


International Federation of Accountants

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Agenda Item
5
Committee: IAASB

Meeting Location: New Orleans

Meeting Date: December 6–10, 2004

Communication with Those Charged with Governance
Objectives of Agenda Item

To review and approve for exposure the proposed revised ISA 260, *The Auditor's Communication with Those Charged with Governance*, and conforming amendments to ISA 570, *Going Concern*, and ISA 701, *Modifications to the Independent Auditor's Report*.

Background

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

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

The IAASB provided comments to the Task Force during a first read of this document at the September (New York) meeting. The Task Force has also received input from:

- IFAC Small and Medium Practices Permanent Task Force (SMP Task Force);
- IFAC Ethics Committee; and
- Bob Waller, the IAASB “plain language” advisor.

Issues
A. Number and nature of requirements

The IAASB asked the Task Force to:

- (a) *Review the requirements of the draft against a modern audit committee charter:*
 - (i) Modern audit charters reviewed reinforce matters such as the importance of free and open communication and meetings with the auditor without management present, discussion of the qualitative aspects of accounting practices rather than just their acceptability, approval of audit fees and significant non-audit fees paid to the auditor, and review of factors that may impact the quality of audit services or the independence or objectivity of the auditor.

- (ii) The draft exposure draft (ED) stands up well in terms of coverage against the audit committee charters reviewed.
- (b) *Reconsider whether all the required communications are necessary:*
- (i) The matters required by the draft ED to be communicated are now summarized in paragraph 5 (b).
 - (ii) Significant changes made to the proposed requirements relate to: restricting the requirement for written independence disclosures to listed entities (see Item C of this memo), significantly revising the treatment of matters that come to the attention of those outside the audit team (see Item D of this memo), and modifying the threshold for “other matters” that the auditor is required to communicate (see paragraph 38 of the draft).
 - (iii) The SMP Task Force noted what they call “considerable scope creep” in paragraph 24 (a) regarding the qualitative aspects of accounting policies. They noted their view that such communications “lie outside the scope of the audit engagement’s true purpose, that of providing an opinion on the financial statements” and “particularly from a small practitioner perspective this work is not appropriate and serves no higher purpose.” The Task Force is of the view that such communications should be part of all audits – small and large. It notes however, that the form of communication allowed for by the draft is responsive to the entity’s circumstances. This means that for small entities with relatively straight forward accounting policies, the requirement to communicate regarding the qualitative aspects of accounting policies could typically be satisfied through informal communications that are already part of the ordinary interaction between the auditor and those charged with governance.
- (c) *Review use of the word “any” throughout the draft:*

The word “any” has been deleted or modified on several occasions as noted in the mark-up.

B. Relationship with other ISAs

- B1. The IAASB asked the Task Force to reconsider how the requirements of other ISAs are treated in ISA 260. In particular, it was noted that not mentioning in ISA 260 communication regarding internal control weaknesses because it is covered in ISA 315, gives the impression that ISA 260 is incomplete. Suggestions included:
- Repeating all, or the more significant communication responsibilities from other ISAs, in the body of ISA 260 (as black or grey text) rather than only in Appendix 2.
 - As a conforming amendment to other ISAs, moving into ISA 260 all, or the more significant communication responsibilities from other ISAs, or those responsibilities in other ISAs that do not sit comfortably in their current position.
- B2. The Task Force reconsidered the relationship between ISA 260 and other ISAs, and confirmed their view that the current configuration is sound in principle, i.e. where another ISA deals in detail with a particular aspect of the audit that involves communication with those charged with governance, the responsibility for that communication should ordinarily be in that other ISA. The purpose of ISA 260 is to set the framework for communication, and to require specific items to be communicated only when:
- (a) The items are themselves integral to the structure of the framework set in ISA 260, e.g., communications re planning; or

- (b) There is not a specific ISA on the topic. The Task Force acknowledges that this choice will not always be clear-cut, e.g., it could be argued that paragraph 24 (c) should be included in ISA 320 “Materiality.” Also, it will require monitoring as new ISAs are updated/created, e.g., paragraph 24 (e) may be more appropriately placed in ISA 580 “Management Representations” when that ISA is revised.

