GENERAL ASSURANCE AND AUDITING
SECTION 5136
misstatements — illegal acts

Additional Resources

INTRODUCTION AND DEFINITION

.01 THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD, Section 5135, sets out the responsibilities of management, those charged with governance and auditors to consider material misstatements in an audit of financial statements or other financial information. [1] Section 5136 provides additional guidance to auditors about material misstatements arising from the consequences of illegal acts. Additional guidance is provided in Section 5136 because the special nature of illegal acts significantly affects the auditor's ability to detect illegal acts and material misstatements arising from the consequences of illegal acts.

.02 THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD, Section 5135, defines misstatements as either error or fraud. A misstatement arising from the consequences of an illegal act may have similar consequences to a misstatement arising from either fraud or error. Accordingly, when performing the procedures set out in Section 5135, the auditor is alert for indications that illegal acts may have occurred.

.03 For the purposes of the CICA Handbook – Assurance, the term "illegal act" means a violation of a domestic or foreign [2] statutory law or government regulation ("law or regulation") attributable to the entity under audit, or to management or employees acting on the entity's behalf. Illegal acts do not include personal misconduct by the entity's management or employees unrelated to the entity's business activities. The term "illegal act" is used although in practice the auditor will normally be dealing with a possibly illegal act rather than a proven illegal act. Final determination of whether an illegal act has occurred can only be made by a court of law.

.04 It is the consequences of an illegal act, not the illegal act itself, that may affect the financial statements. The consequences of illegal acts vary considerably in their nature and amount, and may include penalties such as a fine or forced closure of operations, and expenditures required to bring the entity into compliance with a law or regulation. A penalty may be monetary or non-monetary and is often prescribed in the law or regulation. For example, the consequences of violating an environmental law or regulation could include a fine, a requirement to clean up a contaminated site, or a commitment to reduce harmful emissions by an agreed amount in a specified period, which might require capital expenditures. The effects of the consequences of illegal acts on the financial statements also vary. Management needs to consider whether such consequences should be included in the financial statements as a liability, contingency or commitment.

MANAGEMENT RESPONSIBILITY

.05 Management is responsible for establishing and maintaining policies and procedures to assist in achieving its objective of ensuring, as far as practical, the orderly and efficient conduct of the entity's business. This responsibility includes policies and procedures to identify and monitor compliance with laws and regulations that affect the entity, and to prevent and detect illegal acts.

.06 The nature of management's policies and procedures related to legal compliance will depend on the extent to which the entity is affected by laws and regulations. This extent depends on many factors, such as the entity's industry and the jurisdictions in which it operates. For many entities, such policies and procedures may be informal; for example, the personal involvement of an owner-manager may be sufficient to enable him or her to identify laws and regulations that affect the entity and to monitor compliance. Other entities may use more formal policies and procedures.

.07 If more formal policies and procedures are used, these may include:

(a) establishing a process to identify, monitor and report compliance with laws and regulations; and

(b) developing and monitoring compliance with a code of conduct within the entity (including any subsidiaries).

Such policies and procedures may also involve consulting with or employing specialists.

.08 Policies and procedures may include certain work of internal auditors and the monitoring activities of those charged with governance, including the audit committee or equivalent.

AUDITOR RESPONSIBILITY

.09 The auditor's professional responsibility is to conduct the audit in accordance with generally accepted auditing standards. An audit conducted in accordance with such standards does not provide assurance about an entity's compliance with the laws and regulations that may affect the entity. These standards include, however, a requirement that the nature, timing and extent of the auditor's procedures be designed such that, in the auditor's professional judgment, the risk of not detecting a material misstatement in the financial statements is reduced to an acceptably low level. Such a misstatement may arise from the consequences of an illegal act. Paragraphs 5136.11-.22 provide guidance to the auditor on how to reduce this risk to an acceptably low level. However, an auditor may not detect a material misstatement arising from the consequences of an illegal act:

(a) for the reasons set out in THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD, paragraphs 5135.017-.020 (for example, an illegal act may be accompanied by acts designed to conceal its existence); and

(b) because of the special nature of illegal acts:

(i) Laws and regulations vary considerably in their relationship to the financial statements. Generally, the further removed a law or regulation is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to be aware of the law or regulation, to become aware of an illegal act arising from a violation of that law or regulation, or to recognize whether the act is illegal. For example, occupational safety and health laws relate more to an entity's operating aspects than to its financial and accounting aspects and, consequently, violations of such laws are less likely to be detected by the auditor.

(ii) It is often difficult to recognize whether an act is illegal. Further, recognizing whether an act is illegal is usually outside the professional training of auditors.

