

Auditor Reporting—Key Audit Matters

The following is an excerpt from the February 2013 IAASB meeting highlights. At that meeting, the IAASB further deliberated issues relating to the concept of auditor commentary introduced in its June 2012 Invitation to Comment (ITC), *Improving the Auditor's Report*. Amongst other matters, the IAASB supported the following:

- A revised objective of the auditor for purposes of determining additional information to be included in the auditor's report, as follows: "The objective of the auditor, having formed an opinion on the financial statements, is to communicate in the auditor's report those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements." The objective would be included in a proposed new International Standard on Auditing (ISA), tentatively labeled ISA 701.¹

The IAASB noted that the revised objective is not intended to signal a shift away from significant matters in the financial statements. Rather, it is intended to articulate a focus in the auditor's thought process of selecting matters to report based on the audit performed, with reference to the disclosures in the financial statements as appropriate, thereby enhancing users' understanding of the entity based on insights from further information about the audit.

- Presentation of this additional information as a separate section of the auditor's report under the heading *Key Audit Matters* (KAM).

Amongst other matters, the IAASB noted the following matters for further consideration:

- How proposed ISA 701 should best reflect the IAASB's view that the auditor's judgment of what to report externally is derived from what had been communicated with those charged with governance (TCWG), and whether any clarifications are needed to the requirements or guidance in ISA 260.²
- How the introductory language in the illustrative example of the new section in the auditor's report could be drafted to clearly explain to users that the matters discussed in the auditor's report is not intended to be a comprehensive list of all matters discussed with those charged with governance.
- Whether the initial list of factors presented in the agenda material intended to guide the auditor's decision-making process in relation to external reporting could be further streamlined.
- Whether the proposed requirement for the auditor to include a statement in the auditor's report when no matters for external reporting had been identified is appropriate.

¹ Proposed ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

² ISA 260, *Communication with Those Charged with Governance*

I. Key Issues Considered by DT-701 in Proposing Revisions to ISA 260

1. The Auditor Reporting project proposal acknowledged that revisions to communication requirements in the ISAs, for example ISA 260, may be necessary as part of the project, in part because users have suggested that matters that form part of the communications to TCWG could be used as the basis for enhanced auditor reporting. The project proposal also noted that achieving the project objectives is premised on the need to take into account the activities of, amongst others, the European Commission (EC), the US Public Company Accounting Oversight Board (PCAOB), and the UK Financial Reporting Council (FRC).
2. At its February 2013 meeting, the IAASB asked the ISA 701 Drafting Team (DT-701) to consider whether the auditor's communications with TCWG in accordance with ISA 260 needs to be strengthened, but acknowledged there would likely be scope for incremental improvement to, rather than a substantive revision of, ISA 260.

DT-701 Recommendation

3. In light of relevant developments relating to communications with TCWG, and the approach agreed by the IAASB at its February 2013 meeting to base the auditor's external reporting on matters communicated with TCWG, DT-701 is of the view that amendments should be proposed to ISA 260 concurrently with the issuance of proposed ISA 701 as an exposure draft (ED). In DT-701's view, doing so further strengthens the standard to provide a solid foundation for the auditor communicating significant findings from the audit to TCWG, which in turn forms the basis for the auditor's communication of KAM in the auditor's report. The proposed amendments are shown in marked text from extant ISA 260 in the Appendix to this paper. A full marked version of extant ISA 260 is also included in **Agenda Item 2-J** for reference. During its April 2013 meeting, the IAASB will be asked for its views on the appropriateness of the proposed changes to ISA 260. The DT's process and rationale for these amendments is described below.

The Objectives of ISA 260

4. Paragraph 9 of ISA 260 articulates the following objectives:
 - The objectives of the auditor are:
 - (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
 - (b) To obtain from those charged with governance information relevant to the audit;
 - (c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
 - (d) To promote effective two-way communication between the auditor and those charged with governance.

DT-701 Recommendations

5. DT-701 concluded that, although further specificity could be added to the objectives to acknowledge the requirement for the auditor of a listed entity to communicate KAM in the auditor's report, the concept is covered in paragraphs (c) and (d). Rather, DT-701 was of the view that amendment to "The Role of Communication" section (see paragraph 4 of the Appendix) could be useful to explain the role of two-way communication in determining KAM.

Proposed New Requirements and Application Material in ISA 260

6. In proposing the revisions to ISA 260, DT-701 considered the need to make incremental changes to underpin external reporting under proposed ISA 701, and also considered the following:
 - The EC's proposed regulation in Article 23, which addresses required written long-form reporting to audit committees for public interest entities (PIEs).³
 - The PCAOB's Auditing Standard No. 16 (AS 16), *Communications with Audit Committees*, which was issued in August 2012.⁴
 - The UK FRC's October 2012 changes to ISAs (UK and Ireland) as a result of finalizing its Effective Company Stewardship proposals, which include public reporting by TCWG.

The majority of the proposed changes to ISA 260 relate to additional application material to illustrate what the auditor may communicate and why such communication may be relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.

DT-701 Recommendations

7. DT-701 proposes the following new requirements, and new or revised application material, in ISA 260 to strengthen the foundation on which the auditor will determine KAM:
 - Communication of the significant risks identified by the auditor and the auditor's response to them (see paragraphs 16(a) and A18–A19 of the Appendix) – While the concept of significant risks is already acknowledged in application material (paragraph A13 of extant ISA 260) and may routinely be communicated in practice, greater consistency in reporting would be of benefit given investors' demands for greater transparency on significant risks and areas of significant management and auditor judgment. This also would align ISA 260 with AS 16.
 - Communication about significant transactions outside the entity's normal course of business, or transactions that otherwise appear to be unusual, and the auditor's approach to them (see paragraphs 16(b) and A20–A21 of the Appendix) – While such

³ At the onset of the project, the IAASB considered a preliminary analysis of the proposals in Article 23 to facilitate consideration of whether ISA 260 would provide a reasonable basis for the report to the audit committee. The Staff-prepared analysis presented at the March 2012 IAASB meeting can be accessed at: http://www.ifac.org/sites/default/files/meetings/files/20120312-IAASB-Agenda_Item_4G-Auditor_Reporting_Analysis_of_EC_Article_23_Proposals-for_reference_only.pdf.

