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## Proposed Statement on Auditing Standards: Consideration of laws and Regulations in an Audit of Financial Statements; Exposure Draft (American Institute of Certified Public Accountants) 2009, January 30

American Institute of Certified Public Accountants. Auditing Standards Board

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# EXPOSURE DRAFT

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## PROPOSED STATEMENT ON AUDITING STANDARDS

### CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

*(To supersede Statement on Auditing Standards No. 54, Illegal Acts by Clients [AICPA, Professional Standards, vol. 1, AU sec. 317])*

**January 30, 2009**

**Comments are requested by May 29, 2009**

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be addressed to Sherry Hazel at [shazel@aicpa.org](mailto:shazel@aicpa.org).

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## EXPLANATORY MEMORANDUM

### Introduction

This memorandum provides background to proposed Statement on Auditing Standard (SAS) *Consideration of Laws and Regulations in an Audit of Financial Statements*. This proposed SAS would supersede SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec 317). The accompanying proposed SAS represents the inclusion of comments by the Auditing Standards Board's (ASB's) clarity drafting conventions and convergence with International Standard on Auditing (ISA) 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* as discussed in the following sections.<sup>1</sup>

### Background

#### Clarity

To address concerns over the clarity, length, and complexity of its standards, the ASB is making a significant effort to clarify the SASs.<sup>2</sup> The ASB issued a discussion paper titled *Improving the Clarity of ASB Standards*<sup>3</sup> in March 2007. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions and has undertaken the revision of all of SASs in accordance with those conventions. The proposed SAS has been drafted in accordance with the ASB's clarity drafting conventions, which include the following:

- Establishing objectives for each of the standards
- Including a definitions section, where relevant, in the standards
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A-prefix and presenting them in a section following the requirements section
- Using formatting techniques, such as bullet lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard
- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard

#### Convergence

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<sup>1</sup> The *Clarity Project Explanatory Memorandum* provides a more detailed discussion of the Auditing Standards Board (ASB) Clarity Project.

<sup>2</sup> The pamphlet *Clarification and Convergence* provides information about the ASB's clarity project and can be viewed at [www.aicpa.org/download/auditstd/ASB\\_Clarify\\_%20and\\_Convergence\\_\(8.5x11\).pdf](http://www.aicpa.org/download/auditstd/ASB_Clarify_%20and_Convergence_(8.5x11).pdf).

<sup>3</sup> The discussion paper is available online at [http://www.aicpa.org/download/auditstd/Clarity\\_of\\_ASB\\_Standards\\_Discussion\\_Memo.pdf](http://www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf).

Consistent with the ASB's strategy to converge its standards with those of the International Auditing and Assurance Standards Board,<sup>4</sup> the proposed SAS has been drafted using ISA 250 as a base. Differences between this proposed SAS and ISA 250, for which the ASB believes no compelling reason exists, have been eliminated. Differences in objectives, definitions, or requirements between the proposed SAS and ISA 250 are identified in exhibit A.

The ASB has made various changes to the language of ISA 250 to use terms or phrases that are more commonly used in the United States and to tailor examples and guidance to the U.S. environment. The ASB believes that such changes will not create differences between the application of ISA 250 and the application of the proposed SAS.

## **Effective Date**

The proposed SAS would be effective for audits of financial statements for periods beginning on or after December 15, 2010. This effective date is provisional but will not be earlier than December 15, 2010.

## **Changes From Existing Standards**

The following changes to existing standards summarize what the ASB believes would be the most significant changes to existing standards if the proposed standard was issued. The supplementary materials accompanying this exposure draft illustrate detailed changes made to SAS No. 54.

- Paragraph 14 of the proposed SAS requires the performance of procedures to identify instances of noncompliance with those laws and regulations that may have a material effect on the financial statements (those laws and regulations described in paragraph 6*b* of the proposed SAS). Specifically, paragraph 14*b* requires the auditor to inspect correspondence, if any, with the relevant licensing or regulatory authorities. This procedure is not required by AU section 317. This change in requirements will affect current practice.
- Paragraph .07 of AU section 317 states that an audit performed in accordance with generally accepted auditing standards (GAAS) provides no assurance that noncompliance with laws and regulations will be detected or that any contingent liabilities that may result will be disclosed. However, paragraph 5 of the proposed SAS states that because of the inherent limitations of an audit, some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. The concept of "no assurance" is different from the concept described as "inherent limitations of an audit." However, the differing descriptions of these concepts will not change current practice.
- Paragraph .08 of AU section 317 requires obtaining a written representation from management concerning the absence of noncompliance with laws or regulations.

