

## **IAASB Project Proposal — Communication of Audit Matters with Those Charged with Governance**

### **1. Subject**

Revision of ISA 260, *Communication of Audit Matters with Those Charged with Governance*.

### **2. Reasons the Subject Should Be Studied Now**

Since the issuance of ISA 260, there is an increased focus by regulators, auditing standard setters and investors over the role of those charged with governance over the financial reporting process (audit committees<sup>1</sup>) and their relationship with the external auditor. There has been regulatory and auditing standards development in major jurisdictions resulting in a need to review current “best practice” relating to communication with audit committees and to determine whether ISA 260 (and other relevant ISAs) requires updating.

#### **DEVELOPMENTS IN REGULATORY ENVIRONMENT**

Specific audit matters required to be communicated with audit committees are often linked to local regulatory (or legislative) requirements. As a result of recent major corporate failures, some jurisdictions have accelerated their regulatory activities to enact or assess the need for new corporate governance requirements and specifically for audit committees. A consequential effect of regulatory change is the role required of, or undertaken by, auditing standard setters to bring auditing standards in line with new regulatory changes or to reflect changes in local business practice. However, as major jurisdictions are still in the process of determining whether to implement new regulatory requirements, it is difficult to fully ascertain the impact that such developments will have on auditing practices at an international level. Maintaining an awareness of regulatory development is important to understand *how* auditing practices may be impacted. Appendix A highlights some of the activities in major jurisdictions.

#### **DEVELOPMENTS IN AUDITING STANDARDS**

Developments in auditing standards and practices since the issuance of ISA 260 have a more direct and relevant impact on this project.

#### **Construct of ISA 260**

ISA 260 is an “umbrella” standard providing overarching requirements and guidance with communication of specific audit matters addressed in other relevant ISAs. This approach is consistent with other ISA 260 equivalent national standards; however, the equivalent standards often contain explicit reference to, or summary of, all the mandatory requirements contained in other individual standards. Such an approach provides a more complete presentation of all relevant ISA communication requirements and may reduce the risk that an auditor will omit a required procedure.

#### **Increased Requirements and Guidance**

Many of the ISA 260 equivalent standards issued by major auditing standard setters are based on ISA 260 or contain its basic principles and essential procedures. Since the issuance of ISA 260,

<sup>1</sup> The term “audit committee” has been used for ease of reference instead of ISA 260’s “those charged with governance”.

other ISAs and national standard setters (such as U.S., U.K. and Canada) have increased the communication requirements and guidance for specific audit matters. However, there are differences in the scope of matters to be communicated between ISAs and the national standards. The differences relate primarily in the nature and extent of both those matters required to be communicated and the guidance provided to assist auditors in determining other matters to be communicated. Some of these differences may be a direct consequence of local regulatory requirements and local auditing practice. However, others seem to enhance the guidance in assisting the auditor in fulfilling his responsibilities for communicating audit matters relevant to the audit.

#### ENDORSEMENT ACTIVITIES

ISA 260 was part of the set of ISAs that IOSCO recently commented on for endorsement purposes. IOSCO's more significant comments relate to the scope of matters to be communicated and the applicability of ISA 260. Issues similar to comments raised by IOSCO were identified in developing this proposal and are discussed below.

European Union adoption of ISAs is considered an important step for international convergence. Given the increased focus on communication with audit committees, revising ISA 260 will allow for further convergence of auditing practices for this subject. Establishing a project to revise ISA 260 in 2003 should also permit an exposure draft to be issued before 2005 (see "Resources Required" below).

### 3. Scope of Project

#### (a) List the Major Problems and Issues That Should Be Addressed

Major issues to be addressed include:

- I. Consensus on issues affecting the international environment;
- II. Applicability of ISA 260;
- III. Construct of ISA 260;
- IV. Nature and extent of "audit matters of governance interest"; and
- V. General issues.

#### I. CONSENSUS ON ISSUES AFFECTING THE INTERNATIONAL ENVIRONMENT

For countries where the auditor's communication requirements and relationship with the audit committee is not yet governed by regulation or is not as advanced in practice, auditors look to the IAASB to guide the scope, nature and extent of communications with audit committees for today's audit environment. In considering how to proceed with issues identified, there is a need to understand whether recent developments and auditing practices demonstrate "best practice" (supporting a change to ISA 260 (or other ISA)) or are more reflective of national requirements which may not be applicable at an international level. This was one of the challenges when ISA 260 was first developed i.e. to ensure that it has general applicability at an international level given the fact that corporate governance development, structures and requirements differ among jurisdictions. The project approach will require careful research into differences, a reconsideration of issues previously considered not applicable and whether they now need to be addressed, and an evaluation of changes in relation to basic principles. These elements of the project approach will contribute to the complexity and length of the project.

