

**INTERNATIONAL STANDARD ON AUDITING (UK AND IRELAND) 250**

**SECTION A - CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS**

**SECTION B – THE AUDITOR’S RIGHT AND DUTY TO REPORT TO REGULATORS IN THE FINANCIAL SECTOR**

**CONTENTS**

---

**Section A – Consideration of Laws and Regulations in an Audit of Financial Statements**

	Paragraph
Introduction .....	1 - 8-1
Responsibility of Management for the Compliance With Laws and Regulations .....	9 - 10-3
The Auditor’s Consideration of Compliance With Laws and Regulations .....	11 - 31
Reporting of Noncompliance .....	32 - 38-12
Withdrawal From the Engagement .....	39 - 40
Effective Date .....	40-1 - 40-2
Appendix: Indications that Noncompliance May Have Occurred	

**Section B – The Auditor’s Right and Duty to Report to Regulators in the Financial Sector**

Introduction.....	1 - 16
Appointment as Auditor and Ceasing to Hold Office.....	17 - 20
Conduct of the Audit.....	21 - 49
Reporting .....	50 - 71

Effective Date .....	72
Note on Legal Requirements	
Appendix 1: The Regulatory Framework	
Appendix 2: The Application of the Statutory Duty to Report Regulators	
Appendix 3: Action by the Auditor on Discovery of a Breach of a Regulator’s Requirements	

---

International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) 250 “Consideration of Laws and Regulations in an Audit of Financial Statements” should be read in the context of the Auditing Practices Board’s Statement “The Auditing Practices Board - Scope and Authority of Pronouncements” which sets out the application and authority of ISAs (UK and Ireland).

## Section A

### Introduction

1. The purpose of this International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) is to establish standards and provide guidance on the auditor's responsibility to consider laws and regulations in an audit of financial statements.
  - 1-1. This ISA (UK and Ireland) uses the terms 'those charged with governance' and 'management'. The term 'governance' describes the role of persons entrusted with the supervision, control and direction of an entity. Ordinarily, those charged with governance are accountable for ensuring that the entity achieves its objectives, and for the quality of its financial reporting and reporting to interested parties. Those charged with governance include management only when they perform such functions.
  - 1-2. In the UK and Ireland, those charged with governance include the directors (executive and non-executive) of a company or other body, the members of an audit committee where one exists, the partners, proprietors, committee of management or trustees of other forms of entity, or equivalent persons responsible for directing the entity's affairs and preparing its financial statements.
  - 1-3. 'Management' comprises those persons who perform senior managerial functions.
  - 1-4. In the UK and Ireland, depending on the nature and circumstances of the entity, management may include some or all of those charged with governance (e.g. executive directors). Management will not normally include non-executive directors.
2. **When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements.** 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<sup>1</sup> or employees and the possible effect on other aspects of the audit.

<sup>1</sup> In the UK and Ireland, the auditor also considers the implications for the integrity of those charged with governance.

3. The term “noncompliance” as used in this ISA (UK and Ireland) 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<sup>2</sup> or employees. For the purpose of this ISA (UK and Ireland), noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity’s management or employees.
4. Whether an act constitutes noncompliance is a legal determination that is ordinarily beyond the auditor’s professional competence. The auditor’s training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor’s 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 practice law but ultimately can only be determined by a court of law.
5. 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<sup>3</sup> 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 auditor is to become aware of it or to recognize its possible noncompliance.

5-1. When determining the type of procedures necessary in a particular instance the auditor takes account of the particular entity concerned and the

<sup>2</sup> In the UK and Ireland, such acts include transactions entered into by, or in the name of, the entity or on its behalf by those charged with governance.

<sup>3</sup> In the UK and Ireland, there are also laws or regulations that are to be complied with by those charged with governance.

complexity of the regulations with which it is required to comply. In general, a small company which does not operate in a regulated area will require few specific procedures compared with a large multinational corporation carrying on complex, regulated business.

6. Laws and regulations vary from country to country. National accounting and auditing standards are therefore likely to be more specific as to the relevance of laws and regulations to an audit.
7. This ISA (UK and Ireland) applies to audits of financial statements and does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.
8. Guidance on the auditor's responsibility to consider fraud and error in an audit of financial statements is provided in ISA (UK and Ireland) 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."

8-1. Guidance on the auditor's responsibility to report direct to regulators in the financial sector is provided in Section B of this ISA (UK and Ireland).

### **Responsibility of Management<sup>4</sup> 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<sup>4</sup>. The responsibility for the prevention and detection of noncompliance rests with management<sup>4</sup>.
10. The following policies and procedures, among others, may assist management<sup>5</sup> in discharging its responsibilities for the prevention and detection of noncompliance:
  - Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
  - Instituting and operating appropriate internal control.
  - Developing, publicizing and following a code of conduct.
  - Ensuring employees are properly trained and understand the code of

<sup>4</sup> In the UK and Ireland, this responsibility rests with those charged with governance.

<sup>5</sup> In the UK and Ireland, the policies and procedures may also assist those charged with governance in discharging their responsibilities for the prevention and detection of noncompliance.

conduct.

- Monitoring compliance with the 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 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 department.
- A compliance function.

10-1. In the UK and Ireland, in certain sectors or activities (for example financial services), there are detailed laws and regulations that specifically require directors to have systems to ensure compliance. These laws and regulations could, if breached, have a material effect on the financial statements. In addition, the directors are required to report certain instances of non-compliance to the proper authorities on a timely basis.

10-2. In the UK and Ireland, it is the directors' responsibility to prepare financial statements that give a true and fair view of the state of affairs of a company or group and of its profit or loss for the financial year. Accordingly it is necessary, where possible non-compliance with law or regulations has occurred which may result in a material misstatement in the financial statements, for them to ensure that the matter is appropriately reflected and/or disclosed in the financial statements.

10-3. In the UK and Ireland, in addition, directors and officers of companies have responsibility to provide information required by the auditor, to which they have a legal right of access<sup>6</sup>. Such legislation also provides that it is a criminal offence to give to the auditor information or explanations which are misleading, false or deceptive.

---

<sup>6</sup> In the UK under Section 389A of the Companies Act 1985 or Sections 193(3) and 197 of the Companies Act, 1990 in Ireland.

## The Auditor's Consideration of Compliance With Laws and Regulations

11. The auditor is 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 ISAs (UK and Ireland). This risk is higher with regard to material misstatements resulting from noncompliance with laws and regulations due to factors such as the following:
  - 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 entity's information systems relevant to financial reporting.
  - The effectiveness of audit procedures is affected by the inherent limitations of internal control and by the use of testing.
  - Much of the audit evidence obtained by the auditor is persuasive rather than conclusive in nature.
  - Noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, senior management<sup>7</sup> override of controls or intentional misrepresentations being made to the auditor.
13. **In accordance with ISA (UK and Ireland) 200, "Objective and General Principles Governing an Audit of Financial Statements" the auditor 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.**
14. In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the audit of the financial statements

---

<sup>7</sup> In the UK and Ireland, an additional factor is override of controls by those charged with governance.

whether the entity complies with certain provisions of laws or regulations<sup>8</sup>. In these circumstances, the auditor would plan to test for compliance with these provisions of the laws and regulations.

15. **In order to plan the audit, the auditor 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.**

**15-1. In the UK and Ireland, the auditor should obtain a general understanding of the procedures followed by the entity to ensure compliance with that framework.**

16. In obtaining this general understanding, the auditor would particularly recognize that some laws and regulations may give rise to business risks that 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 license or other title to perform its operations could have such an impact (for example, for a bank, noncompliance with capital or investment requirements)<sup>9</sup>.
17. To obtain the general understanding of laws and regulations, the auditor would ordinarily:
- Use the existing understanding of the entity's industry, regulatory and other external factors;
  - Inquire of management<sup>10</sup> concerning the entity's policies and procedures regarding compliance with laws and regulations;

<sup>8</sup> In Ireland, the Companies (Auditing and Accounting) Act 2003 contains provisions that will require, when commenced, directors of "large" companies to make statements regarding compliance with the Companies Acts, tax laws and any other elements that provide a legal framework within which the company operates and that may materially affect the company's financial statements. Auditors of such companies will be required to review the statements to determine whether they are fair and reasonable having regard to information obtained by the auditor in the course of the audit or other work undertaken for the company. The auditors' review requirements are not addressed in this ISA (UK and Ireland)).

<sup>9</sup> Such requirements exist in the UK under the Financial Services and Markets Act 2000 and in Ireland under the Investment Intermediaries Act 1995, the Central Bank Acts 1942 to 1989 and the Credit Union Act, 1997.

<sup>10</sup> In the UK and Ireland, the auditor makes inquiries of such matters with those charged with governance.

- Inquire of management<sup>10</sup> as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
  - Discuss with management<sup>11</sup> the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments; and
  - 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 auditor should perform further audit procedures to help identify instances of noncompliance with those laws and regulations where noncompliance should be considered when preparing financial statements, specifically:**
- (a) **Inquiring 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.**
  - (c) **Enquiring of those charged with governance as to whether they are on notice of any such possible instances of non-compliance with law or regulations.**
- 18-1. **In the UK and Ireland, the auditor’s procedures should be designed to help identify possible or actual instances of non-compliance with those laws and regulations which provide a legal framework within which the entity conducts its business and which are central to the entity’s ability to conduct its business and hence to its financial statements.**
19. **Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor 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.**

---

<sup>11</sup> In the UK and Ireland, the auditor discusses such matters with those charged with governance.

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<sup>12</sup>, including industry specific requirements; accounting for transactions under government contracts; or the accrual or recognition of expenses for income taxes or pension costs.

20-1. In the UK and Ireland, these laws and regulations include:

- Those which determine the circumstances under which a company is prohibited from making a distribution except out of profits available for the purpose<sup>13</sup>.
- Those laws which require auditors expressly to report non-compliance, such as the requirements relating to the maintenance of proper accounting records or the disclosure of particulars of directors' remuneration in a company's financial statements<sup>14</sup>.

21. Other than as described in paragraphs 18-20, the auditor does not perform other audit 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 auditor should be alert to the fact that audit 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 auditor's attention.** For example, such audit procedures include reading minutes; inquiring of the entity's management<sup>10</sup> and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of classes of transactions, account balances, or disclosures.

22-1. **In the UK and Ireland, when carrying out procedures for the purpose of forming an opinion on the financial statements, the auditor should be alert for those instances of possible or actual noncompliance with laws and regulations that might incur obligations for partners and staff in audit firms to report money laundering offences.**

---

<sup>12</sup> In the UK under Schedule 4 to the Companies Act 1985 or The Companies (Amendment) Act, 1986 in Ireland.

