

## AU-C Section 260

# *The Auditor's Communication With Those Charged With Governance*

Source: SAS No. 122; SAS No. 123; SAS No. 125; SAS No. 128.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

### NOTE

In May 2019, the Auditing Standards Board (ASB) issued SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, and SAS No. 135, *Omnibus Statement on Auditing Standards — 2019*, both of which contain amendments to this section. In July 2019, the ASB issued SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, which also contains amendments to this section.

- The amendments in SAS No. 134 are effective for audits of financial statements for periods ending on or after December 15, 2020, and can be viewed in appendix A of section 700 until the effective date, when they will be applied to this section.
- The amendments in SAS No. 135 are effective for audits of financial statements for periods ending on or after December 15, 2020, and can be viewed in appendix B of section 700 until the effective date, when they will be applied to this section.
- The amendments in SAS No. 137 are effective for audits of financial statements for periods ending on or after December 15, 2020, and can be viewed in the appendix of section 720 until the effective date, when they will be applied to this section.

## Introduction

### Scope of This Section

.01 This section addresses the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this section applies regardless of an entity's governance structure or size, particular considerations apply when all of those charged with governance are involved in managing an entity. This section 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.

.02 This section is written in the context 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 fair presentation of the other historical financial information.

.03 Recognizing the importance of effective two-way communication in an audit of financial statements, this section provides an overarching 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 AU-C sections (see the exhibit, "Requirements to Communicate With Those Charged With Governance in Other AU-C Sections"). In addition, section 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes specific requirements regarding the communication of significant deficiencies and material weaknesses in internal control the auditor has identified during the audit to those charged with governance. Further matters not required by generally accepted auditing standards (GAAS) may be required to be communicated by agreement with those charged with governance or management or in accordance with external requirements. Nothing in this section precludes the auditor from communicating any other matters to those charged with governance.

## Effective Date

.04 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

## Objectives

- .05 The objectives of the auditor are to
- a. communicate clearly with those charged with governance the responsibilities of the auditor regarding 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–.A5)

## Definitions

.06 For purposes of GAAS, the following terms have the meanings attributed as follows:

**Management.** The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance; for example, executive members of a governance board or an owner-manager.

**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. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager.

## Requirements

### Those Charged With Governance

.07 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. (Ref: par. .A6–.A9)

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

.08 If 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. .A10–.A12)

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

.09 In some cases, all of those charged with governance are involved in managing the entity; for example, a small business in which a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this section 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 that person's governance role. These matters are noted in paragraph .14. The auditor should, nonetheless, be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

## Matters to Be Communicated

### ***The Auditor's Responsibilities With Regard to the Financial Statement Audit***

.10 The auditor should communicate with those charged with governance the auditor's responsibilities with regard to the financial statement audit, including that (Ref: par. .A13–.A17)

- 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 prepared, in all material respects, in accordance with the applicable financial reporting framework.
- 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. .A18–.A22)

### ***Significant Findings or Issues From the Audit***

.12 The auditor should communicate with those charged with governance (Ref: par. .A23)

- 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 (Ref: par. .A24–.A25)

- i. 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 and
  - ii. determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.
- b. significant difficulties, if any, encountered during the audit. (Ref: par. .A26)
  - c. disagreements with management, if any. (Ref: par. .A28)
  - 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. (Ref: par. .A27)

#### *Uncorrected Misstatements*

**.13** The auditor should communicate with those charged with governance (Ref: par. .A29–.A30)

- a. uncorrected misstatements accumulated by the auditor and the effect that they, individually or in the aggregate, may have on the opinion in the auditor's report. The auditor's communication should identify material uncorrected misstatements individually. The auditor should request that uncorrected misstatements be corrected.
- b. 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

- a. material, corrected misstatements that were brought to the attention of management as a result of audit procedures. (Ref: par. .A31)
- b. significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management. (Ref: par. .A32)
- 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.
- d. written representations the auditor is requesting. (Ref: par. .A33)

## **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. .A34–.A38)

### **Forms of Communication**

.16 The auditor should communicate in writing with those charged with governance significant findings or issues from the audit (see paragraphs .12–.14) if, 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. .A39–.A41)

### **Restricted Use**

.17 When the auditor communicates matters in accordance with this section in writing, the communication is considered a by-product report.<sup>1</sup> Accordingly, 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.

