



International Federation of Accountants

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Agenda Item 10

Committee: IAASB

Meeting Location: New York

Meeting Date: February 13-16, 2007

The Auditor's Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements

Objective of Agenda Item

1. The objective of this Agenda Item is to review, for approval and issue as an Exposure Draft, the proposed redrafted ISA 250, "The Auditor's Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements" based on the clarity conventions and format adopted by the IAASB.

Task Force Members

2. The Task Force members are:

Ian McPhee IAASB Member
Richard Mifsud (Technical Advisor)

The redrafting support was provided by the Australian Auditing and Assurance Standards Board (AUASB) Technical Group and in particular by Howard Pratt, Michael Sadhu and Chiara Carotenuto.

Introduction

3. The extant ISA 250 was last amended for certain conforming changes arising from the issue of the audit risk standards in 2004, effective for audits of financial statements for periods beginning on or after December 15, 2004. The Task Force was asked to redraft ISA 250 ("Redrafted ISA 250") in accordance with the IAASB's Clarity conventions. Working drafts of the Redrafted ISA 250 were also made available to the Clarity Task Force and IFAC staff. In redrafting ISA 250, the Task Force has considered the comments of the Clarity Task Force and IFAC staff.

Matters for IAASB Consideration

PART I

Suggested basis for reviewing the accompanying material

4. The Task Force has followed a two-step approach to redrafting ISA 250. However, it has highlighted in a single document (see Agenda Item 10-B) all proposed changes to be

incorporated into the Redrafted ISA 250. In Agenda Item 10-B, the proposed amendments are differentiated and separated into the following categories:

- (a) The clarity changes (see explanation below) comprising those required to conform with the clarity drafting conventions, which are shown as marked-up text in Agenda Item 10-B— ‘Level 1’ changes, including proposed elevations and deletions as between the extant ISA 250 and Redrafted ISA 250 (see shaded text in Agenda Item 10-B); and
- (b) Those matters or more significant issues that have a substantive impact on Redrafted ISA 250. These proposed changes are identified in Agenda Item 10-B— ‘Level 2’ changes; highlighted by the surrounding bolded border text, indicating amendments made to align the extant ISA 250 with recently revised ISAs and exposure drafts issued in the clarity format.

Differentiating and categorizing the respective changes in this manner allows identification and distinction between those proposed changes that are required to implement the clarity drafting conventions, and the other proposed changes that have been required to align the extant ISA 250 with recently revised ISAs and exposure drafts issued in the clarity format.

5. Accordingly, the IAASB’s review of the attached material may be assisted if it is read in the following sequence:
 - (i) Commence with Agenda Item 10-B, as this document shows all proposed changes. Agenda Item 10-C (Disposition of the Present Tense), Agenda Item 10-D (Mapping Document) and Part I of this Paper, which provide additional explanation of the proposed ‘Level 1’ changes.
 - (ii) Then, for the purposes of reviewing the proposed ‘Level 2’ changes, review Agenda Item 10-B, along with the explanations contained in Part II of this Paper. The discussion at Part II in this Paper provides details of the more significant issues identified.

Proposed ‘Level 1’ amendments to implement elementary clarity changes

6. The amendments to implement the elementary clarity changes or drafting conventions that have been adopted for Redrafted ISA 250 are:
 - a. Re-ordering the extant ISA 250 into the clarity format.
 - b. Setting the objective, using the form and wording discussed at the September 2006 IAASB meeting.
 - c. Changing “should” to “shall”.
 - d. Redrafting text containing the present tense (see Agenda Item 10-C Disposition of the Present Tense). See below for further details regarding proposed elevations, deletions and other related matters.
 - e. Integrating public sector paragraphs into the body of the ISA.
 - f. Re-formatting lengthy paragraphs or sentences into bullet points etc. to improve readability.
 - g. Minor editorial changes to improve readability and expression.

The comments below provide additional explanations of the 'Level 1' changes, which are considered appropriate to bring to the attention of the IAASB.

A. PROPOSED ELEVATIONS

Auditor to Assess the Need to Obtain Legal Advice

7. In both the following circumstances, the Task Force considered it was appropriate to elevate explanatory guidance in the extant ISA 250, concerning the auditor's consideration of the need to obtain legal advice.

[REDRAFTED ISA 250 PARAGRAPH 17—EXTANT ISA 250 PARAGRAPH 29]

8. In the extant ISA 250 (paragraph 29), when management did not provide satisfactory information that it had complied with laws and regulations, the explanatory guidance directed the auditor to consult with the entity's lawyer about the application of laws and regulations. However, when it was not considered appropriate to consult with the entity's lawyer or their opinion wasn't acceptable to the auditor, the auditor was directed to consider consulting their own lawyer about whether a violation of a law or regulation was involved. The Task Force considered that it was appropriate to elevate this matter to a requirement because it involved the unsatisfactory resolution of a matter dealing with a situation where the auditor believes there may be non-compliance, though it seems more appropriate for the auditor decide in the circumstances, from whom to obtain legal advice.

