



Sri Lanka Accounting and Auditing Standards Monitoring Board

# **Thematic Inspection on Communication with Those Charged with Governance**

**November 2020**

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) is Sri Lanka's Independent Regulator responsible for monitoring compliance of standards in accounting and auditing in relation to financial statements specified in Act No 15 of 1995.

The function of the Board is to monitor compliance with the Sri Lanka Accounting Standards and the Sri Lanka Auditing Standards in the preparation, presentation and audit of financial statements of specified business enterprises.

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## Director General's Message

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB), being engaged in regulating audits since 2007, is the sole independent audit regulator in the country. SLAASMB is committed to ensure the audit market environment is being strengthened over the years, with compliance with and continuous improvement in the audit processes.

Since the commencement of regulating auditors, SLAASMB has been adopting different regulatory mechanisms to induce compliance with Sri Lanka Auditing Standards by the auditors of economically significant entities. Over the years, these mechanisms have been changed with the aim of improving the overall audit processes and aligning with global best practices. In this process, in 2017, SLAASMB initiated the conduct of Thematic Audit Inspections in Sri Lanka. Thematic audit inspections are generally more focused in scope and consider selected areas in greater depth than in the regular inspections of audit. The findings of this Report are based on the Thematic Inspections conducted during 2018 and this is the third Thematic Inspection Report issued by SLAASMB.

The focused theme in this report, "Communication with Those Charged with Governance (TCWG)", is of great importance in today's context since TCWG are the most influential and knowledgeable source that links the auditor with the auditee entity. Due to the powers vested on TCWG, the contribution of TCWG enables the auditor to communicate relevant and appropriate information to conduct a quality audit and in turn to form a proper opinion on the financial statements.

Accordingly, the auditor needs to have a regular, two-way dialog with TCWG, which should be evidenced by proper documentation. The study of the 19 audits of listed entities which have a mandatory requirement to have Audit Committees, have shed light on different aspects of communication with TCWG.

This Report serves as an educational tool to auditors as it describes the current practices and highlights the good practices as well as the areas to be improved with emphasis on the required improvements. It also acknowledges the auditors who have adopted commendable practices and encourage firms to reach greater heights in quality and serve as a means of guiding the auditors who requires to improve their processes. Further, with this report being shared with listed companies and their Audit Committees, we expect this to be a source which would strengthen the functions of TCWG and in turn the companies, in their path to adopting corporate governance good practices.

On behalf of SLAASMB, I take this opportunity to thank the five (5) audit firms which were subject to the Thematic Inspection during 2018, for their active cooperation, the eighteen (18) Audit Committee representatives who spent their valuable time participating at the discussions with SLAASMB and to the dedicated staff of SLAASMB for the tireless effort put into the planning and conducting of the audit inspections and for analyzing and reporting in particular. Further, I trust that this report will be a useful guide for all auditors including the auditors of tomorrow.

**Anusha Mohotti**  
Director General

6 November 2020



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# 1. Executive Summary

The Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB), the independent audit regulator in the country, inspects individual audit engagements as part of the monitoring process with the intention of contributing to enhance audit quality. As a mechanism of monitoring audit quality, in 2017 SLAASMB introduced 'Thematic Inspections', which focus on a specific aspect of the audit in a greater depth than is generally possible in a regular inspection of an audit.

Based on 2017 thematic inspection findings on 'Communication with Those Charged with Governance (TCWG)', and considering the importance of the effective two-way communication between the auditor and TCWG towards enhancing the capital market development, SLAASMB continued with the theme 'Communication with Those Charged with Governance (TCWG)', for the year 2018.

This report explores the compliance with SLAuS 260, Communication with Those Charged with Governance and SLAuS 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management by the auditors of specified business enterprises (SBEs) based on the inspection of individual audits and the highlights of the discussions had with Audit Committees of each SBE, of which the financial statement audits were subjected to thematic inspections during 2018.

