

AU Section 380

The Auditor's Communication With Those Charged With Governance

(Supersedes SAS No. 61.)

Source: SAS No. 114.

Effective for audits of financial statements for periods beginning on or after December 15, 2006.

.01 This section establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements.¹ Although this section 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 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 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.

.03 For purposes of this section:

- a. *Those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and 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.
- b. *Management* means 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.

.04 Recognizing the importance of effective two-way communication to the audit, this section provides a framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated with them. Additional matters to be communicated are identified

¹ The provisions of this section 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 section 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.

in other Statements on Auditing Standards (see Appendix A [paragraph .66]). Further matters may be communicated by agreement with those charged with governance or management, or in accordance with external requirements.

.05 The auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.

.06 Clear communication of specific matters in accordance with this section is an integral part of every audit. However, the auditor is not required to perform procedures specifically to identify other significant matters to communicate with those charged with governance.

The Role of Communication

.07 The principal purposes of communication 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 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 relevant to their responsibilities in overseeing the financial reporting process.

.08 This section focuses primarily on communications from the auditor to those charged with governance. However, effective two-way communication is also very important in assisting:

- a. 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.
- b. 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.
- c. 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.

.09 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.

Legal Considerations

.10 In certain circumstances, the auditor may be required to report to a regulatory or enforcement body certain matters communicated with those charged with governance. For example, governmental auditing standards require auditors to report fraud, illegal acts, violations of provisions of contracts or grant

agreements, and abuse directly to parties outside the audited entity in certain circumstances.

.11 In rare circumstances, laws or regulations may prevent the auditor from communicating certain matters with those charged with governance, or others within the entity. 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 such circumstances, it may be appropriate for the auditor to seek legal advice.

Those Charged With Governance

.12 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated.

.13 Governance structures vary by entity, reflecting influences such as size and ownership characteristics. For example:

- In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. For other entities, a body that is not part of the entity may be 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.

.14 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.

.15 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, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, is relevant in deciding with whom to communicate matters.

.16 When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate. When the entity being audited is a component² of a group,³ 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.

² *Component* means a head office, parent, division, branch, subsidiary, joint venture, associated company, equity investee, or other entity whose financial information is or should be included in the consolidated financial statements of a group.

³ *Group* means an entity whose consolidated financial statements include or should include financial information of more than one component.

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

.17 Audit committees (or similar subgroups with different names) exist in many entities. Although their specific authority and functions 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.

.18 The auditor should evaluate whether communication with a subgroup of those charged with governance, such as the audit committee or an individual, adequately fulfills the auditor's responsibility to communicate with those charged with governance. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters 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 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.
- Whether there is also a need to communicate the information, in full or in summary form, to the governing body. This decision may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor retains the right to communicate with the governing body, a fact the auditor may make explicit in the terms of the engagement.

Communication With Management

.19 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 financial statements.

.20 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.

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

.21 In some cases, all of those charged with governance are involved in managing the entity. In these cases, if matters required by this section are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role.

.22 When all of those charged with governance are involved in managing the entity, the auditor should consider whether communication with person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (See paragraphs .12 and .18.)

Matters to Be Communicated

.23 The auditor should communicate with those charged with governance:

- a. The auditor's responsibilities under generally accepted auditing standards (see paragraphs .26 through .28);
- b. An overview of the planned scope and timing of the audit (see paragraphs .29 through .33); and
- c. Significant findings from the audit (see paragraphs .34 through .44).

.24 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.

.25 Nothing in this section precludes the auditor from communicating any other matters to those charged with governance.

The Auditor's Responsibilities Under Generally Accepted Auditing Standards

.26 The auditor should communicate with those charged with governance the auditor's responsibilities under generally accepted auditing standards, 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.

These responsibilities may be communicated through the engagement letter, or other form of contract that records the terms of the engagement, if that letter or contract is provided to those charged with governance.

.27 The auditor may also communicate that:

- a. 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.

- b. 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.
- c. 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.
- d. 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.

.28 Section 550, *Other Information in Documents Containing Audited Financial Statements*, addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon.^[4] If the entity includes other information in documents containing audited financial statements, the auditor should communicate with those charged with governance the auditor's responsibility with respect to such other information, any procedures performed relating to the other information, and the results. [Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

Planned Scope and Timing of the Audit

.29 The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit. However, it is important for the auditor not to compromise the effectiveness of the audit, particularly where 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 .53 may be relevant in determining the nature and extent of this communication.