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<sup>4</sup> The ASB's convergence paper is available online at [www.aicpa.org/download/auditstd/ASB\\_Convergence\\_Plan.pdf](http://www.aicpa.org/download/auditstd/ASB_Convergence_Plan.pdf).

ISA 250 also contains this requirement. The ASB has decided to move this requirement to AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1). Although the location of the requirement will differ from extant standards and ISA 250, the requirement will remain in GAAS. This will not change current practice.

### **Issue for Consideration**

The ASB asks respondents specifically to consider whether the wording of paragraph 12*b* of the proposed SAS imposes a requirement beyond that in extant U.S. standards.

As drafted, paragraph 12*b* of the proposed SAS requires the auditor to obtain a general understanding of how the entity is complying with the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates. The application material in paragraph A7 provides examples of how this requirement may be fulfilled—mainly through updating the existing understanding of the industry, becoming aware of regulatory and other external factors, updating the understanding of those laws and regulations described in paragraph 6*a*, and making inquiries of management. Currently, the extant SAS (paragraph .08 of AU section 317) requires only inquiries of management to obtain this information.

Respondents are asked whether they believe that paragraph 12*b*, by not specifying that inquiries alone may fulfill the requirement, expands the auditor’s responsibility, and if so, whether the expansion is appropriate.

### **Guide for Respondents**

The ASB is seeking comments specifically on changes resulting from applying the clarity drafting conventions and converging with the ISA, and their effect on the content of the proposed SAS. Respondents are asked to respond, in particular, to the following questions:

1. Are the auditor’s objectives appropriate?
2. Are the revisions from the existing standards to converge with ISA 250 appropriate?
3. Are the differences between the proposed SAS and ISA 250 identified in exhibit A, and other language changes, appropriate?
4. Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

Comments are most helpful when they refer to specific paragraphs; include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA for one

year, beginning May 29, 2009. Responses should be sent to Sherry Hazel at [shazel@aicpa.org](mailto:shazel@aicpa.org).

### **Supplements to the Exposure Draft**

To assist respondents in identifying changes and responding to this request to comment on the proposed SAS, the Audit and Attest Standards staff has prepared supplementary material that compares ISA 250, the proposed SAS, and extant AU section 317. The schedule has four columns containing the following:

1. ISA 250
2. New material in the proposed SAS shown underlined and deleted material shown in strikethrough
3. Requirements and guidance in extant AU section 317 mapped against the proposed SAS to demonstrate how the material in AU section 317 has been reflected in the proposed SAS
4. Comments and rationale

This staff-prepared supplementary material is available on the AICPA Web site at [http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/Consideration of Laws and Regulations in an Audit of Financial Statements.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/Consideration+of+Laws+and+Regulations+in+an+Audit+of+Financial+Statements.htm). It is for information purposes only and does not form part of the exposure draft.

### **Comment Period**

The comment period for this exposure draft ends on May 29, 2009.

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**Consideration of Laws and Regulations in an Audit of Financial Statements**

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# **Proposed Statement on Auditing Standards *Consideration of Laws and Regulations in an Audit of Financial Statements***

## **Introduction**

### **Scope of This Statement on Auditing Standards**

1. This Statement on Auditing Standards (SAS) addresses the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. This SAS does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.<sup>1</sup>

### *Effect of Laws and Regulations*

2. The effect on financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management, or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health, and equal employment opportunity). Noncompliance with laws and regulations may result in fines, litigation, or other consequences for the entity that may have a material effect on the financial statements.

### *Responsibility of Management for Compliance With Laws and Regulations*

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. (Ref: par. A1–A2)

### *Responsibility of the Auditor* (Ref: par. A3–A6)

4. The requirements in this SAS are designed to assist the auditor in identifying material misstatement of the financial statements due to noncompliance with laws and

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<sup>1</sup> AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1) addresses compliance audits performed in accordance with generally accepted auditing standards, the standards for financial audits under *Government Auditing Standards*, and government audit requirements.

regulations. However, the auditor is not responsible for preventing noncompliance and cannot be expected to detect noncompliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, as a whole, are free from material misstatement, whether caused by fraud or error.<sup>2</sup> In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with generally accepted auditing standards.<sup>3</sup> In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for the following reasons:

- Many laws and regulations relating principally to the operating aspects of an entity typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls, or intentional misrepresentations being made to the auditor.
- Whether an act constitutes noncompliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed noncompliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of or recognize the noncompliance.

