

**Communication with Those Charged with Governance Exposure Draft –
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,” 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 the Transnational Auditors Committee of the International Federation of Accountants.

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 evaluate 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 includes specific items to be communicated only when there is not an ISA on the relevant topic. Matters that other ISAs require to be communicated to those charged with governance, for example, communication regarding material weaknesses required by ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” are not repeated in the proposed revised ISA 260. Nonetheless, the proposed revised ISA 260 requires significantly more specific items to be communicated than the existing ISA 260, including 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 to the audit firm and network firm in the previous 12 months and fees currently contracted for.

This approach is more specific 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.

All of Those Charged with Governance Involved in the Management of the Entity

The proposed revised ISA 260, at paragraphs 20 and 21, 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, which may be the case with some small entities in particular. It specifically acknowledges that in such circumstances:

- (a) If matters required by the proposed revised ISA 260 are communicated to person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again to those same person(s) in their governance role; and
- (b) Matters that are required to be communicated, but are relevant only to the oversight function of those charged with governance, ordinarily require no action on the part of the auditor because there is no oversight separate from management.

Communications regarding Auditor Independence

The proposed revised ISA 260, at paragraphs 49, introduces a requirement for written communications to those charged with governance regarding auditor independence. The proposed revised IFAC Code of Ethics for Professional Accountants requires written communications regarding auditor independence in the case of listed entities only. Consistent with the proposed revised Code, paragraph 49 applies to listed entities only. The matters required by paragraph 49 go beyond the proposed revised Code however, by specifically including disclosures regarding fees to the auditor's firm and network firm. The IAASB considers such disclosures important in assisting those charged with governance in monitoring and protecting the auditor's independence. While the primary requirement for these communications relates to listed entities only, paragraph 51 notes that the auditor considers whether they are also appropriate in the case of other entities.

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 two 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, which may cause difficulties when interpreting some ISAs in certain circumstances, for example, 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 difficulty 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 of Terms, the definitions of “those charged with governance” and “management” are to be replaced with the definitions at paragraphs 7(a) and 7(b) of the proposed revised ISA 260, and will include reference to the discussion in paragraphs 9-21 of that ISA.
- (b) Both those charged with governance and management should be referred to where appropriate, for example: “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, for example: “... 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 proposal, the IAASB recognizes that strict adherence to the specific approach 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 the proposed revised ISA 260 and proposed conforming amendments to ISA 570. 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 proposed revised 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 the 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 the proposed revised ISA 260 (see in particular the discussion above regarding "All of Those Charged with Governance Involved in the Management of the Entity"). 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.

Developing Nations

Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed revised ISA in a developing nation environment. Reasons should be provided, as well as 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.