

## **ISA 260, “Communication of Audit Matters with Those Charged with Governance” – Issues Paper**

### **INTRODUCTION**

The current ISA 260 was issued in June 1999. Apart from conforming amendments resulting from the audit risk project and the fraud project, it has not been revised. ISA 260 has 5 black letter requirements:

2. **The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity.**
5. **The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.**
11. **The auditor should consider audit matters of governance interest that arise from the audit of the financial statements and communicate them with those charged with governance.**
- xx. **The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. (Added Feb 2004 as part of the revision of ISA 240 re Fraud).**
13. **The auditor should communicate audit matters of governance interest on a timely basis.**

### **ISSUES**

#### **A Scope**

##### **A 1. COMMUNICATION “FROM” VERSUS “BETWEEN”**

ISA 260.01 states that the ISA is about communication *between* the auditor and those charged with governance. Communication *between* parties should be a two-way process, but in fact the ISA really only deals with one side of the equation, i.e. communication *from* the auditor *to* those charged with governance. It does not include any guidance for those charged with governance re communicating with the auditor (or overseeing the audit, or fulfilling any of their other roles), nor does it provides substantive advice about emerging good practice for auditors in establishing an interactive relationship with those charged with governance.

- (a) There may be an opportunity to use the ISA to provide good practice guidance for communication *by* those charged with governance. This could be done, e.g., as an Appendix aimed directly at those charged with governance.

The Task Force is aware of efforts by other international bodies to provide guidance for those charged with governance, e.g., projects by the OECD<sup>1</sup> and IFAC<sup>2</sup>, and considers those bodies to be better suited to that task. The Task Force believes ISA260 should focus on the behavior of auditors.

The Task Force recommends that the IAASB should not attempt to provide guidance for communication with the auditor *by* those charged with governance.

- (b) In general, the revised ISA could be written more in terms of matters *discussed between* the auditor and those charged with governance, rather than in terms of the auditor *informing* or *reporting to* those charged with governance. This would be consistent with the increasingly active role that appears to be expected of auditors<sup>3</sup> with respect to governance, and with recently revised ISAs such as those dealing with fraud, planning and internal control. However, when there are specific matters that are required to be communicated, the ISA might be better presented as the auditor “communicating with” those charged with governance rather than either “reporting to” (which implies a passive role) or “discussing with” (which may not always be possible or appropriate).

**The Task Force recommends that formal requirements be presented in the context of the auditor “communicating with” those charged with governance, and that the revised ISA should specifically note communication is a two-way process, a fact that would also be reflected in the tone and content of the revised guidance.**

## A 2. WHAT IS THE AUDITOR’S RESPONSIBILITY TO COMMUNICATE?

As the Canadian Standards appropriately point out with respect to reporting to *management*: “When conducting the audit, the auditor may identify certain matters that may be of interest to management. The communication of the matters noted in paragraph [...] is a by-product of the financial statement audit and, therefore, is a derivative communication. It is not part of the process of obtaining sufficient appropriate audit evidence to support the content of the auditor's report on the financial statements.”

The same is true under ISAs for communication with those charged with governance. The stated objective of an ISA audit per ISA 200, “Objective and General Principles Governing an Audit of

<sup>1</sup> An exposure draft of revised “OECD Principles of Corporate Governance” (OECD Principles) was released in January 2004. Like the ISAs and IASs, the OECD Principles have been adopted as one of the Twelve Key Standards for Sound Financial Systems by the Financial Stability Forum.

<sup>2</sup> In late January 2004, an IFAC convened meeting of more than 40 global representatives of the accountancy profession decided to, amongst other things, undertake a “global review of corporate governance practices, recognizing the need to strengthen key areas of corporate oversight. Building on other work done in this area by various international groups, the project would involve the review of current standards and guidelines adopted around the world to ensure that they reflect the role of the audit and the responsibilities of professional accountants in business.” The Task Force will track this project, which may indicate practices to be included in the revised ISA, as it progresses.

<sup>3</sup> For example, in their “Discussion Paper on the Financial Reporting and Auditing Aspects of Corporate Governance” (July 2003; page 66), FEE “recommend that (supervisory) boards explore the use of extended (usually referred to as “long form”) reports to boards by external auditors in combination with oral presentations and discussions allowing for more informal and in-depth exchange of views between the auditor and the audit committee or board. This would provide improved clarity and focus for the benefit of the (supervisory) board and audit committee in fulfilling their responsibilities.”

financial Statements” is to form an opinion on the financial statements.<sup>4</sup> Any reporting to those charged with governance could be seen as only a by-product of the obligation to form an opinion. Expectations about what matters should be communicated as part of this “by-product” have evolved over many years, and have continued to evolve since ISA 260 was issued in 1999. The question now is, what expectations should be formalized at this point in time in the revised ISA 260?

The boundaries around the currently accepted expectations are determined by three conditions that ISA 260.04 imposes before a matter is required to be communicated to those charged with governance. The matter must:

- A 2.1 Come to attention as a result of the performance of the audit of financial statements,
- A 2.2 Be important, and
- A 2.3 Be relevant to those charged with governance in overseeing the financial reporting and disclosure process.