#### II. APPLICABILITY OF ISA 260

ISAs are drafted to apply to all entities and matters requiring mandatory communication would therefore apply to all entities. This continues to be the preferred approach in developing ISAs.

However, some national standards dealing with ISA 260 subject matter require auditors of *listed entities* to communicate specific additional audit matters. In its review of ISA 260, IOSCO recommended splitting the engagements subject to ISA 260 (for example, listed versus non-listed entities). Although such a split is not consistent with how ISAs are developed, the project will nevertheless seek to understand the factors driving required communications.

The project will also consider whether the nature and extent of the communication is affected by the entity's size and complexity. Listed entities, complex entities and small entities<sup>2</sup> often have varying characteristics that may impact on the nature and extent of communications. For example, a listed or larger entity may have a wider gap between management and shareholders as compared to a small entity and consequently, the nature and extent of communication required to satisfy ISA 260 may differ.

### III. CONSTRUCT OF ISA 260

In other national standards dealing with ISA 260 subject matter, explicit reference to required communications in other specific standards is set out by way of a footnote reference detailing the other standards, an appendix summarizing details of the other requirement, or reference to the specific standard in the body of the standard. ISA 260 does not contain such a reference and neither does the other umbrellas standards such as ISA 230, "Documentation", and ISA 580, "Management Representations".

ISA 260's umbrella approach is effective in accommodating an approach of basic principles and essential procedures. However, the current practice of not identifying the specific requirements in other ISAs may give rise to a risk that users will fail to consider other requirements despite IAASB's expectation that all relevant ISAs be considered in conducting an audit in accordance with ISAs.

ISAs that contain specific communication requirements include:

- Proposed audit risk ISA on understanding the entity and assessing the risk of material misstatement (paragraphs 34, 115 and 116).
- ISA 240 on fraud and error (paragraphs 56, 59 to 64);
- ISA 250 on non-compliance with laws and regulations (paragraphs 32 to 34); and
- ISA 545 on fair value measurements and disclosures (paragraph 65).

ISAs currently under development will also likely consider the need for specific communication requirements or guidance. For example, materiality as it relates to adjusted and unadjusted errors; group audits as it relates to communication regarding components; audit reporting as it relates to communication of (potential) modification of the auditor's report; and estimates as it relates to management's estimates.

With communication with the audit committee increasing in importance in today's audit environment, a link between the overall ISA 260 requirements and the specific requirements may be helpful to auditors in ensuring all requirements are considered. However, it should be noted

<sup>2</sup> The proposed revision to IAPS 1005 includes "Where management and those charged with governance are the same individuals and audit matters of governance interest have been communicated to those individuals in their capacity as management of the small entity, the auditor is not required to re-communicate those matters to the same individuals in their capacity as individuals charged with governance."

The IAASB has also decided to consider subsuming small entity guidance into the ISAs.

that this approach would require minor conforming changes to ISA 260 when new communication requirements are set out by other ISAs.

#### IV. NATURE AND EXTENT OF “AUDIT MATTERS OF GOVERNANCE INTEREST”

ISA 260.11 lists those items arising from an audit that are “ordinarily” communicated with audit committees with items requiring mandatory communication set out in relevant ISAs (see ISA 260.11 in Appendix B). Developments in national standards have become more prescriptive or expansive in their minimum requirement for communication. In addition, in its review, IOSCO commented that the matters in ISA 260.11 should be “disclosed” (interpreted to mean “communicated”) and also suggested a number of other audit matters to be considered as matters for communication. Accordingly, the project will consider whether:

1. Certain additional specific audit matters are required to be communicated by the auditor in some or all circumstances; and
2. Additional guidance should be developed to assist the auditor in making his determination whether to communicate other matters identified during the audit.

#### Additional Required Communications

In reviewing other national standards, three types of matters were identified that required communication with audit committees but are not required by the ISAs. As a result, the project needs to address whether communication of these items is required.

- a) Whether audit scope and limitations of the audit should be communicated by the auditor to the audit committee.

