


**International Federation of Accountants**

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

**Agenda Item**
**8**
**Committee:** IAASB

**Meeting Location:** New York

**Meeting Date:** September 13–17, 2004

**Communication with those charged with governance**
**Objectives of Agenda Item**

To provide feedback and guidance to the Task Force on the draft ED at Agenda Item 8-A.

**Background and timetable**

The IAASB gave the Task Force feedback on an Issues Paper at the April 2004 (Toronto) meeting.

The attached draft revision of ISA 260 “Communications of Audit Matters with Those Charged with Governance” is presented for a “first read”.

The Task Force will incorporate the feedback from this meeting into a revised draft, which it plans to present at the December meeting for voting on as an ED.

As stated in the Project Proposal: “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) require updating.” The Task Force has found the recent work of the UK APB to be particularly helpful in preparing the attached draft.

**Joint project**

The Task Force is joint with the Australian AuASB, and also has representation from INTOSAI, the Transnational Auditing Committee and the Institute of Internal Auditors. Members are:

- |                                     |                         |
|-------------------------------------|-------------------------|
| • Ian McPhee, Chair (IAASB & AuASB) | • Kevin Neville (AuASB) |
| • Wolf Böhm (IAASB)                 | • Scott Reed (TAC)      |
| • Denis Desautels (IAASB)           | • Paul Shannon (AuASB)  |
| • Philomena Leung (IIA)             | • Scott Ward (AuASB)    |
| • Tove Myklebust (INTOSAI)          |                         |

**Change in structure**

There has been a significant change in the structure of the attached draft ED relative to the current ISA 260. The current ISA 260 does not specify particular matters that need to be communicated to those charged with governance, but rather requires the auditor to communicate audit matters of governance interest, comprising matters that:

- (a) Come to attention as a result of the performance of the audit of financial statements,
- (b) Are important, and

- (c) Are relevant to those charged with governance in overseeing the financial reporting and disclosure process.

It then offers a list of matters in the grey letter guidance that are ordinarily included in communications.

The draft ED on the other hand, as agreed at the Toronto meeting, specifies particular matters that should be communicated to those charged with governance. The high level blackletter (paragraph 4) requires the following matters to be communicated.

- (a) Relevant matters related to the financial reporting and disclosure process, namely:
- (i) The responsibilities of the auditor, and the planned scope, timing and direction of the audit;
  - (ii) The conduct of, and findings from the audit; and
  - (iii) Auditor independence;
- (b) Any matters that are specified in other ISAs or additional requirements; and any matters that have been agreed with the entity; and
- (c) Any other serious matters that have come to the auditor's attention and are, in the judgment of the auditor, relevant to those charged with governance.

Items (b) and (c) above have supporting grey letter guidance but are not elaborated on in terms of blackletter requirements. Item (a) however, has a number of subordinate blackletter requirements that list matters to be communicated. They include a "catch all" that requires the auditor to communicate, in addition to the specified matters, any other matters that arise from the audit of financial statements and are relevant to those charged with governance in overseeing the financial reporting and disclosure process (paragraph 23 (h)).

As a result of this change, the draft ED offers more certainty about what matters should be communicated, while at the same time ensuring all the matters that would be communicated under the current ISA 260 will continue to be communicated under the revised draft.

Other significant changes in structure are:

- (a) Discussion of the communication process has been significantly enhanced. As agreed in Toronto, it now includes an emphasis on two-way communication and guidance on the timing of communications.
- (b) The general layout of the document is:
- *Introduction*: why the auditor communicates with those charged with governance.
  - *Those charged with governance*: who in particular the auditor communicates with.
  - *Matters of governance interest*: what is to be communicated.
  - *The communication process*: how the communication is made.
  - *Other sections*: sundry matters.