[REDRAFTED ISA 250 PARAGRAPH 22—EXTANT ISA 250 PARAGRAPH 34]

9. It is proposed that the last sentence of the extant ISA paragraph 34 be elevated. Where the auditor believes senior management, including members of the board of directors or those charged with governance), may be involved in non-compliance with relevant laws and regulations and when a higher level of authority to which the auditor could report does not exist, then it would be prudent to require the auditor to assess the need to obtain legal advice. The Task Force considered it is preferable, in view of the seriousness of the circumstances covered by this paragraph, to state unequivocally that the auditor shall assess the need to obtain legal advice, rather than such an obligation being one which the auditor was implicitly required to consider, as per the extant ISA.
10. The proposed elevation was not supported by the IFAC SMP Committee because in their view the proposal was not entirely consistent with requirements in other ISAs, moreover, the obtaining of such advice was regarded as primarily for the benefit of the auditor, rather than enhancing audit quality. It needs to be noted, however, that the requirement does not mandate obtaining legal advice it only requires the auditor to assess the need for such advice.

Considerations When Evaluating Potential Financial Consequences of Non-compliance on the Financial Statements

[REDRAFTED ISA 250 PARAGRAPH 15—EXTANT ISA 250 PARAGRAPH 27]

11. In light of the inter-connection between the requirement to obtain further information to evaluate the possible effect on the financial statements, when the auditor becomes aware of information concerning a possible instance of non-compliance, and the matters that need to be evaluated

with regard to the possible effect on the financial statements, it was considered appropriate to elevate extant ISA 250 (paragraph 27) as a requirement in the Redrafted ISA 250 (paragraph 15), as there are matters that an auditor would be expected to consider in all cases.

B. PROPOSED DELETIONS

OBJECTIVES OF THE AUDITOR

[EXTANT ISA 250 PARAGRAPH 2 AND PARAGRAPH 13]

12. Extant ISA 250 contains the following requirements:

When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. (paragraph 2)

In accordance with ISA 200, “Objective and General Principles Governing an Audit of Financial Statements” the auditor should plan and perform the audit with an attitude of professional skepticism recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations. (paragraph 13)

13. With the adoption of objectives in the Redrafted ISA 250 (paragraph 7), articulation of the responsibilities of management and those charged with governance (paragraph 3) as well as the auditor (paragraph 4-5) respectively, the Task Force considered it was no longer necessary to include the above as requirements in the Redrafted ISA 250. It is clear in the proposed redrafted ISA what the auditor’s responsibilities are, and that there has been no diminution in the standard of audit required. Also, the IFAC SMP Committee was not convinced that paragraph 2 ought to be redrafted as a ‘shall’ requirement. The accompanying explanatory guidance, in Extant ISA 250 (paragraph 2), has been substantially retained (Redrafted ISA 250 paragraph A2). The content in extant ISA 250 (paragraph 13) now substantially covered in Redrafted ISA (paragraph 5) and the objectives (paragraph 7).

DELETION OF REFERENCE TO NATIONAL ACCOUNTING AND AUDITING STANDARDS

[EXTANT ISA 250 PARAGRAPH 6]

14. The explanatory guidance in the above paragraph in the extant ISA 250 refers to national accounting and auditing standards being likely to be more specific as to the relevance of laws and regulations to an audit. In the context of the clarity drafting conventions, the content of this paragraph is considered to be unnecessary and has been deleted.

DELETION OF REFERENCE TO ISA 240

[EXTANT ISA 250 PARAGRAPH 8]

15. The explanatory guidance in the above paragraph in the extant ISA 250 refers to guidance on the auditor’s responsibility to consider fraud and error in an audit that is provided in ISA 240. In the context of the clarity drafting conventions, the content of this paragraph is considered to be unnecessary and has been deleted as it only makes reference to ISA 240.

WITHDRAWAL FROM THE ENGAGEMENT

[EXTANT ISA 250 PARAGRAPH 40—REDRAFTED ISA 250 PARAGRAPH A20]

16. It is proposed to delete the requirements regarding the existing auditor’s obligation to advise the proposed auditor of any professional reasons why the proposed auditor should not accept the appointment. This is because:

- (a) These paragraphs make no specific mention about the impact of laws and regulations with respect to any consideration the auditor might undertake regarding withdrawal from an engagement; and
- (b) The requirement to comply with relevant ethical requirements relating to audit engagements is contained in ISA 200.

Instead, it is suggested the Application and Other Explanatory Material (paragraph A16) identify several exceptional circumstances that may cause the auditor to consider whether to withdraw from the engagement when, amongst other matters, non-compliance with laws and regulations involves the highest authority within the entity. The various exceptional circumstances that may prompt the auditor to consider withdrawal from the engagement, have been drawn from the extant ISA and proposed revised ISA 580, “Written Representations”.