<sup>13</sup> In the UK under Section 263 of the Companies Act 1985 or Section 45 of the Companies (Amendment) Act, 1983 in Ireland.

<sup>14</sup> In the UK under Sections 237(2) and 237(4)(a) of the Companies Act 1985 or Section 193 and 194 of the Companies Act, 1990 in Ireland.

- 22-2. There may be a wide range of laws and regulations falling into this category, many of which fall outside the expertise of individuals trained in financial auditing. There can therefore be no assurance that the auditor appointed to report on an entity's statements will detect all material breaches of such laws and regulations. However, when the auditor suspects the existence of breaches which could be material, the auditor needs to consider whether and how the matter ought to be reported, as set out later in this ISA (UK and Ireland).
- 22-3. Anti-money laundering legislation<sup>15</sup> in the UK and Ireland extends further than the laundering of money that is derived from drug trafficking or is related to terrorist<sup>16</sup> offences and has specific auditor reporting responsibilities<sup>17</sup>. The new anti-money laundering legislation imposes a duty to report money laundering in respect of the proceeds of all crime. The detailed legislation in both countries differs but the impact on the auditor can broadly be summarised as follows:
- Money laundering includes concealing, disguising, converting, transferring, removing, using, acquiring or possessing property<sup>18</sup> which constitutes or represents a benefit from criminal conduct<sup>19</sup>.

<sup>15</sup> In the UK, with effect from 1 March 2004 The Money Laundering Regulations 2003 replaced the 1993 and 2001 regulations and the requirements of the Proceeds of Crime Act 2002 were extended to the provision by way of business of audit services by a person who is eligible for appointment as a company auditor under section 25 of the Companies Act 1989.

In Ireland, with effect from 15 September 2003 the Criminal Justice Act 1994 (Section 32) Regulations 2003 designate accountants, auditors, and tax advisors and others for the purposes of the anti-money laundering provisions of the Criminal Justice Act, 1994, as amended.

<sup>16</sup> In the UK, the Terrorism Act 2000 (as amended by the Anti-terrorism, Crime and Security Act 2001) and associated regulations. The duty to report drug trafficking related money laundering has been subsumed into the general requirement to report the proceeds of crime.

In Ireland, there is similar proposed legislation that the auditor will need to consider in due course.

<sup>17</sup> Anti-money laundering legislation differs in the UK and Ireland, references to such legislation in the main body of the SAS uses generalised wording with the specific requirements of the UK and Irish legislation described in footnotes.

<sup>18</sup> In the UK, "property" is criminal property if it constitutes a person's benefit from criminal conduct or it represents such a benefit (in whole or part and whether directly or indirectly), and the alleged offender knows or suspects that it constitutes or represents such a benefit.

In Ireland, "property" is defined as including money and all other property, real or personal, heritable or moveable, including choses in action and other intangible or incorporeal property.

<sup>19</sup> In the UK, "criminal conduct" is defined as conduct which constitutes an offence in any part of the UK or would constitute such an offence if it occurred in any part of the UK.

Although the anti-money laundering legislation does not contain de minimis concessions in the UK the National Criminal Intelligence Service (“NCIS”) has introduced guidance on reports of limited intelligence value.

- Partners and staff in audit firms are required to report suspicions<sup>20</sup> that a criminal offence, giving rise to direct or indirect benefit has been committed, regardless of whether that offence has been committed by a client or by a third party.
- Partners and staff in audit firms need to be alert to the dangers of making disclosures that are likely to tip off a money launderer or prejudice an investigation (‘tipping-off’<sup>21</sup>), as this will constitute a criminal offence under the anti-money laundering legislation.

---

In Ireland, “criminal conduct” means conduct which constitutes an ‘indictable offence’, or where the conduct occurs outside the State, would constitute such an offence if it occurred within the State and also constitutes an offence under the law of the country or territorial unit in which it occurs, and includes participation in such conduct.

<sup>20</sup> In the UK, as a result of the Proceeds of Crime Act 2002 and the 2003 Money Laundering Regulations auditors are required to report where they know or suspect, or have reasonable grounds to know or suspect, that another person is engaged in money laundering. Partners and staff in audit firms discharge their responsibilities by reporting to their Money Laundering Reporting Officer (“MLRO”) or, in the case of sole practitioners, to NCIS.

In Ireland, the Criminal Justice Act, 1994, as amended, and the Criminal Justice Act, 1994 (Section 32) Regulations, 2003 require auditors and other defined persons to report to the Garda Síochána and the Revenue Commissioners where they suspect that an offence, as defined in the legislation, in relation to the business of that person has been or is being committed. Two further reporting duties exist in Irish law, Section 74 of the Company Law Enforcement Act 2001 requires auditors to report to the Director of Corporate Enforcement instances of the suspected commission of indictable offences under the Companies Acts and Section 59 of the Criminal Justice (Theft and Fraud Offences) Act, 2001 requires ‘relevant persons’, as defined in the section and which includes auditors of companies, to report ‘indications’ that specified offences under the Act have been committed to the Garda Síochána. Additionally, auditors may report direct to the Revenue Commissioners certain offences under Section 1079 of the Taxes Consolidation Act, 1997.

<sup>21</sup> In the UK, ‘tipping off’ is an offence under section 333 of the Proceeds of Crime Act 2002. It arises when an individual discloses matters where:

- (a) There is knowledge or suspicion that a report has already been made, and
- (b) That disclosure is likely to prejudice any investigation which might be conducted following the report.

Whilst “tipping off” requires a person to have knowledge or suspicion that a report has been or will be made, a further offence of prejudicing an investigation is included in section 342 of POCA. Under this provision, it is an offence to make any disclosure which may prejudice an investigation of which a

23. **The auditor should obtain written representations that management<sup>22</sup> has disclosed to the auditor all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing financial statements.**
- 23-1. **Where applicable, the written representations should include the actual or contingent consequences which may arise from the non-compliance.**
24. In the absence of audit evidence to the contrary, the auditor is entitled to assume the entity is in compliance with these laws and regulations.

#### **Compliance with Tax Legislation**

- 24-1. In the UK and Ireland, the auditor's responsibility to express an opinion on an entity's financial statements does not extend to determining whether the entity has complied in every respect with applicable tax legislation. The auditor needs to obtain sufficient appropriate evidence to give reasonable assurance that the amounts included in the financial statements in respect of taxation are not materially misstated. This will usually include making appropriate enquiries of those advising the entity on taxation matters (whether within the audit firm or elsewhere).
- 24-2. In the UK and Ireland, if the auditor becomes aware that the entity has failed to comply with the requirements of tax legislation, the auditor follows the procedures for reporting set out in paragraphs 38 to 38-1 of this ISA (UK and Ireland).

#### **Audit Procedures When Noncompliance is Discovered**

25. The Appendix to this ISA (UK and Ireland) sets out examples of the type of information that might come to the auditor's attention that may indicate noncompliance.

---

person has knowledge or suspicion, or to falsify, conceal, destroy or otherwise dispose of, or cause or permit the falsification, concealment, destruction or disposal of, documents relevant to such an investigation.

In Ireland Section 58 of the Criminal Justice Act, 1994, as amended, establishes the offence of "prejudicing an investigation". This relates both to when a person, knowing or suspecting that an investigation is taking place, makes any disclosure likely to prejudice the investigation or when a person, knowing that a report has been made, makes any disclosure likely to prejudice any investigation arising from the report.

<sup>22</sup> In the UK and Ireland the auditor obtains this written representation from those charged with governance.

26. **When the auditor becomes aware of information concerning a possible instance of noncompliance, the auditor should<sup>23</sup> 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.**
27. When evaluating the possible effect on the financial statements, the auditor considers:
- The potential financial consequences, such as fines, penalties, damages, threat of expropriation of assets<sup>24</sup>, enforced discontinuation of operations and litigation.
  - Whether the potential financial consequences require disclosure.
  - Whether the potential financial consequences are so serious as to call into question the true and fair view (fair presentation) given by the financial statements.

27-1. As the consideration of compliance with laws and regulations may involve consideration of matters which do not lie within the competence and experience of individuals trained in the audit of financial information, it may be necessary for the auditor to obtain appropriate expert advice (whether through the entity or independently) in order to evaluate the possible effect on the entity's financial statements. Where this is the case, the auditor is required to meet the Standards set out in ISA (UK and Ireland) 620 "Using the work of an expert".

28. **When the auditor believes there may be noncompliance, the auditor should document the findings and discuss them with management<sup>11</sup>.** Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.

28-1. **Any discussion of findings with those charged with governance and with management should be subject to compliance with legislation relating to 'tipping off' and any requirement to report the findings direct to a third party.**

---

<sup>23</sup> Subject to compliance with legislation relating to 'tipping off'. See footnote 21.

<sup>24</sup> The Proceeds of Crime Act 2002 ("POCA") establishes an independent Government Department, the Assets Recovery Agency.

In Ireland, the Criminal Assets Bureau, a similar agency responsible for the confiscation of assets was established by the Criminal Assets Bureau Act, 1996.

29. If management<sup>25</sup> does not provide satisfactory information that it is in fact in compliance, the auditor 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 auditor is not satisfied with the opinion, the auditor would consider consulting the auditor's 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 auditor would take.
30. **When adequate information about the suspected noncompliance cannot be obtained, the auditor should consider the effect of the lack of sufficient appropriate audit evidence on the auditor's report.**
31. **The auditor should consider the implications of noncompliance in relation to other aspects of the audit, particularly the reliability of management<sup>26</sup> representations.** In this regard, the auditor reconsiders the risk assessment and the validity of management representations, in case of noncompliance not detected by the entity's internal controls or not included in management representations. The implications of particular instances of noncompliance discovered 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.

## Reporting of Noncompliance

### To Management

32. **The auditor should, as soon as practicable, either communicate with those charged with governance, or obtain audit evidence that they are appropriately informed, regarding noncompliance that comes to the auditor's attention.** However, the auditor 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.
33. **If in the auditor's judgment the noncompliance is believed to be intentional and material, the auditor should communicate the finding without delay.**

<sup>25</sup> In the UK and Ireland, the auditor obtains such information from those charged with governance.

<sup>26</sup> In the UK and Ireland, the auditor also considers the reliability of representations from those charged with governance.

- 33-1. **In the UK and Ireland the auditor should communicate the finding where the non-compliance is material or is believed to be intentional. The non-compliance does not have to be both material and intentional.**
- 33-2. Any communication with those charged with governance, or action by the auditor to obtain evidence that they are appropriately informed is subject to compliance with legislation relating to ‘tipping off’.
34. **If the auditor suspects that members of senior management, including members of the board of directors<sup>27</sup>, are involved in noncompliance, the auditor 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.** Where no higher authority exists, or if the auditor believes that the report may not be acted upon or is unsure as to the person to whom to report, the auditor would consider seeking legal advice.
- 34-1. In the case of suspected Money Laundering it may be appropriate to report the matter direct to the appropriate authority.

