

**STATEMENT OF AUDITING STANDARDS
120
CONSIDERATION OF LAWS AND REGULATIONS
IN AN AUDIT OF FINANCIAL STATEMENTS**

*(Effective for audits of financial statements for periods beginning before 15 December 2004)**

<i>Contents</i>	<i>Paragraphs</i>
Introduction	1 - 8
Responsibility of management for the compliance with laws and regulations	9 - 10
The auditors' consideration of compliance with laws and regulations	11 - 34
Reporting of noncompliance	35 - 43
Withdrawal from the engagement	44 - 46
Compliance with International Standards on Auditing	47
Effective date	48
Appendix - Indications that noncompliance may have occurred	

* HKSA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements" is effective for audits of financial statements for periods beginning on or after 15 December 2004.

STATEMENT OF AUDITING STANDARDS
120
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*Statements of Auditing Standards (SASs) are to be read in the light of SAS 010 "The scope and authority of auditing pronouncements". In particular, they contain basic principles and essential procedures (auditing standards), indicated by paragraphs in **bold italic type**, with which auditors are required to comply in the conduct of any audit including those of companies applying section 141D of the Companies Ordinance. SASs also include explanatory and other material which is designed to assist auditors in interpreting and applying auditing standards.*

Introduction

1. The purpose of this Statement of Auditing Standards (SAS) is to establish standards and provide guidance on the auditors' responsibility to consider laws and regulations in an audit of financial statements.
2. ***When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditors should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. (SAS 120.1)***
3. However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.
4. The term "noncompliance" as used in this SAS refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts, include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. For the purpose of this SAS, noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's management or employees.
5. Whether an act constitutes noncompliance is a legal determination that is ordinarily beyond the auditors' professional competence. The auditors' training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditors' attention may constitute noncompliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the advice of an informed expert qualified to practise law but ultimately can only be determined by a court of law.
6. Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in 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. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are only subject to the many laws and regulations that generally relate to the operating aspects of the business (such as those related to occupational safety and health and equal employment). Noncompliance with laws and regulations could result in financial consequences for the entity such as fines, litigation, etc. Generally, the further removed noncompliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditors are to become aware of it or to recognize its possible noncompliance.
7. This SAS applies to audits of financial statements and does not apply to other engagements in which the auditors are specifically engaged to test and report separately on compliance with specific laws or regulations.
8. Guidance on the auditors' responsibility to consider fraud and errors in an audit of financial statements is provided in SAS 110 "Fraud and error".

Responsibility of management for the compliance with laws and regulations

9. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management.
10. The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of noncompliance:
 - a. monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements;
 - b. instituting and operating appropriate systems of internal control;
 - c. developing, publicizing and following a Code of Conduct;
 - d. ensuring employees are properly trained and understand the Code of Conduct;
 - e. monitoring compliance with the Code of Conduct and acting appropriately to discipline employees who fail to comply with it;
 - f. engaging legal advisors to assist in monitoring legal requirements;
 - g. maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to:

- h. an internal audit function;
- i. an audit committee.

The auditors' consideration of compliance with laws and regulations

11. The auditors are not, and cannot be held responsible for preventing noncompliance. The fact that an annual audit is carried out may, however, act as a deterrent.
12. An audit is subject to the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with SASs. This risk is higher with regard to material misstatements resulting from noncompliance with laws and regulations due to factors such as:
 - a. there are many laws and regulations, relating principally to the operating aspects of the entity, that typically do not have a material effect on the financial statements and are not captured by the accounting and internal control systems;
 - b. the effectiveness of audit procedures is affected by the inherent limitations of the accounting and internal control systems and by the use of testing;
 - c. much of the evidence obtained by the auditors is persuasive rather than conclusive in nature; and
 - d. noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentations being made to the auditors.
13. *In accordance with SAS 100 "Objective and general principles governing an audit of financial statements", the auditors should plan and perform the audit with an attitude of professional skepticism recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations. (SAS 120.2)*
14. In accordance with specific statutory requirements, the auditors may be specifically required to report as part of the audit of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditors would plan to test for compliance with these provisions of the laws and regulations.