Each of these is discussed below in turn. The Task Force has moulded its consideration of these issues into a framework to help the IAASB consider the various matters that might be communicated to those charged with governance. That framework is summarized in section 2.4.

*A 2.1 “come to the attention of the auditor as a result of the performance of the audit”*

There are four elements of this condition that should be examined:

- (a) Are there some matters for which the auditor is the primary source of information, such that it is not a case of something coming to the auditor’s attention, but rather a case of the auditor communicating something they already, necessarily know? An example of this is the planned “scope and timing of the audit, including any limitations thereon, or any additional requirements,” which is identified in the Planning ED as something that is ordinarily discussed with those charged with governance.
- (b) Are there some matters that, if they occur, should always come to the attention of an auditor, and always be reported? For example, uncorrected misstatements aggregated by the auditor during the audit.
- (c) ISA 260.04 states that “The auditor is not required, in an audit in accordance with ISAs, to design procedures for the specific purpose of identifying matters of governance interest.” However, perhaps the expectation that auditors specifically consider and communicate about certain matters *as part of* a standard audit is becoming sufficiently commonplace that it should be reflected as a “core” element of an audit rather than as an add-on. For example, auditing standards in a number of countries require the auditor to comment specifically on the qualitative aspects of accounting policies (as opposed to just considering their acceptability as required to form an opinion on the financial statements).
- (d) ISA 260 relates only to matters that arise “from the audit of the financial statements.” Is this an appropriate restriction, or should the auditor be expected to communicate matters of which she becomes aware, regardless of the source of the knowledge? A restriction with respect to

<sup>4</sup> ISA 200.02: “The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.”

confidential information gained from other clients may be appropriate, but what of information gained through other services provided to the auditee?

A major part of the argument for allowing auditors to perform other services is that there is a spin-off benefit to the entity – why is there no concomitant responsibility to communicate governance matters discovered while performing those other services? A practical difficulty with this concept is the internal difficulty for the audit partner to ensure she is made aware of relevant matters discovered by other, perhaps geographically disparate, sections of a firm (e.g. minor consulting work done for an immaterial subsidiary in a remote location). On the other hand, it is understood that in some jurisdictions, the audit partner is assumed by the law to have constructive knowledge of all relevant matters known to other sections of the firm regarding an audit client (the legal position is being further researched).

The Task Force considers this question can best be addressed by introducing a form of “proximity” that distinguishes between people in the auditor’s firm, other than audit team members, when they are performing:

- Assurance services, or other services where those charged with governance have initiated the service or approved the engagement of the auditor’s firm to provide it – in which case the auditor can reasonably be expected to have knowledge of any relevant matter they discover, versus
- Other services – in which case the auditor cannot be automatically assumed to have knowledge of any relevant matter they discover.

Implementing this distinction may require ISA 260 to introduce specific communication requirements within the auditor’s firm (similar perhaps to the mandated discussions introduced in ISA 240 re fraud) to ensure the auditor is aware of any governance matters arising from relevant services.

**The Task Force recommends that the ISA require the communication of specified matters from each of the categories (a) – (d) above. The table in Section A2.4 of this paper identifies certain of the matters the Task Force will recommend be included (other matters may be added as the Task Force further considers a detailed “shopping list” of matters identified in other ISAs, national Standards etc).**

### *A 2.2 “be important”*

This is akin to a materiality threshold, and seems entirely appropriate. Recent research on the implementation of the UK’s equivalent to ISA 260<sup>5</sup> has indicated that audit committee chairs and CFO’s considered much of the information they were provided with regarding relationships that might bear upon independence “to be unnecessary.” This is to be avoided as “excessive disclosures” can obscure more significant messages. Perhaps guidance could be offered on determining “importance” (e.g. from who’s perspective should it be determined), which the Task Force will consider as the project progresses.

<sup>5</sup> Collier, J., “Communication Between Auditors and Audit Committees – A Research Study” UK APB September 2003

**The Task Force recommends that this criteria be retained, but that the terminology used is changed from “important” to the more familiar “significant.”**

*A 2.3 “relevant to ... overseeing of the financial reporting and disclosure process”*

Should ISA 260 set requirements and offer guidance on communicating governance matters that are not strictly relevant to “overseeing the financial reporting and disclosure process?”

The criteria discussed in A2.1 and A2.2 above, while fraught with issues, are relatively clear-cut as they relate to matters that affect the financial reporting and disclosure process. This criteria (A2.3) however, is more open-ended and relies on an understanding of what matters are relevant to those charged with governance. The term “governance” itself is a moving target that suffers from imprecise definition in the literature at large, particularly as its meaning seems to be growing to capture aspects beyond those traditionally envisaged. For example, Standards Australia has developed a series of “Corporate Governance Standards” that cover not only “good governance principles,” but also “fraud and corruption control,” “organizational codes of conduct,” “corporate social responsibility,” and “whistleblower protection.”

