voltana cancelled orders. Lawyers expect a settlement between $1.2m and $1.6m. Management's $1.4m provision sits inside that range, so it's supported.

The accounting rules (AASB 137). Recognise a provision when there's a present obligation from a past event, an outflow of resources is probable, and the amount can be reliably estimated. A contingent liability is disclosed but not recognised: an obligation that is only possible, or a present obligation where an outflow isn't probable or the amount can't be measured reliably. If the chance of an outflow is remote, nothing is required.

Voltana's two legal matters

The board minutes and large legal payments in May and June pointed to two matters. Linden Ridge received the lawyers' replies directly.

Matter	Management	The lawyers' replies	Conclusion
Overseas cell supplier's claim for about $2.4m after cancelled orders	Provision of $1.4m	Likely to settle for $1.2m to $1.6m	All three tests met; $1.4m sits inside the range: provision supported
Class action filed in the Federal Court in May 2026: batteries lost capacity faster than the marketing promised	Nothing recorded	Early stage; liability possible but not probable; no reliable estimate yet	Contingent liability: disclose its nature and, where practicable, an estimate of its financial effect and the uncertainties. The team checks the draft note

When the lawyer won't answer

Lawyers may limit a reply to protect legal professional privilege, and that's accepted. A refusal is different: management won't allow contact, or the lawyers won't respond appropriately. The auditor then tries alternative procedures, such as:

- asking management and those charged with governance more about each matter;
- arranging a discussion with management and the lawyers together, if possible;
- reading the board minutes and other documents management holds, and examining the lawyers' invoices;
- the auditor's right (section 310) to information and explanations from the company's officers.

If they can't provide sufficient appropriate evidence, the **scope of the audit is limited** and the opinion must be modified: qualified if the possible effects are material, a disclaimer if they could be both material and pervasive (Exam Reference Pack, page 8). Management's word is no substitute: it has the most interest in the answer.

Practice questions

MODULE 4 | 4.1.1 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Searching for legal matters

Steerwell Driving Schools Ltd (imagined) runs 38 driving schools in New South Wales and the ACT, with about 150 instructors, some employed and some on contracts. It has no in-house lawyer and uses two external law firms. This year a learner was hurt when a Steerwell car was hit at an intersection, four schools closed before their leases ended, and the state transport regulator reviewed its instructors' accreditation records. List the procedures you would use to identify litigation and claims, and what each could reveal.

Question 2 - Provision, disclosure or nothing?

For each matter, decide whether Steerwell needs a provision, a contingent liability disclosure, or nothing, and explain why.

Legal matter at 30 June	Your decision	Why
(a) A former instructor's unfair dismissal claim. The lawyers expect it to succeed and to settle for about $45,000.		
(b) Thirty contract instructors have started a Federal Court claim that they were really employees, seeking superannuation and leave. The lawyers say it's at an early stage, could go either way, and can't yet be estimated.		
(c) In 2025 a rival school complained that a Steerwell advertisement copied its slogan. Nothing has happened since, and the lawyers think any claim would be very unlikely to succeed.		
(d) The landlord of a closed school claims $90,000 to restore the premises under the lease. The lawyers say Steerwell will probably have to pay, most likely about $70,000.		

Question 3 - No contact with the lawyers

Steerwell's managing director refuses to let you write to its lawyers about the instructors' claim, saying a letter could damage the company's position in court. How would you respond?

Worked answers

MODULE 4 | 4.1.1 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Steerwell Driving Schools (sample answer)

- **Enquiries of management:** the managing director, finance manager and operations manager, about current, threatened and possible claims: the injured learner, the closed schools, instructor disputes, the regulator.
- **Minutes:** board and committee minutes for the year and up to the report date, for legal matters, settlements, the closures and the regulator's findings.
- **Correspondence with both law firms:** it can reveal matters management hasn't mentioned, and their status.
- **Legal expense accounts:** match every invoice to a matter; a firm or matter not on management's list needs following up.
- **Related records:** the insurance claim for the crash, the regulator's letters, the leases and landlords' letters for the closed schools, and instructors' contracts.
- **Letter of enquiry and representations:** given the risks, management prepares a letter of specific enquiry to both firms, which you send and they answer directly to you; at the end, management confirms in writing that all known actual or possible litigation and claims are disclosed and accounted for.

Question 2 - The four matters

	Decision	Why
(a)	Provision, about $45,000	Present obligation from a past event (the dismissal); outflow probable; reliable estimate
(b)	Contingent liability: disclose	Whether anything is owed depends on the court, so the obligation is only possible, and there's no reliable estimate. Disclose its nature and the uncertainties; consider whether other contractors could claim too
(c)	Nothing	An outflow is remote: no provision and no disclosure
(d)	Provision, about $70,000	The lease created the obligation before year end; payment is probable; the most likely outcome is a reliable estimate (the $90,000 is the landlord's opening claim)

Question 3 - The managing director refuses (sample answer)

- **Understand and explain:** ask what worries the managing director; explain that ASA 502 requires you to seek direct communication with the lawyers when there's a risk of material misstatement, and that the lawyers can limit their reply to protect privilege. Offer a meeting with management present.
- **Go to those charged with governance:** ask the board or audit committee to permit the letter.
- **Reassess:** blocking a check on a significant claim raises questions about management's integrity and its other representations.
- **Try alternative procedures:** further enquiries of management and the board, the minutes and documents about the claim (including court filings), the lawyers' invoices, and your section 310 right to information and explanations from officers.
- **Decide the opinion:** if evidence is still insufficient, management has limited the scope of the audit: qualify if the possible effects are material but not pervasive; disclaim if they could be both. Document it all.