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Proposed statement on auditing standards no. 114
(redrafted): the auditor's communication with
those charged with governance; Exposure draft
(American Institute of Certified Public
Accountants), 2008, April 30

American Institute of Certified Public Accountants. Auditing Standards Board

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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS NO. 114 (REDRAFTED)

THE AUDITOR'S COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

(To Supersede Statement on Auditing Standards No. 114, *The Auditor's Communication With Those Charged With Governance*)

April 30, 2008

Comments are requested by June 30, 2008.

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be addressed to
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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to proposed Statement on Auditing Standard (SAS) No. 114 (Redrafted), *The Auditor's Communication With Those Charged with Governance*. This proposed SAS would supersede SAS No. 114, *The Auditor's Communication With Those Charged with Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380). The accompanying proposed SAS represents the redrafting of SAS No. 114 to apply the Auditing Standards Board's (ASB) clarity drafting conventions and to converge with International Standards on Auditing, as discussed in the following sections.¹

Background

Clarity

To address concerns over the clarity, length and complexity of its standards, the ASB is currently undertaking a significant effort to clarify the SASs. The ASB issued a discussion paper titled *Improving the Clarity of ASB Standards*² in March 2007. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions and has undertaken to revise all of its SASs in accordance with those conventions. The proposed SAS has been drafted in accordance with the ASB's clarity drafting conventions, which include the following:

- Establishing objectives for each of the standards
- Including a definitions section, where relevant, in each standard
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A-prefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bullet lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard

¹ The *Clarity Project Explanatory Memorandum* provides a more detailed discussion of the Auditing Standards Board's (ASB) Clarity Project.

² The discussion paper is available online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard

Convergence

Consistent with the ASB's strategy to converge its standards with those of the International Auditing and Assurance Standards Board (IAASB),³ the proposed SAS has been drafted using International Standard on Auditing (ISA) 260 (Revised and Redrafted), *The Auditor's Communication with Those Charged with Governance*, as a base. Differences between SAS No. 114 and ISA 260 for which the ASB believes there is no compelling reason have been eliminated. Differences in objectives, definitions, or requirements between the proposed SAS and ISA 260 are identified in exhibit B to the exposure draft.

The ASB has made various changes to the language of the ISA to use terms or phrases that are more commonly used in the United States, and to tailor examples and guidance to be more appropriate to the U.S. environment. Where the ASB believes that such changes in language have resulted in a substantive difference between the proposed SAS and the ISA, these differences have also been identified in exhibit B.

Effective Date

The proposed SAS will not become effective for audits of financial statements for periods beginning earlier than December 15, 2010.

Issue for Consideration

Communication of the Risks of Material Misstatement

Paragraph 11 of the proposed SAS requires the auditor to communicate with those charged with governance and provide an overview of the planned scope and timing of the audit. Paragraph A17 contains application material that explains that communication regarding the planned scope and timing of the audit may assist those charged with governance to discuss issues of risk and materiality with the auditor, particularly where there is a robust discussion of risks affecting the entity and its financial statements and the auditor's plans to address them. In approving the proposed SAS for exposure, a member of the ASB suggested that the communication with those charged with governance of issues of risk and materiality is of sufficient importance to be elevated to a requirement. The majority of the ASB believe that such communication is an essential component of the auditor's risk assessment process and, accordingly, is part of the requirement to communicate the planned scope and timing of the audit, as discussed in paragraph A17.

³ The ASB's convergence paper is available online at www.aicpa.org/download/auditstd/ASB_Convergence_Plan.pdf.

The ASB is seeking specific comments as to whether respondents support the position as drafted in the proposed SAS. Respondents who favor including an additional requirement to communicate issues of risk and materiality with those charged with governance are asked to comment on the guidance that auditors might need to fulfill such a requirement.

Guide for Respondents

The ASB is seeking comments specifically on changes resulting from applying the clarity drafting conventions and convergence with ISAs, and their effect on the content of the SAS. Respondents are asked to respond in particular to the following questions:

- (1) Are the objectives to be achieved by the auditor, stated in the proposed SAS, appropriate?
- (2) Are revisions from the existing standards to converge with ISA 260 appropriate?
- (3) Are the differences between the proposed SAS and ISA 260 identified in exhibit B, and other language changes, appropriate?
- (4) Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after July 31, 2008, for one year. Responses should be sent to Sherry Hazel, Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by June 30, 2008. Responses may also be sent by e-mail to shazel@aicpa.org.

