

## **Communication with Those Charged with Governance – Significant Issues**

### **Overview of Exposure Draft Comments**

Thirty-four comment letters were received as listed in Appendix 1. Comment letters are available at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0042>.

Respondents were generally supportive of the exposure draft. Respondents' comments on significant issues are discussed below.

### **Significant Issues**

#### **A. Special Purpose Financial Statements**

- A1. The ED stated that it applied to the audit of financial statements, which includes special purpose financial statements, and that “The standards and guidance in this ISA are to be adapted, as necessary, for audits of historical financial information other than financial statements.”
- A2. One respondent<sup>1</sup> noted several difficulties with applying the ED to special purpose financial statements and recommended that special purpose financial statement should be excluded from the ISA.
- A3. The Task Force considered the range of circumstances to which the ISA should apply, and decided that it is not the distinction between general purpose and special purpose financial statements (nor between financial statements and other historical financial information) that should determine whether the ISA applies or not. Rather the ISA is based upon the relationship between those charged with governance and the information subject to audit, in particular whether those charged with governance have a responsibility to oversee the preparation and presentation of that information by management. Where this responsibility exists, the ISA should apply.
- A4. Two particular circumstances were identified where those charged with governance may not have a responsibility to oversee the preparation and presentation of the information subject to audit, i.e., when the information is prepared solely for management's use, and when the entity engaging the auditor is not the entity responsible for the financial information. These circumstances have been mentioned as examples in paragraph 2.

A4. The Task Force has amended the Draft to make it applicable to audits of historical financial information where those charged with governance have a responsibility to oversee the preparation and presentation of that information.

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<sup>1</sup> KPMG.

## B. Two-Way Communication

- B1. The ED included reference to the desirability of communication being two-way (paragraph 6).
- B2. While generally acknowledging that an ISA cannot mandate two-way communication (because it cannot require those charged with governance to communicate with the auditor), many respondents<sup>2</sup> wanted the importance of two-way communication to be emphasized further. A number of these respondents suggested that replacing the auditor communicates *to* those charged with governance” with “... communicates *with* ...” would help achieve this. Addition of further examples of two-way communication was also suggested, as was some restructuring of the introduction to add emphasis to the importance of two-way communication.

B3. The Task Force reviewed each time the draft used “communicates *to*” and agreed it should be replaced with “communicates *with*” in all cases. The Task Force also agreed with the addition of further examples – see particularly paragraph 55. Also, a new section on “The Role of Communication” has been added. It comprises mostly pre-existing text, but including it in a separate section raises the profile of two-way communication within the document.

## C. “Significant” Versus “Serious” Etc.

- C1. A number of respondents<sup>3</sup> expressed concern that the ED used different words to describe matters to be communicated:
- “Significant” is used frequently in the ED.
  - “Serious” is used only in relation to “other matters” (paragraphs 22 (e), 25 – 2<sup>nd</sup> bullet, 46 and 47).
  - “Major” is used only in relation to matters discussed, or subject to correspondence with management (paragraphs 33 (c) and 42).
  - “Important” is used indirectly in para 53.
- C2. The intent of using different words, in particular “serious” in relation to other matters, was to indicate that a different threshold applies to those matters – it would not be expected that the auditor would be required to communicate such matters unless they were serious (in the common English usage of the term). However, without an explicit explanation of the intended distinction, it seems that use of different words is prone to misunderstanding.
- C3. The Task Force considered alternatives, including retaining the different words with an explanation of the intended distinction, or using a qualifier such as “particularly” or “very” significant. The Task Force also considered the Glossary definition of “significance:”

<sup>2</sup> BCBS, ICAEW, FEE , CIPFA, APB, GT, KPMG, and IOSCO.

<sup>3</sup> DNR, FEE, ICAEW, APB, PwC, ACCA, and EY.

The relative importance of a matter, taken in context. The significance of a matter is judged by the practitioner in the context in which it is being considered. This might include, for example, the reasonable prospect of its changing or influencing the decisions of intended users of the practitioner's report; or, as another example, where the context is a judgment about whether to report a matter to those charged with governance, whether the matter would be regarded as important by them in relation to their duties. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients.

C4. The Task Force decided to include this definition of “significance” in the Draft (footnote 3) and replace all instances of serious, major and important, with “significant” because:

- The definition caters adequately for different thresholds, as the meaning is context-specific, and
- The text of the Draft provides that context.

The Task Force also reviewed the requirements of the ISA to ensure that “significance” is to be interpreted in the context of the auditor’s professional judgment.

