Members in Public Accounting Firms

November 2004

AICPA

American Institute Of Certified Public Accountants

Practice Alert
2004-01

Notice To Readers

This Practice Alert is intended to provide practitioners with information that may help them improve the effectiveness and efficiency of their engagements and practices and is based on existing professional literature, the experience of members of the Professional Issues Task Force (PITF) and information provided by certain AICPA member firms to their own professional staff. This information represents the views of the members of the PITF and has not been approved by any senior technical committee of the AICPA. The auditing portion of this publication is an *Other Auditing Publication* as defined in SAS 95, *Generally Accepted Auditing Standards* and is intended to provide guidance to auditors of nonissuers.[1] *Other Auditing Publications* have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards (SASs). If an auditor applies the auditing guidance included in an *Other Auditing Publication*, the auditor should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of the subject audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate.

Illegal Acts

Introduction

In April 1988, the Auditing Standards Board issued Statement on Auditing Standards No. 54, *Illegal Acts by Clients* ("SAS 54"). SAS 54 prescribes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. SAS 54 also provides guidance on the auditor's responsibility when a possible illegal act is detected.

SAS 54 is the primary source of guidance with respect to the auditor's consideration of the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. However, auditors performing audits in accordance with *Government Auditing Standards* (also referred to as the "Yellow Book") should also be aware that those standards include additional requirements related to illegal acts. Auditors should refer to SAS 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance,* and the AICPA's Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (which has been updated for the 2003 revisions to *Government Auditing Standards*), for additional information on illegal acts and the auditor's reporting responsibilities when performing an audit under *Government Auditing Standards*.

SAS 54 defines illegal acts as violations

[1] Nonissuer refers to any entity other than an "issuer." The term "issuer" is defined in Section 2 of the Sarbanes-Oxley Act as :
An issuer as defined in Section 3 of the Securities Exchange Act of 1934, the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) [of the Exchange Act] or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn. [Parenthetical references to the United States Code omitted].

of laws or government regulations. Additionally, the AICPA's Audit Guide, *Government Auditing Standards and Circular A-133 Audits,* states that it generally has been interpreted under GAAS that the term laws and regulations in SAS 54 implicitly includes provisions of contracts or grant agreements. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

Illegal acts are divided into two categories: 1) those having a **direct and material** effect on financial statement amounts and 2) those having only an **indirect** effect on the financial statements. Some laws and regulations have a direct and material effect on financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts. Other laws and regulations, such as occupational safety and health, food and drug administration, environmental protection, equal employment opportunity, and antitrust violations, may have only an indirect effect on the financial statements.

The auditor's responsibility for detection of illegal acts having a direct and material effect on the financial statements

The auditor must consider laws and regulations that are generally recognized to have a direct and material effect on the financial statements. However, the auditor should consider such laws and regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality, per se.

The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the financial statements is the same as that for misstatements caused by error or fraud and includes assessing the risk that an illegal act may cause the financial statements to contain a material misstatement. The auditor should design the audit to provide reasonable assurance that such illegal acts will be detected. Care should be exercised in planning, performing, and evaluating the results of these procedures. The auditor's planning and risk assessment process should include consideration of the different characteristics of illegal acts and of factors indicating increased risk of illegal acts that have a direct and material effect on the financial statements.

The auditor's responsibility for detection of illegal acts having an indirect effect on the financial statements

The auditor has no direct responsibility to detect and report misstatements resulting from illegal acts having an indirect effect on the financial statements (hereafter referred to as "indirect effect illegal acts") as the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations that have only an indirect effect on the financial statements. The auditor's responsibility is limited to applying auditing procedures to such acts that come to the auditor's attention and being aware that such acts may exist. However, if specific information comes to the auditor's attention regarding the existence of possible indirect effect illegal acts, the auditor should apply audit procedures to determine the potential effects of the possible indirect effect illegal act on the financial statements.