Supplements to the Exposure Draft

To assist respondents in tracking changes and in responding to this request to comment on the proposed SAS, the Audit and Attest Standards staff has prepared supplementary material comprising the following items:

- *Mapping Document.* A schedule that maps the requirements and guidance contained within SAS No. 114 to the proposed SAS to demonstrate how the material in SAS No. 114 has been reflected in the proposed SAS.
- *Changes in Requirements.* An analysis that identifies proposed changes in requirements and explanatory material as a result of redrafting.
- *Detailed Differences Between ISA 260 and the Proposed SAS.* A schedule that provides detailed differences in language between the ISA and the proposed SAS.

This staff-prepared supplementary material is available on the AICPA Web site at <http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Exposure+Drafts+of+Proposed+Statements/Communication.htm>. It is for information purposes only and does not form part of the exposure draft; however it may be useful for respondents in formulating comments.

Comment Period

The comment period for this exposure draft ends on June 30, 2008.

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(2007–2008)**

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**PROPOSED STATEMENT ON AUDITING STANDARDS NO. 114
(REDRAFTED)**

**THE AUDITOR’S COMMUNICATION WITH THOSE
CHARGED WITH GOVERNANCE**

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Requirements of International Standard on Auditing 260 (Redrafted),
Communication with Those Charged with Governance

Proposed Statement on Auditing Standards, *The Auditor's Communication With Those Charged With Governance*

Introduction

Scope of This Statement on Auditing Standards

1. This Statement on Auditing Standards (SAS) addresses the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements.¹ Although this SAS applies regardless of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity. This SAS does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.
2. This SAS has been drafted in terms of an audit of financial statements but may also be applied, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation and presentation of the other historical financial information.
3. Recognizing the importance of effective two-way communication during an audit of financial statements, this SAS provides a framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated. Additional matters to be communicated are identified in other SASs (see exhibit A). Further matters not required by generally accepted auditing standards may be required to be communicated by agreement with those charged with governance or management or in accordance with external requirements. Nothing in this SAS precludes the auditor from communicating any other matters to those charged with governance.

Effective Date

4. This SAS is effective for audits of financial statements for periods beginning on or after [Date]².

¹ The provisions of this Statement on Auditing Standards (SAS) apply to audits of financial statements prepared either in accordance with generally accepted accounting principles or in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. References in this SAS to generally accepted accounting principles are intended to also refer to other comprehensive bases of accounting when the reference is relevant to the basis of accounting used.

² This date will not be earlier than December 15, 2010.

Objectives

5. The objectives of the auditor, in communicating with those charged with governance, are to
 - a. 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. obtain from those charged with governance information relevant to the audit.
 - c. 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.
 - d. promote effective two-way communication between the auditor and those charged with governance. (Ref: par. A1–A4)

Definitions

6. For purposes of the SASs, the following terms have the meanings attributed below:

Those charged with governance. The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases, management has this responsibility). For entities with a board of directors, this term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards.

Management. The person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

Requirements

Those Charged With Governance

7. The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. (Ref: par. A5–A8)

Communication With the Audit Committee or Other Subgroup of Those Charged With Governance

8. When the auditor communicates with a subgroup of those charged with governance, such as the audit committee or an individual, the auditor should determine whether the auditor also needs to communicate with the governing body. (Ref: par. A9–A11)

When All of Those Charged With Governance Are Involved in Managing the Entity

9. In some cases, all of those charged with governance are involved in managing the entity. In these cases, if matters required by this SAS are communicated with a person(s) with management responsibilities and that person(s) also has governance responsibilities, the matters need not be communicated again with the same person(s) in his or her governance role. The auditor should, nonetheless, be satisfied that all of those charged with governance with whom the auditor would otherwise communicate in their governance capacity are adequately informed if the auditor has communicated with only some people having both management and governance responsibilities.