C5. The Task Force recommends that only one word, “significance,” be used to describe matters to be communicated, except in paragraph 46 (b) (i), where “important” is used in the same way it is used in the definition above to add emphasis to a context.

#### **D. Communication by Management with Those Charged with Governance**

D1. The ED, at paragraph 19, permitted the auditor in certain circumstances, not to communicate certain matters if the auditor was satisfied that management had done so effectively (hereinafter “the exception”).

D2. Quite mixed views were expressed on this issue. Regulators in particular<sup>4</sup> were troubled that the existence of the exception may “be seen to weaken the auditor’s general obligations with respect to communications and may conflict with other parts of the revised standard.” Other respondents<sup>5</sup>, in suggesting which matters should be included in the exception, presented a range of views. One respondent suggested clarification of the requirement by requiring those matters not subject to the exception to be communicated “directly.”<sup>6</sup>

D3. The Task Force reviewed each of the matters required by the Draft to be communicated and considered whether it should be subject to the exception. The Task Force agreed that none of the matters other than “supplementary matters” should be subject to the exception. It has made this clear in the draft by requiring that those matters be communicated “directly.” Accordingly, the draft proposes the following matters be communicated directly:

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<sup>4</sup> BSBC and CEBS.

<sup>5</sup> For example, contrast the position of APB with that of IdW.

<sup>6</sup> GT.

- (a) The auditor’s responsibilities in relation to the financial statement audit;
- (b) The planned scope and timing of the audit;
- (c) Findings from the audit; and
- (d) When appropriate, auditor independence.

The Task Force has, however, added guidance to paragraph 19 that communication by management may “affect the form or timing of the auditor’s communication of such matters.”

D4. For supplementary matters, the Task Force has introduced, in paragraph 46, a condition that the obligation to communicate is only invoked if a supplementary matter has, in the auditor’s professional judgment, “not otherwise been communicated effectively with those charged with governance by management or others.” This condition is seen as appropriate for supplementary matters because of the large range of circumstances that is potentially involved. For example, the auditor may become aware of a significant problem with the governance structure as a result of management’s communication of that matter to those charged with governance – in such a case it would make little sense to require the auditor to repeat the matter to those charged with governance.

## **E. Small Entities**

- E1. The ED included paragraphs 20 and 21 to cater for those circumstances when all of those charged with governance are involved in managing the entity. This will most often be the case for SMEs.
- E2. Respondents generally agreed with the treatment proposed in paragraphs 20 and 21, however a number<sup>7</sup> recommended that the Draft go further in addressing the needs of SME auditors. The main suggestions were:
  - Grouping together, perhaps in the introductory section of the Draft, SME considerations mentioned as examples in various places throughout the ED.
  - Emphasizing the lack of formality in both the management practices of SMEs and the auditor’s approach to communication with those charged with governance of SMEs.
  - Restricting the need to communicate to only those instances where the governance function is effective (the argument being, in essence, that where it is ineffective, communication serves no purpose).

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<sup>7</sup> ICAEW, FEE, DNR, PwC, and ACCA.

E3. The Task Force has not changed the basic approach to SME audits. In particular: (a) paragraphs 20 and 21 have been retained, (b) SME considerations have not been grouped (however this will be considered further as part of “clarifying” this ISA), (c) no additional emphasis has been given to the informality of SMEs (the Draft is considered sufficiently flexible as currently drafted), and (d) it has not been restricted to entities where the governance function is effective (to do so was considered to be a derogation of the auditor’s duty to inform).

## F. Corrected Misstatements

- F1. Two respondents<sup>8</sup> questioned the practicality of the requirement to communicate: “material, corrected misstatements that were brought to the attention of management as a result of audit procedures” (old paragraph 33 (a)). They noted that this assumes complete financial statements are available when the audit starts, rather than the reality that preparing and auditing financial statements is an iterative process in which it is often not clear-cut whether or not potential misstatements were identified “as a result of audit procedures.” For example, the auditor may detect a misstatement while management are preparing the financial statements that the entity’s internal controls would otherwise have picked up later in the process.
- F2. The Task Force agrees with this view, and also considers that corrected misstatements are, in some circumstances, likely to be of interest to those charged with governance, e.g.: when they indicate undue bias or weak internal control.

F3. In the Draft, while the Task Force has deleted old paragraph 33 (a), it has included enhanced guidance on this matter as part of the guidance on the requirement to communicate “significant matters arising from the audit that were discussed, or subject to correspondence with management” (see the first dot point of paragraph 42).