### **Timing of Communications**

.18 The auditor should communicate with those charged with governance on a timely basis. (Ref: par. .A42–.A43)

### **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 misstatement and ability to obtain sufficient appropriate audit evidence and should take appropriate action. (Ref: par. .A44–.A46)

## **Documentation**

.20 When matters required to be communicated by this section have been communicated orally, the auditor should include them in the audit documentation, including when and to whom they were communicated.<sup>2</sup> When matters have been communicated in writing, the auditor should retain a copy of the communication as part of the audit documentation. (Ref: par. .A47)

## **Application and Other Explanatory Material**

### **Objectives**

#### ***The Role of Communication (Ref: par. .05)***

.A1 This section 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.

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<sup>1</sup> Paragraphs .06c and .07 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*. [Footnote amended, effective for the auditor's written communications related to audits of financial statements for periods ending on or after December 15, 2012, by SAS No. 125.]

<sup>2</sup> Paragraphs .08–.12 and .A8 of section 230, *Audit Documentation*.

- 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.
- 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 section, 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 GAAS is an integral part of every audit. However, GAAS 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. .05)*

**.A4** Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, law or regulation 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.

**.A5** In certain circumstances, the auditor may be required to report to a regulatory or enforcement body certain matters that have been communicated with those charged with governance. For example, *Government Auditing Standards* requires auditors to report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to such parties in certain circumstances.

## Those Charged With Governance (Ref: par. .07)

**.A6** 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.
- Parties charged with governance of governmental entities may include members or staff of a legislative oversight committee, oversight bodies, or other parties contracting for the audit.

**.A7** 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, when 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.

**.A8** Such diversity means that it is not possible for this section 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 section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

**.A9** Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, includes specific matters to be communicated by group auditors with those charged with governance.<sup>3</sup> When the entity being audited is a component of a group, 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. .08)**

**.A10** 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.
- whether the subgroup (*a*) has the authority to take action regarding 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.

**.A11** 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.

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<sup>3</sup> Paragraphs .45–.48 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

**.A12** 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, when 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, unless prohibited by law or regulation.

## Matters to Be Communicated

### *The Auditor's Responsibilities With Regard to the Financial Statement Audit (Ref: par. .10)*

**.A13** 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 GAAS and that the audit is designed to obtain reasonable, rather than absolute, assurance about whether the financial statements as a whole are free from 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. GAAS 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 law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement.

### *Independence (Ref: par. .10)*

**.A14** GAAS 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. Comprehensive material on threats to independence and safeguards, including application to specific situations, is set forth in the AICPA's "Conceptual Framework for Independence" (ET sec. 1.210.010). [Revised,

January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.A15** Although the auditor's report affirms the auditor's independence, in certain situations, 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 to which the auditor gave significant consideration, in reaching the conclusion that independence has not been impaired.

**.A16** It may be particularly appropriate to communicate with those charged with governance those circumstances or relationships discussed in paragraph .A15 in audits of public interest entities. In addition to entities subject to Securities and Exchange Commission reporting requirements, all of the entities described in the definition of public interest entities in ET section 0.400, *Definitions*, are considered to be public interest entities.

[Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

**.A17** 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)***

**.A18** 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 .A39 may be relevant in determining the nature and extent of this communication.

**.A19** 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;
- 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; and
- the auditor to understand better the entity and its environment.

**.A20** 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 section 320, *Materiality in Planning and Performing an Audit*
- If the entity has an internal audit function, how the auditor and the internal auditors can work together in a constructive and complementary manner, including any planned use of the work of the internal audit function in obtaining audit evidence and the nature and extent of any planned use of internal auditors to provide direct assistance.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

**.A21** Other planning matters that may be appropriate to discuss 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 as warranting particular attention during the audit and any areas for which 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 law, accounting standards, corporate governance practices, and other related matters.
- the actions of those charged with governance in response to previous communications with the auditor.