6. This SAS distinguishes the auditor's responsibilities in relation to compliance with the following two categories of laws and regulations:

- a. The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations (see paragraph 13)
- b. Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations);

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<sup>2</sup> Proposed SAS *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, paragraph 11.

<sup>3</sup> Proposed SAS *Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, paragraph A48.

noncompliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14)

7. In this SAS, differing requirements are specified for each of the previously mentioned categories of laws and regulations. For the category referred to in paragraph 6a, the auditor's responsibility is to obtain sufficient appropriate audit evidence about material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations. For the category referred to in paragraph 6b, the auditor's responsibility is limited to undertaking specified audit procedures that may identify noncompliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this SAS to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected noncompliance with laws and regulations to the auditor's attention. Maintaining an attitude of professional skepticism throughout the audit, as required by paragraph 15 of proposed SAS *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, is important in this context, given the extent of laws and regulations that affect the entity.

### **Effective Date**

9. This proposed SAS would be effective for audits of financial statements for periods beginning on or after December 15, 2010.<sup>4</sup>

### **Objectives**

10. The objectives of the auditor are to

- a. obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations generally recognized to have a direct effect on their determination (see paragraph 6a);
- b. perform specified audit procedures that may identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements (see paragraph 6b); and
- c. respond appropriately to noncompliance or suspected noncompliance with laws and regulations identified during the audit.

### **Definition**

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<sup>4</sup> This date is provisional but will not be before December 15, 2010.

11. For the purposes of this SAS, the following term has the meaning attributed below:

**Noncompliance.** Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management, or employees. Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

## Requirements

### The Auditor's Consideration of Compliance With Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with paragraph 12 of proposed SAS *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the auditor should obtain a general understanding of

- a. the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates, and
- b. how the entity is complying with that framework. (Ref: par. A7)

13. The auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations generally recognized to have a direct effect on their determination (see paragraph 6a). (Ref: par. A8–A10)

14. The auditor should perform the following audit procedures that may identify instances of noncompliance with other laws and regulations that may have a material effect on the financial statements (see paragraph 6b). (Ref: par. A11–A14):

- a. Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
- b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. (Ref: par. A15)

15. During the audit, the auditor should remain alert to the possibility that other audit procedures applied may bring instances of noncompliance or suspected noncompliance with laws and regulations to the auditor's attention. (Ref: par. A16)

16. In the absence of identified or suspected noncompliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 12–16.

### **Audit Procedures When Noncompliance Is Identified or Suspected**

17. If the auditor becomes aware of information concerning an instance of noncompliance or suspected noncompliance with laws and regulations, the auditor should obtain (Ref: par. A18)

- a. an understanding of the nature of the act and the circumstances in which it has occurred; and (Ref: par. A19)
- b. further information to evaluate the possible effect on the financial statements. (Ref: par. A20)

18. If the auditor suspects there may be noncompliance, the auditor should discuss the matter with management (at a level above those involved with the noncompliance, if possible) and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected noncompliance may be material to the financial statements, the auditor should consider the need to obtain legal advice. (Ref: par. A21–A22)

19. If sufficient information about suspected noncompliance cannot be obtained, the auditor should evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

20. The auditor should evaluate the implications of noncompliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. (Ref: par. A23–A24)

### **Reporting of Identified or Suspected Noncompliance**

#### *Reporting Noncompliance to Those Charged With Governance*

21. Unless all of those charged with governance are involved in management of the entity and are aware of matters involving identified or suspected noncompliance already communicated by the auditor,<sup>5</sup> the auditor should communicate with those charged with governance matters involving identified or suspected noncompliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential. (Ref: par. A25)

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<sup>5</sup> Proposed SAS *The Auditor's Communication With Those Charged With Governance* (Redrafted), paragraph 9.

22. If, in the auditor's judgment, the noncompliance referred to in paragraph 21 is believed to be intentional and material, the auditor should communicate the matter to those charged with governance as soon as practicable.

23. If the auditor suspects that management or those charged with governance are involved in noncompliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor should consider the need to obtain legal advice.