15. ***In order to plan the audit, the auditors should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework. (SAS 120.3)***
16. In obtaining this general understanding, the auditors would particularly recognize that some laws and regulations may have a fundamental effect on the operations of the entity. That is, noncompliance with certain laws and regulations 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 licence or other title to perform its operations could have such an impact (for example, for a bank, noncompliance with capital adequacy requirements).
17. To obtain the general understanding of laws and regulations, the auditors would ordinarily:
 - a. use the existing knowledge of the entity's industry and business;
 - b. enquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations;
 - c. enquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
 - d. discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments; and
 - e. discuss the legal and regulatory framework with auditors of subsidiaries in other countries (for example, if the subsidiary is required to adhere to the securities regulations of the parent company).
18. ***After obtaining the general understanding, the auditors should perform procedures to help identify instances of noncompliance with those laws and regulations where noncompliance should be considered when preparing financial statements, specifically:***
 - a. *enquiring of management as to whether the entity is in compliance with such laws and regulations; and*
 - b. *inspecting correspondence with the relevant licensing or regulatory authorities. (SAS 120.4)*
19. ***Further, the auditors should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditors to have an effect on the determination of material amounts and disclosures in financial statements. The auditors should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made. (SAS 120.5)***
20. Such laws and regulations would be well established and known to the entity and within the industry; they would be considered on a recurring basis each time financial statements are issued. These laws and regulations, may relate, for example, to the form and content of financial statements, including industry specific requirements; accounting for transactions under government contracts; or the accrual or recognition of expenses for income taxes or pension costs.
21. Other than as described in paragraphs 18, 19 and 20, the auditors do not test or perform other procedures on the entity's compliance with laws and regulations since this would be outside the scope of an audit of financial statements.
22. ***The auditors should be alert to the fact that procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible noncompliance with laws and regulations to the auditors' attention. (SAS 120.6)***
23. For example, such procedures include reading minutes; enquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of transactions or balances.
24. ***The auditors should obtain written representations that management has disclosed to the auditors all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements. (SAS 120.7)***

25. In the absence of evidence to the contrary, the auditors are entitled to assume the entity is in compliance with these laws and regulations.

Procedures when noncompliance is discovered

26. The Appendix to this SAS sets out examples of the type of information that might come to the auditors' attention that may indicate noncompliance.
27. *When the auditors become aware of information concerning a possible instance of noncompliance, the auditors should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements. (SAS 120.8)*
28. When evaluating the possible effect on the financial statements, the auditors consider:
- a. the potential financial consequences, such as fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation;
 - b. whether the potential financial consequences require disclosure; and
 - c. whether the potential financial consequences are so serious as to call into question the true and fair view given by the financial statements.
29. *When the auditors believe there may be noncompliance, the auditors should document the findings and discuss them with management. (SAS 120.9)*
30. Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.
31. If management does not provide satisfactory information that it is in fact in compliance, the auditors would consult with the entity's lawyer about the application of the laws and regulations to the circumstances and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's lawyer or when the auditors are not satisfied with the opinion, the auditors would consider consulting the auditors' own lawyer as to whether a violation of a law or regulation is involved, the possible legal consequences and what further action, if any, the auditors would take.
32. *When adequate information about the suspected noncompliance cannot be obtained, the auditors should consider the effect of the lack of audit evidence on the auditors' report. (SAS 120.10)*
33. *The auditors should consider the implications of noncompliance in relation to other aspects of the audit, particularly the reliability of management representations. (SAS 120.11)*
34. In this regard, the auditors reconsider the risk assessment and the validity of management representations, in case of noncompliance not detected by internal controls or not included in management representations. The implications of particular instances of noncompliance discovered by the auditors will depend on the relationship of the perpetration and concealment, if any, of the act to specific control procedures and the level of management or employees involved.