While the current ISA 260 offers no impediment to communicating matters that are not related to the financial reporting and disclosure process, it offers no guidance to auditors who become aware of significant governance matters that are beyond the financial reporting and disclosure process. This revision offers scope to address developments in practice and in community expectations by providing more precision regarding matters of governance interest other than those that relate to the financial reporting and disclosure process.

Particularly pertinent here are the requirements of the recently issued ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.” ISA 315 requires the auditor to obtain a broader understanding of the entity and its environment, including consideration of such things as the entity’s ownership and governance, the way it is structured and financed and its objectives, strategies and business risks. This broader understanding could be expected to result in the auditor being more aware than was previously the case of matters of governance interest beyond those directly related to the financial reporting and disclosure process.

In light of this broader knowledge, one matter considered by the Task Force for possible inclusion as an item the auditor should always communicate was: “Whether the auditor is aware of any significant inconsistency between the auditor’s knowledge of the entity’s governance practices, and any governance related disclosures in information that accompanies, but does not form part of the financial statements.” Inclusion of this matter would require an expansion of the auditor’s current responsibility under ISA 720, “Other Information in Documents Containing Audited Financial Statements” to require the auditor to not only “read the other information to identify material inconsistencies with the audited financial statements,” but to also specifically consider governance related disclosures and compare them to the auditor’s knowledge of the entity’s governance practices. The Task Force does not recommend that this matter be included in the revised ISA 260 as a matter that should be communicated in all cases because the lack of precise definition of “governance” means that virtually any disclosure could potentially be interpreted to be a governance related disclosure. Therefore, a particular disclosure framework (e.g. one imposed by national listing requirements) in which certain items can be identified as being the ones the auditor should review,

seems to be a pre-condition to consistent interpretation of a requirement for the auditor to specifically consider governance related disclosures. Further, in deciding not to include this requirement, the Task Force was conscious that:

- ISA 720, in addition to the requirement noted above, also requires the auditor to take action if she becomes aware of a material misstatement of fact in the other information, and
- Statutory or other requirements (e.g. listing rules) in some countries require the auditor to consider certain disclosures about governance practices (see Appendix 1 for details regarding UK listed companies for example). Further, in the public sector, auditors-general commonly have statutory discretion to report on matters relating to an entity's governance practices. The ISA should at least recognize such situations.

**The Task Force believes certain matters that are not directly related to the financial reporting and disclosure process should be communicated to those charged with governance. Its tentative conclusions on what these matters are and the circumstances in which they should be communicated are included in the table in Section A2.4 of this paper.**

#### *A 2.4 A framework*

The principle that emerges from the Task Force's analysis of the above issues is not too far removed from that in the current ISA 260, i.e. **“The auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity.”** (ISA 260.02). In implementing that principle, issues of definition and nuance arise that need to be considered in light of changes in expectations and changes in Auditing Standards (e.g. the broader understanding required by ISA 315 as noted above). The Task Force has constructed the framework outlined on the following pages to identify and analyze these issues of definition and nuance via different categories of matters that could be discussed with, or communicated to, those charged with governance.

Issue A2.3			
	Matters relevant to overseeing the financial reporting and disclosure process	Matters relevant to other aspects of governance	Communication responsibility
Issue A 2.1 (a) Specified matters about which the primary information is generated by the auditor	Matters to be specified will include: <ul style="list-style-type: none"> <li>• Audit scope, relative responsibilities and key planning decisions</li> <li>• Relationships that bear upon independence</li> <li>• Any decision to divide responsibility (ISA 600)</li> </ul>	—	These matters should always be communicated
Issue A 2.1 (b) Specified matters that the auditor should always become aware of (if they exist) as part of the audit	Matters to be specified will include: <ul style="list-style-type: none"> <li>• Issues that might give rise to a modified auditor’s report</li> <li>• Uncorrected misstatements aggregated by the auditor during the audit (ISA 260)</li> </ul>	Matters to be specified will include: <ul style="list-style-type: none"> <li>• Events or conditions which may cast significant doubt on the entity’s ability to continue as a going concern</li> </ul>	When they exist, these matters should always be communicated.
Issue A 2.1 (c) Specified matters that would require work beyond that strictly necessary to form an opinion on the financial statements	Matters to be specified will include: <ul style="list-style-type: none"> <li>• A commentary on the qualitative aspects of accounting policies and management estimates</li> </ul>	Statutory or other requirements (e.g. listing rules) may require the auditor to review specific governance disclosures and communicate their findings to those charged with governance.	These matters should always be communicated
Issue A 2.1 (d) Specified matters that may come to attention as a result of performing the financial statement audit	Matters specified in other ISAs that are in this category include: <sup>6</sup> <ul style="list-style-type: none"> <li>• Management fraud (ISA240)</li> <li>• Material weaknesses in internal control affecting financial statement preparation (ISA 315)</li> <li>• Noncompliance other than that which is trivial or inconsequential (ISA250)</li> <li>• Materially misstated “other information” that management does not correct (Interims ED)</li> </ul>	Matters to be specified will include: <ul style="list-style-type: none"> <li>• Serious abuse of position by senior management</li> <li>• Serious financial mismanagement</li> <li>• Seriously inadequate risk management processes</li> <li>• Serious weaknesses in internal controls not related to the financial statements</li> </ul>	These matters should always be communicated when they come to attention as a result of performing the financial statement audit
Specified matters that the auditor or a member of the audit team may become aware of other than while performing the audit			These matters should be communicated if they come to attention of members of the audit team other than while performing the audit (consider confidentially if information is gained from another client)
Specified matters that other members of the auditor’s firm may become aware of			These matters should be communicated if they come to attention of other members of the firm when performing: <ul style="list-style-type: none"> <li>• Assurance services, or</li> <li>• Other services where those charged with governance have initiated the service or approved the engagement of the auditor’s firm to provide it</li> </ul>
Other matters, e.g. any observed cases of waste or inefficiency, are discussed with those charged with governance as the auditor sees fit in the circumstances			

