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United States Government Accountability Office  
Washington, DC 20548

May 29, 2009

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Subject: AICPA Auditing Standards Board (ASB) January 2009 Exposure Draft for a proposed Statement on Auditing Standards (SAS), entitled “Consideration of Laws and Regulations in an Audit of Financial Statements.”

This letter provides the U.S. Government Accountability Office’s (GAO) comments on the ASB’s proposed SAS on the consideration of laws and regulations in an audit of financial statements. Generally, we support the proposed statement and agree that the standard appropriately addresses auditor responsibilities to consider laws and regulations in a financial statement audit.

### **Comments on Expanding the Auditor’s Responsibility**

The ASB has requested comment on the wording of paragraph 12b of the proposed standard, specifically (1) if this wording expands the auditor’s responsibility related to the entity’s compliance with laws and regulations, and (2) if so, whether the expansion is appropriate. Paragraph 12b would require auditors to obtain a general understanding of how the entity is complying with the legal and regulatory framework applicable to the entity and its industry. The provisions of extant AU 317.08 require auditors to make inquiries of management concerning the entity’s compliance with laws and regulations. The following matrix compares the wording of the extant and the proposed standards.

AU 317.08	Proposed SAS Par. 12
<p><b>.08</b> Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. For example, such procedures include reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of transactions or balances. <u>The auditor should make inquiries of management concerning the client's compliance with laws and regulations.</u> Where applicable, the auditor should also inquire of management concerning—</p> <ul style="list-style-type: none"> <li>• The client's policies relative to the prevention of illegal acts.</li> <li>• The use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations.</li> </ul> <p>The auditor also obtains written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency. (See section 333, <i>Management Representations</i>.) The auditor need perform no further procedures in this area absent specific information concerning possible illegal acts. [underlining added for emphasis]</p>	<p>12. As part of obtaining an understanding of the entity and its environment in accordance with paragraph 12 of proposed SAS <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i>, <u>the auditor should obtain a general understanding of</u></p> <p>a. <u>the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates, and</u></p> <p>b. <u>how the entity is complying with that framework.</u> (Ref: par. A7) [underlining added for emphasis]</p>

We believe it is appropriate to revise the wording of the auditor’s responsibility from the prescriptive requirement in AU 317.08 “to make inquiries of management” to the more principles-based requirement in the proposed standard “obtain a general understanding.” Using the approach set forth in paragraph 12b would allow auditors to determine the most appropriate procedure for obtaining the audit objective based on the relevant facts and circumstances of each audit.

We are concerned, however, that the standard introduces a new term “legal and regulatory framework” without providing a clear explanation of its meaning. In particular, the provisions of paragraphs 12a and 12b would establish auditor requirements related to the entity’s legal and regulatory framework. We recommend defining “legal and regulatory framework” in the definition section of the standard. Without a clear definition, auditors may not understand how to properly interpret and apply the provisions of this standard. Also, lacking a definition, we cannot determine whether paragraph 12b would impose a requirement beyond that in the extant standard.

Our comments on changes resulting from applying the clarity drafting conventions and from converging with the International Standard on Auditing (ISA), along with other suggestions for improving the proposed standard are detailed below.

## Comments on Changes Resulting from Applying the Clarity Drafting Conventions and Convergence with ISAs

(1) We believe that the objectives to be achieved by the auditor, as stated in paragraph 10 of the proposed SAS, are appropriate, except as noted in the first bullet under (3) below.

(2) We agree with the revisions made to the existing standard to converge with the ISA 250.

(3) We agree with the differences between the proposed SAS and ISA 250 except for the following issues:

- We agree with the concern noted in the ASB's matrix comparing ISA 250, the proposed SAS, and AU 317 regarding the ISA language used in paragraphs 7, 10a, and 13. By describing the auditor's objective or responsibility as "to obtain sufficient appropriate evidence about compliance with provisions of laws and regulations," the ISA wording changes and possibly expands auditor responsibilities from obtaining evidence about financial statements amounts and disclosures to obtaining evidence about compliance.