Appendix 2, which contains a listing of relevant requirements from other ISAs, is intended to complement the framework established in ISA 260. With this in mind, the Task Force has:

- (a) Reviewed the requirements cited in Appendix 2 and did not find any that do not sit comfortably in the ISA in which they are currently situated.
 - (b) Added a cross-reference to paragraph 35 in the introductory words to paragraph 24; and
 - (c) Suggested the text relating to going concern issues (previously paragraphs 23 (b) and 26) and expected modifications (previously paragraphs 23 (f) and 32) be moved into ISAs 570 and 700/701 as conforming changes (included at the end of the draft ED).
- B3. The Task Force also considered adding to paragraph 37, either a complete list of communications covered by Appendix 2, or a selection of particularly important matters as examples. It decided, however, not to do this because a complete list would be unnecessarily long and require regular updating, whereas using examples would inappropriately emphasize the matters selected.

C. Independence disclosures

- C1. The Task Force was asked to reconsider whether the independence disclosures required by the draft to be made to those charged with governance:
- (a) Need always be in writing; and
 - (b) Should be mandated only for particular entities, e.g.: listed entities, public interest entities, or large entities. It was noted that where there is minimal separation between management and those charged with governance, such disclosures may be unnecessary.
- C2. In response, and taking account of feedback on this matter from the SMP Task Force¹ and the Ethics Committee, the Task Force has:
- (a) Limited mandatory application of paragraph 32 to listed entities, and made wording changes to reflect the requirements of the Code, which states (underlining added):

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.
 - (b) On the advice of the Ethics Committee, changed declaration to “statement” in paragraph 32 (a); and

¹ Interestingly, the SMP Task Force was not averse to application of paragraph 32 (a) and (b) to small entities.

(c) Limited application of paragraph 32 (c) to components rather than related entities. The definition of related entity in the Code is quite broad, and includes “sister entities.” The Ethics Committee noted to the Task Force that it would be inappropriate, and sometimes contrary to reasonable confidentiality restrictions, to require disclosure of fees received from sister entities. While satisfied with the position in the current draft, the Task Force seeks the advice of the Board as to whether paragraph 32 (c) should also include:

- (i) Parent entities; and
- (ii) Other entities such as Special Purpose Vehicles.

D. The audit team, the firm, and other auditors (including network firms)

D1. The IAASB asked the Task Force to reconsider the section of the draft presented at the September (NY) meeting that sought to establish responsibilities for the auditor to become of aware matters of governance interest that come to the attention of:

- (a) Personnel in the firm or a network firm other than members of the audit team, and
- (b) Personnel in other firms when auditing or reviewing a component of the entity’s financial statements.

D2. A strong view was expressed that the requirements as drafted were too broad to be capable of practical implementation in many cases. In reviewing alternatives, the Task Force was asked be conscious of:

- The link with ISQC 1 – the draft requirement relied on the firm having effective policies and procedures;
- The link with Group Audits – the draft requirement would have considerable application in relation to components (although it would also apply to a single entity with no components when personnel outside the audit team, e.g. consultants, are engaged by the entity);
- The differing legal and professional responsibilities of auditors, e.g., in some jurisdictions, what is known to one partner of a firm may be assumed by law to be known to all partners; whereas in other jurisdictions, information acquired by a practitioner while doing certain tax work is, by law, not allowed to be disclosed to the auditor; and
- The need to recognize that auditors and those charged with governance may choose to add to minimum legal and professional requirements by agreement.

D3. The Task Force has decided not to attempt to establish a blanket set of responsibilities that go beyond what it believes is the minimum that could reasonably be expected in all circumstances (per paragraph 19). Instead, it has expanded the text about informing those charged with governance of what the auditor’s responsibilities are regarding matters that come to the attention of those outside the audit team. The intention of this approach is, firstly, to ensure those charged with governance are clear in relation to the auditors direct responsibilities, but also to provide an informed basis for negotiation between the auditor and those charged with governance about any additional work those charged with governance may want done in this respect.

D4. To achieve this, what were paragraphs 56-58 have been deleted, and the substance of what was paragraph 19 (b) has been included in the new paragraph 19.

