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# Basis for Conclusions: ISA 260 (Revised), Communication with Those Charged with Governance

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*Prepared by the Staff of the International Auditing and  
Assurance Standards Board*



**International Federation  
of Accountants**

**BASIS FOR CONCLUSIONS:  
ISA 260 (REVISED), COMMUNICATION WITH  
THOSE CHARGED WITH GOVERNANCE**

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB) and has not been discussed by the IAASB. It does not form part of ISA 260 (Revised).

## **Background**

1. In light of significant regulatory and auditing standards developments in several jurisdictions since extant ISA 260, “Communication of Audit Matters with Those Charged with Governance” was issued in 1999, and shifts in the expectations of those charged with governance and other stakeholders, the IAASB initiated a project in March 2003 to review the provisions of the ISAs that relate to communication with those charged with governance. As well as IAASB members, the Project Task Force included technical experts nominated by the Australian Auditing and Assurance Standards Board, the International Organization of Supreme Audit Institutions, the Institute of Internal Auditors, and the Transnational Auditors Committee of the International Federation of Accountants.
2. The IAASB issued an exposure draft of proposed ISA 260 (Revised), “The Auditor’s Communication with Those Charged with Governance” (“ED-ISA 260”) in March 2005, with a comment date of July 31, 2005. The IAASB received thirty-nine comment letters from a variety of respondents, including regulators, IFAC member bodies, and firms. The IAASB revised ED-ISA 260 as a result of these comments. The following summarizes the more significant issues raised by respondents, and how the IAASB addressed them.

## **Special Purpose Audit Engagements**

3. ED-ISA 260 stated that it applied to the audit of financial statements, which includes special purpose financial statements, and that “The standards and guidance in this ISA are to be adapted, as necessary, for audits of historical financial information other than financial statements.” One respondent noted several difficulties with applying ED-ISA 260 to special purpose audit engagements.
4. The IAASB considered this general issue separately in the context of the revision of extant ISA 800, “The Auditor’s Report on Special Purpose Audit Engagements.” It concluded that considerations specific to special purpose audit engagements should not be incorporated into the individual ISAs, but should be dealt with, as appropriate, in the revised ISA 800. The IAASB considered that this would prevent over-complicating certain ISAs by the need to include material that is not of general application. It would also assist those standard setters and jurisdictions adopting the ISAs for general purpose audits.

## **Two-way Communication**

5. ED-ISA 260 included reference to the desirability of communication being two-way. While generally acknowledging that an ISA cannot mandate two-way communication (because it cannot require those charged with governance to communicate with the auditor), many respondents wanted the importance of two-way communication to be emphasized further. A number of these respondents suggested that replacing “the auditor communicates to those charged with governance” with “the auditor communicates with those charged with governance” would help achieve this. Addition of further examples of two-way communication was also suggested, as was some restructuring and rewording to add emphasis to the importance of two-way communication, and noting the auditor’s expectation that communication will be two-way. Each of these suggestions was adopted by the IAASB.

## **“Significant” and Similar Terms**

6. A number of respondents expressed concern that ED-ISA 260 used different words to describe matters to be communicated. While “significant” was used frequently in ED-ISA 260, “serious,” “major,” and “important” were also used in particular circumstances.
7. The IAASB noted that the definition of “significance” in the Glossary makes its use context-specific, and agreed that “significant” should be used throughout ISA 260 (Revised).

## **Communication by Management with Those Charged with Governance**

8. Mixed views were expressed on the fact that ED-ISA 260 permitted the auditor, in certain circumstances, not to communicate certain matters if satisfied that management had done so effectively. Regulators in particular were troubled that this may be seen to weaken the auditor’s general obligations with respect to communications and may conflict with other parts of the revised standard. Other respondents presented a range of views on the matters that should be permitted to be treated in this way.
9. The IAASB agreed that communication by management of matters that the auditor is required to be communicated, should not relieve the auditor of the responsibility to do so. ISA 260 (Revised) notes that it may, however, affect the form or timing of the auditor’s communication.

## **Smaller Entities**

10. ED-ISA 260 noted that when matters are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. This will most often be the case for smaller entities. While respondents generally agreed with this, a number recommended that ISA 260 (Revised) go further in addressing the needs of smaller entities by, e.g.:

BASIS FOR CONCLUSIONS:  
ISA 260 (REVISED)

- Emphasizing the lack of formality in the management practices of smaller entities, and the auditor’s approach to communication with those charged with governance of smaller entities.
  - Restricting the need to communicate matters to those instances where the governance function is effective.
11. The IAASB agreed to give more emphasis to considerations specific to smaller entities, but did not agree that requirements to communication should be restricted to those instances where the governance function is effective. ISA 260 (Revised) includes a requirement to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit, and to take appropriate action where it has not. If the governance function is not effective, this will be reflected in the two-way communication, which will prompt the auditor to take appropriate action. This is considered to be a better public interest outcome than relieving the auditor of the responsibility to communicate in such circumstances.

## **Communication of Misstatements**

### **Corrected Misstatements**

12. Respondents questioned the practicality of the requirement proposed in ED-ISA 260 to communicate: “material, corrected misstatements that were brought to the attention of management as a result of audit procedures.” They noted that this assumes complete financial statements are available when the audit starts, rather than the reality that preparing and auditing financial statements is an iterative process in which it is often not clear-cut whether or not potential misstatements were identified “as a result of audit procedures.” For example, while management is preparing the financial statements the auditor may detect a misstatement that the entity’s internal controls would otherwise have identified later in the process.
13. The IAASB discussed whether it is the corrected misstatement or the underlying weakness in internal control that allowed the misstatement to occur, that is important to those charged with governance. It was agreed that the requirement here should be to communicate material weaknesses in design, implementation or operating effectiveness of internal control that have come to the auditor's attention, rather than corrected misstatements.