Matters to Be Communicated

The Auditor's Responsibilities Under Generally Accepted Auditing Standards

10. The auditor should communicate with those charged with governance the auditor's responsibilities under generally accepted auditing standards (Ref: par. A12–A15), including that
 - a. the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management, with the oversight of those charged with governance, are presented fairly, in all material respects, in conformity with generally accepted accounting principles.
 - b. the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

Planned Scope and Timing of the Audit

11. The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: par. A16–A20)

Significant Findings From the Audit

12. The auditor should communicate with those charged with governance the following matters: (Ref: par. A21)

- a. The auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures (when applicable, the auditor should explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under generally accepted accounting principles not to be most appropriate to the particular circumstances of the entity) (Ref: par. A22)
- b. Significant difficulties, if any, encountered during the audit (Ref: par. A23)
- c. Disagreements with management, if any (Ref: par. A24)
- d. Other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process

Uncorrected Misstatements

13. The auditor should communicate with those charged with governance

- a. uncorrected misstatements other than those the auditor believes are trivial, if any, and the effect that they may have on the opinion in the auditor's report, and request their correction.³ In communicating the effect that uncorrected misstatements that are material, individually or in the aggregate, may have on the opinion in the auditor's report, the auditor should address the misstatements individually. (Ref: par. A25)
- b. the implications of a failure to correct misstatements, considering the size and nature of the misstatement judged in the surrounding circumstances, including possible implications in relation to future financial statements.⁴ (Ref: par. A26)
- c. the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

When Not All of Those Charged With Governance Are Involved in Management

14. Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate

³ See AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), regarding the auditor's requirement to communicate misstatements to management.

⁴ See paragraph .06 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), regarding the auditor's requirement to obtain written representation from management regarding uncorrected misstatements.

- a. material, corrected misstatements that were brought to the attention of management as a result of audit procedures. (Ref: par. A27)
- b. significant issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management. (Ref: par. A28)
- c. the auditor's views about significant matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultation has occurred.⁵
- d. written representations the auditor is requesting (the written representations regarding the effects of uncorrected misstatements are an important part of the communication required by paragraph 13). (Ref: par. A29)

The Communication Process

Establishing the Communication Process

- 15. The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. (Ref: par. A30–A34)

Confidentiality

- 16. When the auditor communicates matters in accordance with this SAS in writing, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management, and is not intended to be, and should not be, used by anyone other than these specified parties.

Forms of Communication

- 17. The auditor should communicate in writing with those charged with governance significant findings from the audit (see paragraphs 12–14) when, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. (Ref: par. A35–A37)

Timing of Communications

⁵ Circumstances in which the auditor should be informed of such consultations are described in AU section 625, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1).

18. The auditor should communicate with those charged with governance on a sufficiently timely basis to enable those charged with governance to take appropriate action. (Ref: par. A38–A39)

Adequacy of the Communication Process

19. The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should evaluate the effect, if any, on the auditor’s assessment of the risks of material misstatements and ability to obtain sufficient appropriate audit evidence and should take appropriate action. (Ref: par. A40–A42)

Documentation

20. When matters required to be communicated by this SAS have been communicated orally, the auditor should document them, including when and to whom they were communicated.⁶ When matters have been communicated in writing, the auditor should retain a copy of the communication as part of the audit documentation. (Ref: par. A43)

Application and Other Explanatory Material

The Role of Communication (Ref: par. 5)

- A1. This SAS focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting
- 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.
 - 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.

⁶ AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), requires the auditor to document discussions of significant findings or issues with management and others (including those charged with governance) on a timely basis, including responses. AU section 339 also requires that the audit documentation include documentation of the significant findings or issues discussed and when and with whom the discussions took place.

- 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.
- A2.** Although the auditor is responsible for communicating specific matters in accordance with this SAS, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, management’s communication of these matters to those charged with governance does not relieve the auditor of the responsibility to also communicate them. However, communication of these matters by management may affect the form or timing of the auditor’s communication.
- A3.** Clear communication of specific matters required to be communicated by generally accepted auditing standards is an integral part of every audit. However, generally accepted auditing standards do not require the auditor to perform procedures specifically to identify other significant matters to communicate with those charged with governance.