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

- E1. The Task Force had agreed to review use of the terms “those charged with governance” and “management” throughout the ISAs (and tidy up the use of “directors,” “client,” “board,” etc. which are used in some of the older ISAs).
- E2. As a result of this review the Task Force recommends the text in the attachment to this memo be included in the explanatory memorandum to the ED. The attachment is largely self-explanatory as a request for comment on a protocol for using the terms “those charged with governance,” “management” etc. It should be noted, however, that the Task Force considered whether an omnibus ED, containing conforming changes to the entire body of ISAs as a result of applying the protocol, should be prepared as part of the exposure. It recommends that this not be done, but rather changes to ISAs be made prospectively as each is revised. There are over 1000 references to “those charged with governance,” “management” and related terms in the ISAs, and the Task Force considers that the time involved to prepare, review and approve an omnibus ED with all conforming amendments, let alone the capacity of constituents to review and comment on it, makes that course impractical.

F. Other matters

- F1. *Derivative reporting:* The Task Force has added paragraph 39 to help ensure that when the auditor communicates a matter required by paragraph 39, it does not lead to an erroneous expectation on the part of those charged with governance that the auditor will identify and communicate all such matters that may exist. This was considered necessary given the potentially different interpretations by those charged with governance and the auditor of what matters are serious.
- F2. *Engagement letters and representations:* The Task Force was asked at the previous IAASB meeting to reconsider references in the draft ISA to engagement letters, representation letters and representations requested of those charged with governance. Given that engagement letters are not mandatory (see ISA 210.02) and that ISA 580 “Management Representations” is currently being revised, the Task Force decided to make references to engagement letters and requests for representations more generic (e.g., paragraphs 24 (e) and 48)
- F3. *Other assurance engagements:* The Task Force indicated at a previous IAASB meeting that it would consider whether specific guidance regarding communication with those charged with governance ought to be developed for assurance engagements other than financial statement audits. The Task Force has concluded that there are no particular issues needing to be addressed as a matter of priority and therefore does not recommend extension of this project to other assurance engagements. The Task Force is, however, aware that the wording of the draft ISA restricts its direct application to financial statement audits, rather than audits of other financial information. The Task Force understands that this issue is being considered by the ISA 800 Task Force and believes the generic solution they are developing will be suitable for ISA 260.

Material Presented

Agenda Item 5-A Draft ED, Revised ISA 260 – Clean
(Pages 2053 – 2074)

Agenda Item 5-B Draft ED, Revised ISA 260 – Mark-up from September meeting
(Pages 2075 – 2102)

Action Requested

The IAASB is asked to consider the above issues and to approve the draft revised ISA 260 for public exposure.

TEXT TO BE INCLUDED IN EXPLANATORY MEMORANDUM

1. 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.
2. 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.
3. 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 direct responsibility for the preparation and presentation of the financial statements.
4. 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 formal protocol for doing so, and some ambiguity may persist, particularly in older documents.
5. The IAASB seeks comment on its proposal to apply the following protocol for using “those charged with governance,” “management” and related terms when developing new documents and revising current documents. In developing this protocol, the IAASB recognizes that strict adherence to the specific “rules” noted below 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.
6. Protocol for using “those charged with governance,” “management” and related terms, upon which comment is sought:
 - (a) In the Glossary, the definitions of “those charged with governance” and “management” are to be replaced with the definitions at paragraphs 6 (a) and 6 (b) of [proposed revised] ISA 260 “The Auditor’s Communication With Those Charged With Governance,” including reference to the discussion in paragraphs 8-13 of that ISA.
 - (b) ISAs should not distinguish between “those charged with governance” and “management” whenever it is unnecessary to do so, e.g.:
 - ~~Management~~ The entity is responsible for the fair presentation of financial statements that reflect its the nature and operations ~~of the entity~~. (ISA 500.15)
 - To respond to these factors, the entity’s ~~management or those charged with governance~~ defines its objectives, which are ~~the~~ its overall plans ~~for the entity~~. (ISA 315.30)

- Internal control is the process designed and effected by ~~those charged with governance, management, and other personnel~~ the entity to provide reasonable assurance about (ISA 315.42)
- (c) Both those charged with governance and management should be included where appropriate, e.g.:
 - The term “fraud” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. (ISA 240.04)
- (d) “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)
- (e) “Client” should not be used (typically “entity” will replace the term “client”).