

**PROPOSED REDRAFTED ISA 250
THE AUDITOR'S RESPONSIBILITIES RELATING TO LAWS AND REGULATIONS
IN AN AUDIT OF FINANCIAL STATEMENTS**

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Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to laws and regulations when performing an audit of financial statements. This ISA does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Nature of Laws and Regulations

2. The impact on financial statements of laws and regulations varies considerably. Some laws or regulations determine the form or content of an entity's financial statements such as the amounts to be recorded or the disclosures to be made in financial statements. Other laws or regulations set the legal and regulatory framework under which the entity is allowed to conduct its business. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are only subject 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). Non-compliance with laws and regulations may result in financial consequences for the entity such as fines and litigation. Generally, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognize its possible non-compliance.

Responsibility for Compliance with Laws and Regulations

3. It is the responsibility of management, with the oversight of those charged with governance, to:
 - (a) Ensure that the entity's operations are conducted in accordance with laws and regulations, including compliance with laws and regulations that determine the form or content of the entity's financial statements; and
 - (b) Prevent and detect non-compliance with laws and regulations. (Ref: Para. A1)

Responsibilities of the Auditor

4. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, as described in ISA 200, "Objective and General Principles Governing an Audit of Financial Statements", there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the ISAs. This unavoidable risk may be higher, with regard to material misstatements resulting from non-compliance with laws and regulations, due to factors such as the following:
 - Non-compliance may not be captured by the entity's information systems relevant to financial reporting.

- Non-compliance 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.
5. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional scepticism throughout the audit. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement arising from non-compliance with laws and regulations that may have a material effect on the financial statements and responding appropriately to identified or suspected non-compliance with laws and regulations. The auditor is not, and cannot be, held responsible for preventing non-compliance. However, the fact that an annual audit is carried out may act as a deterrent. (Ref: Para. A2-A4)

Effective Date

6. This ISA is effective for audits of financial statements for periods beginning on or after [date].¹

Objectives

7. The objectives of the auditor are:
- (a) To obtain sufficient appropriate audit evidence about whether the entity is in compliance with laws and regulations that may have a material effect on the financial statements; and
 - (b) To respond appropriately to identified or suspected non-compliance with laws and regulations.

Definition

8. For the purposes of this ISA, the term ‘non-compliance’ refers to acts of omission or commission by the entity being audited, 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. Non-compliance 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

9. When obtaining an understanding of the entity, in accordance with ISA 315 “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment”, the auditor shall obtain a general understanding of:

¹ This date will not be earlier than December 15, 2008.

- (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: Para A5-A6)
- 10. After obtaining the above general understanding, the auditor shall perform further audit procedures to identify instances of non-compliance with those laws and regulations where non-compliance may have a material effect on the financial statements, specifically:
 - (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) Examining correspondence with the relevant licensing or regulatory authorities.
- 11. The auditor shall obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor shall have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made in the financial statements. (Ref: Para. A7 and A11).
- 12. The auditor shall be alert to the possibility that audit procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible non-compliance with relevant laws and regulations to the auditor's attention. (Ref: Para. A8)
- 13. The auditor shall request management, and where appropriate, those charged with governance, to provide written representations that disclose to the auditor all known, actual or possible non-compliance with laws and regulations whose effects are to be considered when preparing financial statements. (Ref: Para. A9-A10)

Audit Procedures when Non-compliance is Identified or Suspected

- 14. When the auditor becomes aware of information concerning a possible instance of non-compliance, the auditor shall obtain:
 - (a) An understanding of the nature of the act and the circumstances in which it has occurred; and
 - (b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A12)
- 15. When evaluating the potential effect on the financial statements of possible non-compliance with laws and regulations, the auditor shall consider the following matters:
 - (a) The potential financial consequences;
 - (b) Whether the potential financial consequences require disclosure; and