#### To the Users of the Auditor’s Report on the Financial Statements

35. **If the auditor concludes that the noncompliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should<sup>23</sup> express a qualified or an adverse opinion.**
36. **If the auditor is 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 auditor should<sup>23</sup> express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.**
37. **If the auditor is unable to determine whether noncompliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should<sup>23</sup> consider the effect on the auditor’s report.**
- 37-1. In the UK and Ireland, if the auditor concludes that the view given by the financial statements could be affected by a level of uncertainty concerning the consequences of a suspected or actual noncompliance which, in the

<sup>27</sup> In the UK and Ireland, the auditor also reports such matters if those charged with governance are suspected of being involved in non compliance.

- auditor's opinion, is significant, the auditor, subject to compliance with legislation relating to 'tipping off', includes an explanatory paragraph referring to the matter in the auditor's report.
- 37-2. In the UK and Ireland, in determining whether disclosures concerning the matter are adequate, or whether an explanatory paragraph needs to be included in the auditor's report, the auditor bases the decision primarily on the adequacy of the overall view given by the financial statements. Steps taken to regularize the position (for example, where there has been an unauthorized material transaction for which authority has subsequently been obtained), or the possible consequences of qualification, are not, on their own, grounds on which the auditor may refrain from expressing a qualified opinion or from including an explanatory paragraph reflecting a significant uncertainty.
- 37-3. In the UK and Ireland, when determining whether a suspected or actual instance of non-compliance with laws or regulations requires disclosure in the financial statements, the auditor has regard to whether shareholders require the information to enable them to assess the performance of the company and any potential implications for its future operations or standing. Where a suspected or actual instance of non-compliance needs to be reflected in the financial statements, a true and fair view will require that sufficient particulars are provided to enable users of the financial statements to appreciate the significance of the information disclosed. This would usually require the full potential consequences to be disclosed and, in some cases, it may be necessary for this purpose that the financial statements indicate that non-compliance with laws or regulations is or may be involved.
- 37-4. In the UK and Ireland, when considering whether the financial statements reflect the possible consequences of any suspected or actual non-compliance, the auditor has regard to the requirements of FRS 12 "Provisions, contingent liabilities and contingent assets"/IAS 37, "Provisions, contingent liabilities and contingent assets". Suspected or actual non-compliance with laws or regulations may require disclosure in the financial statements because, although the immediate financial effect on the entity may not be material, there could be future material consequences such as fines or litigation. For example, an illegal payment may not itself be material but may result in criminal proceedings against the entity or loss of business which could have a material effect on the true and fair view given by the financial statements.

**To Regulatory and Enforcement Authorities**

38. The auditor’s 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, in some countries the auditor is required to report noncompliance by financial institutions to the supervisory authorities). The auditor may need to seek legal advice in such circumstances, giving due consideration to the auditor’s responsibility to the public interest.

- 38-1. **If the auditor becomes aware of a suspected or actual non-compliance with law and regulations which gives rise to a statutory duty to report, the auditor should, subject to compliance with legislation relating to “tipping off”, make a report to the appropriate authority without undue delay.**
- 38-2. Legislation in the UK and Ireland establishes specific responsibilities for the auditor to report suspicions regarding certain criminal offences. In addition, the auditor of entities subject to statutory regulation<sup>28</sup>, has separate responsibilities to report certain information direct to the relevant regulator. Standards and guidance on these responsibilities is given in Section B of this ISA (UK and Ireland) and relevant APB Practice Notes.
- 38-3. The procedures and guidance in Section B of this ISA (UK and Ireland) can be adapted to circumstances in which the auditor of other types of entity becomes aware of a suspected instance of non-compliance with laws or regulations which the auditor is under a statutory duty to report.
- 38-4. Where the auditor becomes aware of a suspected or actual instance of non-compliance with law or regulations which does not give rise to a statutory duty to report to an appropriate authority the auditor considers whether the matter may be one that ought to be reported to a proper authority in the public interest and, where this is the case, except in the circumstances covered in paragraph 38-6 below, discusses the matter with those charged with governance, including any audit committee.
- 38-5. If, having considered any views expressed on behalf of the entity and in the light of any legal advice obtained, the auditor concludes that the matter ought to be reported to an appropriate authority in the public interest, the

<sup>28</sup> Auditors of financial service entities, pension schemes and, in the UK, charities have a statutory responsibility, subject to compliance with legislation relating to “tipping off”, to report matters that are likely to be of material significance to the regulator.

auditor notifies those charged with governance in writing of the view and, if the entity does not voluntarily do so itself or is unable to provide evidence that the matter has been reported, the auditor reports it.

- 38-6. The auditor reports a matter direct to a proper authority in the public interest and without discussing the matter with the entity if the auditor concludes that the suspected or actual instance of non-compliance has caused the auditor no longer to have confidence in the integrity of the those charged with governance.
- 38-7. Examples of circumstances which may cause the auditor no longer to have confidence in the integrity of those charged with governance include situations:
- Where the auditor suspects or has evidence of the involvement or intended involvement of those charged with governance in possible non-compliance with law or regulations which could have a material effect on the financial statements; or
  - Where the auditor is aware that those charged with governance are aware of such non-compliance and, contrary to regulatory requirements or the public interest, have not reported it to a proper authority within a reasonable period.
- 38-8. Determination of where the balance of public interest lies requires careful consideration. An auditor whose suspicions have been aroused uses professional judgment to determine whether the auditor's misgivings justify the auditor in carrying the matter further or are too insubstantial to deserve reporting. The auditor is protected from the risk of liability for breach of confidence or defamation provided that:
- In the case of breach of confidence, disclosure is made in the public interest, and such disclosure is made to an appropriate body or person<sup>29</sup>, and there is no malice motivating the disclosure; and

<sup>29</sup> In the UK, proper authorities could include the Serious Fraud Office, the Crown Prosecution Service, police forces, the Financial Services Authority the Panel on Takeovers and Mergers, the Society of Lloyd's, local authorities, the Charity Commissioners for England and Wales, the Scottish Office For Scottish Charities, the Inland Revenue, HM Customs and Excise, the Department of Trade and Industry and the Health and Safety Executive.

In Ireland, comparable bodies could include the Garda Bureau of Fraud Investigation, the Revenue Commissioners, the Irish Stock Exchange, the Irish Financial Services Regulatory Authority, the Pensions Board, the Director of Corporate Enforcement and the Department of Enterprise Trade and Employment.

- In the case of defamation disclosure is made in the auditor's capacity as auditor of the entity concerned, and there is no malice motivating the disclosure.

In addition, the auditor is protected from such risks where the auditor is expressly permitted or required by legislation to disclose information.

38-9. 'Public interest' is a concept that is not capable of general definition. Each situation must be considered individually. Matters to be taken into account when considering whether disclosure is justified in the public interest may include:

- The extent to which the suspected or actual non-compliance with law or regulations is likely to affect members of the public;
- Whether those charged with governance have rectified the matter or are taking, or are likely to take, effective corrective action;
- The extent to which non-disclosure is likely to enable the suspected or actual non-compliance with law or regulations to recur with impunity;
- The gravity of the matter;
- Whether there is a general ethos within the entity of disregarding law or regulations; and
- The weight of evidence and the degree of the auditor's suspicion that there has been an instance of non-compliance with law or regulations.

38-10. An auditor who can demonstrate having acted reasonably and in good faith in informing an authority of a breach of law or regulations which the auditor thinks has been committed would not be held by the court to be in breach of duty to the client even if, an investigation or prosecution having occurred, it were found that there had been no offence.

38-11. The auditor needs to remember that the auditor's decision as to whether to report, and if so to whom, may be called into question at a future date, for example on the basis of:

- What the auditor knew at the time;
- What the auditor to have known in the course of the audit;
- What the auditor ought to have concluded; and
- What the auditor ought to have done.

The auditor may also wish to consider the possible consequences if financial loss is occasioned by non-compliance with law or regulations which the auditor suspects (or ought to suspect) has occurred but decided not to report.

- 38-12. The auditor may need to take legal advice before making a decision on whether the matter needs to be reported to a proper authority in the public interest.

### Withdrawal From the Engagement

39. The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the noncompliance is not material to the financial statements. Factors that would affect the auditor's conclusion include the implications of the involvement of the highest authority within the entity which may affect the reliability of management<sup>26</sup> representations, and the effects on the auditor of continuing association with the entity. In reaching such a conclusion, the auditor would ordinarily seek legal advice.

- 39-1. Resignation by the auditor is a step of last resort. It is normally preferable for the auditor to remain in office to fulfil the auditor's statutory duties, particularly where minority interests are involved. However, there are circumstances where there may be no alternative to resignation, for example where the directors of a company refuse to issue its financial statements or the auditor wishes to inform the shareholders or creditors of the company of the auditor's concerns and there is no immediate occasion to do so.

40. **As stated in the *Code of Ethics for Professional Accountants*<sup>30</sup> issued by the International Federation of Accountants, on receipt of an inquiry from the proposed auditor, the existing auditor should advise whether there are any professional reasons why the proposed auditor should not accept the appointment.** The extent to which an existing auditor can discuss the affairs of a client with a proposed auditor will depend on whether the client's permission to do so has been obtained and/or the legal or ethical requirements that apply in each country relating to such disclosure. If there are any such reasons or other matters which need to be

<sup>30</sup> In the UK and Ireland the relevant ethical pronouncements with which the auditor complies are the APB's Ethical Standards and the ethical pronouncements relating to the work of auditors issued by the auditor's relevant professional body - see the Statement "The Auditing Practices Board – Scope and Authority of Pronouncements."

disclosed, the existing auditor would, taking account of the legal and ethical constraints, including where appropriate permission of the client, give details of the information and discuss freely with the proposed auditor all matters relevant to the appointment. **If permission from the client to discuss its affairs with the proposed auditor is denied by the client, that fact should be disclosed to the proposed auditor.**

### Effective Date

- 40-1. This ISA (UK and Ireland) is effective for audits of financial statements for periods commencing on or after 15 December 2004.
- 40-2. In the UK, the Money Laundering Regulations 2003 came into force on 1 March 2004. In Ireland, the Criminal Justice Act 1994 (Section 32) Regulations 2003 are effective from 15 September 2003.