⁴ AS 16 can be accessed at: http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf. Appendix 5 of the document includes a PCAOB-prepared comparison between the requirements in AS 16 and ISA 260.

transactions are contemplated in Appendix 2 of ISA 260 as possible qualitative aspects of accounting practices that may be communicated, given the steer in the ITC that auditors could consider these types of transactions for communicating KAM (e.g., significant related party transactions or restatements), such matters would likely always be relevant to TCWG in their oversight role. This also would align ISA 260 with AS 16.

- Clarification that the existing requirement to communicate other significant matters arising during the audit includes significant matters on which there was disagreement with management (see paragraphs 16(e)(i) and A25–A26 of the Appendix) – To align with AS 16 and acknowledge investors’ interest in difficult or contentious matters.
8. DT-701 also recommends the following new requirements, and new or revised application material, to underpin reporting on KAM, in light of the direction in proposed ISA 701:
- Communication about the requirement for auditors of listed entities to include KAM in the auditor’s report (see paragraph 14(b) of the Appendix) – To align with other requirements to communicate about the auditor’s responsibilities, and ensure TCWG are aware of the auditor’s responsibilities relating to KAM at the commencement of the audit.
 - Where applicable, communication about which matters the auditor will include as KAM in the auditor’s report (see paragraphs 16(g) and A29–A30 of the Appendix) – To ensure that TCWG are aware of the results of the auditor’s decision-making process regarding KAM and provide a final opportunity for two-way dialogue before the auditor’s report is issued. Proposed ISA 701 also addresses communication with TCWG when auditors of entities other than listed entities include KAM in the auditor’s report (see also paragraphs 39–41 of this paper).
9. DT-701 also identified other matters for which further application material in ISA 260 could be useful. While some of these matters relate to explicit requirements in AS 16 or proposed Article 23, on balance, DT-701 was of the view that a corresponding requirement was not necessary in proposed ISA 260 (Revised) and that the same objective could be achieved by providing additional guidance to assist auditors in complying with the principles-based requirements in ISA 260. DT-701 also recognized that ISA 260 is intended to apply to all entities, whereas proposed Article 23 is intended to apply to PIEs and AS 16 applies only to listed entities.
10. New application material, and the source thereof, proposed by DT-701 includes the following:
- The possibility of communicating about how risks of material misstatement other than significant risks may be addressed in the audit, and the nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor’s expert (see paragraph A13 of the Appendix) – DT-701 was of the view that the auditor may wish to communicate about how areas assessed as having a high risk of material misstatement were addressed, in addition to the required communication about significant risks, as those areas may be matters requiring significant management or auditor judgment. In addition, AS 16 requires communication about the specialized skills needed related to significant risks, and users have suggested that transparency about those areas where the auditor involved experts would be useful.

- Further emphasis on communicating about accounting estimates (see paragraphs A22–A23 and the reference to Appendix 2 of ISA 260 of the Appendix) – AS 16 and EC Article 23 have an increased focus on accounting estimates, consistent with feedback from investors and regulators that auditors should be scrutinizing and communicating in the auditor’s report about significant findings related to management’s judgments in this area. DT-701 therefore developed additional guidance based on its view of the key requirements in ISA 540.⁵ However, DT-701 did not believe new requirements specific to accounting estimates were needed, as they would likely be covered by the new requirements relating to significant risks (in particular, when they have high estimation uncertainty and are highly dependent upon judgment) and significant transactions outside the ordinary course of business, or transactions that otherwise appear to be unusual.
- Guidance explaining the relationship between significant matters arising during the audit, significant findings from the audit, and the results of the auditor’s procedures (see paragraph A16 of the Appendix) and editorial changes to align terminology within the ISA – DT-701 was of the view that, given the IAASB’s support for how the concept of significant matters arising during the audit is used throughout the ISAs, being more explicit about the relationship between a number of key concepts in the ISAs would provide auditors with a better understanding of the basis for the auditor’s communication with TCWG. DT-701 also was of the view that it would be useful to specifically acknowledge that the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer in accordance with ISA 220.⁶ For example, the auditor may consider highlighting matters on which consultation has taken place that involved differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations, to those charged with governance (see paragraph A28 of the Appendix).

Requirement to Communicate with TCWG in Writing

11. ISA 260 provides discretion for the auditor to communicate either orally or in writing with TCWG. An exception is made in relation to auditors of listed entities communicating about independence, which is required to be in writing. In addition, ISA 265⁷ requires auditors of all entities to communicate significant deficiencies in internal control identified during the audit in writing to those charged with governance. AS 16 takes a similar approach to ISA 260.
12. Proposed Article 23 would require communication to be in writing for all PIEs. A recently issued consultative document by the Basel Committee on Banking Supervision relating to external audits of banks sets out supervisory expectations that, for audits of banks or banking

⁵ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. ISA 540 does not include specific requirements to communicate with TCWG.

⁶ ISA 220, *Quality Control for an Audit of Financial Statements*. Paragraphs 19–22 and A23–A31 of ISA 220 address the responsibilities of both the engagement partner and the engagement quality control reviewer in an engagement quality control review for a listed entity and any other audit engagements for which the firm has determined that an engagement quality control review is required.

⁷ ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 9

organizations, the external auditor should report in writing to the Audit Committee on the outcome of the audit.