Legal or Regulatory Restrictions on Communicating With Those Charged With Governance (Ref: par. 5)

- A4.** Laws or regulations may restrict the auditor’s communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication or other action that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Those Charged With Governance (Ref: par. 7)

- A5.** Governance structures vary by entity, reflecting influences such as size and ownership characteristics. For example,
- in some entities, those charged with governance hold positions (for example, company directors) that are integral parts of the entity’s legal structure. For other entities, a body that is not part of the entity is charged with governance, as with some government agencies.
 - in some cases, some or all of those charged with governance also have management responsibilities. In others, those charged with governance and management are different people.
- A6.** In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee

of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup, such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities.

- A7.** Such diversity means that it is not possible for this SAS to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances. An example of this is entities in which the governance structures are not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. When the appropriate person(s) with whom to communicate is not clearly identifiable, the auditor and the engaging party may need to discuss and agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.
- A8.** When the entity being audited is a component⁷ of a group,⁸ the appropriate person(s) with whom to communicate is dependent on the nature of the matter to be communicated and the terms of the engagement.

Communication With the Audit Committee or Other Subgroup of Those Charged With Governance (Ref: par. 8)

- A9.** When considering communicating with a subgroup of those charged with governance, the auditor may take into account matters such as
- the respective responsibilities of the subgroup and the governing body.
 - the nature of the matter to be communicated.
 - relevant legal or regulatory requirements.

⁷ *Component* means an entity or business activity for which group or component management prepares financial information that is included, or should be included, in the group financial statements.

⁸ *Group* means all the components whose financial information is included in the group financial statements. A group always has more than one component.

- whether the subgroup (a) has the authority to take action in relation to the information communicated and (b) can provide further information and explanations the auditor may need.
- whether the auditor is aware of potential conflicts of interest between the subgroup and other members of the governing body.

A10. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in the terms of the engagement that the auditor retains the right to communicate directly with the governing body.

A11. Audit committees (or similar subgroups with different names) exist in many entities. Although the specific authority and functions of audit committees may differ, communication with the audit committee, where one exists, is a key element in the auditor's communication with those charged with governance. Good governance principles suggest that

- the auditor has access to the audit committee as necessary.
- the chair of the audit committee and, when relevant, the other members of the audit committee meet with the auditor periodically.
- the audit committee meets with the auditor without management present at least annually.

Matters to Be Communicated

The Auditor's Responsibilities Under Generally Accepted Auditing Standards (Ref: par. 10)

A12. The auditor's responsibilities with regard to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that documents the terms of the engagement. Providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them that

- the auditor is responsible for performing the audit in accordance with generally accepted auditing standards and that the audit is designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement.
- an audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an

opinion on the effectiveness of the entity's internal control over financial reporting.

- the auditor is responsible for communicating significant matters related to the financial statement audit that are, in the auditor's professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. Generally accepted auditing standards do not require the auditor to design procedures for the purpose of identifying other matters to communicate with those charged with governance.
- when applicable, the auditor is also responsible for communicating particular matters required by laws or regulations, by agreement with the entity, or by additional requirements applicable to the engagement.

Independence (Ref: par. 10)

A13. Generally accepted auditing standards require independence for all audits. Relevant matters to consider in reaching a conclusion about independence include circumstances or relationships that create threats to auditor independence and the related safeguards that have been applied to eliminate those threats or reduce them to an acceptable level.⁹

A14. Although the auditor's report affirms the auditor's independence, in certain situations, particularly for public interest entities,¹⁰ the auditor may determine that it is appropriate to communicate with those charged with governance circumstances or relationships (for example, financial interests, business or family relationships, or nonaudit services provided or expected to be provided) that, in the auditor's professional judgment, may reasonably be thought to bear on independence, and that the auditor gave significant consideration to, in reaching the conclusion that independence has not been impaired.

⁹ Comprehensive material on threats to independence and safeguards, including application to specific situations, is set forth in the AICPA's *Conceptual Framework for AICPA Independence Standards*.

