

Standard on Auditing (SA) 260 (Revised) Communication with Those Charged with Governance¹

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Revised Standard on Auditing (SA) 260, “Communication with Those Charged with Governance”, should be read in the context of the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”², which sets out the authority of SAs.

¹ Earlier known as Auditing and Assurance Standard (AAS) 27, “Communications of Audit Matters with Those Charged with Governance”.

² Published in the July, 2007 issue of the Journal.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.
2. This SA has been drafted in terms of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation and presentation of the other historical financial information.
3. Recognising the importance of effective two-way communication during an audit of financial statements, this SA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs. Further matters, not required by this or other SAs, may be required to be communicated by laws or regulations, by agreement with the entity, or by additional requirements applicable to the engagement. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A28-A31)

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Communication with Those Charged with Governance

Objectives

5. The objectives of the auditor are to:
- (a) Communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
 - (b) Obtain from those charged with governance information relevant to the audit;
 - (c) Provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
 - (d) Promote effective two-way communication between the auditor and those charged with governance. (Ref: Para. A1-A4)

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Those charged with governance – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector undertakings or an owner-manager. In some cases, those charged with governance are responsible for approving³ the entity's financial statements (in other cases management has this responsibility). For discussion of the diversity of governance structures, see paragraphs A5-A12.

³ As described at paragraph [A43] of [proposed] SA 700, (hitherto known as AAS 28) "The Independent Auditor's Report on General Purpose Financial Statements". The Standard is being revised in the light of the corresponding International Standard.

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(b) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager. Management is responsible for the preparation of the financial statements, overseen by those charged with governance, and in some cases management is also responsible for approving⁴ the entity's financial statements (in other cases those charged with governance have this responsibility).

Requirements

Those Charged with Governance

7. The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. (Ref: Para. A5-A8)

Communication with a Subgroup of Those Charged with Governance

8. When the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A9-A11)

When All of Those Charged with Governance are Involved in Managing the Entity

9. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 12(c). The auditor shall

⁴ See footnote 3.

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nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A12)

Matters to be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

10. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
- (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A13-A14)

Planned Scope and Timing of the Audit

11. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A15-A19)

Significant Findings from the Audit

12. The auditor shall communicate with those charged with governance: (Ref: Para. A20)

- (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting

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framework⁵, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A21)

(b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A22)

(c) Unless all of those charged with governance are involved in managing the entity:

(i) Material weaknesses, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management as required by SA 315⁶ or SA 330⁷;

(ii) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A23)

(iii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. (Ref: Para. A24)

⁵ Revised ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with International Standards on Auditing", Paragraph 13 (a) defines the applicable financial reporting framework as "The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above".

⁶ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 32. SA 315 is published in the February, 2008 issue of the Journal.

⁷ SA 330, "The Auditor's Responses to Assessed Risks", paragraph 19. SA 330 is published in the February, 2008 issue of the Journal.

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Auditor Independence

13. In the case of listed entities, the auditor shall communicate with those charged with governance: (Ref: Para. A25-A27)

- (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms⁸ have complied with relevant ethical requirements regarding independence; and
- (b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and
- (ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The Communication Process

Establishing the Communication Process

14. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A32-A40)

Forms of Communication

⁸ As defined in SQC 1, "Network firm is an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally".

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15. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit when, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A41-A43)

16. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 13.

Timing of Communications

17. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A44-A45)

Adequacy of the Communication Process

18. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A46-A48)

Documentation

19. Where matters required by this SA to be communicated are communicated orally, the auditor shall document them, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation. (Ref: Para. A49)

Application and Other Explanatory Material

Communication with Those Charged with Governance

The Role of Communication (Ref: Para. 5)

A1. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:

- (a) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;
- (b) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
- (c) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

A2. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.

A3. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

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Legal or Regulatory Restrictions on Communicating with Those Charged with Governance

A4. Laws or regulations may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Those Charged with Governance (Ref: Para. 7)

A5. Governance structures may vary reflecting different size and ownership characteristics. For example:

- ◆ In most of the entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government undertakings a body that is not part of the entity is charged with governance.
- ◆ In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

A6. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a

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subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A7. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organisations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315 is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A8. Proposed Revised SA 600, "Special Considerations- Audits of Group Financial Statements (Including the Work of Component Auditors)⁹", includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 8)

⁹ The Exposure Draft of Revised SA 600, has been published in the June, 2008 issue of the Journal.