13. Paragraph 8 above explains DT-701’s proposal to require the auditor to explicitly communicate with TCWG about which matters the auditor will include as KAM in the auditor’s report. Accordingly, DT-701 has taken the approach of retaining the flexibility in ISA 260, but proposes to add further guidance that the form of communication (for example, whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected when a discussion of KAM will be included in the auditor’s report (see paragraph A49 of the Appendix).
14. DT-701 recognized that a number of approaches could be taken if the IAASB is of the view that communication with those charged with governance for should be in writing, whether for listed entities or all entities:⁸
 - The IAASB could propose a requirement for all communications with those charged with governance to be in writing.
 - The IAASB could propose a requirement for communications about the significant findings from the audit to be in writing (i.e., those addressed by paragraph 16 of extant ISA 260, recognizing that other ISAs include communication requirements).
 - The IAASB could propose a requirement for the auditor to communicate in writing about KAM as a basis for the communication in the auditor’s report (which would apply to listed entities, entities other than listed who voluntary include KAM, and any entities required to include KAM by law or regulation).

DT-701 noted that any new requirements may be seen as a substantive change in practice, in particular depending on how the phrase “in writing” is interpreted.

Other Matters Considered By DT-701

15. The following are areas where DT-701 considered, but decided against, including new requirements or application material in ISA 260 or other ISAs at this time:
 - Both AS 16 and Article 23 establish requirements relating to communicating with TCWG about going concern. While ISA 570⁹ includes a requirement for the auditor to communicate with TCWG when events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern, the proposals in Article 23 are more detailed than what is contemplated in the ISA. While DT-701 acknowledged there may be scope to revise the ISAs to address these requirements, it would likely be preferable to factor this into a broader revision of ISA 570 rather than as part of the Auditor Reporting ED.
 - AS 16 also requires the auditor to communicate to the audit committee those corrected misstatements, other than those that are clearly trivial, related to accounts and disclosures that might not have been detected expected through the auditing procedures performed, and discuss with the audit committee the implications that such corrected

⁸ DT-701 acknowledged the challenges of developing requirements for PIEs, as noted in the ITC.

⁹ ISA 320, *Materiality in Planning and Performing an Audit of Financial Statements*

misstatements might have on the entity's financial reporting process. DT-701 considered whether a new requirement or new application material should be included in proposed ISA 260 (Revised). The IAASB had previously considered proposed requirements for communication of corrected misstatements to TCWG when finalizing ISA 260, ISA 320¹⁰ and ISA 450.¹¹ However, it acknowledged concerns that, in light of the fact that the preparation and auditing of financial statements are often concurrent processes, it is difficult to ascertain whether the corrected misstatement was identified as a result of audit procedures, or would have been identified by management as part of the normal financial reporting process or otherwise through the operation of internal control over financial reporting. The IAASB previously concluded that it is the root cause of corrected misstatements that should determine whether they are required to be communicated, and took the view that underlying cause of the misstatements, particularly significant deficiencies in internal control, are more relevant to the responsibilities of TCWG¹² than the corrected misstatements per se. The majority of DT-701 is of the view that this position remains appropriate. One DT member was of the view that, because the auditor is required by ISA 450 to communicate all misstatements accumulated during the audit to management and request management to correct those misstatements, this could form the basis of any communication to those charged with governance, as this information would be relevant to their oversight role.

Matters for IAASB Consideration

1. What are the IAASB's views about the new requirements in ISA 260 proposed in paragraphs 7–8?
2. What are the IAASB's views about whether communication with those charged with governance should be required to be in writing? For example, should communication in writing be required for:
 - (a) Certain types of entities?
 - (b) Certain communications?

II. Key Issues Considered by DT-701 in Developing Proposed New ISA 701

16. The proposed draft of new ISA 701 included as **Agenda Item 2-C** builds upon the decisions made, and the feedback given, at the February 2013 IAASB meeting. It also takes into account various suggestions made by respondents to the ITC as to how best to respond to their concerns about auditors providing original information in the auditor's report. A full read of the proposed ISA is planned for the April 2013 IAASB meeting. This section discusses the key issues considered by DT-701 in formulating the new proposed requirements and related application material, regarding not only what constitutes a KAM, but also how such information is presented in the auditor's report in various circumstances.

¹⁰ ISA 570, *Going Concern*

¹¹ ISA 450, *Evaluation of Misstatements Identified during the Audit*

¹² ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, requires communication to TCWG about significant deficiencies in internal control.

Objective of Proposed ISA 701

17. The objective agreed by the IAASB at its February 2013 meeting is included in paragraph 8 of Agenda Item 2-C, and is intended to articulate a focus on significant matters addressed in the audit performed. However, in agreeing the objective, the IAASB acknowledged that the auditor's discussion of KAM can also assist users' understanding of the entity and the financial statements, and as such, did not believe the Board was moving away from the dual objective included in the ITC. The IAASB asked DT-701 to consider how this could be articulated in proposed ISA 700, and DT-701 was of the view that such a discussion could be prominently placed in the Scope section of the ISA (see paragraphs 2–3 of Agenda Item 2-C).

Determining KAM

18. At its December 2012 meeting, the IAASB agreed that auditors of listed entities should be required to communicate KAM in the auditor's report. Accordingly, proposed ISA 701 includes a requirement for auditors of listed entities to communicate KAM in the auditor's report (see paragraph 10 of Agenda Item 2-C).