C. DISPOSITION OF SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES

- 17. The IFAC SMP Committee has noted that no specific need exists for SME specific material in the Redrafted ISA 250. Accordingly, the Task Force did not see a strong case for the content of IAPS 1005 “The Special Considerations in the Audit of Small Entities” (paragraphs 39 and 40), which note that the legal and regulatory environment pertaining to smaller entities is normally uncomplicated compared with larger and more diversified entities and that the auditor ought to retain a permanent record of applicable industry specific laws and regulations, to be brought forward into the Redrafted ISA 250. Such matters are implicit within the Requirements and accompanying Application and Other Explanatory Material.

PART II

Proposed ‘Level 2’ Changes – Issues for the IAASB’s Attention

- 18. The following are the more significant issues that have been identified and are considered appropriate to bring to the attention of the IAASB, as these proposed changes reflect amendments that are considered necessary to align the extant ISA 250 with recently revised ISAs and exposure drafts issued in the clarity format.

A. RESTRUCTURING TO ACCOMMODATE MORE RECENT CHANGES TO ISAS / EDS

Communication with Those Charged with Governance

- 19. Extant 250 (paragraph 32) contains the following requirement:

The auditor should, as soon as practicable, either communicate with those charged with governance, or obtain audit evidence that they are appropriately informed, regarding noncompliance that comes to the auditor’s attention.

- 20. This requirement is now out of step with the clarity version of ISA 260, “Communication with Those Charged with Governance” which requires the auditor to communicate (directly) significant findings. Accordingly, the Task Force proposes that in the Redrafted ISA 250:
 - (a) Any significant findings involving non-compliance be communicated with those charged with governance (paragraphs 20 and A18); and

- (b) Any other findings involving non-compliance be communicated unless the auditor has obtained evidence that they have been appropriately informed or the matters are inconsequential (paragraph 20 and A18).
- 21. It is also proposed that the Redrafted ISA 250 cater for the circumstances when all of those charged with governance are involved in the management of the entity (Redrafted ISA 250 paragraph 20 and footnote 2).

Documentation

- 22. Extant ISA 250 (paragraph 28) contains the following requirement:
When the auditor believes there may be noncompliance, the auditor should document the findings and discuss them with management.
- 23. The redrafted ISA 230, “Documentation” requires the auditor to document discussions of significant matters with management and others, including when and with whom the discussion took place (paragraph 8).
- 24. Having regard to the above requirements, the Task Force has established a new documentation paragraph, which requires the auditor to document instances of identified or suspected non-compliance and discussions about such matters. In addition, it is proposed to include a requirement to document details of those involved in discussions and the date of discussions, consistent with redrafted ISA 230 (Redrafted ISA 250 paragraphs 27 and A22).

Written representations

- 25. The requirements in the extant ISA 250 (paragraph 23) regarding the auditor’s obligation to obtain written representation from management about disclosure of all known, actual or possible non-compliance with laws and regulations, has been redrafted (Redrafted ISA 250 paragraph 13 and A9 & A10) to allow for the possibility of representations from those charged with governance, consistent with proposed revised ISA 580.

Reporting Non-compliance to Regulatory and Enforcement Authorities

- 26. The explanatory guidance in the extant ISA 250 (paragraph 38) dealing with the auditor’s duty to report certain non-compliance with laws and regulations to regulatory authorities, and thus, the consequent overriding of the duty of confidentiality by statute, law or the courts, has been updated to align with the equivalent requirement, as contained in ISA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” (Redrafted ISA 250 paragraph 26 and A19-A21).

B. MANAGEMENT’S RESPONSIBILITY FOR COMPLIANCE WITH LAWS AND REGULATIONS THAT AFFECT THE FINANCIAL STATEMENTS

[REDRAFTED ISA 250 PARAGRAPH 3—EXTANT ISA 250 PARAGRAPH 9]

- 27. In the context of the audit of the entity’s financial statements, the auditor’s primary focus is on the extent to which the entity complies with those laws and regulations that have a material impact on the financial statements. In this regard, while emphasizing management’s responsibility regarding the entity’s compliance with laws and regulations applicable to its operations and detection of non-compliance therewith, it is important to also note that it is management’s responsibility, with the oversight of those charged with governance, to ensure the

entity complies with those laws and regulations that determine the form or content of the entity's financial statements. This has been articulated in Redrafted ISA 250 (paragraph 3(a)).

Material Presented (Note: Agenda Items 10-A will be used for purposes of the discussion at the meeting.)

Agenda Item 10-A (Pages 653-664)	Proposed ISA 250 (Redrafted) (Clean)
Agenda Item 10-B (Pages 665-680)	Proposed ISA 250 (Redrafted) (Marked up to reflect 'Level 1' proposed redrafting changes and 'Level 2' changes)
Agenda Item 10-C (Pages 681-688)	Disposition of the Present Tense in Extant ISA 250
Agenda Item 10-D (Pages 689-704)	ISA 250 Mapping Document

Action Requested

28. The IAASB is asked to consider the accompanying material and approve the Redrafted ISA 250 for issue as an Exposure Draft.

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