Audit procedures in the absence of specific information indicating the existence of possible illegal acts

The auditor should perform the audit with an attitude of professional skepticism, remaining alert to conditions or events that indicate illegal acts may have occurred. Procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. Considerations as to whether an act is illegal, or of doubtful legality, are frequently outside the auditor's expertise, therefore, the auditor should consider consulting with legal counsel. Additionally, laws and regulations can also vary considerably in terms of their significance to the financial statements.

Possible illegal acts may come to the auditor's attention as a result of inquiries of management and others. The auditor is required to make inquiries of management concerning the client's compliance with laws and regulations. The auditor should also consider the need to obtain representations from the audit committee or others with equivalent authority and responsibility such as the board of directors or the owner in an owner-managed business, (hereinafter referred to as the "audit committee") and the chief legal officer that possible illegal acts brought to their attention have been communicated to the auditor.

Other inquiries may include, but are not limited to:

- Discussions with principal officers as part of the planning process.
- Discussions with legal counsel and others as part of the evaluation of the adequacy of the accounting for, and the need for

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disclosure of, loss contingencies.

- Discussions with senior management as part of obtaining various written client representations.
- Inquiries of appropriate client personnel about whether the IRS has requested any information concerning possible illegal or improper payments as part of an IRS examination of tax returns, and about the content and significance of the client's replies to the IRS.
- Other inquiries of, and discussions with, client personnel regarding various matters during the course of performing auditing procedures. Examples of specific information, which might be obtained through the application of the audit procedures and the evaluation of the results of those procedures, that may raise a question concerning possible illegal acts are:
  a) Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets.
  b) Investigation by a governmental agency, an enforcement proceeding, or payment of fines or penalties.
  c) Violations of laws or regulations cited in reports of examinations by regulatory agencies.
  d) Large payments for unspecified services to consultants, affiliates or employees.
  e) Sales commissions or agents' fees that appear excessive in relation to those normally paid by the client or to the services actually received.
  f) Large payments in cash, purchases of bank cashier's checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions.
  g) Unexplained payments made to government officials or employees.
  h) 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.

In addition, the auditor should obtain representations in the management representation letter regarding:

1) The absence of any "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" and
2) That the auditor has been informed of all possible illegal acts brought to the attention of management.

Additionally, the reading of minutes of board of directors' meetings and of meetings of committees of the board of directors may disclose information that may raise a question concerning possible illegal acts. For example, the minutes may contain information regarding material transactions, foreign operations, legal department reports, or indications of other discussions that may cause the auditor to make further inquiries.

Prior to commencement of the audit, the auditor should consider reaching an understanding with the audit committee as to the communication expectations. Included in the understanding should be the expected nature and extent of communications about violations deemed immaterial either individually or in the aggregate and those perpetrated by lower-level employees.

Action on discovery of possible illegal acts

If, in the course of conducting an audit, the auditor detects or becomes aware of information indicating that an illegal act has or may have occurred, the auditor should perform the following:

1) Obtain an understanding of the nature of the matter and the circumstances in which it has occurred, and sufficient other information to make a preliminary assessment of the matter and its possible effect on the financial statements.
2) Obtain assurance that the audit committee or others with equivalent authority and responsibility such as the board of directors or the owner in an owner-managed busienss (the "audit committee") is adequately informed about possible illegal acts that come to the auditor's attention.
3) Discuss the client investigation, if applicable, of the illegal act with the appropriate level of senior management and/or the audit committee.
4) Evaluate the conclusions reached by the client as a result of the investigation, if applicable.

If the audit is of the financial statements of a smaller or less complex, privately owned company that does not have an audit committee or the levels of management that would exist in a larger organization, the auditor should exercise the appropriate level of professional judgment in determining the extent of the audit procedures to be performed specifically, with respect to the communication that is required to the owner or owners and possibly to the company's legal counsel. In addition, if the owner is involved, and the matter is significant, the auditor should also consider withdrawing from the engagement.

If the audit is of the financial statements of a local government that is overseen by a council or similar body, the auditor should report the information to the chief executive officer or the legislative body/board. If the chief executive officer is believed to be a party to the potential illegal act, the auditor should report the act directly to the legislative body/board.