### Public Sector Perspective

Additional guidance for auditors of public sector bodies in the UK and Ireland is given in:

- Practice Note 10 “Audit of Financial Statements of Public Sector Entities in the United Kingdom (Revised)”
- Practice Note 10(I) “The Audit of Central Government Financial Statements in Ireland”

1. *Many public sector engagements include additional audit responsibilities with respect to consideration of laws and regulations. Even if the auditor’s responsibilities do not extend beyond those of the private sector auditor, reporting responsibilities may be different as the public sector auditor may be obliged to report on instances of noncompliance to governing authorities or to report them in the audit report. In respect to public sector entities, the Public Sector Committee (PSC) has supplemented the guidance included in this ISA (UK and Ireland) in its Study 3, “Auditing for Compliance with Authorities—A Public Sector Perspective.”*

## Appendix

### Indications That Noncompliance May Have Occurred

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

- Investigation by government departments.
- Payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees 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.
- Purchasing 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.
- Complex corporate structures including offshore companies where ownership cannot be identified.
- Unusual transactions with companies registered in tax havens.
- Tax evasion such as the under declaring of income and over claiming of expenses.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorized transactions or improperly recorded transactions.
- Media comment.
- Transactions undertaken by the entity that have no apparent purpose or that make no obvious economic sense.

- Where those charged with governance of the entity refuse to provide necessary information and explanations to support transactions and other dealings of the company.

## Section B

### The Auditor's Right and Duty to Report to Regulators in the Financial Sector

#### Introduction

1. The purpose of this Section of this ISA (UK and Ireland) is to establish standards and provide guidance on the circumstances in which the auditor of a financial institution subject to statutory regulation (a 'regulated entity') is required to report direct to a regulator information which comes to the auditor's attention in the course of the work undertaken in the auditor's capacity as auditor of the regulated entity. This may include work undertaken to express an opinion on the entity's financial statements, other financial information or on other matters specified by legislation or by a regulator.
2. **The auditor of a regulated entity should bring information of which the auditor has become aware in the ordinary course of performing work undertaken to fulfil the auditor's audit responsibilities to the attention of the appropriate regulator without delay when:**
  - (a) **The auditor concludes that it is relevant to the regulator's functions having regard to such matters as may be specified in statute or any related regulations; and**
  - (b) **In the auditor's opinion there is reasonable cause to believe it is or may be of material significance to the regulator.**
3. The auditor of a regulated entity generally has special reporting responsibilities in addition to the responsibility to report on financial statements. These special reporting responsibilities take two forms:
  - (a) *A responsibility to provide a report on matters specified in legislation or by a regulator.* This form of report is often made on an annual or other routine basis and does not derive from another set of reporting responsibilities. The auditor is required to carry out appropriate procedures sufficient to form an opinion on the matters concerned. These procedures may be in addition to those carried out to form an opinion on the financial statements; and
  - (b) *A statutory duty to report certain information, relevant to the regulators' functions, that come to the auditor's attention in the*

*course of the audit work.* The auditor has no responsibility to carry out procedures to search out the information relevant to the regulator. This form of report is derivative in nature, arising only in the context of another set of reporting responsibilities, and is initiated by the auditor on discovery of a reportable matter.

4. The statutory duty to report to a regulator applies to information which comes to the attention of the auditor in the auditor's capacity as auditor. In determining whether information is obtained in that capacity, two criteria in particular need to be considered: first, whether the person who obtained the information also undertook the audit work; and if so, whether it was obtained in the course of or as a result of undertaking the audit work. Appendix 2 to this section of this ISA (UK and Ireland) sets out guidance on the application of these criteria.
5. The auditor may have a statutory right to bring information to the attention of the regulator in particular circumstances which lie outside those giving rise to a statutory duty to initiate a direct report. Where this is so, the auditor may use that right to make a direct report relevant to the regulator on a specific matter which comes to the auditor's attention when the auditor concludes that doing so is necessary to protect the interests of those for whose benefit the regulator is required to act.
6. This section of this ISA (UK and Ireland) deals with both forms of direct reports. Guidance on the auditor's responsibility to provide special reports on a routine basis on other matters specified in legislation or by a regulator is given in the Practice Notes dealing with regulated business, for example banks, building societies, investment businesses and insurers.
7. The standards and explanatory material in this section of this ISA (UK and Ireland) complement but do not replace the legal and regulatory requirements applicable to each regulated entity. Where the application of those requirements, taking into account any published interpretations, is insufficiently clear for the auditor to determine whether a particular circumstance results in a legal duty to make a report to a regulator, or a right to make such a report, it may be appropriate to take legal advice.

#### **Definitions**

8. **The Act:** In the United Kingdom, this comprises the Financial Services and Markets Act 2000 and regulations made under that Act, and any future legislation including provisions relating to the duties of auditors similar to those contained in that statute.

9. In the Republic of Ireland, *the Acts* comprise the Central Bank Acts 1942 to 1989, the Building Societies Act 1989, The Central Bank and Financial Services Authority of Ireland Act, 2003, the Trustees Savings Bank Act 1989, the Insurance Act 1989, the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 1989, the Unit Trusts Act 1990, the ICC Bank Act (section 3) Regulations 1993 and, in the case of investment companies, the Companies Act 1990 and any future legislation<sup>1</sup> including provisions relating to the duties of auditors similar to those contained in those Acts, together with other regulations made under them.
10. **Audit:** for the purpose of this Section of this ISA (UK and Ireland), the term *audit* refers both to an engagement to report on the financial statements of a regulated entity and to an engagement to provide a report on other matters specified by statute or by a regulator undertaken in the capacity of auditor.
11. **Auditor:** the term 'auditor' should be interpreted in accordance with the requirements of the Acts. Guidance on its interpretation is contained in Practice Notes relating to each area of the financial sector to which the duty applies.
12. **Control environment:** the overall attitude, awareness and actions of those charged with governance and management regarding internal controls and their importance in the entity. Factors reflected in the control environment include:
- Management's philosophy and operating style;
  - The entity's organisational structure and methods of assigning authority and responsibility (including segregation of duties and management supervisory controls); and
  - Management's methods of imposing control including the internal audit function, the functions of those charged with governance and personnel policies and procedures.
13. **Those charged with governance:** In the UK and Ireland, those charged with governance include the directors (executive and non-executive) of a company or other body, the members of an audit committee where one

<sup>1</sup> Specifically, the Central Bank and Financial Services Authority of Ireland (no. 2) Bill published in December 2003 is also likely to introduce changes to the duties of auditors.

exists, the partners, proprietors, committee of management or trustees of other forms of entity, or equivalent persons responsible for directing the entity's affairs and preparing its financial statements.

14. **Material significance:** the term 'material significance' requires interpretation in the context of the specific legislation applicable to the regulated entity. A matter or group of matters is normally of material significance to a regulator's functions when, due either to its nature or its potential financial impact, it is likely of itself to require investigation by the regulator. Further guidance on the interpretation of the term in the context of specific legislation is contained in Practice Notes dealing with the rights and duties of auditors of regulated entities to report direct to regulators.
15. **Regulated entity:** an individual, company or other type of entity authorised to carry on business in the financial sector which is subject to statutory regulation.
16. **Regulator:** such persons as are empowered by the Act to regulate business in the financial sector. The term includes the Financial Services Authority (FSA), Irish Financial Services Regulatory Authority (IFSRA) and such other bodies as may be so empowered in future legislation.

### **Appointment as Auditor and Ceasing to Hold Office**

17. Before accepting appointment, the auditor follows the procedures identified in the APB's Ethical Standards and the ethical pronouncements and Audit Regulations issued by the auditor's relevant professional body.
18. In the case of regulated entities, the auditor would in particular obtain an understanding of the appropriate statutory and regulatory requirements and a preliminary knowledge of the management and operations of the entity, so as to enable the auditor to determine whether a level of knowledge of the business adequate to perform the audit can be obtained. The procedures carried out by the auditor in seeking to obtain this preliminary understanding may include discussion with the previous auditor and, in some circumstances, with the regulator.
19. On ceasing to hold office, the auditor may be required by statute or by regulation to make specific reports concerning the circumstances relating to that event, and would also follow the procedures identified in the ethical guidance issued by the relevant professional body.

20. In addition, the auditor of a regulated entity would assess whether it is appropriate to bring any matters of which the auditor is then aware to the notice of the regulator. Under legislation in the UK, this may be done either before or after ceasing to hold office, as the auditor's statutory right to disclose to a regulator information obtained in the course of the auditor's appointment is not affected by the auditor's removal, resignation or otherwise ceasing to hold office.

### **Conduct of the Audit**

21. The duty to make a report direct to a regulator does not impose upon the auditor a duty to carry out specific work: it arises solely in the context of work carried out to fulfil other reporting responsibilities. Accordingly, no auditing procedures in addition to those carried out in the normal course of auditing the financial statements, or for the purpose of making any other specified report, are necessary for the fulfilment of the auditor's responsibilities.
22. It will, however, be necessary for the auditor to take additional time in carrying out a financial statement audit or other engagement to assess whether matters which come to the auditor's attention should be included in a direct report and, where appropriate, to prepare and submit the report. These additional planning and follow-up procedures do not constitute an extension of the scope of the financial statement audit or of other work undertaken to provide a specified report relating to a regulated entity. They are necessary solely in order to understand and clarify the reporting responsibility and, where appropriate, to make a report.
23. The circumstances in which the auditor is required by statute to make a report direct to a regulator include matters which are not considered as part of the audit of financial statements or of work undertaken to discharge other routine responsibilities. For example, the duty to report would apply to information of which the auditor became aware in the course of the auditor's work which is relevant to the FSA's criteria for approved persons, although the auditor is not otherwise required to express an opinion on such matters. However, the legislation imposing a duty to make reports direct to regulators does not require the auditor to change the scope of the audit work, nor does it place on the auditor an obligation to conduct the audit work in such a way that there is reasonable certainty that the auditor will discover all matters which regulators might consider as being of material significance. Therefore, whilst the auditor of a regulated entity is required to be alert to matters which may require a report, the auditor is not expected

to be aware of all circumstances which, had the auditor known of them, would have led the auditor to make such a report. It is only when the auditor becomes aware of such a matter during the conduct of the normal audit work that the auditor has an obligation to determine whether a report to the regulator is required by statute or appropriate for other reasons.

24. Similarly, the auditor is not responsible for reporting on a regulated entity's overall compliance with rules with which it is required to comply nor is the auditor required to conduct the audit work in such a way that there is reasonable certainty that the auditor will discover breaches. Nevertheless, breaches of rules with which a regulated entity is required to comply may have implications for the financial statements and, accordingly, the auditor of a regulated entity needs to consider whether any actual or contingent liabilities may have arisen from breaches of regulatory requirements. Breaches of a regulator's requirements may also have consequences for other matters on which the auditor of a regulated entity is required to express an opinion and, if such breaches represent criminal conduct, could give rise to the need to report to specified authorities.