(iii) Final determination of whether an illegal act has occurred can only be made by a court of law.

.10 Accordingly, an auditor conducting an audit in accordance with generally accepted auditing standards may not detect an illegal act, or recognize an act as being illegal, even if the effect of its consequences on the financial statements is material. The auditor may wish to inform management in an engagement letter that illegal acts may not be detected in an audit conducted in accordance with generally accepted auditing standards.

Identification of laws and regulations

.11 ♦ *The auditor should apply his or her understanding of the entity and its environment, including internal control, and make enquiries of management to identify laws and regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements.* [JAN. 1995 *]

.12 The auditor obtains an understanding of the entity and its environment in accordance with UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, Section 5141. The auditor would apply this understanding to identify laws and regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements. The auditor is more likely to identify such laws and regulations if they:

(a) enter into the determination of financial statement amounts or disclosures, for example, the Income Tax Act for taxable entities or the Bank Act for chartered banks; or

(b) have a fundamental effect on the entity's industry and its operations, for example, an environmental law or regulation for a company that produces toxic chemicals.

.13 Management customarily has a greater understanding of the entity and its environment, and of the laws and regulations that affect the entity, than the auditor. As a result, when planning the audit, it is important for the auditor to supplement his or her knowledge of laws and regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements, by enquiring whether management is aware of any such laws and regulations.

.14 An auditor's level of knowledge of those laws and regulations identified will vary. An auditor will often have only a general understanding of the scope and intention of certain of the laws and regulations identified, for instance, those relating to an entity's operating aspects. An auditor is more likely to have detailed knowledge of the laws and regulations identified if they relate to an entity's financial and accounting aspects.

.15 The auditor may not identify all laws and regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements. However, when performing procedures in the normal course of the audit, the auditor will be alert to the possible existence of other such laws and regulations.

Assessing the risks of material misstatement

.16 As required by UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, paragraph 5141.101, the auditor assesses the risks of material misstatement. If the auditor identifies any laws or regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements, the auditor would consider the likelihood of a violation of such laws or regulations when assessing the risks of material misstatement. Factors that could indicate that the likelihood of violation is other than low include:

(a) violations of such laws or regulations by the entity in the current or a prior period;

(b) recent, well-publicized violations of such laws or regulations by other entities within the industry;

(c) active monitoring of such laws or regulations by a regulatory agency or other groups;

(d) the complexity of such laws or regulations; and

(e) management's lack of experience in interpreting or applying such laws or regulations, for example, because the law or regulation is unusual or recently enacted.

Audit procedures in response to the assessed level of inherent risk

Inherent risk assessed as low

.17 If the auditor assesses inherent risk as low (even if the auditor's risk assessment does not include an expectation of the operating effectiveness of controls), the auditor reduces the risk of not detecting a material misstatement in the financial statements arising from the consequences of an illegal act to an acceptably low level, as required by THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS, paragraph 5143.07, by:

(a) considering evidence obtained by performing procedures in the normal course of the audit (for example, evidence obtained from reading the minutes of meetings of the board of directors or from reading the response to an enquiry letter to a law firm); and

(b) enquiring of and obtaining a written representation from management as described in paragraph 5136.21.

.18 The auditor does not need to perform further procedures unless circumstances encountered during the audit make him or her suspect the financial statements are materially misstated as a result of the consequences of an illegal act.

Inherent risk assessed as other than low

.19 If the auditor assesses inherent risk as other than low, he or she would design procedures as required in THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS, paragraph 5143.07. These procedures might include:

(a) obtaining a more detailed understanding of laws or regulations identified, for example, by enquiry of management, other knowledgeable employees or the entity's legal counsel, or by reviewing the laws or regulations;

(b) enquiry of management about policies and procedures implemented by management to help discharge its responsibility to prevent and detect illegal acts;

(c) tests of controls relating to the policies and procedures implemented by management (if the auditor's risk assessment includes an expectation of the operating effectiveness of controls);

(d) consultation with the entity's legal counsel or other specialists about the application of laws or regulations and the possible effect on the financial statements;

(e) reading correspondence and reports from a regulatory agency or other similar authority; or

(f) reading minutes of meetings of the board of directors or committees established to monitor compliance with those laws or regulations identified.

.20 The auditor would also consider evidence obtained by performing procedures in the normal course of the audit, and enquire of and obtain a written representation from management as described in paragraph 5136.21.

