auditors' reports to those charged with governance

relevant to ACCA Qualification Paper P7

crucial audit output

When considering the reporting 'outputs' of an audit of historical financial information, attention is usually focused on the report issued by the auditors to shareholders, which contains the audit opinion. However, there is another important reporting 'output' produced as a result of the audit process – the auditor's communication to those charged with governance. This short article outlines the main features of this communication and summarises the requirements of ISA 260, *Communication of Audit Matters With Those Charged With Governance*, and the UK equivalent, ISA 260 (UK and Ireland), *Communication of Audit Matters With Those Charged With Governance*.

Auditors are required by ISA 260 to communicate audit matters of governance interest to those charged with governance. It is important that those charged with governance have an understanding of all significant issues that have arisen from the audit process.

RELEVANT PERSONS

The first step is to consider to whom the communication should be directed. ISA 260 does not specify this exactly, but states that 'governance is the term used to describe the role of persons entrusted with the supervision, control and direction of an entity'. This implies that the communication should be with the highest level of management, including the executive and non-executive directors, and the audit committee, where relevant. The identity of the relevant person(s) to whom the communication will be addressed may be clarified in the engagement letter.

Matters to be communicated

In the second step, the auditor should consider the type of issues which should be communicated. ISA 260 provides some guidance as to the matters which ordinarily could be incorporated in the communication, including:

- the overall approach and scope of the audit, including any limitations on the scope of the audit
- the accounting policies, and any changes to them, that could materially affect the financial statements
- adjustments arising as a result of audit procedures which could materially impact the financial statements
- material events or uncertainties which could jeopardise the going concern status, and which require disclosure within the financial statements
- disagreements with management over accounting treatments or disclosures
- any expected modifications to the audit report
- material weaknesses discovered in the internal systems and controls.

All of the above are referred to as 'findings from the audit' (also often called 'management letter points').

The reason for communicating such matters is to ensure that the auditors have brought them to the attention of the people responsible for the accounting and financial reporting function of the entity. Those responsible can then discuss the matters and decide any actions that need to be taken in respect of them. For example, if the management of the entity was totally unaware of the matters regarding control weaknesses, it then has the opportunity to implement corrective action. It could also be the case that the management lacks technical knowledge; for example, it may not be appreciated that a specific accounting policy is in breach of acceptable accounting practice. Again, armed with information from the auditor, management can then resolve the problem by deciding on a new accounting policy.

It is important that material errors found in the financial statements are highlighted to management; if they are left uncorrected, the audit opinion will be modified. Management must be made aware of this and given the opportunity to correct the financial statements if necessary, in order to avoid a modified audit report.

Other relevant matters to be communicated

The communication to those charged with governance should not just contain findings from the audit, but should cover the range of issues related to the audit which the auditor may want to raise with management. Such matters may include:

- details of any threats to independence and objectivity, and of any safeguards adopted
- explanations of the audit approach used (for example, the concept of materiality and its application to the audit process)
- a summary of business risks identified, including an assessment of the likelihood of the risks materialising
- a review of the contents of the management's representation letter
- recommendations, where relevant, to help improve the entity's internal systems and controls.

The timing and form of communication

The auditor should communicate matters to those charged with governance on a timely basis, in order for management to react to the matters raised as soon as possible. Findings from the audit relevant to the accounting and financial reporting function should be communicated before the approval of the financial statements by management. This means that material errors can be corrected by management prior to the audit report being issued, thus avoiding a modification of the report.

ISA 260 discusses the various forms that the communication should take. In most cases, the communication will be in writing, and in the UK and Ireland this is a requirement of the standard. A communication should be

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issued even if there are no matters that the auditor wishes to bring to the attention of those charged with governance, stating that there are no significant findings from the audit to be communicated.

Outside the UK and Ireland, the communication could be made orally. In this situation, it is important that the auditor has a written record within the audit working papers of the discussion of significant matters with management.

Whichever method is used to formally communicate the matters, oral or written, the process should be seen as a two-way dialogue. Management should have the opportunity to respond to the auditor regarding the matters raised.

CONCLUSION

The communication with those charged with governance should be viewed as a crucial reporting 'output' of the audit. It allows management to be informed of significant matters arising from the audit process, and allows management the chance to respond to the auditor regarding these matters, and to take action to improve the accounting and financial reporting function of the entity. ■

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