### Planning

25. **When gaining a knowledge of the business for the purpose of the audit, the auditor of a regulated entity should obtain an understanding of its current activities, the scope of its authorisation and the effectiveness of its control environment.**
26. ISAs (UK and Ireland) require the auditor to gain a sufficient understanding of the reporting entity's business to plan and perform the audit effectively and to assess the risk of material misstatements in the financial statements.
27. In the context of a regulated entity, the auditor's understanding of its business needs to extend to the applicable statutory provisions, the rules of the regulator concerned and any guidance issued by the regulator on the interpretation of those rules, together with other guidance issued by the APB.
28. The auditor is also required to assess the risk of misstatements in the financial statements, or of other errors in relation to other matters on which the auditor is required to report. In making such an assessment the auditor takes into account the control environment, including the entity's higher level procedures for complying with the requirements of its regulator. Such a review gives an indication of the extent to which the general atmosphere

and controls in the regulated entity are conducive to compliance, for example through consideration of *inter alia*:

- The adequacy of procedures and training to inform staff of the requirements of relevant legislation and the rules or other regulations of the regulator;
- The adequacy of procedures for authorisation of transactions;
- Procedures for internal review of the entity's compliance with regulatory or other requirements;
- The authority of, and any resources available to, the compliance officer/Money Laundering Reporting Officer ('MLRO'); and
- Procedures to ensure that possible breaches of requirements are investigated by an appropriate person and are brought to the attention of senior management.

29. In some areas of the financial sector, conducting business outside the scope of the entity's authorisation is a serious regulatory breach, and therefore of material significance to the regulator. In addition, it may result in fines, suspension or loss of authorisation.
30. Where the auditor's review of the reporting entity's activities indicates that published guidance by the regulator may not be sufficiently precise to enable the auditor to identify circumstances in which it is necessary to initiate a report, the auditor would consider whether it is necessary to discuss the matters specified in legislation with the appropriate regulator with a view to reaching agreement on its interpretation.
31. Similarly, where a group includes two or more companies separately regulated by different regulators, there may be a need to clarify the regulators' requirements in any overlapping areas of activity. However, the statutory duty to make a report as presently defined arises only in respect of the legal entity subject to regulation. Therefore the auditor of an unregulated company in a group that includes one or more other companies which are authorised by regulators would not have a duty to report matters to the regulators of those companies.
32. When a regulated entity is subject to provisions of two or more regulators, the auditor needs to take account of the separate reporting requirements in planning and conducting the audit work. Arrangements may exist for one regulatory body to rely on financial monitoring being carried out by another

body (the 'lead regulator') and where this is the case, routine reports by the regulated entity's auditor may be made to the lead regulator alone.

33. However, the auditor's statutory duty to report cannot be discharged by reliance on the lead regulator informing others. Therefore, where the auditor concludes that a matter is of material significance to one regulator, the auditor needs to assess the need for separate reports informing each regulator of matters which the auditor concludes are or may be of material significance to it.

#### **Supervision and Control**

34. **The auditor should ensure that all staff involved in the audit of a regulated entity have an understanding of:**

- (a) **The provisions of applicable legislation;**
- (b) **The regulator's rules and any guidance issued by the regulator; and**
- (c) **Any specific requirements which apply to the particular regulated entity,**

**appropriate to their role in the audit and sufficient (in the context of that role) to enable them to identify situations which may give reasonable cause to believe that a matter should be reported to the regulator.**

35. ISAs (UK and Ireland) require the auditor to exercise adequate control and supervision over staff conducting work on an audit. Consequently, in planning and conducting the audit of a regulated entity the auditor needs to ensure that staff are alert to the possibility that a report to its regulator may be required.
36. Auditing firms also need to establish adequate procedures to ensure that any matters which are discovered in the course of or as a result of audit work and may give rise to a duty to report are brought to the attention of the partner responsible for the audit on a timely basis.
37. The right and duty to report to a regulator applies to information of which the auditor becomes aware in the auditor's capacity as such. They do not extend automatically to any information obtained by an accounting firm regardless of its source. Consequently partners and staff undertaking work in another capacity are not required to have detailed knowledge of the regulator's requirements (unless necessary for that other work) nor to bring

information to the attention of the partner responsible for the audit on a routine basis.

38. However, as discussed further in Appendix 2, firms need to establish lines of communications, commensurate with their size and complexity, sufficient to ensure that non-audit work undertaken for a regulated entity which is likely to have an effect on the audit is brought to the attention of the partner responsible for the audit, who will need to determine whether the results of non-audit work undertaken for a regulated entity ought to be assessed as part of the audit process.

#### **Identifying Matters Requiring a Report Direct to Regulators**

39. **Where an apparent breach of statutory or regulatory requirements comes to the auditor's attention, the auditor should:**
- (a) **Obtain such evidence as is available to assess its implications for the auditor's reporting responsibilities;**
  - (b) **Determine whether, in the auditor's opinion, there is reasonable cause to believe that the breach is of material significance to the regulator; and**
  - (c) **Consider whether the apparent breach is criminal conduct that gives rise to criminal property and, as such, should be reported to the specified authorities.**
40. The precise matters which give rise to a statutory duty on auditors to make a report to a regulator derive from the relevant Acts. Broadly, such matters fall into three general categories:
- (a) The financial position of the regulated entity;
  - (b) Its compliance with requirements for the management of its business; and
  - (c) The status of those charged with governance as fit and proper persons.

Further detailed guidance on the interpretation of these matters in the context of specific legislation applicable to each type of regulated entity is contained in Practice Notes dealing with the rights and duties of auditors of regulated entities to report direct to regulators.

41. In assessing the effect of an apparent breach, the auditor takes into account the quantity and type of evidence concerning such a matter which may

reasonably be expected to be available. If the auditor concludes that the auditor has been prevented from obtaining all such evidence concerning a matter which may give rise to a duty to report, the auditor would normally make a report direct to the regulator without delay.

42. An apparent breach of statutory or regulatory requirements may not of itself give rise to a statutory duty to make a report to a regulator. There will normally be a need for some further investigation and discussion of the circumstances surrounding the apparent breach with the directors in order to obtain sufficient information to determine whether it points to a matter which is or may be of material significance to the regulator. For example, a minor breach which has been corrected by the regulated entity and reported (if appropriate) to the regulator, and which from the evidence available to the auditor appears to be an isolated occurrence, would not normally give the auditor reasonable cause to believe that it is or may be of material significance to the regulator. However a minor breach that results in a criminal offence that gave rise to the criminal property would be reportable to the specified authorities under the anti-money laundering legislation.
43. When determining whether a breach of statutory or regulatory requirements gives rise to a statutory duty to make a report direct to a regulator, the auditor considers factors such as:
- Whether the breach, though minor, is indicative of a general lack of compliance with the regulator's requirements or otherwise casts doubt on the status of those charged with governance as fit and proper persons;
  - Whether a breach which occurred before the auditor's visit to the regulated entity was reported by the entity itself and has since been corrected, such that, at the date of the auditor's discovery, no breach exists;
  - Whether the circumstances giving rise to a breach which occurred before the auditors visit to the regulated entity continue to exist, or those charged with governance have not taken corrective action, or the breach has re-occurred; and
  - Whether the circumstances suggest that an immediate report to the regulator is necessary in order to protect the interests of depositors, investors, policyholders, clients of the entity or others in whose interests the regulator is required to act.

44. The auditor would normally seek evidence to assess the implications of a suspected breach before reporting a matter to the regulator. However, the auditor's responsibility to make a report does not require the auditor to determine the full implications of a matter before reporting: the auditor is required to exercise professional judgment as to whether or not there is reasonable cause to believe that a matter is or may be of material significance to the regulator. In forming that judgment, the auditor undertakes appropriate investigations to determine the circumstances but does not require the degree of evidence which would be a normal part of forming an opinion on financial statements. Such investigations, subject to compliance with legislation relating to 'tipping off'<sup>2</sup>, would normally include:

- Enquiry of appropriate level of staff;
- Review of correspondence and documents relating to the transaction or event concerned; and
- Discussion with those charged with governance, or other senior management where appropriate.

In the case of a life company, it would also be appropriate to consult with the appointed actuary, who also has various statutory duties under insurance companies legislation.

---

<sup>2</sup> In the UK, 'tipping off' is an offence under section 333 of the Proceeds of Crime Act 2002 (POCA). It arises when an individual discloses matters where:

- (a) There is knowledge or suspicion that a report has already been made; and
- (b) That disclosure is likely to prejudice any investigation which might be conducted following the report.

Whilst 'tipping off' requires a person to have knowledge or suspicion that a report has been or will be made, a further offence of prejudicing an investigation is included in section 342 of POCA. Under this provision, it is an offence to make any disclosure which may prejudice an investigation of which a person has knowledge or suspicion, or to falsify, conceal, destroy or otherwise dispose of, or cause or permit the falsification, concealment, destruction or disposal of, documents relevant to such an investigation.

In Ireland, Section 58 of the Criminal Justice Act, 1994, as amended, establishes the offence of 'prejudicing an investigation'. This relates both to when a person, knowing or suspecting that an investigation is taking place, makes any disclosure likely to prejudice the investigation or when a person, knowing that a report has been made, makes any disclosure likely to prejudice any investigation arising from the report.

45. The potential gravity of some apparent breaches may be such that an immediate report to the regulator is essential in order to enable the regulator to take appropriate action: in particular, prompt reporting of a loss of client assets may be necessary to avoid further loss to investors or others in whose interests the regulator is required to act. The auditor is therefore required to balance the need for further investigation of the matter with the need, subject to compliance with legislation relating to ‘tipping off’, for prompt reporting.
46. On completion of the auditor’s investigations, the auditor needs to ensure that the facts and the basis for the auditor’s decision (whether to report or not) is adequately documented such that the reasons for that decision may be clearly demonstrated should the need to do so arise in future.

#### **Reliance on Other Auditors**

47. An auditor with responsibilities for reporting on financial statements including financial information of one or more components audited by other auditors is required to obtain sufficient appropriate audit evidence that the work of the other auditors is adequate for the purposes of the audit. The same principle applies to reliance on another auditor in a different type of engagement. The auditor of a regulated entity who relies on work undertaken by other auditors needs to establish reporting arrangements such that the other auditors bring to the attention of the auditor of the regulated entity matters arising from their work which may give rise to a duty to report to a regulator.
48. The nature of the reporting arrangements will depend on the nature of the work undertaken by the other auditors. For example, the statutory duty to make a report relates to the legal entity subject to regulation rather than to the entire group to which that entity may belong. Consequently, the auditor of a holding company authorised by one regulator would not be expected to have knowledge of all matters which come to the attention of a subsidiary's auditor. The auditor of the regulated entity would, however, have a duty to report, where appropriate, matters which arise from the audit of the regulated entity's own financial statements and of the consolidated group figures.
49. Where the audit of a regulated entity is undertaken by joint auditors, knowledge obtained by one auditing firm is likely to be deemed to be known by the other. Care will therefore be needed in agreeing and implementing arrangements to exchange information relating to matters

which may give rise to a duty to report to a regulator including compliance with legislation relating to tipping off.