Requirement to Communicate KAM When a Qualified or Adverse Opinion Is Expressed

19. Importantly, under this new requirement, communicating KAM is required not only when the auditor issues an unmodified opinion, but also when the auditor issues a qualified or adverse opinion. DT-701 is of the view that, similar to the way ISA 705¹³ addresses identified matters that would have otherwise required a modification of the auditor's opinion when an adverse opinion or disclaimer of opinion is expressed, investors and other users would likely still find it informative for the auditor to include a discussion of KAM in the auditor's report on matters other than that which gave rise to the modification of the auditor's opinion.
20. However, paragraph 17 of Agenda Item 2-C is intended to ensure that matters for which the auditor is expressing a modified opinion (which is required by ISA 705 to be presented in the Basis for Modified Opinion paragraph) are not also presented in the KAM section of the auditor's report. The related application material in paragraph A37 explains that, while matters for which the opinion is modified are, by their nature, key audit matters, separating the discussion of these matters from those required to be communicated under proposed ISA 701 gives them the appropriate prominence in the auditor's report. The Illustrations in Section B of **Agenda Item 2-A** show how modified opinions are presented in light of the suggested improvements in the ITC.
21. DT-701 agreed, however, that it would be inappropriate for the auditor to include a discussion of KAM when a disclaimer of opinion was expressed, as doing so would contradict the nature of a disclaimer of opinion (i.e., that the auditor was unable to obtain sufficient appropriate audit

¹³ Paragraph A20 of ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, explains that an adverse opinion relating to a specific matter described in the basis for qualification paragraph does not justify the omission of a description of other identified matters that would have otherwise required a modification of the auditor's opinion. In such cases, the disclosure of such other matters of which the auditor is aware may be relevant to users of the financial statements.

evidence on which to base the opinion). Accordingly, paragraph 10 of Agenda Item 2-C prohibits the auditor from doing so.¹⁴

Matters for IAASB Consideration

3. Does the IAASB agree with DT-701's recommendation that KAM be required for listed entities in all circumstances except when the auditor disclaims an opinion on the financial statements? If so, does the IAASB agree with how KAM would be presented in such circumstances?

The Auditor's Decision-Making Process

22. At its February 2013 meeting, the IAASB asked DT-701 to consider how proposed ISA 701 should best reflect the IAASB's view that the auditor's judgment of what to report externally is derived from what had been communicated with TCWG. The IAASB has also reaffirmed the view it expressed in the ITC that matters to be discussed in the auditor's report should be left to the judgment of the auditor, with robust guidance in proposed ISA 701 to inform the auditor's judgment and decision-making process. As noted in Section I above, DT-701 believes it is first necessary for certain communications in ISA 260 to be strengthened to enhance consistency in reporting of the most significant matters to TCWG.
23. The proposed requirement in paragraph 11 of Agenda Item 2-C builds upon the discussions at the February 2013 IAASB meeting – the primary criterion being the matters that were discussed with TCWG, with the auditor's decision-making process designed to narrow those matters to a smaller number of matters based on the auditor's judgment about which matters were of most significance in the audit. Consistent with the approach supported by the IAASB, the auditor is required, at a minimum, to take four key areas into account (referred to in this paper as "factors" or "criteria"). DT-701 is of the view that these factors are those areas investors and other users consistently mentioned as topics of interest on which the auditor's insights would be valuable (see paragraphs A6–A7 of Agenda Item 2-C). They are:
- Whether the matter was, or is related to, a significant risk identified in accordance with ISA 315.¹⁵
 - The degree of difficulty encountered in obtaining sufficient appropriate audit evidence about the matter.
 - The difficulty of the judgment involved.
 - Whether the auditor identified a significant deficiency in internal control relating to the matter.
24. Within each of these areas, DT-701 identified areas where application material could usefully highlight the linkage to the communications with TCWG, as well as the value of including

¹⁴ In such circumstances, it may be possible for the auditor to use an Other Matter paragraph to highlight matters the auditor judges relevant to users' understanding of the disclaimer of opinion not covered in the Basis for Disclaimer of Opinion paragraph.

¹⁵ ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

discussion in the auditor's report in relation to these factors. For example, DT-701 was of the view that it would be useful to explain:

- The potential relevance of more than one factor to a matter, which may increase the likelihood of the auditor identifying it as a KAM (see paragraph A9 of Agenda Item 2-C).
- The fact that revisions to the auditor's risk assessment and reevaluation of the planned audit procedures in relation to a matter may result in the auditor identifying it as a KAM (see paragraph A8 of Agenda Item 2-C).
- The relationship between matters discussed with the engagement quality control reviewer and those that may be determined to be KAM (see paragraphs A14–A15 of Agenda Item 2-C)

25. Further, DT-701 was of the view that it would be useful to highlight in proposed ISA 701 the challenges of communicating key audit matters in certain areas to users who do not have the benefit of the two-way communication that those charged with governance do. Paragraph A28 highlights areas that were cited by respondents to the ITC as potentially difficult to describe in KAM, for example:

- The auditor's subjective views about significant qualitative aspects of the entity's accounting practices.
- Significant risks of material misstatement due to fraud, in particular when the auditor's work did not detect any material misstatements.
- Communication of significant deficiencies in internal control identified by the auditor.

This is not to suggest that the auditor may not determine such matters as KAMs; if this is the case, the auditor may be able to highlight the significance of the matter in other ways without inadvertently providing information about the entity that would be more appropriately disclosed by management or TCWG.

Matters for IAASB Consideration

4. Does the IAASB agree with DT-701's proposed requirement and related application material to guide the auditor's decision-making process in determining KAM to communicate in the auditor's report?
5. Does the IAASB believe there are matters that are communicated with those charged with governance that might not appropriate to communicate publicly in the auditor's report? If so, how should proposed ISA 701 address them?

Consequences of the Auditor Determining that There Are No KAM to Report, Documentation Requirements and Guidance on the Number of KAMs

26. At its February 2013 meeting, the IAASB considered a proposed requirement for the auditor to explicitly include a statement that the auditor had "nothing to report" when the auditor concluded, using the factors required by the proposed ISA, that there were no key matters to report. IAASB members had mixed views, ranging from support for an explicit statement to questions as to whether such a circumstance would ever occur in practice for a listed entity,

given the premise of the auditor reporting the “most important” matters based on what had been communicated with TCWG.