¹⁰ In addition to entities subject to Securities and Exchange Commission reporting requirements, the *Conceptual Framework for AICPA Independence Standards* considers the following entities to be *public interest entities*: (1) employee benefit and health and welfare plans subject to Employee Retirement Income Security Act audit requirements; (2) governmental retirement plans; (3) entities or programs (including for-profit entities) subject to Single Audit Act OMB Circular A-133 audit requirements and entities or programs subject to similar program oversight; and (4) financial institutions, credit unions, and insurance companies. These entities are public interest entities because their audited financial statements are (1) directly relied upon by significant numbers of stakeholders to make investment, credit, or similar decisions or (2) indirectly relied upon through regulatory oversight (for example, in the case of pension plans, banks, and insurance companies) and, therefore, the potential extent of harm to the public from an audit failure involving one of these entities would generally be significant.

A15. The form and timing of communications regarding independence may be affected by the entity's governance structure and whether a formal subgroup, such as an audit committee, exists. In situations in which all of those charged with governance are involved in managing the entity, the auditor may determine that those charged with governance have been informed of relevant facts regarding the auditor's independence through their management activities or through other means, such as the engagement letter. This is particularly likely when the entity is owner-managed and the auditor's firm has little involvement with the entity beyond a financial statement audit.

Planned Scope and Timing of the Audit (Ref: par. 11)

A16. Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly when some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable. Certain factors described in paragraph A36 may be relevant in determining the nature and extent of this communication.

A17. Communication regarding the planned scope and timing of the audit may assist

- those charged with governance to understand better the consequences of the auditor's work and to identify any areas in which they may request the auditor to undertake additional procedures;
- those charged with governance to discuss issues of risk and materiality with the auditor, particularly when there is a robust discussion of risks affecting the entity and its financial statements and the auditor's plans to address them; and
- the auditor to understand better the entity and its environment.

A18. Matters communicated may include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error
- The auditor's approach to internal control relevant to the audit including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting
- The application of materiality in the context of an audit, as discussed in AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1)
- If the entity has an internal audit function, the extent to which the auditor will use the work of internal audit and how the external and internal auditors can best work together

A19. Other planning matters that the auditor may consider discussing with those charged with governance include

- the views of those charged with governance about the following matters:
 - 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 believe are relevant to 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 the possibility of fraud.
- the actions of those charged with governance in response to developments in financial reporting, laws, accounting standards, corporate governance practices, and other related matters.
- the actions of those charged with governance in response to previous communications with the auditor.

A20. Although communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor’s sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings From the Audit (Ref: par. 12)

A21. The communication of significant findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged

with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Qualitative Aspects of the Entity's Significant Accounting Practices (Ref: par. 12a)

A22. Generally accepted accounting principles provide for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. Open and constructive communication about qualitative aspects of the entity's significant accounting practices may include comment on the acceptability of significant accounting practices. Appendix A identifies matters that may be included in this communication.

Significant Difficulties Encountered During the Audit (Ref: par. 12b)

A23. Significant difficulties encountered during the audit may include matters such as

- significant delays in management providing required information.
- an 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.
- management's unwillingness to provide information about management's plans for dealing with the adverse effects of the conditions or events that lead the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern.

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

Disagreements With Management (Ref: par. 12c)

A24. Discussions with those charged with governance include any disagreements with management that arose during the audit, regardless of whether they were satisfactorily resolved, about matters that, individually or in the aggregate, could be significant to the entity's financial statements or the auditor's report. Disagreements with management may occasionally arise over, among other things, the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. For purposes of this

SAS, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

Uncorrected Misstatements (Ref. par. 13a and 13b)

A25. When there are a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements rather than the details of each individual uncorrected misstatement.

A26. To reduce the possibility of misunderstandings, the auditor may request a written representation from those charged with governance that explains why uncorrected misstatements brought to their attention have not been corrected. Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Corrected Misstatements (Ref: par. 14a)

A27. The auditor also may communicate corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.