## Reporting

### The Auditor's Statutory Duty to Report Direct to Regulators

50. **When the auditor concludes, after appropriate discussion and investigations, that a matter which has come to the auditor's attention gives rise to a statutory duty to make a report, subject to compliance with legislation relating to 'tipping off', the auditor should bring the matter to the attention of the regulator without undue delay in a form and manner which will facilitate appropriate action by the regulator. When the initial report is made orally, the auditor should make a contemporaneous written record of the oral report and should confirm the matter in writing to the regulator.**
51. Except in the circumstances referred to in paragraph 54 the auditor seeks to reach agreement with those charged with governance on the circumstances giving rise to a report direct to the regulator. However, where a statutory duty to report arises, the auditor is required to make such a report regardless of:
- (a) Whether the matter has been referred to the regulator by other parties (including the company, whether by those charged with governance or otherwise); and
  - (b) Any duty owed to other parties, including the those charged with governance of the regulated entity and its shareholders (or equivalent persons).
52. Except in the circumstances set out in paragraph 54, the auditor sends a copy of the auditor's written report to those charged with governance and (where appropriate) audit committee of the regulated entity.
53. In normal circumstances, the auditor would wish to communicate with the regulator with the knowledge and agreement of those charged with governance of the regulated entity. However, in some circumstances immediate notification of the discovery of a matter giving reasonable grounds to believe that a reportable matter exists will be necessary - for example, a phone call to alert the regulator followed by a meeting to discuss the circumstances.

54. **When the matter giving rise to a statutory duty to make a report direct to a regulator casts doubt on the integrity of those charged with governance or their competence to conduct the business of the regulated entity, the auditor should, subject to compliance with legislation relating to ‘tipping off’, make the report to the regulator without delay and without informing those charged with governance in advance.**
55. Speed of reporting is essential where the circumstances cause the auditor no longer to have confidence in the integrity of those charged with governance. In such circumstances, there may be a serious and immediate threat to the interests of depositors or other persons for whose protection the regulator is required to act; for example where the auditor believes that a fraud or other irregularity may have been committed by, or with the knowledge of, those charged with governance, or have evidence of the intention of those charged with governance to commit or condone a suspected fraud or other irregularity.
56. In circumstances where the auditor no longer has confidence in the integrity of those charged with governance, it is not appropriate to provide those charged with governance with copies of the auditor’s report. Since such circumstances will be exceptional and extreme, the auditor may wish to seek legal advice as to the auditor’s responsibilities and the appropriate course of action.

#### **Money Laundering**

57. For a number of years auditors in the UK have been required to report to an appropriate authority where they suspect the laundering of money which either derived from drug trafficking or was related to terrorist offences. In the UK, partners and staff in audit firms must continue to report non-compliance with certain laws related to terrorism<sup>3</sup> but new anti-money laundering legislation<sup>4</sup> in the UK and Ireland has extended both the

<sup>3</sup> In the UK, the Terrorism Act 2000 (as amended by the Anti-terrorism, Crime and Security Act 2001) and associated regulations. The duty to report drug trafficking related money laundering has been subsumed into the general requirement to report the proceeds of crime.

In Ireland, there is similar proposed legislation that auditors will need to consider in due course.

<sup>4</sup> In the UK, with effect from 1 March 2004 The Money Laundering Regulations 2003 replaced the 1993 and 2001 regulations and the requirements of the Proceeds of Crime Act 2002 were extended to the provision by way of business of audit services by a person who is eligible for appointment as a company auditor under section 25 of the Companies Act 1989 or Article 28 of the Companies (Northern Ireland) Order 1990.

definition of what money laundering comprises and the auditor's reporting responsibilities<sup>5</sup>. The anti-money laundering legislation now imposes a duty to report money laundering in respect of the proceeds of all crime. The detailed legislation in both countries differs but common features include:

- Money laundering includes concealing, disguising, converting, transferring, removing, using, acquiring or possessing property<sup>6</sup> which constitutes or represents a benefit from criminal conduct<sup>7</sup>. Although the anti-money laundering legislation does not contain de minimis concessions in the UK the National Criminal Intelligence Service (NCIS) has introduced guidance on reports of limited intelligence value;
- Partners and staff in audit firms are required to report all suspicions<sup>8</sup> that a criminal offence, giving rise to any direct or indirect benefit has

In Ireland, with effect from 15 September 2003 the Criminal Justice Act 1994 (Section 32) Regulations 2003 designate accountants, auditors, and tax advisors and others for the purposes of the anti-money laundering provisions of the Criminal Justice Act, 1994, as amended.

<sup>5</sup> Anti-money laundering legislation differs in the UK and Ireland, references to such legislation in the main body of this ISA (UK and Ireland) use generalised wording with the specific requirements of the UK and Irish legislation described in footnotes.

<sup>6</sup> In the UK, 'property' is criminal property if it constitutes a person's benefit from criminal conduct or it represents such a benefit (in whole or part and whether directly or indirectly), and the alleged offender knows or suspects that it constitutes or represents such a benefit.

In Ireland, 'property' is defined as including money and all other property, real or personal, heritable or moveable, including choses in action and other intangible or incorporeal property.

<sup>7</sup> In the UK, 'criminal conduct' is defined as conduct which constitutes an offence in any part of the United Kingdom or would constitute such an offence if it occurred in any part of the UK.

In Ireland, 'criminal conduct' means conduct which constitutes an 'indictable offence', or where the conduct occurs outside the State, would constitute such an offence if it occurred within the State and also constitutes an offence under the law of the country or territorial unit in which it occurs, and includes participation in such conduct.

<sup>8</sup> In the UK, as a result of the Proceeds of Crime Act 2002 and the 2003 Money Laundering Regulations auditors are required to report where they know or suspect or have reasonable grounds to know or suspect that another person is engaged in money laundering. Partners and staff in audit firms discharge their responsibilities by reporting to their Money Laundering Reporting Officer ('MLRO') or, in the case of sole practitioners, to the National Criminal Intelligence Service.

In Ireland, the Criminal Justice Act, 1994, as amended, and the Criminal Justice Act, 1994 (Section 32) Regulations, 2003 require auditors and other defined persons to report to the Garda Síochána and the Revenue Commissioners where they suspect that an offence as defined in the legislation in relation to the business of that person has been or is being committed. Two further reporting duties exist in Irish law, Section 74 of the Company Law Enforcement Act 2001 requires auditors to report to the Director

been committed, regardless of whether that offence has been committed by a client or by a third party;

- Partners and staff in audit firms need to be alert to the dangers of making disclosures that are likely to tip off a money launderer or prejudice an investigation ('tipping off'), as this will constitute a criminal offence under the anti-money laundering legislation.

This ISA (UK and Ireland) does not address these responsibilities although, when reporting to a regulator (whether under a statutory duty or right) the auditor has regard to the offence of 'tipping off'.

#### **The Auditor's Right to Report Direct to Regulators**

**58. When a matter comes to the auditor's attention which the auditor concludes does not give rise to a statutory duty to report but nevertheless may be relevant to the regulator's exercise of its functions, the auditor should, subject to compliance with legislation relating to 'tipping off':**

- (a) Consider whether the matter should be brought to the attention of the regulator under the terms of the appropriate legal provisions enabling the auditor to report direct to the regulator; and, if so**
- (b) Advise those charged with governance that in the auditor's opinion the matter should be drawn to the regulators' attention.**

**Where the auditor is unable to obtain, within a reasonable period, adequate evidence that those charged with governance have properly informed the regulator of the matter, the auditor should, subject to compliance with legislation relating to 'tipping off', make a report direct to the regulator without undue delay.**

**59. The auditor may become aware of matters which the auditor concludes are relevant to the exercise of the regulator's functions even though they fall outside the statutory definition of matters which must be reported to a**

---

of Corporate Enforcement instances of the suspected commission of indictable offences under the Companies Acts and Section 59 of the Criminal Justice (Theft and Fraud Offences) Act, 2001 requires 'relevant persons', as defined in the section and which includes auditors of companies, to report 'indications' that specified offences under the Act have been committed to the Garda Síochána. Additionally, auditors may report direct to the Revenue Commissioners certain offences under Section 1079 of the Taxes Consolidation Act, 1997.

regulator. In such circumstances, the Acts provide the auditor with protection for making disclosure of the matter to the appropriate regulator.

60. Where the auditor considers that a matter which does not give rise to a statutory duty to report is nevertheless, in the auditor's professional judgment, such that it should be brought to the attention of the regulator, it is normally appropriate for the auditor to request those charged with governance of the regulated entity in writing to draw it to the attention of the regulator.

#### **Contents of a Report Initiated by the Auditor**

61. **When making or confirming in writing a report direct to a regulator, the auditor should:**
- (a) **State the name of the regulated entity concerned;**
  - (b) **State the statutory power under which the report is made;**
  - (c) **State that the report has been prepared in accordance with ISA (UK and Ireland) 250, Section B 'The auditor's Right and Duty to Report to Regulators in the Financial Sector';**
  - (d) **Describe the context in which the report is given;**
  - (e) **Describe the matter giving rise to the report;**
  - (f) **Request the regulator to confirm that the report has been received; and**
  - (g) **State the name of the auditor, the date of the written report and, where appropriate, the date on which an oral report was made to the regulator and the name and title of the individual to whom the oral report was made.**
62. Such a report is a by-product of other work undertaken by the auditor. As a result it is not possible for the auditor or the regulator to conclude that all matters relevant to the regulator were encountered in the course of the auditor's work. The auditor's report therefore sets out the context in which the information reported was identified and indicates the extent to which the matter has been investigated and discussed with those charged with governance.

**Context of a Report**

63. Matters to which the auditor may wish to refer when describing the context in which a report is made direct to a regulator include:
- The nature of the appointment from which the report derives. For example, it may be appropriate to distinguish between a report made in the course of an audit of financial statements and one which arises in the course of a more limited engagement, such as an appointment to report on specified matters by the FSA or IFSRA;
  - The applicable legislative requirements and interpretations of those requirements which have informed the auditor's judgment;
  - The extent to which the auditor has investigated the circumstances giving rise to the matter reported;
  - Whether the matter reported has been discussed with those charged with governance;
  - Whether steps to rectify the matter have been taken.