## Key findings from thematic audit inspections

- Auditor's professional judgement of the appropriate persons to be considered as TCWG with consistency in such determination is a key to better two-way communication
- Establishing the communication process at the planning stage, helps to enhance effectiveness of two-way communication
- The entity's governance structure affects the method of communication and matters to be communicated. Accordingly, the method of communication and matters to be communicated are essentially not determined based on firm's policies and procedures
- Engagement letter is used as the main tool to communicate auditor's responsibilities towards the financial statement audit, and separate engagement letters are used for non-audit services

- Meetings, presentations and letters are common methods of communication during different stages of the audit
- Insights from TCWG at such meetings and presentations are useful for effective two-way communication
- Lack of evidence of the two-way communication is a common finding

## Highlights from Audit Committee discussions

- Entity's governance structure and regulatory influence, affect the effectiveness of discharging duties and responsibilities by the Audit Committee
- Audit Committee plays a major role in relation to the appointment of the auditor, determining of audit fee, obtaining non-audit services, and ensuring maintenance of auditor independence
- Active involvement of Audit Committee throughout the audit process and meeting auditors without the presence of the management, is important in minimizing the audit expectation gap
- Audit Committees' chaired by persons with financial acumen effectively contributes in delivering the functions of Audit Committees

Better communication between the auditor and TCWG is an important input in the audit process and is a main component in the process of preparing and presenting audited financial statements. Therefore, the auditors could consider the changes to be made in the firm policies and procedures based on good practices and weaknesses enumerated in this report. Further, the Audit Committee being the main sub-committee responsible in the financial reporting process of a company, could improve the effective discharge of their functions by implementing good practices suggested in this report. Considering the improvements envisaged by adopting the good practices identified during the inspections, SLAASMB as the regulator who monitor compliance with both the accounting standards and the auditing standards, considers the importance of promoting better communication between the auditor - regulator-TCWG in Sri Lanka.

## 2. Preface

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) monitors compliance with Sri Lanka Auditing Standards by the auditors when conducting audits of financial statements of specified business enterprises (SBEs), as part of the monitoring process. In 2017 SLAASMB introduced thematic inspections to supplement its annual programme of regular inspections of individual audits.

Thematic inspections are deliberately narrow in scope, and are chosen to focus on a specific aspect of the audit in a greater depth than is generally possible in regular inspection of audits.

A thematic inspection looks at the application of firms' policies and procedures in respect of a specific area or aspect of the audit, to make comparisons among audit firms with a view of identifying both good practices and areas of common weaknesses.

Previous thematic inspections of SLAASMB were focused on:

- Work of Engagement Quality Control Reviewer - 2017, and
- Communication had with Those Charged with Governance - 2017

Reports on these reviews can be found in <http://slaasmb.gov.lk/observations-found-in-2017/>.

Based on the findings of inspections carried out in 2017, and considering the importance of the effective two-way communication between the auditor and Those Charged with Governance (TCWG) and its contribution towards enhancing the capital market development, SLAASMB decided to continue with the theme 'Communication had with Those Charged with Governance (TCWG)', in the year 2018 as well.

SLAASMB considers these thematic inspections to be of value to audit firms as the findings contribute to develop or enhance the communication with TCWG while contributing to their own processes of continuous improvements to enhance the audit quality. It would also be of interest to Audit Committees, as it enables recognizing the service provided by the individual audit firms and in ensuing better interaction with their auditors in the future.

SLAASMB appreciates the co-operation extended by each audit firm and the staff of such firm during the conduct of the inspections, by providing necessary information, including firm's methodologies and global quality requirements, in relation to the focus area.

This exercise paved way for SLAASMB to meet representatives of Audit Committees and to assess the extent of communications they have had with their auditor in the capacity of TCWG.

SLAASMB is also enthusiastic towards maintaining a smooth interrelationship among the auditor-regulator-TCWG in its future endeavors as well.



## 3. Background and Scope

### 3.1 Background

SLAASMB introduced thematic inspections as an independent exercise of value addition to the regular audit inspections program, in 2017.