- (c) Whether the potential financial consequences are so serious as to call into question the true and fair view (or fair presentation in all material respects) given by the financial statements. (Ref: Para. A13)
- 16. When the auditor believes there may be non-compliance, the auditor shall discuss the findings with management and, where appropriate, those charged with governance. (Ref: Para. A14)
- 17. When satisfactory information about the entity's compliance with laws and regulations is not provided by management or, as appropriate, those charged with governance, the auditor shall assess the need to obtain legal advice concerning possible non-compliance.
- 18. When sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's report.
- 19. The auditor shall evaluate the implications of non-compliance with laws and regulations in relation to other aspects of the audit and take appropriate action. (Ref: Para. A15-17)

Reporting of Non-compliance

Reporting Non-compliance to Those Charged with Governance

- 20. Unless all of those charged with governance are involved in management of the entity,² the auditor shall communicate with those charged with governance:
 - (a) Any significant findings involving non-compliance with laws and regulations arising from the audit, including matters that have a material effect on the financial statements; and
 - (b) Any other findings involving non-compliance with laws and regulations that come to the auditor's attention, unless the auditor has obtained audit evidence that they have been appropriately informed or the matters are clearly inconsequential. (Ref: Para. A18)
- 21. If in the auditor's judgment the non-compliance is believed to be significant and intentional, communication of the findings with those charged with governance, shall be as soon as practicable.
- 22. If the auditor suspects that management or those charged with governance are involved in non-compliance, 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

² In accordance with ISA 260 "Communication with Those Charged with Governance", where all of those charged with governance are also involved in managing the entity, when matters are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

not be acted upon or is unsure as to the person to whom to report, the auditor shall assess the need to obtain legal advice. (Ref: Para. A16)

Reporting Non-compliance to the Users of the Auditor's Report on the Financial Statements

23. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall modify the audit opinion so as to express a qualified or an adverse opinion in accordance with ISA 705, "Modifications to the Opinion in the Independent Auditor's Report".
24. If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.
25. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by the entity, in accordance with ISA 705, the auditor shall evaluate the effect on the audit opinion.

Reporting Non-compliance to Regulatory and Enforcement Authorities

26. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether there is a responsibility to report the identified or suspected non-compliance to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A19-A21)

Documentation

27. The auditor shall document instances of identified or suspected non-compliance with laws and regulations and discussions about such matters with management, and where applicable, those charged with governance and parties outside the entity. The auditor shall also document when and with whom the discussions took place. (Ref: Para. A22)

Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations

Responsibilities of Management and Those Charged with Governance (Ref: Para. 2-3)

- 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. The following policies and procedures, among others, may assist those charged with governance and management in discharging their responsibilities for the prevention and detection of non-compliance:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate 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 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.

Responsibilities of the Auditor (Ref: Para. 4-5)

- A2. Non-compliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect non-compliance with all laws and regulations. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit, including for example, the auditor's consideration of the integrity of management or employees.
- A3. Whether an act constitutes non-compliance is a matter for legal determination, which may be beyond the auditor's professional competence to determine. However, 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 non-compliance with relevant laws and regulations. Determining whether a particular act constitutes or is likely to constitute non-compliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.
- A4. 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, it may be necessary for the audit plan to include appropriate tests for compliance with these provisions of the laws and regulations.

The Auditor's Consideration of Compliance with Laws and Regulations (Ref: Para. 9-13)

Obtaining an Understanding of the Legal and Regulatory Framework

- A5. In obtaining a general understanding of the legal and regulatory framework applicable to the entity and the industry or sector, certain laws and regulations that may give rise to business risks and which have a fundamental effect on the operations of the entity, may need particular attention by the auditor. Non-compliance 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, non-compliance with the requirements of the entity's license or other title to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements).
- A6. To obtain the general understanding of laws and regulations, the auditor may need to for example:
- Use the existing understanding of the entity's industry, regulatory and other external factors;
 - Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations;
 - Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
 - Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims;
 - Discuss the legal and regulatory framework with auditors of subsidiaries in other countries (for example, if the subsidiary is required to adhere to the securities regulations of the parent company)

Laws and Regulations Considered on a Recurring Basis

- A7. Certain well established laws and regulations, known to the entity and within the industry or sector, may need to be considered on a recurring basis each time financial statements are issued; such laws and regulations could include those that relate to for example:
- The form and content of financial statements, including industry specific requirements;
 - Accounting for transactions under government contracts; or
 - The accrual or recognition of expenses for income taxes or pension costs.
- A8. Audit procedures applied to form an opinion on the financial statements, may bring instances of possible non-compliance 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 legal counsel concerning litigation, claims and assessments; and

- Performing substantive tests of details of classes of transactions, account balances, or disclosures.