ISA 260.11 refers to the audit scope, general approach, expected limitations and other additional requirements as matters “ordinarily” communicated. Other national auditing standards *require* the auditor to communicate these matters as well as the form of reports the auditor expects to make. Although these matters are discussed in ISA 210, “Terms of Audit Engagements”, communication of these matters is not a bold type (or “black letter”) requirement. For some national auditing standards, this requirement is placed in the context of planning the audit which also emphasizes the importance of communications with the audit committee early on as well as throughout the audit.

- b) Whether qualitative aspects of accounting policies should be communicated with the audit committee.

ISA 260.11 refers to the selection of, or changes in, significant accounting policies and practices as matters “ordinarily” communicated. Other national auditing standards *require* the auditor to communicate matters related to the qualitative aspects of the entity’s accounting policies (financial reporting practices). In addition to the requirement to communicate, the following guidance is also provided in other standards to assist the auditor:

- The initial selection of and changes in significant accounting policies;
- The effect of significant accounting policies in controversial or emerging areas;
- The existence of other acceptable alternative accounting policies and the acceptability of the policy adopted by management;
- The effect of significant unusual transactions; and
- The appropriateness of significant estimates and judgments made by management.

Proposed audit risk ISA, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” paragraph 34 requires the auditor to obtain an understanding of the entity’s application and selection of accounting policies. The guidance includes reference to the methods used to account for significant and unusual transactions and the effect of significant accounting policies in emerging areas. This proposed ISA and ISA 260 do not require the auditor to communicate matters related to the entity’s accounting policies. Revision of ISA 700 (proposed ISA 701 on modified audit reports), “The Auditor’s Report on Financial Statements” also provides an opportunity to expand guidance on disagreement with management over the appropriateness of accounting policies and communication of the matter with the audit committee.

ISA 540, “Audit of Accounting Estimates” currently does not provide guidance on communications with the audit committee. Revision of this ISA by the Estimates Project Task Force provides an opportunity for additional requirements and guidance in the context of management’s estimates and judgment to be added.

c) Whether auditor independence should be confirmed to the audit committee.

ISA 100, “Assurance Engagements” paragraph 33 requires the auditor to comply with IFAC’s Code of Ethics for Professional Accountants (the Code) and ISA 100.34 further requires the auditor to be independent. Specific independence requirements are governed by Section 8 of the Code (revised and effective for assurance reports dated on or after December 31, 2004). With respect to listed entities, the Code states that there should be regular communications between the firm and the audit committee and specifically, the firm should communicate orally and in writing at least annually, all relationships and other matters that may reasonably be thought to bear on independence (see paragraph 8.39 and 8.40 of the Code in Appendix B).

Independence requirements in other jurisdictions are also set out in the respective code of ethics. However, some national standards also include in their ISA 260 equivalent standard required communication related to the auditor’s independence. Such requirements include:

1. Applying to listed entities as a minimum (in some national standards, also to non-listed entities);
2. Communication annually and in writing;
3. Communication includes:
  - a. Confirmation of the auditor’s independence;
  - b. Disclosure of relationships between the auditor (and related entities / businesses) that in the auditor’s judgment may bear on independence;
  - c. Safeguards in place related to independence; and
  - d. Disclosure on total fees (audit and non-audit related).

The project will consider whether ISA 260 should require communication with the audit committee over the auditor’s independence including reconciling Section 8.39 and 8.40’s specific requirements relating to listed entities.

#### ISA 260.11- Other Items Ordinarily Communicated

The following are other matters in ISA 260.11 that are “ordinarily” communicated with the audit committee. Although there is a relevant ISA that discusses the relevant subject matter, the ISA does not have a specific requirement (or further guidance) on communicating the matter to the audit committee.

<b>ISA 260.11</b>	<b>Relevant ISA</b>
The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;	Part C: Inquiry Regarding Litigation and Claims of ISA 501, "Audit Evidence-Additional Consideration for Specific Items"
Audit adjustments, whether or not recorded by the entity that have, or could have, a significant effect on the entity's financial statements;	ISA 320, "Audit Materiality"
Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;	ISA 570, "Going Concern"
Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;	ISA 700, "The Auditor's Report on Financial Statements"
Expected modifications to the auditor's report;	ISA 700, "The Auditor's Report on Financial Statements"
Any other matters agreed upon in the terms of the audit engagement.	ISA 210, "Terms of Audit Engagements"

As noted above, IOSCO commented that all the items in ISA 260.11 should be communicated. The project will consider whether the above matters should be required to be communicated to the audit committee.