.30 Communication regarding the planned scope and timing of the audit may:

- a. Assist those charged with governance in understanding better the consequences of the auditor's work for their oversight activities, discussing with the auditor issues of risk and materiality, and identifying any areas in which they may request the auditor to undertake additional procedures; and
- b. Assist the auditor to understand better the entity and its environment.

.31 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.

^[4] [Footnote deleted, December 2010, to reflect conforming changes necessary due to the issuance of SAS Nos. 118–120.]

- The concept of materiality in planning and executing the audit, focusing on the factors considered rather than on specific thresholds or amounts.
 - Where 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.
- .32** Other planning matters that the auditor may consider discussing with those charged with governance include:
- The views of those charged with governance about:
 - 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.
- .33** While communication with those charged with governance may assist the auditor in planning the scope and timing of the audit, it does not change the auditor's sole responsibility to determine 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

- .34** The auditor should communicate with those charged with governance the following matters:
- a. The auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures (see paragraphs .37 and .38).
 - b. Significant difficulties, if any, encountered during the audit (see paragraph .39).
 - c. Uncorrected misstatements, other than those the auditor believes are trivial, if any (see paragraphs .40 and .41).
 - d. Disagreements with management, if any, (see paragraph .42).

- e. 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 oversight of the financial reporting process.

.35 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. The auditor also may communicate other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.
- b. Representations the auditor is requesting from management. The auditor may provide those charged with governance with a copy of management's written representations.
- c. Management's consultations with other accountants (see paragraph .43).
- d. Significant issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management (see paragraph .44).

.36 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

.37 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 B [paragraph .67] provides guidance on the matters that may be included in this communication.

.38 The auditor should explain to those charged with governance why the auditor considers a significant accounting practice not to be appropriate and, when considered necessary, request changes. If requested changes are not made, the auditor should inform those charged with governance that the auditor will consider the effect of this on the financial statements of the current and future years, and on the auditor's report.

Significant Difficulties Encountered During the Audit

.39 The auditor should inform those charged with governance of any significant difficulties encountered in dealing with management related to the performance of the audit. Significant difficulties encountered during the audit may include such matters 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 auditors 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.

Uncorrected Misstatements

.40 Section 312, *Audit Risk and Materiality in Conducting an Audit*, requires the auditor to accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. The auditor should communicate with those charged with governance uncorrected misstatements and the effect that they may have on the opinion in the auditor's report, and request their correction. In communicating the effect that material uncorrected misstatements may have on the opinion in the auditor's report, the auditor should communicate them individually. Where there are a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the misstatements, rather than the details of each individual misstatement.

.41 The auditor should discuss with those charged with governance the implications of a failure to correct known and likely misstatements, if any, considering qualitative as well as quantitative considerations, including possible implications in relation to future financial statements. The auditor should also communicate with those charged with governance 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.

Disagreements With Management

.42 The auditor should discuss with those charged with governance any disagreements with management, whether or not 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.

Management's Consultations With Other Accountants

.43 In some cases, management may decide to consult with other accountants about auditing and accounting matters. When the auditor is aware that such consultation has occurred, the auditor should discuss with those charged with governance his or her views about significant matters that were the subject of such consultation.⁵

⁵ Circumstances in which the auditor should be informed of such consultations are described in paragraph .07 of section 625, *Reports on the Application of Accounting Principles*.

Significant Issues Discussed, or Subject to Correspondence, With Management

.44 The auditor should communicate with those charged with governance any significant issues that were discussed or were the subject of correspondence with management. Significant issues may include such matters 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.

Independence

.45 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.⁶

.46 Although the auditor's report affirms the auditor's independence, in certain situations, particularly for public interest entities,⁷ 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.

.47 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 where 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 where the entity is owner-managed, and the auditor's firm has little involvement with the entity beyond a financial statement audit.

⁶ Comprehensive guidance on threats to independence and safeguards, including application to specific situations, is set forth in the AICPA's *Conceptual Framework for AICPA Independence Standards* [ET section 100-1].

⁷ In addition to entities subject to Securities and Exchange Commission reporting requirements, the *Conceptual Framework for AICPA Independence Standards* [ET section 100-1] 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 directly relied upon by significant numbers of stakeholders to make investment, credit, or similar decisions or 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.