27. Proposed ISA 700 (Revised) includes a requirement for the auditor of a listed entity to explain the auditor’s responsibilities with respect to communication with TCWG, including the requirement to take those communications into account when determining KAM to be communicated in the auditor’s report.¹⁶ The inclusion of this wording without a corresponding KAM section in the auditor’s report would implicitly signal that the auditor had determined there was nothing to report. DT-701 also acknowledged the views that the concept of “matters of most significance” would likely always lead the auditor to identify at least one KAM.
28. However, DT-701 has further explored how an explicit statement of “nothing to report” could be required in the auditor’s report, and drafted the proposed requirement in paragraph 12 of Agenda Item 2-C to solicit feedback from the IAASB and the Consultative Advisory Group (CAG). The requirement has been structured in such a way that, in addition to including an explicit statement in the auditor’s report, the auditor of a listed entity is required to discuss the conclusion of “nothing to report” with both the engagement quality control reviewer and those charged with governance as input to the auditor’s decision-making process. Paragraph 15 of Agenda Item 2-C and the related application material in paragraph A23 explain how the presentation in the auditor’s report is affected when the auditor has “nothing to report.”
29. Paragraph 12 of Agenda Item 2-C includes a proposed documentation requirement when the auditor has “nothing to report” and paragraph 22 of Agenda Item 2-C includes a proposed documentation requirement that would apply in all cases where KAM are communicated in the auditor’s report. Feedback from the ITC and previous IAASB discussions have indicated that a documentation requirement would be useful, but it was also acknowledged that the determination of KAM could be viewed as a significant matter required to be documented in accordance with ISA 230,¹⁷ even without a specific documentation requirement in proposed ISA 701.
30. DT-701 also considered whether guidance would be necessary for auditors regarding the number of matters that would be expected to be included as KAM for a listed entity. The ITC had signaled the IAASB’s view that, while the auditor would not be precluded from including a discussion of any number of KAM, a range of two to ten matters may generally be appropriate for a listed entity. A few respondents to the ITC commented on this, suggesting guidance in the standard would be useful, but suggested seven as an appropriate high end of the range. Paragraph A10 of Agenda Item 2-C addresses this matter.

Matters for IAASB Consideration

6. Does the IAASB agree with DT-701’s proposed requirements and related application material for an explicit statement when the auditor of a listed entity determines there are no KAM on which to report?
7. Does the IAASB agree with DT’s 701’s proposed documentation requirements?
8. What are the IAASB’s views about the appropriateness of providing guidance in proposed ISA

¹⁶ See paragraph 38 of proposed ISA 700 (Revised) in **Agenda Item 2-F**.

¹⁷ ISA 230, *Audit Documentation*

701 regarding the number of matters that may be communicated as KAM?

Communicating KAM in the Auditor's Report

31. In developing proposed requirements 13-14 and 16 of Agenda Item 2-C addressing how KAM should be communicated in the auditor's report for a listed entity, DT-701 considered its preferred presentation for a revised illustrative report, taking into account feedback from respondents to the ITC. Illustration 1 in Section A of **Agenda Item 2-A** shows how an unmodified opinion for a listed entity would be presented in light of the suggested improvements in the ITC and includes revised examples of KAMs.
32. Given concerns that KAM could be misinterpreted as "separate assurance on individual matters" or "hidden qualifications", coupled with the view that users need to understand the premise on which such information is provided, DT-701 was of the view that it would be useful to consider mandating:
 - The use of a heading "Key Audit Matters" in the auditor's report, unless otherwise prescribed by law or regulation;
 - Specific language to be used in all auditors' reports for listed entities to facilitate users' understanding of the context in which KAM are provided;
 - The use of subheadings to distinguish between individual matters; and
 - Standardized material to be included in the Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report describing the auditor's responsibilities relating to KAM that should be included in the auditor's report in all cases where KAM is presented in the auditor's report, including a description of the criteria proposed to be established by ISA 701.
33. The requirement in paragraph 14 of Agenda Item 2-C highlights statements that respondents to the ITC, in particular auditors, believed were necessary in the auditor's report so as to not widen the expectations gap by providing KAM. Through the use of the phrase "shall state", the requirement would mandate these specific words to be presented in the auditor's report, though DT-701 has explored how they could be presented in the illustrative example to reduce the amount of standardized wording preceding the entity-specific KAM. DT-701 acknowledged that the IAASB could choose to take a more flexible approach, depending on its views as to importance of these statements as context to the KAM (for example, by requiring such concepts to be explained, or only specifying some of these statements as mandatory in the auditor's report).
34. Placement of both the section in the auditor's report and individual matters within the section would be left to the auditor's judgment. However, application material indicates and the illustrative example would show the section placed in close proximity to the auditor's opinion and individual matters organized in order of relative importance (see paragraphs A18–A19 of Agenda Item 2-C).
35. DT-701 did not believe that a particular level of detail or specific content should be required for each item of KAM, and instead has constructed the requirement in paragraph 16 of Agenda Item 2-C to allow for auditor judgment about "the sufficiency and appropriateness of the

descriptions to enhance users' understanding of the matter in the context of the audit that was performed". The application material in paragraphs A24–A36 of Agenda Item 2-C has been developed in light of feedback from respondents to the ITC that flexibility in presentation is necessary, in particular to take into account: the need to communicate clearly and concisely in the auditor's report; the manner in which the matters are disclosed in the financial statements; circumstances affecting the auditor's risk assessment or the availability of audit evidence; and the potential effects of law, regulation and relevant ethical requirements in determining the nature and extent of the descriptions of KAM in the auditor's report.

36. Importantly, the proposed ISA acknowledges that law or regulation may restrict the auditor's communication of certain matters and relevant ethical requirements may prohibit the disclosure of confidential information, and suggests that the auditor may consider it appropriate to seek legal advice in certain circumstances (see paragraphs A35–A36 of Agenda Item 2-C).

Matters for IAASB Consideration

9. In addition to the 3 example KAM, the illustrative report in Agenda Item 2-A includes standardized language in both the KAM and Auditor's Responsibilities sections. What are the IAASB's view about:
- (i) Whether all (or some) of this material is necessary in the auditor's report and, if so, if the particular words used in the example should be required?
 - (ii) How much flexibility should be given to auditors to determine the placement of this information (i.e., is it necessary in the KAM section or could it be presented elsewhere)?