**Communication of Information by the Regulator**

64. The Acts provide that, in certain exceptional circumstances, regulators may pass confidential information to another party. The precise circumstances in which regulators may disclose information varies, but in general they may do so if considered necessary to fulfil their own obligations under the appropriate Act, or, in some cases, to enable the auditor to fulfil the auditor's duties either to the regulated entity or, in other cases, to the regulator. Confidential information remains confidential in the hands of the recipient.
65. In so far as the law permits, regulators have confirmed that they will consider taking the initiative in bringing a matter to the attention of the auditor of a regulated entity in circumstances where:
- (a) They believe the matter is of such importance that the auditor's knowledge of it could significantly affect the form of the auditor's report on the entity's financial statements or other matters on which the auditor is required to report, or the way in which the auditor discharges the auditor's reporting responsibilities; and
  - (b) The disclosure is for the purpose of enabling or assisting the regulator to discharge its functions under the Acts.

66. The auditor needs to be aware that there may be circumstances in which the regulators are unable to disclose such information. Where the auditor of a regulated entity is not informed by the regulator of any matter, therefore, the auditor cannot assume that there are no matters known to the regulator which could affect the auditor's judgment as to whether information is of material significance. However, in the absence of disclosure by the regulator, the auditor can only form a judgment in the light of evidence to which the auditor has access.

#### **Relationship With Other Reporting Responsibilities**

67. **When issuing a report expressing an opinion on a regulated entity's financial statements or on other matters specified by legislation or a regulator, the auditor:**
- (a) **Should consider whether there are consequential reporting issues affecting the auditor's opinion which arise from any report previously made direct to the regulator in the course of the auditor's appointment; and**
  - (b) **Should assess whether any matters encountered in the course of the audit indicate a need for a further direct report.**
68. The circumstances which give rise to a report direct to a regulator may involve an uncertainty or other matter which requires disclosure in the financial statements. The auditor will therefore need to consider whether the disclosures made in the financial statements are adequate for the purposes of giving a true and fair view of the regulated entity's state of affairs and profit or loss. Where the auditor concludes that an uncertainty which has resulted in such a report is significant, the auditor is required by ISA (UK and Ireland) 700 "The Auditor's Report on Financial Statements" to consider whether to add an explanatory paragraph drawing attention to the matter in the auditor's report.
69. Similarly, circumstances giving rise to a report direct to a regulator may also require reflection in the auditor's reports on other matters required by legislation or another regulator.
70. In fulfilling the responsibility to report direct to a regulator, it is important that the auditor not only assess the significance of individual transactions or events but also consider whether a combination of such items over the course of the work undertaken for the auditor's primary reporting responsibilities may give the auditor reasonable grounds to believe that they

constitute a matter of material significance to the regulator, and so give rise to a statutory duty to make a report.

71. As there is no requirement for the auditor to extend the scope of the audit work to search for matters which may give rise to a statutory duty to report, such an assessment of the cumulative effect of evidence obtained in the course of an audit would be made when reviewing the evidence in support of the opinions to be expressed in the reports the auditor has been appointed to make. Where such a review leads to the conclusion that the cumulative effect of matters noted in the course of the audit is of material significance to the regulator, it will be appropriate for a report to be made as set out in paragraph 61 above. However, reports indicating a 'nil return' are not appropriate.

### **Effective Date**

72. In the United Kingdom, the Money Laundering Regulations 2003 came into force on 1 March 2004. In Ireland, the Criminal Justice Act 1994 (Section 32) Regulations 2003 are effective from 15 September 2003. This Section of this ISA (UK and Ireland) is effective for audits of financial statements for periods commencing on or after 15 December 2004.

### **Note on Legal Requirements**

- i** Reference should be made to the legislation itself for an understanding of the relevant points of law. In interpreting the legal requirements it is also appropriate to refer to guidance published by the regulators and that contained in Practice Notes issued by the Auditing Practices Board.

#### **Legal Requirements in the United Kingdom**

- ii** The auditor's right to report to a regulator is contained in The Financial Services and Markets Act 2000, sections 342 and 343.
- iii** The auditor's duty to report to a regulator is set out in the Statutory Instrument The Financial Services and Markets Act 2000 (Communication by Auditors) Regulations 2001.

#### **Legal Requirements in the Republic of Ireland**

- iv** The auditor's duty to report to a regulator is set out in:
  - (a) The Building Societies Act 1989, section 89(i);
  - (b) The Central Bank Act 1989, section 47;
  - (c) The Trustee Savings Bank Act 1989, section 38(i);
  - (d) The Insurance Act 1989, section 35(i);
  - (e) The European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 1989, sections 83(2) to (7);
  - (f) The Unit Trusts Act 1990, section 15;
  - (g) The Stock Exchange Act 1995, section 34;
  - (h) The Investment Intermediaries Act 1995, section 33 (applicable to investment and insurance intermediaries);
  - (i) The Pensions (Amendment) Act 1996, section 83;
  - (j) The Credit Unions Act 1997, section 122; and
  - (k) The Companies Act 1990, section 258.

Further reporting duties are included in the Central Bank and Financial Services Authority of Ireland (no. 2) Bill published in December 2003.

**Appendix 1****The Regulatory Framework**

1. In both the UK and Ireland, legislation exists in the principal areas of financial services to protect the interests of investors, depositors in banks and other users of financial services. Regulated entities operating in the financial sector are required to comply with legal and regulatory requirements concerning the way their business is conducted. Compliance with those rules is monitored in four principal ways:
  - Internal monitoring by those charged with governance of the regulated entity;
  - Submission of regular returns by the regulated entity to the regulator;
  - Monitoring and, in some cases, inspection of the entity by the regulator;
  - Subject to compliance with legislation relating to ‘tipping off’, reports by the reporting entity’s auditor on its financial statements and other specified matters required by legislation or by the regulator.

**Responsibility for Ensuring Compliance**

2. Ensuring compliance with the requirements with which a regulated entity is required to comply in carrying out its business is the responsibility of those charged with governance of a regulated entity. It requires adequate organisation and systems of controls. The regulatory framework provides that adequate procedures for compliance must be established and maintained. Those charged with governance of a regulated entity are also normally required to undertake regular reviews of compliance and to inform the regulator of any breach of the rules and regulations applicable to its regulated business. In addition, regulators may undertake compliance visits.
3. The auditor of regulated entity normally has responsibilities for reporting, subject to compliance with legislation relating to ‘tipping off’, on particular aspects of its compliance with the regulator’s requirements. However, the auditor has no direct responsibility for expressing an opinion on an entity’s overall compliance with the requirements for the conduct of its business, nor does an audit provide any assurance that breaches of requirements which are not the subject of regular auditors’ reports will be detected.

**The Role of Auditors**

4. Those charged with governance of regulated entities have primary responsibility for ensuring that all appropriate information is made available to regulators. Normal reporting procedures (including auditor's reports on records, systems and returns, and regular meetings with those charged with governance and/or management and auditors) supplemented by any inspection visits considered necessary by the regulators should provide the regulators with all the information they need to carry out their responsibilities under the relevant Act.

**Routine Reporting by Auditors**

5. Regulators' requirements for reports by auditors vary. In general terms, however, such reports may include opinions on:
  - The regulated entity's annual financial statements;
  - The regulated entity's compliance with requirements for financial resources; and
  - The adequacy of the regulated entity's system of controls over its transactions and in particular over its clients' money and other property.
6. As a result of performing the work necessary to discharge their routine reporting responsibilities, or those arising from an appointment to provide a special report required by the regulator, the auditor of a regulated entity may become aware of matters which the auditor considers need to be brought to the regulator's attention sooner than would be achieved by routine reports by the entity or its auditor.
7. The auditor of a regulated entity normally has a right to communicate in good faith, subject to compliance with legislation relating to 'tipping off', information the auditor considers is relevant to the regulators' functions.

**The Auditor's Statutory Duty to Report to the Regulator**

8. In addition, the auditor is required by law to report, subject to compliance with legislation relating to 'tipping off', direct to a regulator when the auditor concludes that there is reasonable cause to believe that a matter is or may be of material significance to the regulator. The precise matters which result in a statutory duty to make such a report vary, depending upon the specific requirements of relevant legislation and the regulator's rules. In

general, however, a duty to report to a regulator arises when the auditor becomes aware that:

- The regulated entity is in serious breach of:
  - Requirements to maintain adequate financial resources; or
  - Of requirements for those charged with governance to conduct its business in a sound and prudent manner (including the maintenance of systems of control over transactions and over any clients' assets held by the business); or
- There are circumstances which give reason to doubt the status of those charged with governance or senior management as fit and proper persons.

**Confidentiality**

9. Confidentiality is an implied term of the auditor's contracts with client entities. However, subject to compliance with legislation relating to 'tipping off', in the circumstances leading to a right or duty to report, the auditor is entitled to communicate to regulators in good faith information or opinions relating to the business or affairs of the entity or any associated body without contravening the duty of confidence owed to the entity and, in the case of a bank, building society and friendly society, its associated bodies.
10. The statutory provisions permitting the auditor to communicate information to regulators relate to information obtained in the auditor's capacity as auditor of the regulated entity concerned. Auditors and regulators therefore should be aware that confidential information obtained in other capacities may not normally be disclosed to another party.

**Appendix 2****The Application of the Statutory Duty to Report to Regulators****Introduction**

1. The statutory duty to report to a regulator, subject to compliance with legislation relating to ‘tipping off’, applies to information which comes to the attention of the auditor in the auditor’s capacity as auditor. However, neither the term 'auditor' nor the phrase “in the capacity of auditor” are defined in the legislation, nor has the court determined how these expressions should be construed.
2. As a result, it is not always clearly apparent when an accounting firm should regard itself as having a duty to report to a regulator. For example, information about a regulated entity may be obtained when partners or staff of the firm which is appointed as its auditor carry out work for another client entity; or when the firm undertakes other work for the regulated entity. Auditors, regulated entities and regulators need to be clear as to when the normal duty of confidentiality will be overridden by the auditor’s statutory duty to report to the regulator.
3. In order to clarify whether or not an accounting firm should regard itself as bound by the duty, the APB has developed, in conjunction with HM Treasury, the IFSRA and the regulators, guidance on the interpretation of the key conditions for the existence of that duty, namely that the firm is to be regarded as auditor of a regulated entity and that information is obtained in the capacity of auditor.
4. Guidance on the interpretation of the term 'auditor' in the context of each Act is contained in the separate Practice Notes dealing with each area affected by the legislation.
5. This appendix sets out guidance on the interpretation of the phrase “in the capacity of auditor”. The Board nevertheless continues to hold the view that the meaning of the phrase should be clarified in legislation in the longer term.

