IAASB International Auditing and Assurance Standards Board

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Meeting:	IAASB Consultative Advisory Group
Meeting Location:	New York
Meeting Date:	April 8–9, 2013

Agenda Item

B.4

Auditor Reporting—Proposed Changes to ISA 260 to Underpin the Auditor's Communication of Key Audit Matters in the Auditor's Report

Objective of Agenda Item

1. To discuss revisions to ISA 260[1] that are likely necessary to underpin the auditor's communication of key audit matters in the auditor's report.

I. Matters for CAG Consideration

2. 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 those charged with governance (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).

3. At its February 2013 meeting, the IAASB asked the ISA 701[2] 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

4. 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[3] 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 key audit matters (KAM) in the auditor's report. The proposed amendments are shown in marked text from extant ISA 260 in the Appendix to this paper. The DT's process and rationale for these amendments is described below.

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[1] ISA 260, *Communication with Those Charged With Governance*

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

[3] Issues relating to the development of proposed ISA 701 are included in **Agenda Item B.2** and the proposed standard is included in **Agenda Item B.3**.

The Objectives of ISA 260

5. 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

6. 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

7. 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).[4]
   - The PCAOB's Auditing Standard No. 16 (AS 16), *Communications with Audit Committees*, which was issued in August 2012.[5]
   - 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.

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[4] 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.

[5] 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.

DT-701 Recommendations

8. 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 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.

9. 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).

10. 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.

11. 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.[6] 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.[7] 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).

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

[7] 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.

Requirement to Communicate with TCWG in Writing

12. 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 265[8] 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.

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

14. 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).

15. 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:[9]

    - 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

16. 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 570[10] includes a requirement for the auditor to

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

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

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 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 320[11] and ISA 450.[12] 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 TCWG[13] 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 CAG Consideration

1. What are Representatives' views about the new requirements in ISA 260 proposed in paragraphs 8–9 of this paper (and illustrated in the Appendix)?
2. What are the Representatives' views about whether communication with TCWG should be required to be in writing? For example, should communication in writing be required for:
    (a) Certain types of entities?
    (b) Certain communications?

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

11 ISA 570, *Going Concern*

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

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

Appendix

Extracts of Relevant Paragraphs in ISA 260 Proposed to Be Revised

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

   ~~(c)~~(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.[14]

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)

[14] 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. A22~~17~~–A23)

~~(b)~~(d) Significant difficulties, if any, encountered during the audit; (Ref: Para. A24~~18~~)

~~(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 ~~S~~significant matters~~, if any,~~ arising during~~from~~ the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A25~~19~~–A26)

(ii) Written representations the auditor is requesting; ~~and~~

(f) Any ~~O~~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. A27~~20~~–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)

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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.[15]

[15] 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.[16]

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.[17]
- The views of those charged with governance of:
  - o The appropriate person(s) in the entity's governance structure with whom to communicate.
  - o The allocation of responsibilities between those charged with governance and management.
  - o The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - o Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - o Significant communications with regulators.
  - o 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

[16] 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.

[17] 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 300[18] 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 240[19] 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.[20] 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.

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

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

20 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(c~~a~~))

A22~~A17~~. 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(d~~b~~))

A24~~A18~~. Significant difficulties encountered during the audit may include such matters as:

- Significant delays by management, the unavailability of entity personnel, or an unwillingness ~~in~~by management to provid~~ing~~e required information needed for the auditor's procedures.
- An unreasonably ~~unnecessarily~~ 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.[21]

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 16(e~~c~~)(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(f~~d~~))

A27~~A20~~. 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.[22] 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.[23]

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

[21] ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*

[22] 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.

[23] 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

A45~~A34~~. Those charged with governance may be required by law or regulation, or may choose~~wish~~, 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)

A49~~A38~~. 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)

A52~~A41~~. 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(c~~a~~), and discussed in paragraphs A22~~17~~–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,[24] including, for example:
  - How ~~M~~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.

[24] ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

- o Whether the significant assumptions used by management in developing the accounting estimate are reasonable.
- o 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.
- ~~o Risks of material misstatement.~~
- o Indicators of possible management bias.
- o 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.
- ~~o~~ The adequacy of d~~D~~isclosure of estimation uncertainty in the financial statements.
- o

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.