#### *Reporting Noncompliance in the Auditor's Report on the Financial Statements*

24. If the auditor concludes that the noncompliance has a material effect on the financial statements, and it has not been adequately reflected in the financial statements, the auditor should, in accordance with paragraphs 20–60 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1) express a qualified or adverse opinion on the financial statements. (Ref: par. A26)

25. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements has, or is likely to have, occurred, the auditor should express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with AU section 508. (Ref: par. A26)

26. If the auditor is unable to determine whether noncompliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor should evaluate the effect on the auditor's opinion in accordance with AU section 508.

#### *Reporting Noncompliance to Regulatory and Enforcement Authorities*

27. If the auditor has identified or suspects noncompliance with laws and regulations, the auditor should determine whether the auditor has a responsibility to report the identified or suspected noncompliance to parties outside the entity. (Ref: par. A27–A28)

#### **Documentation**

28. The auditor should document identified or suspected noncompliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance, and other parties both inside and outside the entity. (Ref: par. A29)

## **Application and Other Explanatory Material**

### **Responsibility for Compliance With Laws and Regulations**

*Responsibility of Management for Compliance With Laws and Regulations* (Ref: par. 3)

A1. Management, with the oversight of those charged with governance, is responsible for ensuring that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements, or they may prescribe the applicable financial reporting framework. They may also establish certain legal rights and obligations of the entity, some of which will be recognized in the entity's financial statements. In addition, laws and regulations may provide for the imposition of penalties in cases of noncompliance.

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of noncompliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements
- Instituting and operating appropriate systems of internal control
- Developing, publicizing, and following a code of conduct
- Ensuring employees are properly trained and understand the code of conduct
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it
- Engaging legal advisors to assist in monitoring legal requirements
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function
- An audit committee
- A legal function
- A compliance function

*Responsibility of the Auditor* (Ref: par. 4–8)

A3. Noncompliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of noncompliance, regardless of

materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management or employees.

A4. Whether an act constitutes noncompliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognize that some acts, coming to the auditor's attention, may constitute noncompliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, AU section 508 sets forth how these audit responsibilities are addressed in the auditor's report. Furthermore, where specific statutory reporting requirements exist, it may be necessary for the audit plan to include appropriate tests for compliance with these provisions of the laws and regulations.

#### *Considerations Specific to Governmental Entities*

A6. Governmental entities may have additional audit responsibilities with respect to the consideration of laws and regulations, which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

### **The Auditor's Consideration of Compliance With Laws and Regulations**

#### *Obtaining an Understanding of the Legal and Regulatory Framework (Ref: par. 12)*

A7. To obtain a general understanding of the legal and regulatory framework and how the entity complies with that framework, the auditor may, for example

- use the auditor's existing understanding of the entity's industry, regulatory, and other external factors;
- update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements.
- inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations (including the prevention of noncompliance), if appropriate;
- inquire of management regarding the policies or procedures adopted for identifying, evaluating, and accounting for litigation claims; and
- inquire of management regarding the use of directives issued by the entity and periodic representations obtained by the entity from management at appropriate levels of authority concerning compliance with laws and regulations.

*Laws and Regulations Generally Recognized to Have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements* (Ref: par. 13)

A8. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6a). These laws and regulations generally are (1) directly relevant to the determination of material amounts and disclosures in the financial statements and readily evident to the auditor as such, and (2) limited in number. They could include those that relate to, for example

- the form and content of financial statements (for example, statutorily-mandated requirements);
- industry-specific financial reporting issues;
- accounting for transactions under government contracts (for example, laws and regulations that may affect the amount of revenue to be accrued); or
- the accrual or recognition of expenses for income tax or pensions costs.

A9. Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), whereas others may be relevant to the financial statements as a whole. The auditor's responsibility to detect and report misstatements resulting from noncompliance with laws and regulations having a direct effect on the determination of material amounts and disclosures in the financial statement is the same as that for misstatements caused by error or fraud as described in proposed SAS *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

A10. Noncompliance with other laws and regulations (those described in paragraph 6b) may result in fines, litigation, or other consequences for the entity, the costs of which may need to be provided for or disclosed in the financial statements but are not considered to have a direct effect on the financial statements as described in paragraph 6a.

*Procedures to Identify Instances of Noncompliance—Other Laws and Regulations* (Ref: par. 14)

A11. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6b). Noncompliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations or call into question the entity's continuance as a going concern. For example, noncompliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, noncompliance with capital or investment requirements).

