

AU-C Section 250

Consideration of Laws and Regulations in an Audit of Financial Statements

Source: SAS No. 122.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

Introduction

Scope of This Section

.01 This section addresses the auditor's responsibility to consider laws and regulations in an audit of financial statements. This section 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.¹

Effect of Laws and Regulations

.02 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 for Compliance With Laws and Regulations (Ref: par. .A1–.A7)

Responsibility of Management

.03 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.

¹ Section 935, *Compliance Audits*, addresses compliance audits performed in accordance with generally accepted auditing standards, the standards for financial audits under *Government Auditing Standards*, and government audit requirements.

Responsibility of the Auditor

.04 The requirements in this section are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing noncompliance and cannot be expected to detect noncompliance with all laws and regulations.

.05 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.² In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Because of the inherent limitations of an audit, an unavoidable risk exists 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 (GAAS).³ 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 made to the auditor.
- Whether an act constitutes noncompliance is ultimately a matter for legal determination, such as 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.

.06 This section distinguishes the auditor's responsibilities regarding 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. The provisions of 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
 - i. fundamental to the operating aspects of the business,
 - ii. fundamental to an entity's ability to continue its business, or
 - iii. necessary for the entity to avoid material penalties

(for example, compliance with the terms of an operating license, regulatory solvency requirements, or environmental regulations); therefore, noncompliance with such laws and regulations may have a material effect on the financial statements (see paragraph .14).

² Paragraph .12 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

³ Paragraph .A49 of section 200.

.07 In this section, differing requirements are specified for each of the previously mentioned categories of laws and regulations. For the category referred to in paragraph .06a, the auditor's responsibility is to 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. For the category referred to in paragraph .06b, the auditor's responsibility is limited to performing specified audit procedures that may identify noncompliance with those laws and regulations that may have a material effect on the financial statements.

.08 The auditor is required by this section 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 professional skepticism throughout the audit, as required by section 200, *Overall Objectives 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.⁴

Effective Date

.09 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

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 .06a),
- 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 .06b), and
- c. respond appropriately to noncompliance or suspected noncompliance with laws and regulations identified during the audit.

Definition

.11 For the purposes of this section, the following term has the meaning attributed as follows:

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.

⁴ Paragraph .17 of section 200.

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 section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the auditor should obtain a general understanding of the following:⁵ (Ref: par. .A8)

- a. The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates
- b. How the entity is complying with that framework

.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 .06a). (Ref: par. .A9–.A11)

.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 .06b): (Ref: par. .A12–.A15)

- a. Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations
- b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities (Ref: par. .A16)

.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. .A17–.A18)

.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–.15 of this section and the requirement in section 580, *Written Representations*, related to requesting written representations from management regarding the entity's compliance with laws and regulations.⁶

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. .A19–.A20)

- 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: par. .A21)

⁵ Paragraph .12 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

⁶ Paragraph .13 of section 580, *Written Representations*.

.18 If the auditor suspects noncompliance may exist, the auditor should discuss the matter with management (at a level above those involved with the suspected noncompliance, if possible) and, when 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 professional 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. .A22–.A23)

.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,⁷ and take appropriate action. (Ref: par. .A24–.A25)

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 aware of matters involving identified or suspected noncompliance already communicated by the auditor,⁸ the auditor should communicate with those charged with governance matters involving 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. .A26)

.22 If, in the auditor's professional 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 should communicate the matter to the next higher level of authority at the entity, if it exists. When no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure about 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 section 705A, *Modifications to the Opinion in the Independent Auditor's Report*, express a qualified or adverse opinion on the financial statements.⁹ (Ref: par. .A27)

.25 If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether

⁷ Paragraphs .22–.26 of section 580.

⁸ Paragraph .09 of section 260, *The Auditor's Communication With Those Charged With Governance*.

⁹ Paragraphs .08–.09 of section 705A, *Modifications to the Opinion in the Independent Auditor's Report*.

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 section 705A.¹⁰ (Ref: par. .A27)

.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 section 705A.¹¹

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. .A28–.A29)

Documentation

.28 The auditor should include in the audit documentation a description of the identified or suspected noncompliance with laws and regulations and the results of discussion with management and, when applicable, those charged with governance and other parties inside or outside the entity.¹² (Ref: par. .A30)

Application and Other Explanatory Material

Responsibility for Compliance With Laws and Regulations (Ref: par. .03–.08)

Responsibility of Management

.A1 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 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 also may 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

¹⁰ [Footnote deleted, January 2012, to reflect conforming changes necessary due to the issuance of SAS No. 123.]

¹¹ [Footnote deleted, January 2012, to reflect conforming changes necessary due to the issuance of SAS No. 123.]

¹² Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.

- Developing, publicizing, and following a code of ethics or code of conduct
- Ensuring employees are properly trained and understand the code of ethics or code of conduct
- Monitoring compliance with the code of ethics or 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

.A3 Because of the inherent limitations described in paragraph .05, an audit performed in accordance with GAAS provides no assurance that all non-compliance with laws and regulations will be detected or that any contingent liabilities that result will be disclosed.

.A4 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. Noncompliance can result from fraudulent activity. Section 240, *Consideration of Fraud in a Financial Statement Audit*, addresses the auditor's responsibility if fraud or suspected fraud is detected.

