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Basis for Conclusions:  
ISA 250 (Redrafted),  
Consideration of Laws and  
Regulations in an Audit of  
Financial Statements

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*Prepared by the Staff of the International Auditing and  
Assurance Standards Board*



**International Federation  
of Accountants**

## **BASIS FOR CONCLUSIONS:**

### **ISA 250 (REDRAFTED), CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS**

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 250 (Redrafted), "Consideration of Laws and Regulations in an Audit of Financial Statements," which was unanimously approved by the IAASB in March 2008.<sup>1</sup>

#### **Background**

1. In September 2006, the IAASB agreed the conventions to be used in drafting future International Standards on Auditing (ISAs). These conventions are commonly referred to as the IAASB's Clarity conventions.<sup>2</sup>
2. The IAASB has undertaken to redraft all of its ISAs in accordance with the Clarity conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 250 is in the latter category.
3. The IAASB issued an exposure draft of proposed ISA 250 (Redrafted) (ED-ISA 250) in April 2007, with a comment date of July 31, 2007. The IAASB received forty-eight comment letters from a variety of respondents, including IFAC member bodies, national standard setters, firms, regulators, government organizations, and others. Input was also received from IFAC's Small and Medium Practices Committee. The IAASB made changes to ED-ISA 250 in response to these comments. In addition, the IAASB discussed significant issues in the development of ED-ISA 250, and the finalization of ISA 250 (Redrafted), with its Consultative Advisory Group (CAG).
4. This Basis for Conclusions explains the more significant issues raised by respondents on ED-ISA 250, and how the IAASB addressed them. In general, ED-ISA 250 received strong support from respondents in terms of how the extant ISA had been redrafted in accordance with IAASB's Clarity conventions.

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<sup>1</sup> See minutes of the March 10-14, 2008 IAASB meeting at <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0142>.

<sup>2</sup> The IAASB's Clarity conventions, and the authority and obligation attaching to them, are established in the amended Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface.) The amended Preface can be accessed at [http://www.ifac.org/download/IAASB\\_Preface.pdf](http://www.ifac.org/download/IAASB_Preface.pdf). Elements of the authority and obligation attaching to the Clarity conventions have been exposed as part of ISA 200 (Revised and Redrafted), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing."

## Categories of Laws and Regulations

### Clarity of the Distinction between the Categories of Laws and Regulations

5. In developing ED-ISA 250, the IAASB acknowledged that proper application of ISA 250 requires an understanding of the two different categories of laws and regulations that the requirements of the extant ISA address: those that are generally recognized to have a direct effect on the financial statements; and those that may have a material effect on an entity's financial statements in the event of non-compliance. Accordingly, the IAASB clarified the distinction by first noting, in paragraph 2 of ED-ISA 250, that the impact laws and regulations can have on the financial statements varies considerably, and then introducing, in paragraph 6 of ED-ISA 250, material describing the two different categories of relevant laws and regulations.
6. A few respondents requested further clarification of the different categories of laws and regulations, and of the relationship between the material in paragraphs 2 and 6 of ED-ISA 250 and the objectives of the auditor. Some respondents were of the view that the use of the word "direct" gives rise to an ambiguity about which category a type of law or regulation belongs, as different interpretations may exist regarding what is meant by a "direct" effect, versus an "indirect" effect, on the financial statements. A lack of clarity was also noted due to inconsistencies in wording within ED-ISA 250.
7. The IAASB considered these matters and concluded that the description in paragraph 6 of ED-ISA 250 of the categories of laws and regulations is clear and accurate. The IAASB agreed, however, that the clarity of the ISA would be enhanced by elaborating on the material in paragraph 2 and more closely aligning it with the distinctions made in paragraph 6 and the objectives stated in the ISA.
8. Accordingly, paragraph 2 of ISA 250 (Redrafted) discusses the impact of laws and regulations in terms of those that have "a direct effect" and those that "do not have a direct effect" on an entity's financial statements. More specifically, paragraph 2 clarifies that the provisions of laws and regulations that have a direct effect on the financial statements do so because they directly determine the reported amounts and disclosures in an entity's financial statements. Laws and regulations that do not have a direct effect on the financial statements are those that are to be complied with by management or set the provisions under which an entity is allowed to conduct its business, in respect of which non-compliance may have a material effect on the financial statements. The IAASB believes that these changes enhance consistency within the ISA and have the benefit of introducing the different types of laws and regulations earlier in the ISA.
9. The IAASB further clarified the distinction between the two categories of laws and regulations by:
  - (a) Specifying in the Introduction section of the ISA the differing responsibilities of the auditor in respect of each of the categories (see paragraph 7 of ISA 250 (Redrafted)); and
  - (b) Explaining in the Application and Other Explanatory Material that even though non-compliance with "other laws and regulations" may result in fines, litigation or other consequences for the entity which need to be provided for in the financial

statements, such laws and regulations are not considered to have a direct effect on the financial statement (see paragraph A8 of ISA 250 (Redrafted)).