Reporting of noncompliance

To management

35. *The auditors should, as soon as practicable, either communicate with the audit committee, the board of directors and senior management, or obtain evidence that they are appropriately informed, regarding noncompliance that comes to the auditors' attention. (SAS 120.12)*
36. However, the auditors need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.
37. *If in the auditors' judgement the noncompliance is believed to be intentional and material, the auditors should communicate the finding without delay. (SAS 120.13)*
38. *If the auditors suspect that members of senior management, including members of the board of directors, are involved in noncompliance, the auditors should report the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or a supervisory board. (SAS 120.14)*

39. Where no higher authority exists, or if the auditors believe that the report may not be acted upon or is unsure as to the person to whom to report, the auditors would consider seeking legal advice.

To the users of the auditors' report on the financial statements

40. *If the auditors conclude that the noncompliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditors should express a qualified (disagreement) or an adverse opinion in accordance with SAS 600 "Auditors' reports on financial statements". (SAS 120.15)*
41. *If the auditors are precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements, has, or is likely to have, occurred, the auditors should express a qualified (limitation of scope) opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SAS 600. (SAS 120.16)*
42. *If the auditors are unable to determine whether noncompliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditors should consider the effect on the auditors' report in accordance with SAS 600. (SAS 120.17)*

To regulatory and enforcement authorities

43. The auditors' duty of confidentiality would ordinarily preclude reporting noncompliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statute, law or by courts of law (for example, the auditors are required to report certain noncompliance by financial institutions to the supervisory authorities). The auditors may need to seek legal advice in such circumstances, giving due consideration to the auditors' responsibility to the public interest.

Withdrawal from the engagement

44. The auditors may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditors consider necessary in the circumstances, even when the noncompliance is not material to the financial statements. Factors that would affect the auditors' conclusion include the implications of the involvement of the highest authority within the entity which may affect the reliability of management representations, and the effects on the auditors of continuing association with the entity. In reaching such a conclusion, the auditors would ordinarily seek legal advice.
45. In accordance with Statement 1.207 "Changes in a professional appointment" issued by the Hong Kong Institute of Certified Public Accountants, on receipt of a request for professional clearance from the proposed auditors, the existing auditors would need to advise whether there are professional reasons why the proposed auditors should not accept the appointment. The extent to which the existing auditors can discuss the affairs of the entity with the proposed auditors will depend on whether the entity's permission to do so has been obtained. If there are any such reasons or other matters which need to be disclosed, the existing auditors would, taking account of the legal and ethical constraints, including where appropriate permission of the entity, give details of the information and discuss freely with the proposed auditors all matters relevant to the appointment.
46. If permission from the entity for the existing auditors to discuss its affairs with the proposed auditors is denied by the entity, in accordance with Statement 1.207, the existing auditors should report that fact to the proposed auditors who should not accept the nomination.

Compliance with International Standards on Auditing

47. Compliance with the auditing standards in this SAS ensures compliance in all material respects with International Standard on Auditing 250 "Consideration of Laws and Regulations in an Audit of Financial Statements".

Effective date

48. This SAS is effective for audits of financial statements for periods beginning before 15 December 2004.

Appendix

Indications that noncompliance may have occurred

Examples of the type of information that may come to the auditors' attention that may indicate that noncompliance with laws or regulations has occurred are listed below.

- a. Investigation by government departments or payment of fines or penalties.
- b. Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- c. 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.
- d. Purchasing at prices significantly above or below market price.
- e. Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer or transfers to numbered bank accounts.
- f. Unusual transactions with companies registered in tax havens.
- g. Payments for goods or services made other than to the country from which the goods or services originated.
- h. Payments without proper exchange control documentation.
- i. Existence of an accounting system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- j. Unauthorized transactions or improperly recorded transactions.
- k. Media comment.