

Communication with Those Charged with Governance – Proposed Explanatory Memorandum

Introduction

This memorandum provides background to, and an explanation of, the proposed revised International Standard on Auditing (ISA) 260, under a new title of “The Auditor’s Communication With Those Charged With Governance,” and proposed conforming amendments to ISA 570, “Going Concern,” and ISA 701, “Modifications to the Independent Auditor’s Report,” approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in March 2005.

Background

In light of significant regulatory and auditing standards developments in several jurisdictions, and shifts in the expectations of those charged with governance and other stakeholders, the IAASB initiated a project to review the provisions of the ISAs that relate to communication with those charged with governance.

This is a joint project with the Australian Auditing and Assurance Standards Board. The Project Task Force also has technical experts nominated by the International Organization of Supreme Audit Institutions, the Institute of Internal Auditors and IFAC’s Transnational Auditors Committee.

Significant Proposals

THE COMMUNICATION PROCESS

The proposed revised ISA 260 includes a new section dealing with the communication process in recognition of its importance in audit effectiveness. It acknowledges that the communication process will vary with the engagement circumstances, and requires the auditor to establish a mutual understanding with those charged with governance of the form, timing and expected general content of communications. It explains that effective communication is ordinarily two-way, and provides guidance on establishing expectations, and the form, timing and confidentiality of communications. It also requires the auditor to consider the adequacy of the two-way communication.

MATTERS TO BE COMMUNICATED

The proposed revised ISA 260 sets out a framework for communication with those charged with governance and generally requires specific items to be communicated only when there is not a specific ISA on the relevant topic. Nonetheless, the proposed revised ISA 260 requires significantly more specific items to be communicated than the existing ISA 260, including any serious matters beyond the financial reporting and disclosure process of which the auditor becomes aware. It also requires, for listed entities, certain categorized disclosures about fees paid in the previous 12 months and fees currently contracted for.

This approach offers more certainty than the existing ISA 260 regarding which matters should be communicated, while at the same time ensuring all matters that would be communicated under the existing ISA 260 will continue to be communicated under the proposed revised ISA.

Also, a new appendix lists the main requirements of other ISAs regarding communication with those charged with governance to complement the framework established in this ISA.

ALL OF THOSE CHARGED WITH GOVERNANCE INVOLVED IN THE MANAGEMENT OF THE ENTITY

The proposed revised ISA 260 recognizes the different role that communication with those charged with governance plays when all of those charged with governance are involved in the management of the entity. It specifically acknowledges that in such circumstances:

- (a) Matters communicated to management need not be communicated again to those same people in their role as those charged with governance; and
- (b) Matters that relate solely to the oversight of management are not relevant because there is no separate oversight.

USE OF “THOSE CHARGED WITH GOVERNANCE,” “MANAGEMENT,” AND OTHER TERMS

In conjunction with revising ISA 260, the IAASB has reviewed use of “those charged with governance,” “management” and related terms, such as “directors,” “client” and “board,” in the ISAs.

Underlying use of the terms “management” and “those charged with governance” in most ISAs have been 2 general presumptions:

- (a) Management and those charged with governance are different people.
- (b) Management is responsible for the financial statements, whereas those charged with governance have an oversight responsibility only.

These presumptions are not appropriate in all circumstances however, and as a result ambiguity may exist when interpreting some ISAs in certain circumstances, e.g. when those charged with governance are the same people (person) as management, and in jurisdictions where those charged with governance, rather than management, have the responsibility to approve the financial statements.

In recent years, documents issued by the IAASB have sought to be clearer about such matters by acknowledging, for example, “the role of those charged with governance is often undertaken by the owner-manager where there are no other owners” (ISA 315.71). Although there is an increased emphasis on clarifying the use of “management” and “those charged with governance,” there is currently no set IAASB approach for doing so, and some ambiguity may persist, particularly in older documents.

The IAASB seeks comment on its proposal to apply the following approach to using “those charged with governance,” “management” and related terms when developing new documents and revising current documents.

- (a) In the Glossary, the definitions of “those charged with governance” and “management” are to be replaced with the definitions at paragraphs 5 (a) and 5 (b) of proposed revised ISA 260, and will include reference to the discussion in paragraphs 7-19 of that ISA.

- (b) Both those charged with governance and management should be referred to where appropriate, e.g.: “Management or those charged with governance are is responsible for the fair presentation of financial statements that reflect the nature and operations of the entity. (ISA 500.15)
- (c) “Board,” “director(s)” and “audit committee” should not be used as generic terms. They may be used to illustrate a point, e.g.: “... recent change of senior management, those charged with governance, e.g. an entity’s board of directors, or ownership.” (ISA 210.11)
- (d) “Client” should not be used (ordinarily “entity” will replace the term “client”).

In developing this approach, the IAASB recognizes that strict adherence to the specific “rules” noted above will not necessarily always result in the desired clarity of expression, and in some circumstances therefore additional explanations may need to be added when “those charged with governance,” “management” or a related term is used.

Guide for Commentators

The IAASB welcomes comments on proposed revised ISA 260 and proposed conforming amendments to ISAs 570 and 701. The IAASB is seeking comments on all matters addressed in the exposure draft, including but not limited to the significant proposals discussed above. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for any proposed changes to wording.

Recognizing that the ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below:

SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES

Consistent with the IAASB’s decision to include any special considerations relevant to the audit of small entities within the text of ISAs themselves, the guidance in paragraph 41 of IAPS 1005, “The Special Considerations in the Audit of Small Entities,” has been revised as considered necessary and incorporated in this proposed revised ISA. Consequently, paragraph 41 of IAPS 1005 **will be withdrawn** when revised ISA 260 becomes effective. Respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in proposed revised ISA 260. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

SPECIAL CONSIDERATIONS IN THE AUDIT OF PUBLIC SECTOR ENTITIES

Where considered necessary, any special considerations in the audit of public sector entities have also been included in this proposed revised ISA. These issues were addressed with the assistance of a nominee of the Auditing Standards Committee of the International Organization of Supreme Audit Institutions. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in this proposed revised ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

TRANSLATIONS

Recognizing that many respondents intend to translate this proposed revised ISA for adoption in

their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing this proposed revised ISA.