Obtain an understanding regarding the illegal act

In obtaining an understanding of the nature of the matter and the circumstances in which it has occurred, and sufficient other information to make a preliminary assessment of the matter and its possible effect on the financial statements, the auditor should inquire of the client's management at a level above those involved, if possible, and consult with the client's legal counsel or other specialists, as necessary. Based on the information that the auditor obtains about the possible illegal act, the auditor is required to:

- Determine whether it is likely that an illegal act has occurred,
- If so, determine and consider the possible effect of the illegal act on the client's financial statements, and
- If the matter is other than clearly inconsequential, determine

whether the audit committee has been informed of the situation and is taking appropriate action to investigate the matter.

Determine whether the audit committee has been informed about the illegal act

The communications with the audit committee should describe the act and the circumstances of its occurrence, as understood by the auditor. In addition, the auditor should communicate the potential effect on the financial statements and related disclosures. The communication may be either oral or written. If the communication is oral, the auditor should document the discussion.

Client investigation of the possible illegal act

When the audit committee is informed of possible illegal acts that come to the auditor's attention, an investigation into the matter may be made by the audit committee. In certain circumstances, the auditor may insist on an investigation in order to conclude on the effect of the possible illegal act on the financial statements.

Oftentimes in conducting these investigations, the audit committee may seek assistance from outside counsel and other experts such as forensic accountants, if necessary. The auditor may consider requesting that the audit committee keep the auditor apprised of the progress of the investigation and to facilitate discussions concerning the investigation between outside counsel and the auditor.

At the conclusion of the investigation, the auditor should consider requesting that he or she attend the investigative team's presentation to the audit committee and documenting the discussion.

After the audit committee has investigated the possible illegal act and presented the scope of their procedures, their conclusions and any remedial actions to the auditor, the auditor should evaluate the conclusions and determine how they affect the audit of the financial statements. The auditor should coordinate with the appropriate level of senior management and/or the audit committee, based upon the facts and circumstances, to facilitate the auditor's consultation with the client's outside legal counsel about the legal ramifications of the possible illegal act, including, for example, whether there is a penalty which might attach to the illegal act and, if so, the amount, or whether the transaction(s) in question has significance with respect to deductibility of stated amounts for tax purposes and under "cost plus" contracts or other similar situations that apply.

Based on these discussions and the results of the investigation, the auditor should assess the need for additional audit procedures, disclosures in the financial statements, communication of internal control deficiencies, and/or modifications to the audit report. Depending on the results of the investigation, the auditor may also need to consider whether to withdraw from the engagement.

If the client fails to give the occurrence of an illegal act the appropriate level of consideration or fails to take the steps deemed warranted, the auditor should consider the implications of the illegal act in relation to his or her initial evaluations and reevaluate:

- Engagement risk.
- Reliance on management's role in the functioning of internal control.
- Reliance on management's representations.
- Validity and propriety of other similar transactions.

Additionally, the auditor should consider whether any concerns might be mitigated by the performance of additional substantive audit procedures.

The auditor should be sure that the company's board of directors or audit committee is fully aware of the possible consequences of the act and has formally approved the course of action to be followed, when the circumstances so warrant.

Material illegal acts

The materiality of an illegal act cannot be appropriately assessed by considering only the quantitative effects; the auditor must also consider the qualitative effects of the illegal act. These effects may often be found to overshadow the act's immediate effect. Accounting and disclosure ramifications of loss contingencies associated with illegal acts should be considered in accordance with FASB Statement of Standards No. 5, *Accounting for Contingencies*. The determination of the significance of potential illegal acts will generally entail consultation with the client's legal counsel.

Immaterial illegal acts

The aggregate of all immaterial illegal acts should be evaluated in relation to the materiality level for the financial statements as a whole. The auditor should consider the effect of each individual misstatement and consider recording an individual misstatement that has a material effect on an individual account or group of accounts, even though that individual misstatement may be offset by other unadjusted misstatements. The auditor needs to also consider the qualitative aspects of the illegal act such as how the illegal act affects the auditor's ability to rely on management representations.