A thematic inspection focus on firms' policies and procedures in respect of a specific area or aspect of the audit, by inspecting selected audit engagements of such firm. This facilitates comparisons among firms with a view to identifying both good practices and areas of improvements in relation to the selected theme or specific area.

This report sets out the principal findings of the thematic inspection conducted by SLAASMB during 2018.

The auditor's communication with TCWG is an important 'output' produced in the process of an audit. This consists of different modes of communication, namely meetings, presentations, inquiries and letters etc.

This thematic inspection has considered the auditors' communication with TCWG in the audit of financial statements, at the engagement level.

According to Sri Lanka Auditing Standards (SLAuSs), clear communication of specific matters to relevant parties is an integral part of every audit. Thereby, the auditor is responsible for communicating matters with TCWG on a timely manner, based on their relevance and importance to the financial reporting process.

In recognising the importance of two-way communication in an audit of financial statements, both SLAuS 260 - Communication with Those Charged with Governance and SLAuS 265 - Communicating Deficiencies in Internal Control to Those Charged with Governance and Management, provide an overarching framework for the auditor. Further, such framework identifies some specific matters to be communicated with TCWG by the auditor as well.

While SLAuSs 260 and 265 recognises the importance of the two-way communication in an

audit of financial statements, certain best practices stipulated in the Code of Best Practice on Corporate Governance (Corporate Governance Code) can be considered as good insights to follow by TCWG. It can strengthen the process of having an effective two-way communication with the auditor from the perspective of the entity being audited.

This report intends to foster better communication with TCWG and discussions on how the findings could support in enhancing the audit quality. Further, it supports the implementation of corporate governance best practices in Sri Lanka by listed entities, mainly in relation to Audit Committees.

The objectives that the auditor will achieve by communicating with TCWG during an audit of financial statements are:

- a) To communicate clearly with TCWG the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
- b) To obtain information relevant to the audit from TCWG;
- c) To provide TCWG with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
- d) To promote two-way communication between the auditor and TCWG.

#### **(SLAuS, 260 P 9)**

A Listed Entity is required to comply with Corporate Governance best practices as a continuing listing requirement of the Colombo Stock Exchange (CSE). Corporate Governance Code recognizes the Audit Committee as the main subcommittee of the Board which assists the Board of Directors in fulfilling their oversight responsibility relating to;

- Preparation, presentation and adequacy of disclosures in the financial statements, in accordance with Sri Lanka Accounting Standards; and

- Independence and performance of the company's external audit

For the purpose of evaluating the communication the auditor has with TCWG, to achieve the intended objectives and the application of such requirements in Sri Lanka, SLAASMB inspected a sample of nineteen (19) audit engagements as depicted in Table 1.1 below carried out by five (5) audit firms which performs majority of audits of economically significant listed entities.

<b>Firm</b>	<b>Number of audit engagements</b>
Firm A	5
Firm B	5
Firm C	3
Firm D	3
Firm E	3
<b>Total</b>	<b>19</b>

Table 1.1

As this thematic inspection focus on audit engagements of 19 listed entities, SLAASMB invited the representatives of the Audit Committee of respective companies for discussions to evaluate the effectiveness of two-way communication between the auditor and TCWG. Accordingly, representatives from 18 Audit Committees participated at the discussions with SLAASMB. The Audit Committee that failed to attend the said discussion was of an entity engaged in the hotel industry audited by firm C.

### 3.2 Overview

Communication with TCWG by the auditor varies based on the facts such as the auditor's experience with the auditee, assessed audit risk, nature of the entity, and other regulatory requirements etc. The 19 audit engagements inspected representing 5 audit firms, comprised of different types of communication had with TCWG by the auditors and, different forms of documentation maintained for that purpose.

Auditors can encourage better communication with TCWG, by highlighting the importance of effective interaction between the two parties, in order to

facilitate active involvement of TCWG in the audit of financial statements.

Similarly, auditors can emphasize on the value addition to a company from the external audit, by determining the appropriate levels of TCWG to direct different types of communication.