The Communication Process

Establishing a Mutual Understanding

.48 The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. Clear communication of the auditor's responsibilities (paragraphs .26 through .28), an overview of the planned scope and timing of the audit (paragraphs .29 through .33), and the expected general content of communications helps establish the basis for effective two-way communication.

.49 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 the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; or concerns about 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.

.50 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 .60).

Forms of Communication

.51 The auditor should communicate in writing with those charged with governance significant findings from the audit (see paragraphs .34 and .35) 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. Other communications may be oral or in writing.

.52 Effective communication may involve formal presentations and written reports as well as less formal communications, including discussions. Written communications may include an engagement letter that is provided to those charged with governance.

.53 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 such factors 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.

.54 When a significant matter is discussed with an individual member of those charged with governance, for example, 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.

.55 When the auditor communicates matters in accordance with this section 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.

Timing of Communications

.56 The auditor should communicate with those charged with governance on a sufficiently timely basis to enable those charged with governance to take appropriate action.

.57 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 to overcome the difficulties, or if the difficulties are likely to lead to a modified opinion.

.58 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

.59 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 take appropriate action to address the effectiveness of the communication process. (See paragraph .62.)

.60 As discussed in paragraph .08, effective two-way communication assists both the auditor and those charged with governance. Further, section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, identifies participation by those charged with governance, including their interaction with internal audit, 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.

.61 The auditor need not design specific procedures to support the evaluation required by paragraph .59. 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.
- 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 communicated 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.

.62 If, in the auditor's judgment, the two-way communication between the auditor and those charged with governance is not adequate, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements. The auditor should consider the effect, if any, on the auditor's assessment of the risks of material misstatements.

.63 The auditor may discuss the situation with those charged with governance. If the situation cannot be resolved, the auditor may take such actions as:

- 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

.64 When matters required to be communicated by this section have been communicated orally, the auditor should document them.⁸ When matters have been communicated in writing, the auditor should retain a copy of the communication. Documentation of oral communication may include a copy of minutes prepared by the entity if those minutes are an appropriate record of the communication.

Effective Date

.65 This section is effective for audits of financial statements for periods beginning on or after December 15, 2006.

⁸ Section 339, *Audit Documentation*, 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. That section also requires that the audit documentation include documentation of the significant findings or issues discussed, and when and with whom the discussions took place.

Appendix A

Requirements to Communicate With Those Charged With Governance in Other Statements on Auditing Standards

A1. Requirements for the auditor to communicate with those charged with governance are included in other Statements on Auditing Standards. This section does not change the requirements in:

- a. Paragraph .17 of section 317, *Illegal Acts by Clients*, to communicate with the audit committee or others with equivalent authority and responsibility illegal acts that come to the auditor's attention.
- b. Paragraphs .36–.37 of section 801, *Compliance Audits*, for the auditor to communicate (i) in writing to management and those charged with governance identified significant deficiencies and material weakness in internal control over compliance, even in the absence of a governmental audit requirement to report on internal control over compliance; and (ii) to those charged with governance of the entity, the auditor's responsibilities under GAAS, *Government Auditing Standards*, and the governmental audit requirement, an overview of the planned scope and timing of the compliance audit, and significant findings from the compliance audit.
- c. Paragraph .22 of section 316, *Consideration of Fraud in a Financial Statement Audit*, to inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity.
- d. Paragraph .79 of section 316, *Consideration of Fraud in a Financial Statement Audit*, to communicate with those charged with governance fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with those charged with governance about misappropriations perpetrated by lower-level employees.
- e. Paragraph .20 of section 325, *Communicating Internal Control Related Matters Identified in an Audit*, to communicate in writing to management and those charged with governance control deficiencies identified during an audit that upon evaluation are considered significant deficiencies or material weaknesses.

[Revised, December 2010, to reflect conforming changes necessary due to the issuance of SAS No. 117.]

Appendix B

Qualitative Aspects of Accounting Practices

The communication in accordance with paragraph .34a of this section, and discussed in paragraphs .37 and .38, 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 guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in section 342, *Auditing Accounting Estimates*, and section 328, *Auditing Fair Value Measurements and Disclosures*, including, for example:
 - 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.
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