Revised Examples of KAM

37. Feedback from respondents to the ITC highlighted that, while a number of the topics addressed by the ITC illustrative examples were relevant, further detail was needed in the examples to illustrate why the particular matter was important from an audit perspective. However, significant concern was expressed about the auditor being required, or otherwise deciding to, include a detailed list of audit procedures. A contrasting concern was the difficulty in summarizing the auditor's extensive audit procedures, in particular in relation to complex areas, in a meaningful way. DT-701 sought to incorporate this feedback and strike an appropriate balance between the need to provide context about why a matter was important to the audit and how it was addressed and the view that KAM should be clear and concise.
38. Illustration 1 in Section A of Agenda Item 2-A includes revised examples of KAM. DT-701 was of the view that, given the potential guidance on the range of KAM (see paragraph 30 above), three examples could be presented in the ED.

Matters for IAASB Consideration

10. In light of the proposed criteria for the auditor's decision-making process for determining KAM, what are the IAASB's views about:
- (a) The appropriateness of topics addressed by the revised examples of KAM;
 - (b) The level of detail included in each of the examples;

- (c) The number of examples that should be provided in an illustrative report in the ED; and
- (d) The interaction between the examples, the introductory language, and the standardized language to describe the auditor's responsibilities relating to KAM. For example, is it useful to require disclosure of the factors the auditor considers in determining KAM in the description of the auditor's responsibilities?

Requirements When KAM Are Included for Entities Other than Listed Entities

39. Previous IAASB discussions have indicated that proposed ISA 701 needs to address circumstances where auditors of entities other than listed entities communicate KAM in the auditor's report. DT-701 is of the view that such circumstance could possibly occur in one of three ways:
- When the auditor is requested to do so by management or TCWG of the entity (e.g., when the entity's competitors are listed entities for which KAM is required);
 - When the auditor is required to do so by law, regulation, or national auditing standards (i.e., the requirement for listed entities to communicate KAM is extended to other entities, for example PIEs or all entities); or
 - When the auditor decides to do so on a voluntary basis.
40. Some concern has been expressed that if auditors of entities other than listed entities communicate KAM in the auditor's report, appropriate steps need to be taken to ensure doing so is appropriate in the circumstances of the engagement. It was also noted that KAM should only be included when the auditor has applied all the relevant requirements in proposed ISA 701 (i.e., that the auditor cannot selectively decide to limit KAM to one matter when the application of the factors in the ISA would likely have resulted in reporting on more than one matter), so that the presentation of KAM is done consistently when compared to an auditor's report of a listed entity. The reporting requirements for KAM when included for other than listed entities result in the same presentation of standardized language as for listed entities (i.e., the report is not differentiated even if provided on a voluntary basis).
41. Some feedback to the ITC indicated that auditors of entities other than listed entities would like the option to communicate KAM in the auditor's report if they decide it would be useful in the circumstances of the engagement. DT-701 is of the view that, in such circumstances, it would only be appropriate for the auditor to do so after discussing this with management or TCWG. Therefore, proposed ISA 701 includes a requirement for the auditor to do so (see paragraph 18 and application material in paragraphs A39–A40 of Agenda Item 2-C). However, there may be practical challenges to implementing such a requirement, in particular if management or TCWG do not agree with the auditor's decision to include KAM. As the form and content of the auditor's report is the responsibility of the auditor, using the tool of KAM likely should not be restricted by management and TCWG.

Matters for IAASB Consideration

11. What are the IAASB's views on the applicability of proposed ISA 701 to audits of entities other than listed entities? In particular:

- | |
|--|
| <p>(a) Does the IAASB believe the requirement in proposed ISA 701 is appropriate?</p> <p>(b) What are the IAASB's views as to the practical challenges of auditors providing such information on a voluntary basis?</p> <p>(c) Does the IAASB agree that there should be no differentiation in the auditor's report when KAM is provided for an entity other than a listed entity?</p> |
|--|

Form and Content of the Auditor's Report Prescribed by Law or Regulation

42. ISA 700 allows for flexibility in reporting when law or regulation prescribe the form and content of the auditor's report, and the IAASB has previously agreed that such flexibility should continue as part of the "Building Blocks" approach. DT-701 is of the view that the concept of KAM is sufficiently flexible and would not be in conflict with national initiatives aimed at enhancing auditing reporting, for example, the French justification of assessments model, the UK FRC corporate governance model, and the EC's Article 22 proposals.
43. Paragraph 5 of Agenda Item 2-C explains that law or regulation may also require the auditor to include additional communication in the auditor's report about specific matters. It further notes that, if those requirements are intended to provide information that is consistent with the objective and requirements of proposed ISA 701, the requirements in proposed ISA 701 relating to the form and content of such communication can be applied. Paragraph 20 of Agenda Item 2-C and related application material explain how the wording in the auditor's report may be tailored in such circumstances, acknowledging that a heading other than "Key Audit Matters" may be required, and law or regulation may require disclosure in a particular form or level of detail. DT-701 is of the view that this flexibility in relation to KAM should be explored in the context of proposed ISA 700 (Revised) as part of the May 2013 IAASB-National Auditing Standard Setters (NSS) meeting.

III. Other Matters

44. DT-701 also intends to consider potential conforming amendments to other ISAs in advance of the June 2013 IAASB meeting, as follows:
- ISA 210,¹⁸ in the form of additional application material to link to the auditor's responsibility to communicate KAM and the possibility that the auditor, management and TCWG may agree to communicate KAM for audits of entities other than listed entities.
 - ISA 220¹⁹ and ISQC 1,²⁰ in the form of new requirements to require discussion of significant risks, significant or unusual transactions, and disagreements with management with the engagement quality control reviewer to align with proposed revisions to ISA 260. Additional application material may also be useful to acknowledge the engagement quality control reviewer's consideration of the KAM section of the auditor's report.