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A9. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- ◆ The respective responsibilities of the subgroup and the governing body.
- ◆ The nature of the matter to be communicated.
- ◆ Relevant legal or regulatory requirements.
- ◆ Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

A10. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prevented by laws or regulations, the auditor retains the right to communicate directly with the governing body.

A11. Audit committees (or similar subgroups with different names) exist in many jurisdictions. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- ◆ The auditor will be invited to regularly attend meetings of the audit committee.
- ◆ The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- ◆ The audit committee will meet the auditor without management present at least annually.

When All of Those Charged with Governance are Involved in Managing the Entity (Ref: Para. 9)

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A12. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognise this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

Matters to be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit (Ref: Para. 10)

A13. The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement. Providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- ◆ The auditor's responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising from the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.
- ◆ The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- ◆ When applicable, the auditor's responsibility for communicating particular matters required by laws or regulations, by agreement with the entity or by additional requirements applicable to the engagement.

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A14. Laws or regulations, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

Planned Scope and Timing of the Audit (Ref: Para. 11)

A15. Communication regarding the planned scope and timing of the audit may:

- (a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and
- (b) Assist the auditor to understand better the entity and its environment.

A16. Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

A17. Matters communicated may include:

- ◆ How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- ◆ The auditor's approach to internal control relevant to the audit.

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- ◆ The application of materiality in the context of an audit.¹⁰

A18. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- ◆ Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together in a constructive and complementary manner.
- ◆ The views of those charged with governance of:
 - The appropriate person(s) in the entity's governance structure with whom to communicate.
 - The allocation of responsibilities between those charged with governance and management.
 - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
 - Matters, which those charged with governance, consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
 - Significant communications with regulators.
 - Other matters, which, those charged with governance, consider may influence the audit of the financial statements.
- ◆ The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.

¹⁰ Proposed Revised SA 320, "Materiality in Planning and Performing an Audit". Hitherto known as AAS 13, "Audit Materiality". The Standard is being revised in the light of the corresponding Proposed International Standard, ISA 320.

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- ◆ The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- ◆ The responses of those charged with governance to previous communications with the auditor.

A19. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings from the Audit (Ref: Para. 12)

A20. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 12(a))

A21. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures. Open and constructive communication about significant qualitative aspects of the entity's accounting practices may include comment on the acceptability of significant accounting practices. Appendix 1 identifies matters that may be included in this communication.

Significant Difficulties Encountered During the Audit (Ref: Para. 12(b))

A22. Significant difficulties encountered during the audit may include such matters as:

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- ◆ Significant delays in management providing required information.
- ◆ An unnecessarily brief time within which to complete the audit.
- ◆ Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- ◆ The unavailability of expected information.
- ◆ Restrictions imposed on the auditor by management.
- ◆ Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.¹¹

Significant Matters Discussed, or Subject to Correspondence with Management
(Ref: Para. 12(c)(ii))

A23. Significant matters discussed, or subject to correspondence with management may include such matters as:

- ◆ Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- ◆ Concerns about management's consultations with other accountants on accounting or auditing matters.
- ◆ Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.

¹¹ The concept of modification of the auditor's opinion has been dealt in SA 700, "The Auditor's Report on Financial Statements" (hitherto known as AAS 28). The AASB is however also in the process of developing a Standard corresponding to ISA 705, "Modifications to the Opinion in the Independent Auditor's Report".

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Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 12(d))

A24. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

Auditor Independence (Ref: Para. 13)

A25. The auditor is subject to independence and other ethical requirements as enunciated in the Code of Ethics issued by the ICAI¹².

A26. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

- (a) Threats to independence, which may be categorised as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and
- (b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

The communication required by paragraph 13(a) may include an inadvertent violation of relevant ethical requirements as they relate to auditor independence, and any remedial action taken or proposed.

A27. The communication requirements relating to auditor independence that apply in the case of listed entities may also be relevant in the case of some other entities, particularly those that may be of significant public interest because, as a result of their business, their size or their corporate status, they have a wide range of stakeholders. Examples of entities that are not listed entities, but where

¹² Attention of the members is also invited, for instance, to the Guidance Note on Independence of Auditors, issued by the ICAI.