A12. Many laws and regulations relating principally to the operating aspects of the entity do not affect the financial statements (their financial statement effect is indirect) and are not captured by the entity's information systems relevant to financial reporting. Those other laws or regulations may include those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of identified or suspected noncompliance.

A13. An auditor ordinarily does not have sufficient basis for recognizing possible noncompliance with such laws and regulations. Even when noncompliance with such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the noncompliance unless he or she is informed by management, or evidence exists of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

A14. Because the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 14 are directed to bring to the auditor's attention instances of noncompliance with laws and regulations that may have a material effect on the financial statements.

A15. In some regulatory environments, the amount of an entity's correspondence with licensing or regulatory authorities is voluminous. In using his or her judgment in such circumstances, the auditor may consider the following to determine the extent of inspection that may identify instances of noncompliance:

- The nature of the entity
- The nature and type of correspondence

*Noncompliance Brought to the Auditor's Attention by Other Audit Procedures* (Ref: par. 15)

A16. Audit procedures applied to form an opinion on the financial statements may bring instances of noncompliance or suspected noncompliance with laws and regulations to the auditor's attention. For example, such audit procedures may include

- reading minutes;
- inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims, and assessments; and
- performing substantive tests of details of classes of transactions, account balances, or disclosures.

A17. Because the effect of laws and regulations on financial statements can vary considerably, written representations as required by paragraph 6 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1) provide necessary audit evidence about management's knowledge of identified or suspected noncompliance with laws and regulations, the effects of which may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the auditor.<sup>6</sup>

### **Audit Procedures When Noncompliance is Identified or Suspected**

*Indications of Noncompliance With Laws and Regulations* (Ref: par. 17)

A18. When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of noncompliance with laws and regulations:

- Investigations by regulatory organizations and government departments or payment of fines or penalties
- Payments for unspecified services or loans to consultants, related parties, employees, or government officials or government employees
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received
- Purchases made at prices significantly above or below market price
- Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer, or transfers to numbered bank accounts
- Unusual transactions with companies registered in tax havens
- Payments for goods or services made other than to the country from which the goods or services originated
- Existence of an information system that fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence
- Unauthorized transactions or improperly recorded transactions
- Adverse media comment
- Noncompliance with laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor
- Failure to file tax returns or pay government duties or similar fees that are common to the entity's industry or the nature of its business

*Obtaining an Understanding of an Act of Identified or Suspected Noncompliance* (Ref: par. 17a)

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<sup>6</sup> AU section 333, par. .02-.04.

A19. Procedures an auditor may perform to obtain an understanding of the nature of identified or suspected noncompliance and the circumstances in which it has occurred include the following:

- Examining supporting documents, such as invoices, cancelled checks, and agreements, and comparing with accounting records
- Confirming significant information concerning the matter with the other party to the transaction or with intermediaries, such as banks or lawyers
- Determining whether the transaction has been properly authorized
- Considering whether other similar transactions or events may have occurred, and applying procedures to identify them

*Matters Relevant to the Auditor's Evaluation* (Ref: par. 17b)

A20. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include

- the quantitative and qualitative materiality of the effect of noncompliance. The potential financial consequences of noncompliance with laws and regulations on the financial statements may include the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation. For example, an illegal payment of an otherwise immaterial amount could be material if a reasonable possibility exists that it could lead to a material contingent liability or a material loss of revenue.
- whether the potential financial consequences require disclosure. For example, if material revenue or earnings are derived from transactions involving noncompliance, or if noncompliance creates significant risks associated with material revenue or earnings, such as loss of a significant business relationship, that information may require disclosure. Loss contingencies resulting from noncompliance that may require disclosure may be evaluated in the same manner as other loss contingencies under FASB Statement No. 5.
- whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

*Audit Procedures* (Ref: par. 18)

A21. The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of noncompliance with laws and regulations.

A22. If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. The auditor may request management to arrange for such consultation with the entity's legal counsel. When it is not considered appropriate to consult with the entity's legal counsel or when the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult the auditor's own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud, and what further action, if any, the auditor would take.