However, the wording in the proposed SAS does not appropriately address this concern, and we recommend revising paragraphs 7, 10a and 13 to more accurately explain the relationship between provisions of laws and regulations and financial statement amounts and disclosures. The proposed wording in these paragraphs suggests that the laws and regulations **determine** financial statement amounts and disclosures, but in most situations, the laws and regulations **have an effect on the determination** of financial statement amounts and disclosures, which auditors need to understand. This latter wording also is consistent with the descriptions of the two categories of laws and regulations in paragraph 6 of the proposed standard.

We also recommend clarifying that auditors are concerned with **provisions** of laws and regulations rather than with all aspects of those laws and regulations. In addition to being overly broad in implying that an entire law or regulation, rather than just applicable provisions of the law or regulation, may affect the entity's financial statements, the wording in the proposed SAS suggests that a law or regulation either (1) has a direct effect on the determination of amounts and disclosures (par 6a), or (2) does not have a direct effect, but compliance with which may be fundamental to the entity's operations (par 6b). In fact, an entity may conclude that certain provisions of a law or regulation have a direct effect while other provisions of the same law or regulation may not have a direct effect but may be fundamental to the entity's operations.

To address these two issues we recommend revising paragraphs 7, 10, 13 and 14 as follows:

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, where those provisions are 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. The provisions of other laws and regulations, where those provisions 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); 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 whose determination is affected 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 the provisions of those laws and regulations, where the provisions that may have a material effect on the financial statements.

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 whose determination is affected by provisions of those laws and regulations, where the provisions are~~ generally recognized to have a direct effect on their ~~determination~~ financial statements (see paragraph 6a);
- b. perform specified audit procedures that may identify instances of noncompliance with the provisions of other laws and regulations, where the provisions 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.

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 whose determination is affected by the legal and regulatory provisions~~ generally recognized to have a direct effect on ~~their determination~~ the financial statements. (see paragraph 6a). (Ref: par. A8–A10)

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

- In the second sentence of paragraph A8 we suggest deleting the wording that states that laws and regulations that have a direct effect on determination of material amounts and disclosures in the financial statements generally are “limited in number.” This may not always be the case, as the number of laws and regulations generally recognized to have a material effect on the financial statements can vary depending on the entity being audited. Also, the number of laws and regulations is irrelevant; auditors have responsibilities related to material misstatements due to noncompliance with laws and regulations, regardless of number.
- In paragraph A9, we recommend replacing ‘detect and report’ with ‘detect and evaluate’ in order to more accurately describe the auditor’s responsibilities. The auditor does not **report** misstatements resulting from non-compliance with laws and regulations but evaluates the possible effects on the financial statements.
- In order to make the wording of paragraph A12 consistent with the description of other laws and regulations in paragraph 6b, we recommend adding the word *directly* to the first sentence of paragraph A12, as follows:

A12. Many laws and regulations relating principally to the operating aspects of the entity do not **directly** affect the financial statements (their financial statement effect is indirect) and are not captured by the entity’s information systems relevant to financial reporting.

- In paragraph A20 we recommend deleting the reference to FASB Statement No. 5. The reference makes the example appear not applicable to entities that use a financial reporting framework other than FASB. The SAS should be framework neutral.

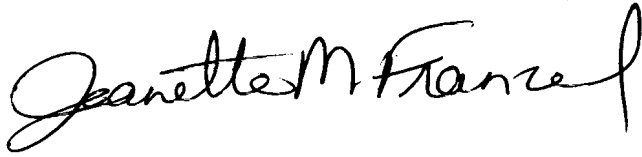
(4) We agree with the governmental considerations included in the proposed standard.

(5) Other Comments

- In paragraph A22 we recommend replacing the word ‘contravention’ with a word more frequently used in the U.S., such as ‘violation,’ to make the SAS more understandable for all readers.

We thank you for considering our comments on these important issues.

Sincerely yours,

A handwritten signature in black ink that reads "Jeanette M. Franzel". The signature is written in a cursive style with a large, looping initial "J".

Jeanette Franzel  
Managing Director  
Financial Management and Assurance

cc: Mr. Harold Monk, Chair  
Auditing Standards Board

The Honorable Mark W. Olson, Chairman  
Public Company Accounting Oversight Board