### **Uncorrected Misstatements**

14. The proposed requirement of ED-ISA 260 regarding communication of uncorrected misstatements is now dealt with as part of proposed ISA 450 (Revised and Redrafted), “Evaluation of Misstatements Identified during the Audit,” which was approved by the IAASB at its October 2006 meeting.

## **Overarching Framework for Communication**

15. ED-ISA 260 provided an overarching framework for the auditor’s communication with those charged with governance. While identifying specific matters to be communicated, it also acknowledged that other matters can be required by other ISAs, “additional external requirements,” or agreement with the entity

## **Other ISAs**

16. The Explanatory Memorandum accompanying ED-ISA 260 noted: “matters that other ISAs require to be communicated ... are not repeated in the proposed revised ISA 260.” ED-ISA 260 did, however, contain a partial list of such matters. While one respondent explicitly supported not repeating such matters in this ISA, several respondents noted that it would be helpful for practitioners if ISA 260 (Revised) had an appendix that contains a complete list of such matters.
17. The IAASB therefore added an appendix which lists paragraphs in other ISAs that contain specific requirements to communicate with those charged with governance

## **Additional External Requirements, and Matters Agreed with the Entity**

18. In relation to “additional external requirements,” one respondent questioned why ED-ISA 260 included “a requirement to comply with another requirement.” While recognizing that the auditor has a responsibility to be aware of, and comply with, those external requirements, the respondent noted that a failure of the auditor to comply should not result in the audit not having been conducted in accordance with ISAs. Similar sentiments were expressed by a number of respondents regarding the proposed requirement to communicate matters agreed with the entity, particularly when they require the auditor to do work beyond that necessary to form an opinion on the financial statements.
19. The IAASB agreed with the respondents that it is not essential for communication of matters required by agreement with the entity or by additional external requirements, to be required for those reasons alone by ISA 260 (Revised). However, since communicating such matters would be expected of a high-quality audit, reference to these matters has been retained as part of the overarching framework established in ISA 260 (Revised).

## **Supplementary Matters**

20. ED-ISA 260 proposed a requirement to communicate “other matters of which the auditor is aware that, in the auditor’s professional judgment, are serious and relevant to the responsibilities of those charged with governance.” The guidance accompanying this requirement noted that “such matters, which may arise from the audit of the financial statements or otherwise come to the attention of the auditor, include, e.g., significant decisions or actions by senior management that lack appropriate authorization, and seriously deficient governance structures or processes.”
21. While one respondent was concerned that ED-ISA 260 would restrict the scope of required communications to “matters relevant to the financial reporting and disclosure

process,” several other respondents expressed concern about that this particular proposal would require communication of matters that are related to neither the audit of the financial statements nor the responsibility of those charged with governance to oversee the financial reporting process, and could create expectations that could not be fulfilled. Another respondent suggested that the proposal be confined to communicating about “matters involving senior management.” Other issues raised included how the auditor can determine which matters those charged with governance would consider significant, and what threshold should be applied in determining which matters to communicate.

22. The IAASB agreed that for the auditor to deal properly with such matters is important in the public interest. However, after considerable deliberation, members also:
  - (a) Expressed concern about extension of the auditor’s responsibilities beyond matters necessary to form an opinion on the financial statements;
  - (b) Expressed caution that the scope of the audit should not be seen as including a “search” responsibility with respect to supplementary matters; and
  - (c) Referred to practical difficulties in implementing the proposal because it did not offer enough certainty about the boundaries of the auditor’s communication responsibility, which in turn leaves the auditor:
    - (i) Exposed to risk after the event at the hands of those who have the benefit of hindsight, and
    - (ii) Unable properly to direct staff as to what matters to bring to the engagement partner’s attention.
23. In light of these considerations, the IAASB decided to deal with supplementary matters in the guidance material, but to make it clear that “nothing in the ISA precludes the auditor from communicating any other matters to those charged with governance.”

## **Communications on Independence Issues**

24. One respondent suggested that the auditor should be required to report to those charged with governance any communications with external specialists, legal counsel, or other auditors in order to make those charged with governance aware of potentially significant matters and ensure that there are not any relationships that would affect the independence of the auditor through using those parties. The IAASB did not consider that a specific requirement to this effect was needed in ISA 260 (Revised), particularly as the use of other auditors and experts is currently being addressed in the projects to revise ISA 600, “Using the Work of Another Auditor” and ISA 620, “Using the Work of an Expert.”

## **Confidentiality**

25. Concern was expressed by some respondents about guidance in ED-ISA 260 that the auditor ordinarily states in written communications to those charged with governance that it is not to be disclosed to a third party, or quoted or referred to, without the auditor’s prior written consent. It was suggested that this guidance introduced a risk for regulatory

BASIS FOR CONCLUSIONS:  
ISA 260 (REVISED)

authorities that an auditor may inappropriately withhold written consent, and therefore restrict a regulatory authority's access to information regarding a regulated entity.

26. The IAASB amended the wording of this guidance to make it clear that when communications with those charged with governance are made available to regulators or other third parties, it is important that the third party be informed that the communication was not prepared with them in mind and, therefore, that appropriate language be included in the communication.

## **Documentation and Written Communication**

27. ED-ISA 260 combined in one section, discussion of (a) forms of communication, and (b) documentation. It was evident from the comments of a number of respondents that this approach led to some confusion between the purpose of communicating in writing, and of documenting matters in the audit file. To address this, the IAASB created a new section on documentation, separating it from "forms of communication." ISA 260 (Revised) also includes references to the engagement letter to reinforce its potential as a means of communication with those charged with governance.



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