**In the Capacity of Auditor**

6. In determining whether information is obtained in the capacity of auditor, two criteria in particular should be considered:

- (a) Whether the person who obtained the information also undertook the audit work; and if so
- (b) Whether it was obtained in the course of or as a result of undertaking the audit work.

7. It is then necessary to apply these criteria to information about a regulated entity which may become known from a number of sources, and by a number of different individuals within an accounting firm. Within a large firm, for example, information may come to the attention of the partner responsible for the audit of a regulated entity, a partner in another office who undertakes a different type of work, or members of the firm's staff at any level. In the case of a sole practitioner who is the auditor of a regulated entity, information about a regulated entity may also be obtained by the practitioner in the course of work other than its audit.

#### **Non-Audit Work Carried out in Relation to a Regulated Entity**

- 8. Where partners or staff involved in the audit of a regulated entity carry out work other than its audit (non-audit work) information about the regulated entity will be known to them as individuals. In circumstances which suggest that a matter would otherwise give rise to a statutory duty to report, subject to compliance with legislation relating to ‘tipping off’, if obtained in the capacity of auditor, it will be prudent for them to make enquiries in the course of their audit work in order to establish whether this is the case from information obtained in that capacity.
- 9. However where non-audit work is carried out by other partners or staff, neither of the criteria set out in paragraph 6 is met in respect of information which becomes known to them. Nevertheless the firm should take proper account of such information when it could affect the audit so that it is treated in a responsible manner, particularly since in partnership law the knowledge obtained by one partner in the course of the partnership business may be imputed to the entire partnership. In doing so, two types of work may be distinguished: first, work which could affect the firm's work as auditor and, secondly, work which is undertaken purely in an advisory capacity.
- 10. A firm appointed as auditor of a regulated entity needs to have in place appropriate procedures to ensure that the partner responsible for the audit function is made aware of any other relationship which exists between any department of the firm and the regulated entity when that relationship could affect the firm's work as auditor. Common examples of such work include

accounting work, particularly for smaller entities, and provision of tax services to the regulated entity.

11. *Prima facie*, information obtained in the course of non-audit work is not covered by either the right or the duty to report to a regulator. However, the firm appointed as auditor needs to consider whether the results of other work undertaken for a regulated entity need to be assessed as part of the audit process. In principle, this is no different to seeking to review a report prepared by outside consultants on, say, the entity's accounting systems so as to ensure that the auditor makes a proper assessment of the risks of misstatement in the financial statements and of the work needed to form an opinion. Consequently, the partner responsible for the audit needs to make appropriate enquiries in the process of planning and completing the audit (see paragraph 67 above). Such enquiries would be directed to those aspects of the non-audit work which might reasonably be expected to be relevant to the audit. When, as a result of such enquiries, those involved in the audit become aware of issues which may be of material significance to a regulator such issues should be considered, and if appropriate reported, subject to compliance with legislation relating to 'tipping off, following the requirements set out in this Section of this ISA (UK and Ireland).
12. Work which is undertaken in an advisory capacity, for example to assist the directors of a regulated entity to determine effective and efficient methods of discharging their duties, would not normally affect the work undertaken for the audit. Nevertheless, in rare instances, the partner responsible for such advisory work may conclude that steps considered necessary in order to comply with the regulator's requirements have not been taken by the directors or that the directors intend in some respect not to comply with the regulator's requirements. Such circumstances would require consideration in the course of work undertaken for the audit, both to consider the effect on the auditor's routine reports and to determine whether the possible non-compliance is or is likely to be of material significance to the regulator.

#### **Work Relating to a Separate Entity**

13. Information obtained in the course of work relating to another entity audited by the same firm (or the same practitioner) is confidential to that other entity. The auditor is not required, and has no right, to report to a regulator confidential information which arises from work undertaken by the same auditing firm for another client. However, as a matter of sound practice, individuals involved in the audit of a regulated entity who become aware (in a capacity other than that of auditor of a regulated entity) of a matter

which could otherwise give rise to a statutory duty to report would normally make enquiries in the course of their audit of the regulated entity to establish whether the information concerned is substantiated.

14. In carrying out the audit work, the auditor is required to have due regard to whether disclosure of non-compliance with laws and regulations to a proper authority is appropriate in the public interest. standards and guidance on this general professional obligation is set out in Section A of this ISA (UK and Ireland).

**Conclusion**

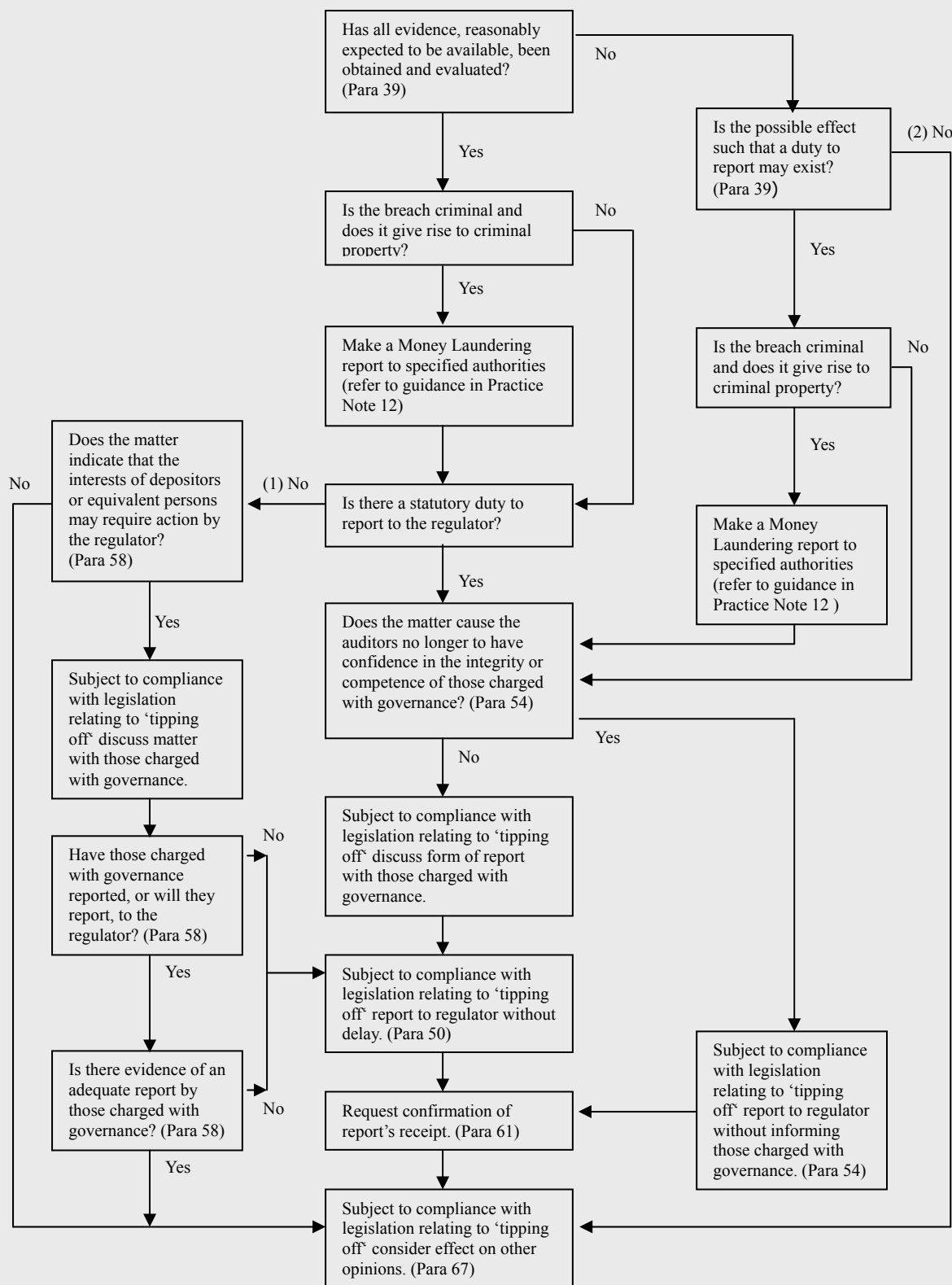
15. The phrase “in his capacity as auditor” limits information subject to the duty to report to matters of which the auditor becomes aware in the auditor’s capacity as such. Consequently, it is unlikely that a partnership can be said to be acting in its capacity as auditor of a particular regulated entity whenever any apparently unrelated material comes to the attention of a partner or member of staff not engaged in that audit, particularly if that material is confidential to another client.
16. The statutory duty to report to a regulator, subject to compliance with legislation relating to ‘tipping off’, therefore does not extend automatically to any information obtained by an accounting firm regardless of its source. Accounting firms undertaking audits of regulated entities need, however, to establish lines of communication, commensurate with their size and organisational structure, sufficient to ensure that non-audit work undertaken for a regulated entity which is likely to have an effect on the audit is brought to the attention of the partner responsible for the audit and to establish procedures for the partner responsible for the audit to make appropriate enquiries of those conducting such other work as part of the process of planning and completing the audit.

### **Appendix 3**

#### **Action by the Auditor on Discovery of a Breach of a Regulator's Requirements**

1. This appendix sets out in the form of a flowchart the steps involved in assessing whether a report to a regulator is required when a breach of the regulator's requirements comes to the attention of the auditor.
2. The flowchart is intended to provide guidance to readers in understanding this Section of this ISA (UK and Ireland). It does not form part of the auditing standards contained in the ISA (UK and Ireland).

## Action by the Auditor on Discovery of a Breach of a Regulator’s Requirements



(1) This route would be only followed when a distinct right to report to the regulator exists. Otherwise, where no duty to report exists, the auditor would next consider the effect on other opinions.

(2) Where the auditor considers that a distinct right to report to the regulator exists, the auditor would next consider the question marked (1).

## **NOTICE TO READERS**

**© The Auditing Practices Board Limited**

This document has been obtained from the website of the Financial Reporting Council (FRC) and its operating Boards, which includes the Auditing Practices Board (APB). Use of the website is subject to the WEBSITE TERMS OF USE, which may be viewed in a separate section of the website. Readers should be aware that although the FRC and its Boards seek to ensure the accuracy of information on the website, no guarantee or warranty is given or implied that such information is free from error or suitable for any given purpose: the published hard copy alone constitutes the definitive text.

The ISAs (UK and Ireland) are based on International Standards on Auditing of the same titles, which have been issued by the International Auditing and Assurance Standards Board and published by the International Federation of Accountants.