## G. Other ISAs and Additional External Requirements, and Matters Agreed with the Entity

### *Appendix of Other ISAs*

- G1. The Explanatory Memorandum accompanying the ED noted: “matters that other ISAs require to be communicated ... are not repeated in the proposed revised ISA 260.” The ED did, however, contain a partial list of such matters at paragraph 44.
- G2. Several respondents<sup>9</sup> noted that it would be helpful for practitioners if the ISA had an appendix that contains a complete list of such matters, and another noted that paragraph 44 should either be made complete or removed altogether<sup>10</sup>. One respondent<sup>11</sup> explicitly supported not repeating such matters in this ISA.

<sup>8</sup> IdW and PwC.

<sup>9</sup> ICAEW, GAO, CEBS, ACCA, GT and KPMG.

<sup>10</sup> PAAB.

<sup>11</sup> DFCG.

- G3. Early drafts of the ED included an appendix of matters required by other ISAs. It was not included in the final ED, however, largely because of the difficulty of ensuring it is in fact complete when quite a few of the current ISAs do not distinguish between communicating with those charged with governance and communicating with management. This meant that a high degree of subjectivity was required in deciding whether particular requirements should be included or not. Another reason the IAASB decided to remove the appendix was the difficulties of keeping it up-to-date as other ISAs are amended.

G4. For the reasons noted above, the Task Force does not support including an appendix of matters required by other ISAs. Further, the Task Force considers that including a partial list of matters required by other ISAs is not desirable as it could give the impression that those matters mentioned are somehow more important than those that are not. The Task Force therefore recommends that paragraph 44 be deleted. The Task Force also notes that retaining paragraph 44 or adding an appendix is inconsistent with the direction of the Clarity project, which is deleting “educational” material and reducing cross-references between ISAs.

*“A Requirement to Comply with Another Requirement”*

- G5. One respondent<sup>12</sup> questioned why paragraph 43 (a), in relation to “additional external requirements,” included “a requirement to comply with another requirement.” While recognizing “that the auditor has a responsibility to be aware of, and comply with, those external requirements,” they stated their view that “a failure of the auditor to comply should not result in the audit not having been conducted in accordance with ISAs.” Similar sentiments were expressed by a number of respondents<sup>13</sup> regarding the requirement of paragraph 43 (b) to communicate matters agreed with the entity, particularly when they require the auditor to do work beyond that necessary to form an opinion on the financial statements, e.g.:

As a general principle, we believe that the boundaries of the scope of the ISAs should be the auditor’s responsibilities in the audit of financial statements and the actions that are necessary to support a high quality audit. We do not believe that the ISAs should embed requirements that extend beyond that scope.

G6. The Task Force considers that communicating matters required by additional external requirements and matters that have been agreed with the entity, is an integral part of “a high-quality audit” and, therefore, that reference to these matters should be retained as part of the framework established in the Draft. It does, however, agree that it is not essential for communication of these matters to be a black lettered requirement. The Task Force therefore recommends that paragraph 43 be retained as a grey letter paragraph.

<sup>12</sup> EY.

<sup>13</sup> JICPA, PwC, EY and KPMG.

## H. “Other Matters”

H1. Both paragraph 32 and 46 of the ED used the term “other matters.” This appeared to cause confusion for some respondents.

H2. The Task Force decided to change the term used in paragraph 46 to “supplementary matters.” This change also helps reinforce the concept that such matters are not expected to be identified as a normal part of the audit.

H3. Several respondents<sup>14</sup> expressed some concern about the requirement in paragraph 46 to communicate matters that (a) come to the auditor’s attention other than as a result of performing the audit, or (b) are not directly relevant to the responsibility of those charged with governance to oversee the financial reporting process. This issue was discussed several times by the IAASB before approving the ED, and the Task Force did not consider that the arguments advanced by respondents introduced any reasons that had not already been considered by the IAASB during its discussions.

H4. The Task Force therefore did not alter the principle of paragraph 46. It did, however, restructure and reword paragraphs 46 and 47 to make the requirement clearer, and to add the condition that the auditor has no obligation to repeat matters that have, in the auditor’s professional judgment, otherwise been communicated effectively (see paragraph D4 of this memorandum).

H5. The Task Force found the flowchart in Appendix 2 to this memorandum helpful in considering this issue, and asks the IAASB whether it would like to include the flowchart as an Appendix to the Draft.