<sup>6</sup> Some matters identified in existing ISAs have a communication requirement of “should consider,” e.g. misstatements that may cause material misstatements in future (ISA 240) and significant risks related to fair value measurements (ISA 545). The Task Force will review each instance of this form of communication responsibility in the ISAs and recommend to the IAASB whether it should be reclassified.

### A 3. REPORTING TO OTHERS

ISA 260.01 states: “This ISA does not provide guidance on communications by the auditor to parties outside the entity, for example, external regulatory or supervisory agencies.” However, if for example, the auditor:

- is dissatisfied with the action those charged with governance have taken on significant matters communicated to them; or
- observes significant, and recurring or uncorrected, governance deficiencies directly related to the manner in which those charged with governance are discharging their responsibilities,

it *may* be appropriate to report to a regulator. Other alternatives that may be available to the auditor include:

- discussing the matter with a higher authority in the governance structure that is outside the entity, e.g., the shareholders in general meeting or, in the public sector, a central agency such as a Department of Finance,
- considering resigning, and/or
- including comment as an emphasis of matter in the audit report on the financial statements.

The appropriate action will depend on the specific matters identified and the legal position of the auditor in the particular jurisdiction. For example, in some countries it may be expected that the auditor will attend and speak at the AGM, while in other countries there may be no provision in the law for such an action.

**The Task Force believes it would not be practicable to attempt to provide definitive guidance for such situations beyond a general discussion of the alternatives and noting that it may be appropriate to consult legal counsel.**

### A 4. OTHER ENGAGEMENTS

ISA 260 addresses financial statement audits only, not reviews or other assurance engagements. While it is likely that practitioners conducting reviews and other assurance engagements would benefit from referring to ISA 260, the Task Force believes it would be unnecessarily difficult to attempt to draft one standard that would be generic, yet sufficiently specific to meet the requirements of each individual type of engagement.

For example, in an assurance engagement covered by ISAE 3000, “Assurance Engagements Other than Audits or Reviews of Historical Financial Information,” it is possible for the party responsible for the subject matter, the party responsible for the subject matter information, and the engaging party, to be three different entities. In such a situation, determining the appropriate party with whom the auditor should communicate would be considerably more complex than in a financial statement audit engagement. Similarly, while there may be some difficulties in defining which matters are appropriately identified as related to the “financial reporting and disclosure process” for the purpose of the ISA, those difficulties would be far greater if the subject matter of the engagements to be covered by the ISA were to be open-ended.

**The Task Force recommends:**

- **Restricting the scope of this project to financial statement audits only, but**
- **Specifically considering what action the IAASB should take (if any) to cater for other assurance engagements, at least towards the end of the project.**

## A 5. SMALL ENTITY AUDITS

The IAASB has decided “that for ISAs issued subsequent to March 2003, whenever necessary, considerations in the audit of small entities should be included in the body of those ISAs,” and that the relevant content of the IAPS 1005, “The Special Considerations in the Audit of Small Entities” will be withdrawn.

Currently, IAPS 1005.41 notes: “ISA 260 requires the auditor to determine the relevant individuals who are charged with governance and with whom audit matters of governance interest are communicated. The governance structure in a small entity may not be well defined, or those charged with governance of the small entity may be the same individuals as those charged with management of the entity. It may also include spouses or other relatives, who may not be involved in the supervision or control of the entity on a day-to-day basis. The auditor determines who are entrusted with the supervision, control and direction of the small entity.”

**The Task Force proposes to include this (or similar) guidance in the revised ISA 260.****B. Terminology: “those charged with governance”**

Is the term “those charged with governance” still appropriate?

(It is worth noting that “those charged with governance” has been used throughout our literature in recent years, so any change in ISA 260 would necessitate conforming changes, although some conforming changes will be needed regardless since some of the older documents use terms such as: “audit committee” and “board of directors.”)

A number of matters related to this issue are discussed in B1 to B4 below, and the Task Force’s conclusion is noted in the black lettered paragraph at the end of this section.