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communication of auditor independence may be appropriate, include public sector entities, credit institutions, insurance companies, and retirement benefit funds. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A28. Those charged with governance are responsible for ensuring, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A29. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant deficiencies in governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorisation.

A30. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind, of which the auditor has become aware, with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A31. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

- (a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;

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- (b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and
- (c) No procedures were carried out to determine whether other such matters exist.

The Communication Process

Establishing the Communication Process (Ref: Para. 14)

A32. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A33. Matters that may also contribute to effective two-way communication include discussion of:

- ◆ The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- ◆ The form in which communications will be made.
- ◆ The person(s) in the audit team and amongst those charged with governance who will communicate regarding particular matters.
- ◆ The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor, matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- ◆ The process for taking action and reporting back on matters communicated by the auditor.

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- ◆ The process for taking action and reporting back on matters communicated by those charged with governance.

A34. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A48).

Considerations Specific to Smaller Entities

A35. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A36. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this SA to be communicated with those charged with governance. Such discussions recognise management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.

A37. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognising management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Communication with Third Parties

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A38. Those charged with governance may wish to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

- a) That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, should not be relied upon by third parties;
- (b) That no responsibility is assumed by the auditor to third parties; and
- (c) Any restrictions on disclosure or distribution to third parties.

A39. The auditor may be required by laws or regulations to, for example:

- ◆ Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. The auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;
- ◆ Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as Central Government in the case of some public sector undertakings; or
- ◆ Make reports prepared for those charged with governance publicly available.

A40. Unless required by laws or regulations to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

Forms of Communication (Ref: Para. 15-16)

Communication with Those Charged with Governance

A41. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 15 and 16 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A42. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- ◆ Whether the matter has been satisfactorily resolved.
- ◆ Whether management has previously communicated the matter.
- ◆ The size, operating structure, control environment, and legal structure of the entity.
- ◆ In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
- ◆ Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
- ◆ The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- ◆ The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- ◆ Whether there have been significant changes in the membership of a governing body.

A43. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarise the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications (Ref: Para. 17)

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A44. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- ◆ Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
- ◆ It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion.
- ◆ Similarly, it may be appropriate to communicate material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention as soon as practicable.
- ◆ Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices.
- ◆ When auditing both general purpose and special purpose financial statements, it may be appropriate to co-ordinate the timing of communications.

A45. Other factors that may be relevant to the timing of communications include:

- ◆ The size, operating structure, control environment, and legal structure of the entity being audited.
- ◆ Any legal obligation to communicate certain matters within a specified timeframe.

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- ◆ The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- ◆ The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., non-compliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process (Ref: Para. 18)

A46. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- ◆ The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- ◆ The apparent openness of those charged with governance in their communications with the auditor.
- ◆ The willingness and capacity of those charged with governance to meet with the auditor without management present.
- ◆ The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- ◆ Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.

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- ◆ Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- ◆ Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A47. As noted in paragraph A1, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.¹³ Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A48. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- ◆ Modifying the auditor's opinion on the basis of a scope limitation.
- ◆ Obtaining legal advice about the consequences of different courses of action.
- ◆ Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- ◆ Withdrawing from the engagement where permitted in the relevant jurisdiction.

¹³SA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", paragraph A66.

Communication with Those Charged with Governance

Documentation (Ref: Para. 19)

A49. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Material Modifications to ISA 260, Communication with Those Charged with Governance

The SA 260, "Communication with Those Charged with Governance" does not contain any material modifications vis-a-vis ISA 260.

Appendix

(Ref: Para. 12(a), and A21)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 12(a), and discussed in paragraph A21, may include such matters as:

Accounting Policies

- ◆ The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- ◆ The initial selection of, and changes in significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- ◆ The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- ◆ The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

Communication with Those Charged with Governance

- ◆ For items for which estimates are significant, issues discussed in Proposed Revised SA 540¹⁴ including, for example:
 - Management's identification of accounting estimates.
 - Management's process for making accounting estimates.
 - Risks of material misstatement.
 - Indicators of possible management bias.
 - Disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- ◆ The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- ◆ The overall neutrality, consistency, and clarity of the disclosures in the financial statements.

Related Matters

- ◆ The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- ◆ The extent to which the financial statements are affected by unusual transactions, including non-recurring amounts recognised during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- ◆ The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible

¹⁴ The Exposure Draft of Revised SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", has been published in the September, 2008 issue of the Journal.

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assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.

- ◆ The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.