Enquiry of and written representation from management

.21 ♦ *The auditor should enquire of and obtain a written representation from management to confirm that either:*

(a) management is not aware of any illegal or possibly illegal acts; or

(b) management has disclosed to the auditor all facts related to illegal or possibly illegal acts. [JAN. 1995]

.22 The auditor may wish to combine this written representation from management with the written representation to be obtained from management about claims and possible claims (see COMMUNICATIONS WITH LAW FIRMS REGARDING CLAIMS AND POSSIBLE CLAIMS, paragraph 6560.19).

Circumstances encountered during the audit that may indicate illegal acts

.23 In the normal course of the audit, the auditor could encounter circumstances that may make him or her suspect the financial statements are materially misstated as a result of the consequences of an illegal act. The auditor would refer to THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD, paragraphs 5135.083-.084 and related Appendix C, in such circumstances. In addition to some of the examples listed in Appendix C, further examples are:

(a) comments made in the response letter obtained in accordance with COMMUNICATIONS WITH LAW FIRMS REGARDING CLAIMS AND POSSIBLE CLAIMS, Section 6560;

(b) investigation by a government agency, an enforcement proceeding or payment of unusual fines or penalties;

(c) violations of laws or regulations cited in correspondence, and reports issued by regulatory agencies made available to the auditor;

(d) unusually large cash receipts or payments, transfers to numbered or offshore bank accounts or accounts in financial institutions with which the entity does not normally do business;

(e) unsupported payments;

(f) increased or unusual legal or consulting fees;

(g) allegations of illegal acts made by suppliers, creditors or employees; and

(h) media comment.

Management's involvement in illegal acts

.24 If management, particularly at the highest level, is involved in an illegal act, the auditor may not be able to obtain the evidence necessary to complete the audit and report on the financial statements. In such circumstances, the auditor would consider obtaining legal advice about his or her contractual or statutory responsibilities and the appropriate course of action.

Difficulty in obtaining sufficient appropriate audit evidence

.25 If the auditor is unable to obtain sufficient appropriate audit evidence by performing procedures such as those described in paragraphs 5136.17-.20, he or she would refer to RESERVATIONS IN THE AUDITOR'S REPORT, Section 5510.

Communication of illegal acts

.26 THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD, paragraphs 5135.093-.101, provide guidance for communication of misstatements to an appropriate level of management, and to the audit committee or equivalent. This guidance applies to the communication of misstatements arising from the consequences of an illegal act. Additional guidance on the content, documentation and timing of the communication of misstatements arising from the consequences of an illegal act is provided in COMMUNICATION WITH MANAGEMENT OF MATTERS IDENTIFIED DURING THE FINANCIAL STATEMENT AUDIT, Section 5750, and COMMUNICATIONS WITH THOSE HAVING OVERSIGHT RESPONSIBILITY FOR THE FINANCIAL REPORTING PROCESS, Section 5751.

.27 When the auditor has obtained evidence that indicates an illegal or possibly illegal act, other than one considered inconsequential, may have occurred, the auditor would ensure the audit committee and appropriate levels of management are informed. Determining which levels of management to inform is a matter of professional judgment. In the context of an audit, some illegal acts may be inconsequential and, in the auditor's judgment, management need not be informed. For example, parking violations would normally be considered inconsequential.

.28 ♦ *When the auditor has obtained evidence that indicates an illegal or possibly illegal act, other than one considered inconsequential, may have occurred, the auditor should ensure the audit committee or equivalent and appropriate levels of management are informed.* [JAN. 1995 *]

.29 Management is responsible for taking appropriate action after being informed about an illegal act. If the auditor believes the action taken by management is inappropriate, even if the consequences of the illegal act are not material to the financial statements, he or she needs to consider the implications for the audit, particularly with respect to management respresentations.

.30 When the auditor has obtained evidence that indicates an illegal act may have occurred, and after having ensured that the appropriate level of management and the audit committee or equivalent is informed, the auditor would also consider his or her responsibilities to communicate illegal acts to third parties. Communication of illegal acts to parties other than management and the audit committee or equivalent is not ordinarily the auditor's responsibility. In fact, the auditor's duty of confidentiality would normally preclude such communication except in connection with the expression of an opinion on the financial statements. However, the auditor may, in some circumstances, have a statutory duty to communicate certain matters to third parties, such as regulators. The auditor would consider obtaining legal advice if in doubt about this responsibility. Legal advice is particularly important if the auditor resigned, was removed or was unable to report on the financial statements.

Footnotes

1. In this Section, the term "financial information" may be used in place of "financial statements".

2. Foreign statutory laws or government regulations mean laws or regulations of other jurisdictions where the entity operates.

* Editorial change — June 1996 and June 2005.

* Editorial change — March 2002.