## B 1. JURISDICTIONAL ISSUES

ISA 260.06 notes that “The structures of governance vary from country to country reflecting cultural and legal backgrounds ...” Typically, governance literature that attempts to be relevant to more than one jurisdiction has a similar discussion and, like ISA 260, makes certain generalizations and then settles upon terminology that it will use. In practical terms, it seems there is no escape from this general approach (of course the wording of ISA 260.06 will be reviewed, but the basic structure will likely remain the same).

## B 2. BOARD

The OECD Principles use the term “board.” The term “board” has the benefit of being commonly understood and less cumbersome than “those charged with governance.” However, the term “board” may create some confusion when dealing with a two-tier structure (i.e. where there are two boards). Also, the OECD Principles are focused on publicly traded companies, whereas the IAASB is broader

in its coverage, including private companies, and non-corporates in the private sector, and is also cognizant of public sector issues.

### B 3. AUDIT COMMITTEE

ISA 260.07 says “... in entities where a unitary board has established an audit committee, the auditor may decide to communicate with the audit committee, or with the whole board, depending on the importance of the audit matters of governance interest.” Audit committees have become more prevalent and more active since ISA 260 was originally developed, and much of the governance literature with respect to audit issues focuses on the audit committee. Further, audit committees are not only relevant for entities with a unitary board.<sup>7</sup>

ISA 260 could be re-framed to use “audit committee” as the main term on the assumption that having an audit committee is becoming the norm. If we followed this approach we would need to acknowledge that when there is no audit committee, the communication is with the “board” as a whole, and to identify circumstances for when communication with the “board” as a whole is appropriate even where there is an audit committee. Also, using “audit committee” would allow the ISA to be more precise in distinguishing, as appropriate, between communicating with the “board” as a whole and communicating with a sub-group of the “board” that deals in more detail with financial statement matters.

On the other hand, the duties and responsibilities of audit committees can vary widely between, and even within, jurisdictions, and so using this term may be too readily open to misinterpretation.

### B 4. MANAGEMENT

ISA 260.03 says that “Those charged with governance include management only when it performs (certain) functions.” But, incongruously, footnote 1 in the ISA notes that the governance structure should be independent of management.

Further, the Materiality Task Force have remarked (IAASB, July 2003 – Agenda Item 10):

“The term ‘those charged with governance’ is a relatively new addition to the Glossary and to ISAs. The split of responsibilities between management and those charged with governance is not always clear and is exacerbated by structures of governance varying from country to country and within different types of entity (e.g. in smaller entities, management and those charged with governance are often the same individuals). This is recognized in ISA 260 ... which includes several paragraphs of guidance in relation to determining those persons who are charged with governance. The guidance in ISA 260 is not, however, included in the Glossary or in other ISAs which are now incorporating the term.

A particular issue that the Task Force has encountered is how to refer to those individuals in an entity who are responsible for approving and issuing the financial statements. This has led to the rather unsatisfactory inclusion in its draft exposure draft of the term ‘those who are \_\_\_\_\_ responsible for approving and issuing the financial statements.’

<sup>7</sup> Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States on behalf of the European Commission, Internal Market Directorate General, January 2002. Pages 5, 62 and 78.

Given the increasing importance that is likely to attach to the distinction between the responsibilities of management and those charged with governance, the Task Force believes that IAASB needs to clarify the definitions.”

Potentially, we could end up in our literature with 5 distinct levels within an entity, viz: the board, the audit committee, management, those who are responsible for approving and issuing the financial statements, and non-management employees. While this may be helpful sometimes when absolute precision is needed, a proliferation of terms can of itself cause confusion and create difficulties.

**The Task Force recommends that the current terminology, i.e., “those charged with governance” continue to be the predominant term used. This will necessitate use of other terms in some circumstances, for example: “those who are responsible for approving and issuing the financial statements” because it is likely that some of the communication responsibilities of the revised ISA 260 will be aimed at different people or subgroups depending on the functions they perform.**

**Further, the Task Force intends to undertake a review of all instances where any of the above terms, but in particular “management,” are used in the existing ISAs (and EDs), and to:**

- **Recommend a series of definitions or protocols that refer to the relevant functions performed, rather than the people or body within any particular form of organization who performs those functions, to allow a consistent terminology regime to be implemented regardless of jurisdiction or organizational structure, and**
- **Recommend conforming changes.**

### **C. Identifying those charged with governance**

ISA 260.05 requires the auditor to “determine the relevant persons who are charged with governance and with whom audit matters of governance interest are communicated.” ISA 260.03 essentially defines the relevant persons as those “entrusted with the supervision, control and direction of an entity.” It adds that: “Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties.” (ISA 260.07 provides further brief guidance.)

The Task Force believes the current definition’s focus on “supervision, control and direction” is not consistent with modern governance concepts. However, there is no generally accepted definition of “governance” and a review of the literature failed to uncover any particular consensus about the key words that should be included in a brief definition (perhaps because it is a rapidly evolving area).

The most recent ED of the OECD Principles identifies 8 key functions that a board should fulfill (see Attachment 2), but it does not include a concise definition that could be adopted for the ISA.