¹⁸ ISA 210, *Agreeing the Terms of Audit Engagements*

¹⁹ ISA 220, *Quality Control for an Audit of Financial Statements*

²⁰ ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

- ISA 600,²¹ in the form of additional application material to explain that law, regulation or national auditing standards may require the auditor to communicate the names, locations and planned responsibilities of other auditors that perform procedures in the audit, based on requirements in both AS 16 and proposed Article 23.
- ISA 706²² and other ISAs that include requirements and guidance addressing Emphasis of Matter and Other Matter paragraphs, in the form of revised requirements and application material to retain the concepts yet appropriately distinguish them from KAM (to be done in coordination with DT-700 in light of the interaction with reporting on going concern).

As appropriate, DT-701 and Staff will also provide input into DT-700's process to revise ISA 705, in light of the proposed requirements in ISA 701 relating to presentation of KAM when a qualified or adverse opinion is expressed.

²¹ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

²² ISA 706, *Emphasis of Matter and Other Matters Paragraphs in the Independent Auditor's Report*

Proposed Revisions to ISA 260

Introduction

The Role of Communication

4. This ISA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:
- (a) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements; ~~Reordered bullets in extant ISA 260 – this was previously the last~~
 - (b) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;
 - (c) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
 - ~~(e)~~(d) The auditor in determining the nature and extent of key audit matters to be communicated in the auditor's report in accordance with proposed ISA 701.²³

Requirements

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

14. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:
- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; ~~and~~
 - (b) In the case of audits of financial statements of listed entities, the auditor is also responsible for communicating key audit matters in the auditor's report based on the matters communicated with those charged with governance; and
 - ~~(b)~~(c) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9–A10)

²³ Proposed ISA 701, Communicating Key Audit Matters in the Independent Auditor's Report

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A16–~~A17~~)
- ~~(a)~~ The significant risks identified by the auditor and the auditor's response to them; (Ref: Para. A18–A19)
 - ~~(b)~~ The significant transactions outside the entity's normal course of business, or transactions that otherwise appear to be unusual, the auditor's understanding of the business rationale for such transactions and the auditor's approach to them; (Ref: Para. A20–A21)
 - ~~(a)~~~~(c)~~ The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A~~2247~~–A23)
 - ~~(b)~~~~(d)~~ Significant difficulties, if any, encountered during the audit; (Ref: Para. A~~2418~~)
 - ~~(c)~~~~(e)~~ Unless all of those charged with governance are involved in managing the entity:
 - (i) Significant matters on which there was disagreement with management and any other significant matters, if any, arising during~~from~~ the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A~~2549~~–A26)
 - (ii) Written representations the auditor is requesting; ~~and~~
 - ~~(f)~~ Any Other significant matters, if any, arising from~~during~~ the audit that, in the auditor's professional judgment, are ~~relevant~~significant to the oversight of the financial reporting process; ~~and~~ (Ref: Para. A~~2720~~–A28)
 - ~~(g)~~ Where applicable, taking into account the matters the auditor has communicated with those charged with governance, which matters the auditor will include as key audit matters in the auditor's report in accordance with ISA 701. (Ref: Para. A29–A30)

Application and Other Explanatory Material

Planned Scope and Timing of the Audit (Ref: Para. 15)

A13. Matters communicated may include:

- ~~How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error. How the auditor proposes to address other identified risks of material misstatement beyond those identified as significant risks.~~
- The auditor's approach to internal control relevant to the audit.
- The application of the concept of materiality in the context of an audit.²⁴

²⁴ ISA 320, *Materiality in Planning and Performing an Audit*

- The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.²⁵

A14. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, ~~the extent to which how~~ the external auditor ~~will use the work of internal audit, and how the external~~ and internal auditors can ~~best~~ work together in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.²⁶
- The views of those charged with governance of:
 - The appropriate person(s) in the entity's governance structure with whom to communicate.
 - The allocation of responsibilities between those charged with governance and management.
 - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
 - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
 - Significant communications with regulators.
 - Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

Significant Findings from the Audit (Ref: Para. 16)

A16. The matters in paragraphs 16(a)–(e) are required to be communicated to those charged with governance because they represent significant matters arising during the audit that are

²⁵ ISA 620, *Using the Work of an Auditor's Expert*, establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

²⁶ ISA 610 (Revised), *Using the Work of Internal Auditors*, paragraph 18, and ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 31 [conforming amendments approved February 2013]

directly relevant to their responsibility to oversee the financial reporting process. Communication about these matters assists those charged with governance in understanding the results of the auditor's procedures, significant findings from the audit, and the basis for the auditor's opinion on the financial statements as a whole.

Significant Risks (Ref: Para. 16(a))

A18. When communicating about the planned scope and timing of the audit, the auditor may communicate how the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error. ISA 300²⁷ notes that, as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of risks. Timely communication about significant changes to the planned audit strategy or the significant risks identified and the reasons for such changes as they arise during the audit is also likely to be relevant to the responsibilities of those charged with governance to oversee the financial reporting process.

A19. ISA 240²⁸ establishes requirements for the auditor to communicate with those charged with governance when performing risk assessment procedures and when the auditor has identified or suspects fraud. The communication required by paragraph 16(a) of this ISA includes the auditor's communication about significant risks of material misstatement due to fraud. The nature and extent of this communication takes into account whether the auditor is discussing a presumed risk of fraud, such as revenue recognition or management override of controls, or a fraud risk specifically identified in the context of the entity and the audit.

Significant or Unusual Transactions (Ref: Para. 16(b))

A20. ISA 315 explains that significant risks often relate to significant non-routine transactions. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.²⁹ Material misstatement of the financial statements, including fraudulent financial reporting, can arise from significant or unusual, or highly complex, transactions, especially those:

- Not in the ordinary course of business.
- Which appear to have been designed to have a particular accounting treatment or tax, legal or regulatory outcome.
- Where the form of such transactions appears overly complex or where extensive advice regarding the structuring of the transaction has been taken.
- Where management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Involving related parties.