Significant Issues Discussed or Subject to Correspondence With Management (Ref: par. 14b)

A28. Significant issues discussed, or the subject of correspondence, with management may include matters such as

- business conditions affecting the entity and business plans and strategies that may affect the risks of material misstatement.
- discussions or correspondence in connection with the initial or recurring retention of the auditor including, among other matters, any discussions or correspondence regarding the application of accounting principles and auditing standards.

Written Representations (Ref: par. 14d)

A29. The auditor may provide those charged with governance with a copy of management's written representations.

The Communication Process

Establishing the Communication Process (Ref: par. 15)

A30. Clear communication of the auditor’s responsibilities (paragraphs 10 and A12–A15), an overview of the planned scope and timing of the audit (paragraphs 11 and A16–A20), and the expected general content of communications help establish the basis for effective two-way communication.

A31. Matters that may also contribute to effective two-way communication include discussion of

- the purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- the form in which communications will be made.
- the person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.
- the auditor’s expectation that communication will be two-way and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include strategic decisions that may significantly affect (a) the nature, timing, and extent of audit procedures; (b) the suspicion or the detection of fraud; or (c) concerns with the integrity or competence of senior management.
- the process for taking action and reporting back on matters communicated by the auditor.
- the process for taking action and reporting back on matters communicated by those charged with governance.

A32. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor’s view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A42).

Communication With Management

A33. Many matters may be discussed with management in the ordinary course of an audit, including matters to be communicated with those charged with governance in accordance with this SAS. Such discussions recognize management’s executive responsibility for the conduct of the entity’s operations and, in particular, management’s responsibility for preparing the financial statements.

A34. Before communicating matters with those charged with governance, the auditor may discuss them with management unless that is inappropriate. For example, it

may not be appropriate to discuss with management questions of management's competence or integrity. In addition to recognizing management's responsibility, these initial discussions may clarify facts and issues and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Forms of Communication (Ref: par. 17)

A35. Effective communication may involve formal presentations and written reports as well as less formal communications, including discussions. The auditor may communicate matters other than those identified in paragraph 17 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A36. 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 formal or informal manner) may be affected by factors such as

- 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 being audited.
- legal or regulatory requirements that may require a written communication with those charged with governance.
- 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.
- in the case of a special purpose financial statement audit, whether the auditor also audits the entity's general purpose financial statements.

A37. When a significant matter is discussed with an individual member of those charged with governance, such as the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications (Ref: par. 18)

A38. The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter and the action expected to be taken by those charged with governance. The auditor may consider communicating

- planning matters early in the audit engagement and, for an initial engagement, as part of the terms of the engagement.
- significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor in overcoming the difficulties or if the difficulties are likely to lead to a modified opinion.

A39. Other factors that may be relevant to the timing of communications include

- 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, timely communication of a material weakness to enable appropriate remedial action to be taken).
- whether the auditor is auditing both general purpose and special purpose financial statements.

Adequacy of the Communication Process (Ref: par. 19)

A40. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance. Rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include

- the appropriateness and timeliness of actions taken by those charged with governance in response to matters communicated by the auditor. When significant findings or issues raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- the apparent openness of those charged with governance in their communications with the auditor.

- the willingness and capacity of those charged with governance to meet with the auditor without management present.
- the apparent ability of those charged with governance to fully comprehend matters raised by the auditor, such as the extent to which those charged with governance probe issues and question recommendations made to them.
- difficulty in establishing with those charged with governance a mutual understanding of the form, timing, and expected general content of communications.
- where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities as well as their management responsibilities.

A41. As discussed in paragraph A1, effective two-way communication assists both the auditor and those charged with governance. Further, AU section 314 identifies participation by those charged with governance, including their interaction with internal auditors (if any) and external auditors, as an element of the entity's control environment. Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A42. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take actions such as the following:

- Modifying the auditor's opinion on the basis of a scope limitation
- Obtaining legal advice about the consequences of different courses of action
- Communicating with third parties (for example, a regulator) or a higher authority in the governance structure that is outside the entity, such as the owners of a business (for example, shareholders in a general meeting), or the responsible government agency for certain governmental entities
- Withdrawing from the engagement

Documentation (Ref: par. 20)

A43. Documentation of oral communication may include a copy of minutes prepared by the entity as part of the audit documentation if those minutes are an appropriate record of the communication.