Disclosure of illegal acts to third parties

Disclosure of an illegal act to parties other than the client's audit committee is not ordinarily part of the auditor's responsibility, and such disclosure would normally be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects his or her opinion on the financial statements. The auditor should recognize, however, that a duty to notify parties outside the client may exist. A duty to notify parties outside of the client may include the following:

- To a successor auditor when the successor makes inquiries in accordance with AU section 315, *Communications Between Predecessor and Successor Auditors*. In accordance with AU section 315, communications between predecessor and successor auditors require the specific permission of the client.
- In response to a subpoena.
- To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive finan-

cial assistance from a government agency. *Government Auditing Standards* state that the client may be required by law or regulation to report illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general) and that if the client fails to report such acts, then the auditor should report the illegal acts directly to the external party specified in the law or regulation. Additionally, when an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take appropriate steps to remedy the illegal acts that the auditor reported to it. See Chapter 5 of *Government Auditing Standards* and the AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* for additional guidance.

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with his or her legal counsel before discussing illegal acts with parties outside the client.

Reporting considerations

The auditor may be faced with various reporting issues as a result of becoming aware of acts that he or she suspects may be illegal. Depending upon the particular circumstances, the auditor may consider modifying the auditor's report. Such modification may result from one or more of the following considerations.

Scope limitation

Generally, the auditor should disclaim an opinion on the financial statements when precluded by the client from applying all the procedures considered necessary in the circumstances. In situations not involving a client-imposed scope restriction (e.g. appointment of the auditor after the client's physical inventory has been taken) and depending upon the auditor's assessment of the importance of the omitted procedures, the auditor may consider qualifying the opinion or disclaiming an opinion. In the latter case, the decision should reflect the auditor's assessment of the significance of the matter to the particular entity and the pervasiveness and magnitude of the potential direct and indirect effects of the acts in question on the client's financial statements taken as a whole.

Departure from generally accepted accounting principles

When the auditor has been able to conduct the audit in accordance with generally accepted auditing standards and concludes an event or transaction has not been properly accounted for or disclosed in the financial statements, the auditor may qualify the opinion or issue an adverse opinion depending upon the magnitude of the potential effects of the event or transaction. If the departure from generally accepted accounting principles results from inadequate disclosure, the auditor's modified report should provide the information omitted by the client.

Inability to determine materiality of an illegal act

In the event that the auditor is unable to conclude as to the materiality of an illegal act, the auditor should modify his or her report or disclaim an opinion to adequately reflect the uncertainty.

Client refusal to accept report

If the client refuses to accept a report that has been modified for a client-imposed scope restriction or a departure from generally accepted accounting principles, including inadequate disclosure, the auditor should withdraw from the engagement. If a client refuses to accept a report that has been modified for other reasons, the auditor may have no alternative but to withdraw from the engagement. In any case of withdrawal, the reasons for the withdrawal should be indicated in writing to the audit committee. Deciding whether there is a need to notify parties outside the client's organization of an illegal act is the responsibility of the company's management. However, as previously indicated, the auditor may have a duty to notify parties outside the client.

Audits performed under *Government Auditing Standards*

Auditors performing audits under *Government Auditing Standards* also must issue a report on internal control over financial reporting and on compliance and other matters that reports on the scope and results of testing of the auditee's internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. The AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* provides additional guidance on the auditor's responsibilities with regard to this report.

Documentation

The audit documentation should include appropriate documentation with respect to:

- The required inquiries related to possible illegal acts and compliance with laws and regulations.
- Company policies relative to the prevention of illegal acts, and the use of directives and periodic representations concerning compliance with laws and regulations.
- Circumstances identified that indicate the possible existence of illegal acts and conclusions reached thereon, if applicable.
- The auditor's assessment of the procedures performed by the company to determine that the illegal act was properly accounted for and disclosed, if applicable.
- Whether any uncorrected misstatements appear to represent illegal acts, if applicable.
- Written representation from management concerning the absence of violations or possible violations of laws and regulations.
- Discussions with management, the audit committee, and, if applicable, the board of directors.
- Representations from the audit committee regarding satisfactory completion of any investigations into possible illegal acts undertaken at their direction and satisfactory resolution of the matters identified in the investigation, if applicable.