## I. Auditor Independence

### *Applicable Only to Listed Entities*

I1. The ED required listed entities to make certain disclosures to those charged with governance regarding independence (paragraph 49). Many respondents<sup>15</sup> recommended that this requirement be widened to include other entities. The main suggestions were to include all public sector entities, all public interest entities, or all entities.

I2. This requirement was restricted to listed entities to be consistent with the IFAC Code of Ethics. The Code also notes:

Certain entities 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 such entities might include listed companies, credit institutions, insurance companies, and pension funds. Because of the strong public interest in the financial statements of listed entities, certain paragraphs in this section deal with additional matters that are relevant to the audit of listed entities. Consideration should be given to the

<sup>14</sup> JICPA, ICAI, AICPA, PwC, DTT, ACCA, GT, and EY.

<sup>15</sup> BCBS, ICAEW, CIPFA, DFCG, ACAG, CEBS, PAAB, IAIS, and EY.

application of the principles set out in this section in relation to the audit of listed entities to other audit clients that may be of significant public interest.

13. The Task Force notes that paragraph 51 (“The auditor considers whether the communications set out in paragraph 49 are also relevant in the case of entities that are not listed entities ...”) contains a similar sentiment to the above quote from the Code.

14. The Task Force has amended paragraph 51 to make it more closely aligned with the Code, and considers that this is adequate to ensure that communications regarding independence are made in the case of non-listed entities when it is relevant to do so.

*Including Associates*

15. The communication required by paragraph 49 includes fees paid by “the entity and components included in its financial statements.” The definition of “component” in the Glossary (which in this respect is consistent with that in [proposed] ISA 600 (Revised), “The Audit of Group Financial Statements) includes joint ventures and associated companies.
16. IFAC Ethics Committee staff has brought to the Task Force’s attention that the inclusion of “joint ventures and associated companies” would effectively extend the scope of fees to be tracked beyond the requirement of the United States’ SEC, around which most international firms’ internal tracking systems are currently designed. The cost to firms of extending systems to track this information would be significant.

17. Given the minimal benefit that is likely to accrue to those charged with governance from the disclosure of fees paid by joint ventures and associates, versus the significant cost of compiling that information, the Task Force has restricted the application of paragraph 49 to “controlled components.”

*In the Preceding 12 Months*

18. One respondent<sup>16</sup> queried how to interpret the requirement to communicate total fees charged “in the preceding 12 months”. For example, this could mean the 12 months preceding either the date of the communication, or the date of the financial statements.

19. The phrase “in the preceding 12 months” has been replaced with “during the period covered by the financial statements.”

*Contravention of the Code*

110. A new requirement has been added, at paragraph 51.1, for the auditor to communicate a contravention of the Code as it relates to auditor independence. The Code itself acknowledges that inadvertent contraventions may occur, and provides guidance for such situations, which is referred to the footnote to this paragraph.

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<sup>16</sup> ACCA.

**J. Documentation**

- J1. The ED combined in one section (mainly paragraph 56), discussion of (a) forms of communication, and (b) documentation. As a result, the emphasis regarding documentation was on which of the matters that have been communicated orally should be documented in the form of written communications, minutes or otherwise.
- J2. It was evident from the comments of a number of respondents that this approach lead to some confusion between the purpose of communicating in writing, and of documenting matters in the audit file. To address this, the Task Force created a new section on documentation, separating it from “forms of communication.”
- J3. The new section (paragraphs 69.1 and 69.2) requires documentation of significant matters communicated with those charged with governance, and two other matters as follows:
  - (a) One respondent<sup>17</sup> suggested, due to the importance of determining the person with whom the auditor should communicate, that: “in complex situations, the auditor should document the process followed and conclusions reached for identifying relevant persons with whom to communicate.” While not adopting these exact words, the Task Force agreed with this sentiment and has included a documentation requirement regarding paragraph 13 (see paragraph 69.2 (a)).
  - (b) The Task Force reviewed the other decisions required by the Draft, and determined that:
    - (i) When all of those charged with governance are involved in managing the entity, a documentation requirement should be included with respect to paragraph 21: “whether communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity” (see paragraph 69.2 (b)). The Task Force considered this appropriate because when all of those charged with governance are involved in managing the entity, the auditor is relieved of the requirement to make certain communications.
    - (ii) No specific documentation requirement should be included regarding the auditor’s evaluation of the adequacy of the two-way communication process (paragraph 65). It was considered that because this evaluation will often be informal, requiring documentation in all cases is unnecessary.