**The Task Force believes that the key functions of those charged with governance, as that term is used in ISA 260, are:**

- **To oversee the strategic direction of the entity, and**

- **To discharge accountability obligations to owners (or others who are ultimately responsible for appointing those charged with governance and from whom those charged with governance derive their authority, e.g., parliament).**

**It recommends that this be the basis of the definition to be used in ISA 260.**

#### **D. Other references to governance in the ISAs**

There are extensive references in other ISAs to communication with those charged with governance. As noted in B above, the Task Force intends to review all uses of such terminology in the ISAs and recommend conforming changes where appropriate.

At the February IAASB meeting, the Board discussed whether ISA 230, “Documentation,” when revised, should include an appendix that identifies all instances in other ISAs where documentation requirements appear. It was tentatively agreed that such an appendix would be included.

The ISA 260 Task Force believes that approach is not appropriate for ISA 260 (mainly because the volume of other references would make such an appendix unwieldy and because frequent changes to the other ISAs would often render the appendix out-of-date).

**The Task Force recommends that the revised ISA 260 briefly cites (in the grey letter) a non-exhaustive list of key communication requirements in other ISAs, and then in the black letter includes a requirement to communicate matters set out in other ISAs (see Appendix 3 for an example of this approach per the Canadian Standard).**

#### **E. Timing of communications**

The UK Research Study “Communication Between Auditors and Audit Committees” (APB – September 2003) noted “There was always pressure on Audit Committee time with the possibility that if something important did arise at the last minute there would be no slack in the timetable to cope.” ISA 260 requires the auditor’s communication to be timely, but offers very little guidance on the matter.

**The Task Force will seek to develop further guidance to assist auditors with the timeliness of communication. Such guidance will likely:**

- Be linked to a greater emphasis on communication as a process, which includes discussions, rather than treating it simply as a report issued at a point in time; and
- Include a requirement to communicate certain matters during the initial planning phase of the audit (rather than only in the completion phase).

#### **F. Other issues**

Other issues that will be mentioned in the revised text include:

- If the auditor cannot establish an appropriate relationship with those charged with governance (e.g. if they cannot access those charged with governance without management present if and when the auditor believes that to be appropriate), the auditor should consider resigning.
- The revised ISA will note the possible independence implications of advocating particular accounting treatments.

- It will be noted that contractual responsibilities can expand the auditor's mandate, and may include requirements to communicate particular matters to those charged with governance.

Are there other issues the IAASB considers should be dealt with in the revised ISA 260.

**G. IOSCO comments**

The IAASB is seeking endorsement of ISAs by the International Organization of Securities Commissions (IOSCO). As part of that process, IOSCO reviewed 5 ISAs in late 2002. ISA 260 was one of the ISAs reviewed. IOSCO's comments and the Task Force's responses are included as Appendix 4.

The Task Force seeks feedback on its responses to IOSCO's comments.

**Extracts from the UK Listing Rules and Combined Code**

(referred to in Issue A 2.3 of the Issues Paper attached)

A company's statement under 12.43A(b) must be reviewed by the auditors before publication only insofar as it relates to Code provisions A.1.2, A.1.3, A.6.1, A.6.2, D.1.1, D.2.1 and D.3.1 of the Combined Code. ... The auditors must state in their report if in their opinion the company has not complied with any of the requirements of paragraph 12.43A (c)(ii), (iii), (iv), (ix) and (x) of the listing rules and, in such a case, must include in their report, so far as they are reasonably able to do so, a statement giving the required particulars.

A.1.2 The board should have a formal schedule of matters specifically reserved to it for decision.

A.1.3 There should be a procedure agreed by the board for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.

A.6.1 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Act provisions relating to the removal of a director, and reappointment should not be automatic.

A.6.2 All directors should be subject to election by shareholders at the first opportunity after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details to enable shareholders to take an informed decision on their election.

D.1.1 The directors should explain their responsibility for preparing the accounts, and there should be a statement by the auditors about their reporting responsibilities.

D.2.1 The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.

D.3.1 The board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non-executive directors, should be named in the report and accounts.

Paragraph 12.43A (c) relates to disclosures about directors' remuneration.

**Extract from the draft revised OECD  
Principles of Corporate Governance (January 2003)**

(referred to in Issue C of the Issues Paper attached)

The board should fulfill certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
2. Monitoring the effectiveness of the company's governance practices and making changes as need.
3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
4. Aligning key executives and Board remuneration with the longer term interests of the company.
5. Ensuring a formal and transparent Board nomination and election process.
6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
8. Overseeing the process of disclosure and communications.

**Extracts from Canadian Section 5751 “Communications with Those Having Oversight Responsibility for the Financial Reporting Process”**

(referred to in Issue D of the Issues Paper attached)

16 Matters set out in other assurance standards concerning communications with the audit committee include:

- a. fraud and misstatements arising from error (see THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD AND ERROR IN AN AUDIT OF FINANCIAL STATEMENTS, Section 5135);
- b. illegal or possibly illegal acts (see MISSTATEMENTS – ILLEGAL ACTS, Section 5136);
- c. significant weaknesses in internal control identified by the auditor (see INTERNAL CONTROL IN THE CONTEXT OF AN AUDIT, Section 5220); and
- d. related party transactions identified by the auditor which are not in the normal course of operations and which involve significant judgments made by management concerning measurement or disclosure (see AUDIT OF RELATED PARTY TRANSACTIONS, Section 6010).