#### Additional Guidance

Other national standards contain guidance related to the following subject matters that is not in the ISAs.

- ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" — reporting instances of non-compliance to the audit committee.
- ISA 580, "Management Representations" — communicating management's representations to the audit committee.
- ISA 720, "Other Information in Documents Containing Audited Financial Statements" — communicating inconsistencies between the financial statements and other information to the audit committee.
- Proposed IAPS on Group Audits — communicating matters related to the audit committee of the subsidiary / component to the parent audit committee where the client is preparing group financial statements.

The project will consider whether additional guidance should be developed within ISA 260, or the relevant ISA, to assist the auditor in determining whether the above matter should be communicated to the audit committee.

## V. GENERAL ISSUES

### Determining “those charged with governance”

The auditor is required to “determine the relevant persons who are charged with governance”. The guidance in ISA 260 discusses the need to use judgment, taking into account the governance structure, engagement structure and relevant legislation. Where corporate governance is not as well established in a certain country or is only set out for listed entities, the project will consider expanding the guidance to include the thoughts that those charged with governance are those having the authority to act on the auditor’s findings and who are in a position to provide the relevant information and explanations to the auditor.

### Timing

ISA 260.13 requires the auditor to communicate audit matters on a timely basis. The project will consider whether to expand ISA 260 to include—

- The importance of communicating matters related to the audit scope, limitation of an audit, the audit approach and the auditor’s responsibility to the audit committee earlier on in the audit (during planning phase).
- The timing of communicating audit matters arising from the audit in relation to the timing / date of the auditor’s report.

### Two-way Communication

ISA 260 emphasizes the need for two-way communication between the auditor and the audit committee in referring to communications “with those charged with governance”. ISA 260.10 also states that “the effectiveness of communications is enhanced by developing a constructive working relationship between the auditor and those charged with governance”. The project will consider whether to add some more emphasis on the two-way nature of the communications and the fact that communications *from* the audit committee can be of importance in understanding the entity, planning the audit and resolving audit matters.

### **(b) Describe Any Implications For Persons Or Groups Other Than the Committee**

1. Ethics Committee: The need to consult with the Ethics Committee if new requirements or guidance is added on the issue of auditor independence.
2. Small and Medium Practices Task Force: Guidance where no formal audit committee exists and any other specific small entity related guidance if applicable.
3. Public Sector Committee: Public sector perspective or inclusion of similar guidance within ISA 260 through INTOSAI input.
4. CAG: Early communication of issues identified and planned approach, including understanding matters that may be particularly relevant to the European Union countries and its planned adoption of ISAs in 2005.
5. IOSCO: Early communication of planned approach and response to the issues IOSCO raised in its review of ISA 260.

### **(c) Consider Whether IT Requires Particular Consideration**

It is not anticipated that IT requires particular consideration.

### **4. Indicate the Type of Material to Be Published**

Revision of ISA 260 and possible consequential conforming changes to other ISAs as necessary.

## 5. Resources Required

An IAASB Task Force with sufficient and appropriate regional representation of IAASB members and one IAASB Staff.

Proposed timeline:

- Establish task force – May 2003
- Issues Paper – February 2004
- First Read – June 2004
- Issue Exposure Draft – September 2004
- Effective date – For periods ending on or after December 2005

## 6. List Important Sources of Information That Address the Matter Being Proposed

### REGULATORY

- Sarbanes-Oxley Act.
- SEC Proposed Rules “Strengthening the Commission’s Requirements Regarding Auditor Independence”.
- UK Interim Report “Co-ordinating Group on Audit and Accounting Issues” (DTI, July 2002).
- UK “Audit Committees Combined Code Guidance” (FRC / Smith Report Jan 2003).
- EU report “Group of a Modern Regulatory Framework for Company Law in Europe “(High Level Group of Company Law Experts, Nov 2002).
- Canadian report “The Joint Committee on Corporate Governance”.

### AUDITING STANDARDS SETTERS

- Relevant ISAs.
- U.S. ASB Proposed AU 380 “Communication with Audit Committees” (Feb 2003).
- U.S. ASB Proposed AU 310 “Appointment of the Independent Auditor” (Feb 2003).
- Canada CICA 5751 “Communications with Those Having Oversight Responsibility for the Financial Reporting Process” (Nov 2001).
- U.K. APB SAS 610 “Communication of Audit Matters to Those Charged with Governance” (Revised June 2001).
- Australian AUS 710 “Communicating with Management on Matters Arising From an Audit” (May 1999).
- Japan JICPA communication requirements.
- U.S., U.K., Canada and Australia related auditing guidance on fraud, laws and regulations and related parties.
- General inquiries of other national auditing standards setters.