Appendix A: Qualitative Aspects of Accounting Practices

A44.

The communication in accordance with paragraph 12a of this SAS and discussed in paragraph A22 may include such matters as the following:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, considering 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 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 material 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 AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), and AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), including the following examples:
 - Management's identification of accounting estimates
 - Management's process for making accounting estimates
 - Risks of material misstatement
 - Indicators of possible management bias
 - 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, 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 and 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 nonrecurring 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)

Appendix B: Amendment to AU Section 550

A45.

This amendment to AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), adds a requirement that the auditor communicate to those charged with governance the auditor's responsibility with respect to other information, any procedures performed relating to the other information, and the results.

Communication With Those Charged With Governance

.08 The auditor should communicate with those charged with governance the auditor's responsibility with respect to other information, any procedures performed relating to the other information, and the results.

Exhibit A: Requirements to Communicate With Those Charged With Governance in Other Statements on Auditing Standards, as Codified

Requirements for the auditor to communicate with those charged with governance are included in other Statements on Auditing Standards (SASs). This SAS does not change the requirements in

- a. paragraph .17 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1).
- b. paragraph .22 of AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1).
- c. paragraphs .22 and .79 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1).
- d. paragraph .20 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1).
- e. paragraph .08 of AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

Exhibit B: Comparison of Requirements of Proposed Statement on Auditing Standards No. 114 (Redrafted), *The Auditor’s Communication With Those Charged With Governance*, With Requirements of International Standard on Auditing 260 (Redrafted), *Communication with Those Charged with Governance*

This analysis was prepared by the Audit and Attest Standards staff to highlight substantive differences between Proposed Statement on Auditing Standards No. 114 (Redrafted), *The Auditor’s Communication With Those Charged With Governance*, with International Standard on Auditing 260 (Redrafted), *Communication with Those Charged with Governance*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board.

The Auditing Standards Board (ASB) has made various changes to the language throughout the proposed Statement on Auditing Standards (SAS), *The Auditor’s Communication With Those Charged With Governance*, as compared with International Standard on Auditing (ISA) 260, *Communication with Those Charged with Governance*, to enhance the readability of the SAS. The changes to the proposed SAS include

- in paragraph 5, the addition of the phrase “in communicating with those charged with governance” relating to the objectives of the auditor.
- in paragraph 6, changes to the language of the definitions of *those charged with governance* and *management*.
- in paragraph 12a, changing the ISA language from “significant qualitative aspects of the entity’s accounting practices” to “qualitative aspects of the entity’s significant accounting practices.”
- in paragraph 17, changing the ISA language from “Written communications need not include all matters that arose during the course of the audit” to “This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved.”
- in paragraph 18, adding the word *sufficiently* to modify *timely* and the phrase *to enable those charged with governance to take appropriate action*.

Such changes are not intended to create differences between the application of ISA 260 and the application of the proposed SAS.

Consistent with requirements in paragraphs 11 and 15–17 of Proposed ISA 450 (Redrafted), *Evaluation of Misstatements Identified during the Audit*, paragraph 13 of the proposed SAS adds a requirement for the auditor to communicate certain matters regarding uncorrected misstatements.

Consistent with SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, Professional Standards, vol. 1, AU sec. 380), paragraphs 14a and 14c of the proposed SAS require, when not all of those charged with governance are involved in managing the entity, the auditor to communicate (1) material, corrected misstatements that were brought to the attention of management as a result of audit procedures and (2) the auditor's views about significant matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultation has occurred. The ISA does not require communication of these matters. The ASB believes that it is important for these matters to be communicated to those charged with governance of nonissuers in the United States.

Consistent with SAS No. 114, paragraph 16 of the proposed SAS requires the auditor, when communicating matters in accordance with the SAS in writing, to indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management and is not intended to be, and should not be, used by anyone other than these specified parties. The ISA does not require this indication.

Paragraphs 13 and 16 of ISA 260 require the auditor to communicate certain matters regarding independence in the case of listed entities. These requirements are not applicable to the audits of nonissuers in the United States and, therefore, are not included in the proposed SAS.