**24 The auditor should communicate with the audit committee matters arising from the financial statement audit. Such matters include:**

- a. **matters set out in other assurance standards concerning communications with the audit committee;**
- b. ...

**Appendix 4**

**Comments from the International Organization of Securities Commissions**

(referred to in Issue G of the Issues Paper attached)

1	A clear statement of the purpose or objective of the required communications should be included. This should refer to the need for those charged with governance and the auditors to clearly understand their respective responsibilities. It should also refer to the necessity of sharing information, through candid and meaningful dialogue, to assist both parties in discharging their responsibilities as well as the need for auditors to provide constructive observations that arise from the audit process.	Agree – these objectives are similar to those identified in the UK Standard. Care needs to be taken however, when speaking about the responsibilities of those charged with governance, not to seek to impose obligations that are not generally accepted in all jurisdictions.
1	Additionally, the objective of the standard should articulate the entities that are subject to the standard. For example, in order to ensure an effective and meaningful implementation, the standard may apply only to public entities and non-public entities that have either an audit committee or that have otherwise formally designated oversight of the financial reporting process.	Not favored – The revised ISA will continue to apply to all entities. While additional requirements may be considered for auditors of public interest entities if thought absolutely necessary, prima facie having different requirements for different classes of auditees is not seen as being in the public interest.
2	The standard should require reporting to those charged with governance of the financial reporting process (i.e. audit committee, finance committee, or formally designated body). If an entity does not have in place a body who is charged with governance of the financial reporting and disclosure process, it would be appropriate to look to those charged with governance of the entity in the broader context (i.e. board of directors, supervisory board etc).	Agree – this is the intent of the current ISA 260, however, if it is not apparent from the current wording, it will be made clearer.
3	The last sentence of footnote 1, which is cited in the first sentence of paragraph 3, states that, “a common principle is that the entity should have in place a governance structure which enables the board to exercise objective judgment on corporate affairs, including financial reporting, independent in particular from management.” The last sentence of paragraph 3 states, "Those charged with governance include management only when it performs such functions." While not directly in conflict with	Agree that clarification is required. This is addressed in issue C of the attached paper.

	the provisions in footnote 7, the provisions in this phrase are ambiguous and inconsistent with the desired objective of the standard. As such, the last sentence of paragraph 3 should be deleted in order to alleviate the potential interpretation that a member of management may serve a governance capacity over the financial reporting and disclosure process.	
5 & 7	Second and third sentences in paragraph 7 would be more appropriate as the second and third sentence in para 5.	Editorial point – will be considered as ISA 260 is re-drafted.
5 & 8	The first sentence in para 8 would be more appropriate as the last sentence in paragraph 5.	Editorial point – will be considered as ISA 260 is re-drafted.
8	Instead of stipulating the framework that should be followed and thereby making the standard applicable to all entities, consideration should be given to bifurcating engagements subject to the requirements of the standard. For example, audit engagements of listed versus non-entities	Not favored – see response to second point on para 1 above.
11	The last part of the introductory para reads, "Ordinarily such matters include:." In order to provide clear, transparent and definitive guidance that will promote investor confidence in the communication process, the matters listed in this program should be required to be disclosed to those charged with governance. Accordingly the last sentence of the introductory para should be modified to read, "While auditors may choose to communicate additional matters, the communications required under the standard include:."	Agree that clarification is required as to which issues should be communicated in all financial statement audits. This is addressed in issue A2 of the attached paper.  The Task Force has not yet taken a position on whether each of the items mentioned in ISA 260.11 should be required for all audits but, prima facie, it agrees with the view put by IOSCO.
11	Notwithstanding the previous comment, items enumerated in paragraph 11 should be reconsidered and, in particular, whether the items below merit inclusion. Additionally, as noted above, para 11 should note that the list is not all-inclusive. We believe certain items also warrant communication. It may be appropriate to consider, however, whether there are matters that always require communication or whether communication would be appropriate based on the judgment of the auditor.  <ul style="list-style-type: none"> <li>All uncorrected misstatements, known or projected, identified by the</li> </ul>	The Task Force is collating a "shopping list" of possible items that could be communicated by the auditor. The list is being compiled from sources such as ISAs, the Code of Ethics, national standards, codes and regulations, and current literature.  The items mentioned here by IOSCO have been included on that list for