*Evaluating the Implications of Noncompliance* (Ref: par. 20)

A23. As required by paragraph 20, the auditor evaluates the implications of noncompliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of noncompliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

A24. In rare cases the auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the noncompliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. Factors that may affect the auditor's conclusion may include the implications of the failure to take remedial action, which may affect the auditor's ability to rely on management representations, and the effects of continuing association with the entity. If withdrawal from the engagement is prohibited, the auditor may consider alternative actions, including describing the noncompliance in an Other Matter(s) paragraph in the auditor's report.<sup>7</sup>

### **Reporting of Identified or Suspected Noncompliance**

*Reporting Noncompliance to Those Charged With Governance* (Ref: par. 21)

A25. The communication may describe the act of identified or suspected noncompliance, the circumstances of its occurrence, and the effect on the financial statements. To avoid communicating matters that are clearly inconsequential, the auditor may reach agreement in advance with those charged with governance on the nature of such matters to be communicated. Management may wish to have its remedial actions communicated to

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<sup>7</sup> AU section 508

those charged with governance simultaneously. Possible remedial actions include disciplinary action against involved personnel, seeking restitution, adoption of preventive or corrective company policies, and modifications of specific control activities, including monitoring controls.

*Issuance of a Modified Opinion on the Financial Statements* (Ref: par. 24–25)

A26. If management or those charged with governance refuse to accept a modified opinion on the financial statements for the circumstances described in paragraphs 24 and 25, the auditor may withdraw from the engagement and indicate the reasons for withdrawal in writing to those charged with governance.

*Reporting Noncompliance to Regulatory and Enforcement Authorities* (Ref: par. 27)

A27. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected noncompliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary by jurisdiction and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law, or courts of law. In the following circumstances a duty to notify parties outside the entity may exist:

- To a successor auditor when the successor makes inquiries in accordance with AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1)
- In response to a subpoena
- To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may consult with legal counsel before discussing noncompliance with parties outside the entity.

*Considerations Specific to Governmental Entities*

A28. The auditor of a governmental entity may be required to report on compliance with laws, regulations, and provisions of contracts or grant agreements as part of the audit of the governmental entity's financial statements, for example in an audit conducted in accordance with *Government Auditing Standards*. The auditor may also be required to communicate instances of noncompliance to appropriate oversight bodies and funding agencies.

**Documentation** (Ref: par. 28)

A29. The auditor's documentation of findings regarding identified or suspected noncompliance with laws and regulations may include, for example,

- copies of records or documents.
- minutes of discussions held with management, those charged with governance, or other parties inside or outside the entity.

*Exhibit A: Comparison of Proposed Statement on Auditing Standards Consideration of Laws and Regulations in an Audit of Financial Statements With International Standard on Auditing 250, Consideration of Laws and Regulations in an Audit of Financial Statements*

This analysis was prepared by the Audit and Attest Standards staff to highlight substantive differences between proposed Statement on Auditing Standards *Consideration of Laws and Regulations in an Audit of Financial Statements*, with International Standard on Auditing 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* and the rationale thereof. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board.

The Auditing Standards Board (ASB) has made various changes to the language throughout proposed Statement on Auditing Standards (SAS) *Consideration of Laws and Regulations in an Audit of Financial Statements*, as compared with International Standard on Auditing (ISA) 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. The changes to the proposed SAS include

- in paragraphs 10a and 13, changing the phrase *compliance with* to *material amounts and disclosures in the financial statements that are determined by*; changing *the determination* to *their determination*; and deleting *of material amounts and disclosures in the financial statements* at the end of the sentence, to address the ASB's concerns that the ISA language expanded the auditor's responsibility to encompass all aspects of those laws and regulations described in paragraph 6a of the proposed standard, as opposed to focusing on the amounts and disclosures included in the financial statements. The ASB has discussed this issue with the International Auditing and Assurance Standards Board, and the wording in the proposed SAS reflects the intent of the ISA.
- in paragraphs 10b and 14, changing *to help identify* to *that may identify*. The ASB believes that the wording of the SAS better conveys the intent of the ISA.
- in paragraph 18, adding the phrase (*at a level above those involved with the noncompliance, if possible*).

Such changes have been made to make the proposed SAS easier to read and apply. The ASB believes that such changes will not create differences between the application of ISA 250 and the application of the proposed SAS.

Paragraph 16 of ISA 250 requires the auditor to request that management and, where appropriate, those charged with governance provide written representations regarding known or suspected instances of noncompliance with relevant laws and regulations. The

ASB believes this requirement is more appropriately placed in AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1). The placement of these requirements does not create differences between the ISAs as a whole and generally accepted auditing standards as a whole.