J4. The revised Draft includes a new section on documentation (paragraphs 69.1 and 69.2).

**K. Effective Date**

- K1. One respondent<sup>18</sup> has noted that “Because the communication with those charged with governance is heavily influenced by local laws and regulations the standard will need to be

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<sup>17</sup> GAO

<sup>18</sup> CNCC.

adapted to the national environment and the French Institutes therefore recommend that the effective date be postponed by at least a year.”

- K2. Another respondent<sup>19</sup> noted that the existing ISA 260 is outdated and that, under the Clarity project, the revised ISA 260 will not be released until 2007 (and therefore not effective until, say, 2008). They urged the IAASB to “finalise and issue the revised ISA 260 under the existing ISA format.”

K3. The view of the IAASB is sought on how long the implementation period should be, and whether the current ISA should be retained until the “clarified” ISA 260 is completed.

#### **L. Other Issues**

- L1. *“Those charged with governance” versus “management”*: Respondents were generally supportive of adopting the approach outlined in the Explanatory Memorandum to (a) use in the Glossary, paragraph 7’s definitions of “those charged with governance” and “management,” including a reference to the discussion in paragraphs 9-21, (b) refer to both those charged with governance and management where appropriate, and (c) essentially remove words like “director” and “client” in IAASB literature.
- L2. *Conforming amendment*: No substantive comments were received on the conforming amendments to ISA 570, “Going Concern”.

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<sup>19</sup> AUASB.

**Respondents**

**Appendix 1**

	<b>MEMBER BODIES</b>
AICPA	American Institute of Certified Public Accountants (United States)
CIPFA	Chartered Institute of Public Finance and Accountancy (UK)
CICPA	Chinese Institute of Certified Public Accountants (China)
CNCC	Compagnie Nationale des Commissaires aux Comptes + Conseil Superieur de l'Ordre des Experts-Comptables (France)
DNR	Den Norske Revisorforening (Norway)
FAD	Foreningen Auktoriserade Revisorer (Sweden)
IdW	Institut der Wirtschaftsprufer (Germany)
ICPAK	Institute of Certified Public Accountants of Kenya (Kenya)
ICPAS	Institute of Certified Public Accountants of Singapore (Singapore)
ICANZ	Institute of Chartered Accountants of New Zealand (New Zealand)
NIVRA	Koninklijk Nederlands Instituut van Registeraccountants (Royal NIVRA) (The Netherlands)
CICA	The Canadian Institute of Chartered Accountants (Canada)
ICAEW	The Institute of Chartered Accountants in England and Wales (UK)
ICAI	The Institute of Chartered Accountants in Ireland (Ireland)
ICAS	The Institute of Chartered Accountants of Scotland (Scotland)
ICAZ	The Institute of Chartered Accountants of Zimbabwe (Zimbabwe)
JICPA	The Japanese Institute of Certified Public Accountants (Japan)
ACCA	The Association of Chartered Certified Accountants (UK)
	<b>FIRMS</b>
DTT	Deloitte Touche Tohmatsu (United States)
EY	Ernst & Young Global (United Kingdom)
GT	Grant Thornton International (United States)
KPMG	KPMG (Canada)
PwC	PricewaterhouseCoopers (United Kingdom)
	<b>OTHER</b>
DFCG	Association Nationale des Directeurs Financiers et de Contrôle de Gestion (France)
APB	Auditing Practices Board (United Kingdom)
CEBS	Committee of European Banking Supervisors (United Kingdom)
CDI	Dansk Industri (Confederation of Danish Industries) (Denmark)
FEE	Federation des Experts Comptables Europeens (Belgium)
iwp	Institut Osterreichischer Wirtschaftsprufer (Austria)
LSCA	London Society of Chartered Accountants (United Kingdom)
PAAB	Public Accountants' and Auditors' Board (South Africa)
BCBS	Basel Committee on Banking Supervision (Switzerland)
GAO	United States Government General Accountability Office (USA)
AUASB	Australian Government, Auditing and Assurance Board (Australia)
ACAG	Australasian Council of Auditors-General (Australia)
IAAS	International Association of Insurance Supervisors (Switzerland)
IOSCO	International Organization of Securities Commissions (Spain)

**Appendix 2**

The Task Force found the following flowchart helpful in considering the issue discussed in H1-H5 of this memorandum, and asks the IAASB whether it would like to include it as an Appendix to the Draft