<p>auditors (other than those judged inconsequential) and whether or not management has adjusted the accounts for them. The standard is unclear on the distinction between adjustments that could have a significant effect on the financial reporting process and uncorrected misstatements.</p> <ul style="list-style-type: none"> <li>• The process used by management in formulating sensitive accounting estimates and the basis for the auditor's conclusion regarding the reasonableness of those estimates.</li> <li>• The methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial auditing areas for which there is a lack of authoritative guidance or consensus.</li> <li>• The initial selection of, and changes in, significant accounting policies or their application. The current requirement in ISA 260 (paragraph 11) is only those policies and practices that have, or could have, the material effect on the financial statements.</li> <li>• The auditor's judgment about the quality, not just the acceptability, of the entity's accounting principles.</li> <li>• Consistent with ISA 720 "Other Information In Documents Containing Audited Financial Statements," the auditor's consideration of other information and the results thereof.</li> <li>• The auditor's independence including matters that might bear on the auditor's independence.</li> <li>• The entity's internal control environment.</li> <li>• The entity's corporate governance structure.</li> <li>• Where appropriate, management's comments/proposed actions with respect to matters communicated.</li> <li>• Any unusual transactions affecting the accounts and extent to which they are separately disclosed.</li> <li>• Suspected or actual non-compliance with legal or regulatory requirements.</li> <li>• The auditor's views about the matters that were the subject of consultation between management and other accountants, when management decides to consult with other accountants about auditing and accounting matters and the auditor is aware that such consultation has occurred.</li> <li>• Any significant issues that were discussed with management in connection with the initial or recurring retention of the auditor including, among other matters, any discussions regarding the</li> </ul>	<p>consideration, but the Task Force has not yet deliberated on which items should be included in ISA260.</p> <p>The Task Force is also keen to avoid a "cook book" approach to ISA 260, and believes it needs to strike a balance between prescribing definitive lists of items to communicate and establishing principles that govern the exercise of judgment by the auditor.</p>
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	application of accounting principles and auditing standards.	
11	The matter regarding disagreements with management is ambiguous. In order to clarify, the word "consideration" in the last sentence of the bullet should be changed to "discussion." The sentence would then read, "These communications include discussion of whether the matter has, or has not, been resolved and the significance of matter."	Editorial point – will be considered as ISA 260 is re-drafted.
11	<p>The word "other" in the penultimate bullet of para 11, gives the idea that the matter dealt in this point could be marginal or unimportant.</p> <p>Internal control matters should be a central point of discussion and exchange of ideas and information in the relationships between auditors and those charged with governance. The discussion should not be limited to weaknesses in internal control or to the prevention or detection of fraud and error.</p> <p>With regards to the last matter of the bullet point, which reads: "fraud involving management," auditors should communicate not only "management fraud" but also "employee fraud" to those charged with governance. Furthermore auditors should also communicate material misstatements resulting from errors.</p> <p>With reference to all these points, the standard should be better coordinated with ISA 240 and make the necessary references (for example to paragraphs 28 to 30 and 59 to 67). Finally, reference should be made to ISA 250 paragraph 32, which states that auditors should communicate non-compliance matters to their attention</p>	<ul style="list-style-type: none"> <li>• “other” – editorial point – will be considered as ISA 260 is re-drafted</li> <li>• Internal control – to a great extent it is up to those charged with governance what they will want to discuss. It may not be practical to attempt to mandate “discussion” about, e.g., internal control.</li> <li>• Fraud and uncorrected misstatements – since the IOSCO letter was written, this matter has been given particular attention in the revision of the Fraud ISA</li> <li>• Coordination with other ISAs – see issue D in the attached paper</li> </ul>
13	Both timely and periodic communications contribute to the audit process. Consideration should be given to adding language that clarifies this. The standard should make it clear when the auditor is to report to those charged with governance. For example, the following sentence, or a derivative thereof, would be added to paragraph 13, "auditors are encouraged to have periodic meetings or discussions with those charged with governance concerning the results of interim financial information, the auditor’s plan related to the audit of the annual financial statements, significant events that may affect the financial reporting results of process (sic) for as well as the	Agree – encouragement to adopt best practice to the extent those charged with governance are willing to participate will be included in the revised ISA. (e.g., see Issue A1 (a) in the attached paper).

	results of the fiscal year end.”	
15 & 16	Certain kinds of communications, particularly those that are critical matters, such as in the case of fraud, non-compliance with law or significant doubt about "going concern," are ordinarily expected to be communicated in writing. Therefore more guidance should be provided on how to address with (sic) those kinds of matters.	Agree – critical matters should generally be communicated in writing – the relative attention given to written versus oral communication will be reviewed.
16	The last sentence in para 16 is ambiguous. In order to provide clear and definitive guidance, the last sentence should be modified by deleting the words "it may be advisable for the auditor to confirm" and replaced with "the auditor considers confirming." As a result of this change, the sentence would read, "In certain circumstances, depending on the nature, sensitivity, and significance of the matter, the auditor considers confirming in writing with those charged with governance any oral communications on audit matters of governance interest.	Agree
17	This para allows auditors, under certain circumstances, to communicate with management and to rely upon the fact that management will report the matters discussed to those charged with governance. This approach could in effect remove those charged with governance from the communication process; accordingly the last sentence of this para should be deleted.	While this sentence does require the auditor to be “satisfied that such communications have effectively and appropriately been made,” the wording should be reviewed and a strong preference for direct communication should be noted. .

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