**.A22** 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)**

**.A23** 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)*

**.A24** Financial reporting frameworks ordinarily allow 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. The appendix, "Qualitative Aspects of Accounting Practices," identifies matters that may be included in this communication.

**.A25** Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. In communicating with those charged with governance about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates, the auditor may consider communicating

- the nature of significant assumptions,
- the degree of subjectivity involved in the development of the assumptions, and
- the relative materiality of the items being measured to the financial statements as a whole.

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

**.A26** 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.

*Other Findings or Issues*

**.A27** The auditor may become aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement. The communication to those charged with governance that an audit conducted in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements may be necessary if, for example, an entity engages an auditor

to perform an audit of its financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with one or more of the following:

- a. *Government Auditing Standards*
- b. OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*
- c. Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

*Disagreements With Management (Ref: par. .12c)*

**A28** 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 section, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

*Uncorrected Misstatements (Ref: par. .13)*

**A29** The auditor is not required to accumulate misstatements that the auditor believes are trivial.<sup>4</sup> When there are a large number of individually immaterial 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.

**A30** The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, taking into account the size and nature of the misstatement judged in the surrounding circumstances, and possible implications with regard to future financial statements.

*Corrected Misstatements (Ref: par. .14a)*

**A31** 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 Findings or Issues Discussed or Subject to Correspondence With Management (Ref: par. .14b)*

**A32** Significant findings or 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 engagement of the auditor including, among other matters, any discussions or correspondence regarding accounting practices or the application of auditing standards.

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<sup>4</sup> Paragraph .05 of section 450, *Evaluation of Misstatements Identified During the Audit*.

*Written Representations (Ref: par. .14d)*

**.A33** 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)*

**.A34** Clear communication of the following helps establish the basis for effective two-way communication:

- 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)
- The expected general content of communications

**.A35** 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 (a) strategic decisions that may significantly affect 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.

**.A36** 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 .A44).

### *Communication With Management*

**.A37** 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 section. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation and fair presentation of the financial statements.

**.A38** 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 appropriate individuals within the function before communicating with those charged with governance. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

### ***Forms of Communication (Ref: par. .16)***

**.A39** 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 .16 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

**.A40** 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 an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

**.A41** 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)***

**.A42** 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.

**.A43** 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)***

**.A44** 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 about 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.
- when 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.

**.A45** As discussed in paragraph .A1, effective two-way communication assists both the auditor and those charged with governance. Further, section 315 identifies participation by those charged with governance, including their

interaction with the internal audit function (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. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

**.A46** 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 when withdrawal is possible under applicable law or regulation

### **Documentation (Ref: par. .20)**

**.A47** 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.

.A48

## Appendix—Qualitative Aspects of Accounting Practices

The communication required by paragraph .12a and discussed in paragraphs .A24–.A25 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 (when 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 with regard 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 section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, 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)

.A49

## Exhibit—Requirements to Communicate With Those Charged With Governance in Other AU-C Sections

Requirements for the auditor to communicate with those charged with governance are included in other AU-C sections. This section does not change the requirements in

- a. paragraph .17 of section 210, *Terms of Engagement*
- b. paragraphs .21, .38ci, and .39–.41 of section 240, *Consideration of Fraud in a Financial Statement Audit*
- c. paragraphs .14, .18, and .21–.23 of section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- d. paragraph .11 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- e. paragraph .27 of section 550, *Related Parties*
- f. paragraphs .10b–c, .12a, .15a, .17a, and .18 of section 560, *Subsequent Events and Subsequently Discovered Facts*
- g. paragraph .19 of section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- h. paragraphs .45–.48 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
- i. paragraphs .12, .14, .20, and .29 of section 705A, *Modifications to the Opinion in the Independent Auditor's Report*
- j. paragraph .09 of section 706A, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*
- k. paragraphs .08, .12, .15, and .18 of section 720A, *Other Information in Documents Containing Audited Financial Statements*
- l. paragraph .06 of section 730, *Required Supplementary Information*
- m. paragraphs .23–.28 of section 930, *Interim Financial Information*
- n. paragraphs .36–.37 of section 935, *Compliance Audits*

[Revised: September 2012, to reflect conforming changes necessary due to the issuance of SAS No. 126.]

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