### OTHER

- IOSCO comment letter (dated October 15, 2002).
- Limited firm guidance materials.

## 7. Factors That May Add To Complexity or Length of Project

Factors that may add to the complexity of this project include:

- Agreeing the scope of additional requirements and guidance that should apply at an international level.



- Timing of regulatory developments and its impact on local auditing standards may not be clear during the proposed project timeline.

Prepared by Sylvia Barrett

Date February 18, 2003

**Appendix A: Corporate Governance Regulatory Activities**

In the U.S., the Sarbanes-Oxley Act is the most relevant regulatory development impacting communications with audit committees. The U.K. is considering changes to its Combined Code on Corporate Governance for listed entities that include recommendations set out by the Audit Committees Combined Code Guidance. The European Commission also commissioned the High Level Group of Company Law Experts to consider the benefits of a common code of corporate governance for Europe and its report included recommendations on the role of audit committees.

In reviewing these reports on regulatory corporate governance development, the following themes were noted:

1. Increased emphasis on the audit committee as the body responsible (on behalf of the Board of Directors or Shareholders) for overseeing the financial reporting process and the external audit. This includes the appointment and oversight of the auditor;
2. Requirements for the auditor to report directly to the audit committee;
3. Required communications with the audit committee relating to the entity's critical accounting policies and practices; and
4. The audit committee's responsibilities for the approval of non-audit services.

## Appendix B: Relevant Extracts of the Code and ISA 260.11 Relating to Communication with Those Charged with Governance

### SECTION 8 OF THE CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

- 8.39 Audit committees can have an important corporate governance role when they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships and other matters that might, in the firm's opinion, reasonably be thought to bear on independence.
- 8.40 Firms should establish policies and procedures relating to independence communications with audit committees, or others charged with governance. In the case of the audit of listed entities, the firm should communicate orally and in writing at least annually, all relationships and other matters between the firm, network firms and the audit client that in the firm's professional judgment may reasonably be thought to bear on independence. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in this section.

### ISA 260, "COMMUNICATIONS WITH THOSE CHARGED WITH GOVERNANCE"

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.** Ordinarily such matters include:
- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
  - The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
  - The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
  - Audit adjustments, whether or not recorded by the entity that have, or could have, a significant effect on the entity's financial statements;
  - Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
  - Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;
  - Expected modifications to the auditor's report;
  - Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management;
  - Any other matters agreed upon in the terms of the audit engagement.

**Comments by Technical Managers/Committee Secretaries**

The comments of *each* Technical Manager are required before this Project Proposal is considered by the committee proposing to undertake the project.

**Secretary to FMAC**

CLASSIFICATION

*Class:* A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Robin MathiesonDate April 21, 2003**Secretary to IAASB**

CLASSIFICATION

*Class:* A      B1      B2      C

SUGGESTED PRIORITY

OTHER COMMENTS

Signed \_\_\_\_\_

Date \_\_\_\_\_

**Secretary to Education**

CLASSIFICATION

*Class:* A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Claire EganDate April 22, 2003

**Secretary to Ethics**

## CLASSIFICATION

*Class: A*

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

This project is a priority from an ethics point of view with regards to independence. Section 8 of the Code of Ethics already includes some guidance relating to independence issues in connection with communications with those charged with governance (audit committees).

Signed Gill SpaulDate April 22, 2003**Secretary to Compliance**

## CLASSIFICATION

*Class: A*

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

Signed Peter JohnstonDate April 15, 2003**Secretary to PSC**

## CLASSIFICATION

*Class: A*

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

Signed Jerry GutuDate April 25, 2003

**Secretary to TAC**

## CLASSIFICATION

*Class:* A

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

This topic has been discussed recently by the TAC. The firms have significant interest in this area and the relevance to the profession at this time necessitates best practice guidance on a global level.

Signed Russell GuthrieDate April 17, 2003**Secretary to SMP Task Force**

## CLASSIFICATION

*Class:* A

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

The auditor of small entities needs to know whom to communicate with.

Signed Robin MathiesonDate April 21, 2003**Technical Director**

## CLASSIFICATION

*Class:* A      B1      B2      C

## SUGGESTED PRIORITY

## OTHER COMMENTS

Signed \_\_\_\_\_

Date \_\_\_\_\_