.A5 Whether an act constitutes noncompliance with laws and regulations is a matter for legal determination, which ordinarily is 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.

.A6 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, section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*, and section 935, *Compliance Audits*, set forth how these audit responsibilities are addressed in the auditor's report. Furthermore, when 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

.A7 Auditors of governmental entities may have additional responsibilities with respect to the consideration of laws and regulations, which relate to the

audit of financial statements or may extend to other aspects of the entity's operations.¹³

The Auditor's Consideration of Compliance With Laws and Regulations

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

.A8 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 and 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 about 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;
- 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; and
- consider the auditor's knowledge of the entity's history of noncompliance 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)

.A9 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 .06a). These laws and regulations generally are directly relevant to the determination of material amounts and disclosures in the financial statements and readily evident to the auditor. 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

¹³ See section 935; *Government Auditing Standards*; and OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*.

- the accrual or recognition of expenses for income tax or pension costs.

.A10 Some provisions in those laws and regulations may be directly relevant to specific assertions in the financial statements (for example, the completeness of income tax provisions), whereas others may be directly relevant to the financial statements as a whole. The auditor's responsibility regarding misstatements resulting from noncompliance with laws and regulations having a direct effect on the determination of material amounts and disclosures in the financial statements is the same as that for misstatements caused by fraud or error, as described in section 200.

.A11 Noncompliance with other provisions of such laws and regulations, and the laws and regulations described in paragraph .06b, 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 .06a.

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

.A12 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 .06b). 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).

.A13 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. Their indirect effect may result from the need to disclose a contingent liability because of the allegation or determination of identified or suspected noncompliance. 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. An auditor may not have a sufficient basis for recognizing possible noncompliance with such laws and regulations.

.A14 For the category referred to in paragraph .06b, the auditor's responsibility is limited to performing specified audit procedures (see paragraph .14) that may identify noncompliance with those laws and regulations that may have a material effect on the financial statements. Even when those procedures are performed, the auditor may not become aware of the existence of noncompliance unless there is evidence of noncompliance in the records, documents, or other information normally inspected in an audit of financial statements.

.A15 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 intended to bring to the auditor's attention instances of noncompliance with laws and regulations that may have a material effect on the financial statements.

.A16 In some cases, the amount of an entity's correspondence with licensing or regulatory authorities is voluminous. In exercising professional judgment

in such circumstances, the auditor may consider the following in determining 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)

.A17 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 the following:

- Reading minutes
- Inquiring of the entity's management and in-house or external legal counsel concerning litigation, claims, and assessments
- Performing substantive tests of details of classes of transactions, account balances, or disclosures

.A18 Because the effect of laws and regulations on financial statements can vary considerably, written representations, as required by section 580, 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.¹⁴

Audit Procedures When Noncompliance Is Identified or Suspected

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

.A19 If 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

¹⁴ Paragraph .04 of section 580.

- 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 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. .17)

.A20 Procedures an auditor may perform to address the requirements of paragraph .17 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 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)

.A21 Matters relevant to the auditor's evaluation of the possible effect on the financial statements include the following:

- The quantitative effect of noncompliance. The potential financial consequences of noncompliance with laws and regulations on the financial statements may include the imposition of fines, penalties, or damages; the threat of expropriation of assets; enforced discontinuation of operations; and litigation.
- The qualitative materiality of the effect of noncompliance. 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 accrual or disclosure under the applicable financial reporting framework. 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 the applicable financial reporting framework.

- 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)

.A22 The auditor may discuss the findings with those charged with governance, in which case 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.

.A23 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. If it is not considered appropriate to consult with the entity's legal counsel or if 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 about whether a violation of a law or regulation is involved; the possible legal consequences, including the possibility of fraud; and what further action, if any, the auditor may take.

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

.A24 As required by paragraph .20, the auditor evaluates the implications of noncompliance with regard 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.

.A25 The auditor may consider whether withdrawal from the engagement, when withdrawal is possible under applicable law or regulation, 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. Factors that may affect the auditor's decision 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. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is not possible under applicable law or regulation, the auditor may consider alternative actions, including describing the noncompliance in an other-matter(s) paragraph in the auditor's report.¹⁵

¹⁵ Paragraph .08 of section 706A, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*.

Reporting of Identified or Suspected Noncompliance

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

.A26 The communication of matters involving identified or suspected noncompliance may describe the act of identified or suspected noncompliance, the circumstances of its occurrence, and the effect on the financial statements. The auditor may reach agreement in advance with those charged with governance on the nature of matters that would be considered clearly inconsequential and, thus, need not be communicated.

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

.A27 If management or those charged with governance refuse to accept a modified opinion on the financial statements for the circumstances described in paragraphs .24–.25, the auditor may withdraw from the engagement, when withdrawal is possible under applicable law or regulation, and indicate the reasons for withdrawal in writing to those charged with governance.

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

.A28 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:

- In response to inquiries from an auditor to a predecessor auditor, in accordance with the requirements of section 210, *Terms of Engagement*¹⁶
- In response to a court order
- In compliance 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

.A29 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 also may be required to communicate instances of noncompliance to appropriate oversight bodies and funding agencies.

¹⁶ Paragraphs .11–.12 of section 210, *Terms of Engagement*.

Documentation (Ref: par. .28)

.A30 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.
-