#### **The audit team, the firm, and other auditors (including network firms)**

Consistent with the IAASB's discussion at the April (Toronto) meeting, the draft ED:

- Notes in paragraph 19 (b) that the extent of auditor's responsibility regarding matters of governance interest that come to the attention of other auditors and members of the firm outside the audit team, is something that would be communicated to those charged with governance in the context of planning the audit, and
- Includes the following blacklettered text at paragraph 56:

The auditor should ensure the firm has adequate policies and procedures to provide it with reasonable assurance that the auditor becomes aware of any important matter directly related to the preparation or fair presentation of the entity's financial statements, where such a matter comes to the attention of:

- (a) Personnel in the firm or a network firm, other than members of the audit team, when performing any professional service<sup>1</sup> for the entity or a related entity<sup>2</sup>, or
- (b) Personnel in other firms when auditing or reviewing a component of the entity's financial statements.

Footnotes:

1 In some countries, legislation can prevent personnel within a firm or network firm from communicating to the auditor, matters of which they become aware while performing certain professional services, e.g.: tax consulting. In such cases, the auditor communicates this fact with those charged with governance and with management, and seeks to have the affected personnel released from such confidentiality restrictions to the extent possible.

2 This footnote cites the definition of a related entity per the Code of Ethics.

Determining the "proximity" of a matter of which a professional accountant other than the auditor becomes aware, has several facets. Each of these could be used alone or in combination with other facets, to determine the auditor's responsibility:

- Who the other professional accountant is – a member of the audit team, other partners/staff in the auditor's firm, a partner/staff in a network firm, a partner/staff in another firm.
- The nature of the matter of which that professional accountant becomes aware – is it directly related the entity's financial statements, is it otherwise related to overseeing the financial reporting and disclosure process, is it related to other responsibilities of those charged with governance.
- The significance of the matter.
- Who the other professional accountant is engaged by – the client, the client's parent, a subsidiary of the client, an associate of the client, a joint venturer of the client, an investor in the client, an entity in which the client has invested, an unrelated entity.
- What service that professional accountant is providing – financial statement audit/review, agreed upon procedures related to financial information/other information, non-financial assurance service, other service (e.g., consulting) where those charged with governance have/have not initiated the service and/or approved the engagement of the firm to provide it.

If the Board were disposed to the auditor having an obligation to communicate matters of governance interest other than those directly related to the financial statements that personnel in the firm and network firms become aware of, then paragraph 56 of the draft ED could be

modified to include such matters. Similarly, the responsibility of the auditor with respect to such matters that come to the attention of other auditors could also be modified.

Further, while the Task Force is comfortable with including paragraph 56 as part of ISA260, it notes that this paragraph deals with a quality control matter that the Board may like to consider exposing as a conforming amendment to ISQC 1 also.

### **Materiality**

The ISA 260 Task Force has been liaising with the Materiality Task Force regarding the placement of a section of text developed by the Materiality Task Force dealing with communication with those charged with governance. The relevant extracts from the cover memo and draft ISA prepared by the Materiality Task Force are attached to this memo. While certain of the issues, and the ISA260 Task Force's views and suggestions, are summarized below, the major substantive issues involved relate to materiality rather than communication and are likely to be resolved as part of the discussion on the Materiality Agenda Item scheduled to be discussed prior to this Agenda Item.

In essence, what is proposed is that if the ED on Materiality is ready before the ED of ISA 260, then the Materiality ED will contain conforming amendments to ISA 260 and ISA 580 related to the following points. If, however, the Materiality ED and the ISA 260 ED are released together, these matters will be covered in the ISA 260 ED only:

- *Communication of Materiality:* The Materiality Task Force has proposed a blackletter requirement to communicate the materiality level unless it is probable that doing so would influence the preparation of the financial statements. Paragraph 16 of the draft ED of ISA 260 has a generic blackletter requirement to communicate regarding planning. A supporting greyletter requirement (the 1<sup>st</sup> dot point of paragraph 20) picks up much of the text from the Materiality Task Force, noting that the materiality level is ordinarily communicated but not when it is probable that doing so would influence the preparation of the financial statements.
- *Communication of Misstatements:* The draft ED of ISA 260 (paragraphs 23 (c) and 28-31) contains substantially all the requirements drafted by the Materiality Task Force except the proposed blackletter: "The auditor should also consider whether the auditor has a responsibility to report certain misstatements to regulatory and enforcement authorities". The draft ED of ISA 260 does, however, contain a generic reference to this matter in paragraph 59: "In some jurisdictions there may be circumstances where the auditor is required to report to a regulatory or enforcement body certain matters required by this ISA to be communicated to those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action."
- *Communication of Qualitative Aspects of the Entity's Accounting Practices:* The draft ED of ISA 260 (paragraphs 23 (a) and 24-25) contains substantially all the requirements drafted by the Materiality Task Force
- *Representations from those charged with governance:* The Materiality Task Force has proposed conforming amendment to the blackletter of ISA 580 to require the auditor to obtain written representations from those charged with governance regarding uncorrected misstatements. The ISA 260 Task Force does not believe a blackletter requirement is

appropriate, but has included reference to obtaining such a representation in the greyletter paragraph 30.

ISA 260 Task Force and the Materiality Task Force will continue to liaise about the placement and wording of these provisions.

**“Those charged with governance” versus “management” etc.**

The Task Force agreed in Toronto to review the use of the terms “those charged with governance”, “management”, “directors” etc. This review, to be completed for the December meeting, will likely result in conforming changes to other ISAs being proposed as part of the exposure of ISA 260, and will have a direct affect on the content of Appendix 2 to the current draft.

**Material Presented**

Agenda Item 8-A                      Draft ED of revised ISA 260  
(Pages 1885 – 1906)

**Action Requested**

The IAASB is asked to provide feedback and guidance to the Task Force on the draft ED.

## ATTACHMENT – MATERIALITY

*FROM THE DRAFT COVERING MEMO OF THE MATERIALITY TASK FORCE*

## COMMUNICATIONS TO THOSE CHARGED WITH GOVERNANCE

The Task Force was asked to continue developing the section dealing with communication to those charged with governance, and to liaise with the Task Force addressing the revision of ISA 260 on communication with those charged with governance as appropriate to determine the ultimate content and disposition of the standards and guidance.

The Task Force has moved the paragraphs relating to communications with those charged with governance to an appendix as proposed conforming changes to ISA 260. The appropriateness of this depends on whether ISA 260 is ultimately revised to be a detailed or umbrella standard, and the timing of the publication of the exposure draft of the proposed revised ISA 260. The Materiality Task Force is liaising with the Communications Task Force on these matters.

*FROM THE DRAFT APPENDIX REFERRED TO ABOVE***Conforming Changes to Other ISAs****ISA 260 ‘Communication of Audit Matters with Those Charged with Governance’**

~~11a. 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.~~

~~11b. The uncorrected misstatements communicated to those charged with governance need not include the misstatements below a designated amount.~~

COMMUNICATION OF MATERIALITY

11a. The auditor should communicate to those charged with governance the materiality level the auditor determined for the financial statements unless the auditor believes it probable that such communication would influence management’s approach to the preparation of the financial statements.

11b. The auditor ordinarily discusses with those charged with governance the application of materiality in the audit as part of a broader communication of the general approach and overall scope of the audit. The auditor explains that the circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or in aggregate, even if they are of a lower level than the auditor had determined to be material when planning the audit. The auditor also makes clear to those charged with governance that, due to the inherent limitations of an audit, there may be misstatements that the audit will not detect.

11c. The auditor does not communicate to those charged with governance, or to management, the materiality level for the financial statements if the auditor believes that such communication

might, for example, result in management being less attentive to the detection and correction of misstatements.