### **Relationship between the Categories of Laws and Regulations and the Requirements**

10. A few respondents were unclear about the relationship between the different categories of laws and regulations stated in paragraph 6 of ED-ISA 250 and the requirements of the ISA. In particular, it was questioned which of the categories of laws and regulations relate to the requirements in paragraphs 11-14 of ED-ISA 250.
11. The IAASB agreed that the clarity of the ISA would be enhanced by specifying the link between the different categories of laws and regulations and the Requirements section. Accordingly, the IAASB referenced the category of laws and regulations which have a direct effect on the financial statements, described in paragraph 6(a) of ISA 250 (Redrafted), to the relevant requirement in paragraph 13 of ISA 250 (Redrafted) (paragraph 11 of ED-ISA 250). Similarly, the category of laws and regulations described in paragraph 6(b) is now referenced to the relevant requirement in paragraph 14 of ISA 250 (Redrafted) (paragraph 12 of ED-ISA 250). In addition, the IAASB aligned the wording of the categories with the wording of the requirements to avoid any confusion about the responsibilities of the auditor in connection with the categories.
12. The IAASB concluded that it would not be appropriate to limit the requirement in paragraph 15 of ISA 250 (Redrafted) (paragraph 13 of ED-ISA 250) to either one of the categories described in paragraph 6. The intent of the requirement is to direct the auditor to be alert to non-compliance with laws and regulations regardless of their nature. The IAASB believes that this treatment is consistent with the extant ISA. It is also consistent with the requirement in paragraph 22 of ISA 250 (Redrafted) which requires the auditor to communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit.
13. The IAASB also concluded that it would not be appropriate to link the requirement in paragraph 16 of ISA 250 (Redrafted) (paragraph 14 of ED-ISA 250) to the categories of laws and regulations noted in paragraph 6 because the requirement to obtain written representations applies regardless of the nature of the laws and regulations.

### **Objectives**

14. Paragraph 8 of ED-ISA 250 proposed the following objectives of the auditor:

The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence that the financial statements are not materially misstated due to non-compliance with laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements;
- (b) To perform specified procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and
- (c) To respond appropriately to identified or suspected non-compliance with laws and regulations.

15. The majority of respondents were of the view that the proposed objectives were appropriate. However, some respondents were concerned that the objective in paragraph 8(b) was too procedural and not sufficiently outcome-oriented. In addition, one respondent suggested limiting the scope of this objective to instances of non-compliance with laws and regulations “that are known to the entity.”
16. The IAASB acknowledged that it is generally desirable for objectives to be expressed in terms of “outcomes.” However, it concluded that such an approach would not be appropriate in the case of ISA 250 (Redrafted). The nature of the auditor’s responsibilities with respect to “other laws and regulations” is such that specificity in the objective is necessary to ensure a close linkage with the requirements of the ISA and to make clear precisely what is expected of the auditor.
17. Regarding the proposal to limit the scope of the objective, the IAASB concluded that the wording of the objective appropriately circumscribes the auditor’s responsibilities in relation to material matters. It was noted that the inclusion of the phrase “that are known to the entity” has the potential of imposing a greater restriction on the scope of the auditor’s work than intended, and would not be consistent with the extant ISA 250.
18. The IAASB did not accept the suggestion made by a few respondents to restrict the objective in paragraph 8(c) to those laws and regulations dealt with in the preceding two objectives. The IAASB concluded that that objective is consistent with the extant ISA and appropriately reflects the auditor’s responsibility to consider a response to non-compliance or suspected non-compliance with laws and regulations regardless of the nature of the non-compliance (other than when the matter is clearly inconsequential). The IAASB, however, modified that objective to make clear that the auditor’s responsibility is to respond to non-compliance or suspected non-compliance with laws and regulations when such non-compliance is identified during the audit, rather than to seek out and identify other non-compliance. See paragraph 10(c) of ISA 250 (Redrafted).
19. In addition to the above, the IAASB agreed, in response to comments from some IAASB CAG Representatives, that it would be appropriate to rephrase the objective in paragraph 8(a) of ED-ISA 250 in the positive form. This avoids the use of a double-negative in the objective, and aligns it more closely with the content of extant ISA 250. See paragraph 10(a) of ISA 250 (Redrafted).

### **Responsibility of Management for Detecting Non-Compliance with Laws and Regulations**

20. A few respondents expressed concern that the references in ED-ISA 250 to management’s responsibility for the detection of non-compliance with laws and regulations implied a responsibility to detect *all* instances of non-compliance with laws and regulation. It was argued that this would be too onerous and impracticable.
21. The IAASB concluded that it would be inappropriate to suggest that management is capable of detecting all instances of non-compliance. Accordingly, the IAASB agreed to delete references that might suggest this. The IAASB noted that the responsibility of management is adequately described, for purposes of the ISAs, in paragraph 3 of ISA 250 (Redrafted) in relation to ensuring that the entity’s operations are conducted in accordance with laws and regulations, including compliance with the provisions of laws

and regulations that determine the reported amounts and disclosures in the entity's financial statements.

### **Risk-Based Approach Versus a Procedural Approach**

22. In developing ED-ISA 250, the IAASB recognized that there were some parts of the extant ISA 250 that were procedurally oriented, particularly in relation to the auditor's responsibility to identify instances of non-compliance with laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements. The IAASB took the view that the approach taken in extant ISA 250 is appropriate in the light of the subject matter addressed and, accordingly, agreed that the project to clarify ISA 250 should be subject to limited redrafting to reflect only the conventions and matters of clarity generally.
23. A few respondents and IAASB CAG Representatives suggested that ED-ISA 250 could, or should be, subsequently revised to align it more closely with the risk-based approach adopted in other ISAs. Other respondents, however, supported the redrafting only of the extant ISA and did not view a future revision as necessary.
24. The IAASB considered these comments and determined that adopting a risk-based approach in the ISA would go beyond the scope of the project to redraft extant ISA 250. Accordingly, no changes have been made in this regard. The representations made in responses to the ED will be carried forward for consideration when determining priorities for future revisions of standards.