²⁷ ISA 300, *Planning an Audit of Financial Statements*, paragraph A13

²⁸ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

²⁹ ISA 315 (Revised), paragraph A132

A21. Communication with those charged with governance about such transactions may include:

- The auditor's understanding of the policies management used to account for the transactions;
- The extent to which the financial statements are affected by unusual transactions, including non-recurring amounts recognized during the period; and
- The extent to which such transactions are separately disclosed in the financial statements.

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(~~ca~~))

A22A17. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates for which there is significant measurement uncertainty. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing and presenting the financial statements.

A23. As a result, the auditor's views on the subjective aspects of the financial statements, including the auditor's evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks, may be particularly relevant to the responsibility of those charged with governance for oversight of the financial reporting process. Open and constructive communication about significant qualitative aspects of the entity's accounting practices may also include comment on the acceptability of significant accounting practices. Appendix 2 identifies matters that may be included in this communication.

Significant Difficulties Encountered during the Audit (Ref: Para. 16(~~db~~))

A24A18. Significant difficulties encountered during the audit may include such matters as:

- Significant delays by management, the unavailability of entity personnel, or an unwillingness in management to provideing required information needed for the auditor's procedures.
- An unreasonably unnecessary brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- ~~The unavailability of expected information.~~
- Restrictions imposed on the auditor by management.
- Complaints or concerns regarding accounting or auditing matters that have been brought to the auditor's attention.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.³⁰

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 16(ee)(i))

A26. Paragraph 16(e)(i) requires the auditor to communicate with those charged with governance about significant matters on which there was disagreement with management. This communication includes any disagreements, whether or not satisfactorily resolved, that individually or in the aggregate could have been significant to the entity's financial statements or the auditor's report. Disagreements with management do not include initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(fe))

A27A20. Other significant matters arising ~~during~~from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(e) and related application material, for audits of financial statements of listed entities, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer in accordance with ISA 220.³¹ For example, the auditor may consider highlighting matters on which consultation has taken place that involved differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations, to those charged with governance.

Key Audit Matters in the Auditor's Report (Ref: Para. 16(g))

A29. Proposed ISA 701 requires the auditor to communicate key audit matters in the auditor's report for audits of financial statements of listed entities and paragraph 14 of this ISA requires the auditor of a listed entity to communicate about that responsibility with those charged with governance. Proposed ISA 701 also addresses circumstances when an auditor of an entity other than a listed entity communicates key audit matters in the auditor's report, and establishes a requirement for the auditor to communicate with those charged with governance when the auditor decides to do so on a voluntary basis.³²

A30. The form and content of the auditor's report, including the discussion of key audit matters, is the sole responsibility of the auditor. Because the auditor's decision-making process about what to include as key audit matters in the auditor's report is informed by the matters

³⁰ ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*

³¹ ISA 220, *Quality Control for an Audit of Financial Statements*. Paragraphs 19–22 and A23–A31 of ISA 220 address the responsibilities of both the engagement partner and the engagement quality control reviewer in an engagement quality control review for a listed entity and any other audit engagements for which the firm has determined that an engagement quality control review is required.

³² Proposed ISA 701, paragraph 18

communicated to those charged with governance, the requirement in paragraph 16(g) is intended to ensure that those charged with governance are aware of what will be communicated in the auditor's report. Such communication enables those charged with governance to be made aware of the manner in which the auditor intends to describe the key audit matters in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. Although the final form and content of the auditor's report is determined at the end of the audit, remaining alert to which matters are likely to be considered of most significance to the audit during the planning and performance of the audit assists the auditor in finalizing the auditor's report on a timely basis.

Supplementary Matters (Ref: Para. 3)

A34. Law or regulation may prescribe a specific form or content of the auditor's communication with those charged with governance. For example, the auditor may be required to document the interactions with those charged with governance and describe the process by which the auditor was appointed or report on specific matters relating to the entity's financial statements or the audit.

The Communication Process

Establishing the Communication Process (Ref: Para. 18)

Communication with Third Parties

A45A34. Those charged with governance may be required by law or regulation, or may choose to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

- (a) That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, and should not be relied upon by third parties;
- (b) That no responsibility is assumed by the auditor to third parties; and
- (c) Any restrictions on disclosure or distribution to third parties.

Forms of Communication (Ref: Para. 19–20)

A49A38. In addition to the significance of a particular matter, the form of communication (for example, whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- Whether a discussion of key audit matters will be included in the auditor's report.
- Whether the matter has been satisfactorily resolved.
- Whether management has previously communicated the matter.

- The size, operating structure, control environment, and legal structure of the entity.
- In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
- Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.

Timing of Communications (Ref: Para. 21)

A52A44. Other factors that may be relevant to the timing of communications include:

- Whether a discussion of key audit matters will be included in the auditor's report.
- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (for example, noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Appendices to ISA 260

Note: Appendix 1 of ISA 260 is not reproduced, but conforming changes will be necessary to refer to requirements to communicate with those charged with governance included in ISA 610 (Revised), ISA 610 (Revised 2013), and proposed ISA 701.

Appendix 2 of ISA 260 – Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(ca), and discussed in paragraphs ~~A2247–A23~~, may include such matters as:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in ISA 540,³³ including, for example:
 - How Management's identification of accounting estimates identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.
 - Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
 - Whether management's decision to recognize, or to not recognize, the accounting estimates in the financial statements is in accordance with the applicable financial reporting framework.
 - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why, as well as the outcome of accounting estimates made in prior periods
 - Management's process for making accounting estimates (e.g., when management has used a model), including whether the selected measurement basis for the accounting estimate is in accordance with the applicable financial reporting framework.

³³ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

- Whether the significant assumptions used by management in developing the accounting estimate are reasonable.
- Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
- ~~Risks of material misstatement.~~
- Indicators of possible management bias.
- How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
- ~~The adequacy of disclosure of estimation uncertainty in the financial statements.~~
- _____

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (for example, disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- ~~The extent to which the financial statements are affected by unusual transactions, including non-recurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements.~~
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.