#### COMMUNICATION OF MISSTATEMENTS

**11d. The auditor should communicate misstatements identified by the auditor during the audit that management declines to correct, other than those that the auditor believes are clearly trivial, to those charged with governance, unless they are the same persons as management (as may be the case in smaller entities). The auditor should also consider whether the auditor has a responsibility to report certain misstatements to regulatory and enforcement authorities.<sup>1</sup>**

11e. In communications with those charged with governance, the auditor explains why the auditor considers misstatements to be material. As described in ISA 320, “Materiality in the Identification and Evaluation of Misstatements,” misstatements are not dismissed as immaterial solely because they are of a lesser amount than the auditor determined as the materiality level for the financial statements as a whole when planning the audit. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are of a lesser amount.

11f. Where it aids the communication process, the auditor may communicate a summary of those uncorrected misstatements that the auditor judges to be immaterial in aggregate (e.g. by informing those charged with governance of the number and overall sum of immaterial misstatements) rather than communicating the details of each individual misstatement.

11g. The auditor discusses with those charged with governance management’s reasons for not correcting the misstatements, the implications for the auditor’s report and the possible implications in relation to future financial statements if they remain uncorrected (e.g. where, although immaterial in the current period, the accumulation of such misstatements over time could lead to an aggregate material misstatement in the future). Where the auditor considers it appropriate, the auditor requests those charged with governance to ask management to correct the misstatements.

11h. The auditor considers whether misstatements that management has previously corrected, of which the auditor is aware, should be communicated to those charged with governance so as to assist them to fulfill their governance responsibilities. It may be helpful to communicate material misstatements that have been previously corrected by management, or frequently recurring immaterial misstatements which, although corrected, may be indicative of significant weaknesses in the systems of internal control or the design or operation of the entity’s financial reporting process.

#### COMMUNICATION OF QUALITATIVE ASPECTS OF THE ENTITY’S ACCOUNTING PRACTICES

**11i. The auditor should communicate to those charged with governance the auditor’s views about the qualitative aspects of the entity’s accounting practices and financial**

<sup>1</sup> Requirements specific to the communication of misstatements resulting from fraud, or a suspected fraud, are set out in ISA 240 (Revised), ‘The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements’. In some jurisdictions the auditor may have other responsibilities to report certain misstatements to regulatory and enforcement authorities.

**reporting that the auditor considers when forming an opinion on the financial statements.**

- 11j. In the course of the audit of the financial statements, the auditor considers the quality, as well as the acceptability, of the entity's accounting practices and financial reporting, including matters that have a significant impact on the relevance, reliability, comparability and understandability of the information provided by the financial statements (e.g. the consistency of the entity's accounting policies and their application, and the overall balance and clarity of the information contained in the financial statements). The auditor may conclude that some of these qualitative aspects affect whether the financial statements are prepared, all material respects, in accordance with the applicable financial reporting framework and, if so, discusses the implications for the auditor's report with those charged with governance; for example, the effects of [intentional] [inappropriate] bias in accounting estimates.

**ISA 580 'Management Representations'**

5a. **The auditor should obtain written representations from management that:**

- ~~(a) It acknowledges its responsibility for the design and implementation of internal control to prevent and detect error; and~~
- ~~(b) It believes the effects of those uncorrected misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.~~

**5b. The auditor should obtain written representations from those charged with governance that they believe the effects of those uncorrected misstatements identified by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations<sup>2</sup>.**

5c. Because those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties, it is important that the auditor obtains a written representation from them that uncorrected misstatements are, in their opinion, immaterial, both individually and in the aggregate. If those charged with governance do not accept that certain of the uncorrected misstatements identified by the auditor during the audit are misstatements (e.g. they may disagree with the auditor's judgments concerning financial statement amounts involving measurement uncertainty), the auditor asks them to provide a written explanation of their reasons for not accepting that those items are misstatements.

<sup>2</sup> The summary need not include any misstatements that the auditor believes are 'clearly trivial'.