Written Representations

- A9. ISA 580, “Written Representations” establishes requirements and provides guidance on obtaining appropriate representations from management. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledge its responsibility for internal control designed, implemented and maintained to:
- (a) Ensure the entity’s operations are conducted in compliance with laws and regulations, including those that have a material effect on the financial statements.
 - (b) Prevent and detect non-compliance with laws and regulations.
- A10. Because the impact on financial statements of laws and regulations can vary considerably and there are risks to the detection of non-compliance, written representations provide audit evidence about management’s knowledge of actual or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, by themselves, written representations do not provide sufficient appropriate audit evidence and, accordingly, do not relieve the auditor of the responsibility to obtain other audit evidence.

Limit on Extent of Audit Procedures to be Undertaken

- A11. Other than undertaking the audit procedures set out in paragraphs 9 to 13, the auditor need not perform other audit procedures regarding the entity’s compliance with laws and regulations, since this would be outside the scope of an audit of the financial statements. However, depending on the result of the audit procedures performed, the auditor may need to undertake additional audit procedures as required by this ISA.

Audit Procedures when Non-compliance is Identified or Suspected (Ref: Para. 14-19)

- A12. When the auditor becomes aware of either the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:
- Investigation by regulatory organisations and government departments or payment of fines or penalties.
 - Payments for unspecified services or loans to consultants, related parties, employees 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.
 - Purchasing at prices significantly above or below market price.

- Unusual payments in cash, purchases in the form of cashiers' cheques 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.
 - Payments without proper exchange control documentation.
 - Existence of an accounting system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
 - Unauthorised transactions or improperly recorded transactions.
 - Media comment.
- A13. The potential financial consequences of possible non-compliance with laws and regulations on the financial statements, might include the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation.
- A14. 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 non-compliance with laws and regulations.
- A15. When non-compliance has not been detected by the entity's internal controls or not included in written representations, the auditor's risk assessment and the validity of written representations may need reconsideration by the auditor.
- A16. The implications of particular instances of non-compliance 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. In exceptional cases, the auditor may need to consider whether withdrawal from the engagement is necessary when:
- (a) The entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the non-compliance is not material to the financial statements;
 - (b) The auditor has identified issues relating to management's commitment to competence, communication and enforcement of integrity and ethical values, or diligence; or
 - (c) The auditor believes continuing association with the entity affects the auditor.
- In deciding whether withdrawal from the engagement is necessary the auditor may need to obtain legal advice.

Considerations Specific to Public Sector Entities

- A17. In the public sector, withdrawal from the engagement may not be an option. In such cases, the auditor may, as an alternative action, describe the non-compliance in an “Other Matter(s)” paragraph in the auditor’s report

Reporting of Non-compliance (Ref: Para. 20-26)

Reporting Non-compliance to Those Charged with Governance (Ref: Para. 21)

- A18. The auditor may consider reaching an agreement with those charged with governance and management, in advance, on the nature and type of matters to be communicated.

Reporting Non-compliance to Regulatory and Enforcement Authorities (Ref: Para. 26)

- A19. The auditor’s professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the client entity. However, the auditor’s legal responsibilities vary by country and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some countries, the auditor of a financial institution has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. Also, in some countries the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.
- A20. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified or suspected non-compliance with laws and regulations.

Considerations Specific to Public Sector Entities

- A21. Many public sector engagements may include additional audit responsibilities with respect to consideration of laws and regulations, which may relate to the audit of financial statements or extend to other aspects of the entity’s operations. A public sector auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the audit report.

Documentation (Ref: Para. 27)

- A22. The auditor’s documentation of findings regarding identified or suspected non-compliance with laws and regulations may include for example:
- Copies of records or documents; and
 - Minutes of conversations or discussions held with management or those charged with governance or parties outside the entity.

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