Out of the 5 audit firms which were subjected to inspection, 3 firms had drawn special attention towards the awareness of TCWG regarding new regulations on financial reporting and auditing which are to be effective in the future. These types of proactive communication helps to improve the overall audit quality.

Auditors can evaluate the effectiveness of firm's policies and procedures which were in effect to meet the requirements of SLAuSs 260 and 265. Continuous improvements to such policies and procedures, and application of them to all the audit engagements supports in uplifting the audit quality of the country.

Communication had with the auditor by TCWG depends on the governance structure of the entity, perception of TCWG about the relationship between the entity's management and the auditor, nature of business and regulatory influence etc.

Entities which essentially adhered to the Corporate Governance Code inevitably achieves an effective two-way communication with their auditor. Further, such entities also receive a value addition through the process of the external audit.

Audit Committees can enhance their involvement in relation to the financial reporting function of the entity, through proper interaction with the external auditor.

The principal findings arising from the inspection of audit engagements are set out in Section 4, an evaluation of the communication had by TCWG with the auditor based on discussions SLAASMB had with the Audit Committee representatives is set out in Section 5 and the detailed suggestions to improve qualitative aspects are set out in Section 6.

## 4. Principal Findings from Inspection of Audit Engagements

### 4.1 Determining Appropriate Persons with whom to Communicate

The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

**(SLAuS 260, P 11)**

Firms have identified the appropriate persons to be considered as TCWG based on their professional judgment and the organizational structure of the audited entity. Therefore, the same firm has identified TCWG at different capacities for different audit engagements conducted by them as depicted in table 2.1. However, in firms A and B, there was a consistency in identification of TCWG for each engagement selected for the inspection.

Firm	Number of Engagements				
	AC only	BD+ Mgt	AC+ BD	Mgt+ AC+ BD	Mgt+ AC
A	5				
B				5	
C	1		2		
D		2		1	
E			2		1
<b>Total</b>	<b>6</b>	<b>2</b>	<b>4</b>	<b>6</b>	<b>1</b>

Table 2.1<sup>1</sup>

<sup>1</sup>AC – Audit Committee

BD – Board of Directors

Mgt - Management

Audit Committee being the appropriate sub group which mainly carries responsibility for supervision of the financial reporting function of an entity. Therefore, communicating with the Audit Committee is a key element in the auditor's communication with TCWG. As reflected in table 2.1, except in 2 audit engagements of firm D, all the auditors have identified Audit Committee as the appropriate level to communicate with, in the capacity of TCWG.

In one of the audit engagements of firm A, the auditor has had communications with the Audit Committee of the ultimate parent company of the entity. This could be an effective way of communication when TCWG of the parent and its components are common, since it enables avoidance of duplication of communication.

However, it was observed that the Chairperson of the Audit Committee of the ultimate parent company was not a member of the Board of Directors of the particular subsidiary company. In such context, the auditor has considered that such arrangement does not impact the effectiveness of the communication, since the said group of companies use to conduct common Board Meetings for all the companies in the group.

### 4.2 Matters to be Communicated

SLAuS 260 identifies following as matters that an auditor is required to communicate with TCWG.

- 1) Auditor's responsibilities in relation to the financial statement audit
- 2) Planned scope and timing of the audit
- 3) Significant findings from the audit
- 4) Auditor independence

Detailed analysis of how these matters have been communicated with TCWG in the audit engagements inspected is given below.

#### 4.2.1 Auditor's Responsibility

The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit.

**(SLAuS 260, P 14)**

Engagement letter has been used by the auditors as the tool to communicate the auditor's responsibility in relation to the audit of financial statements.

All the firms except firm E, have included a separate caption in the engagement letter for the 'other services' notwithstanding the fact that the auditor has provided or not provided services other than the statutory audit services to the same client. This caption of other services, clearly mentions that any services other than the statutory audit and related works specified in the engagement letter, are subject to a separate engagement letter or written agreement. When an agreed upon procedures had been performed by firm E for an auditee in the insurance business to ascertain the compliance with insurance regulation, the said other service had not been referred to in the engagement letter.

In the audits conducted by firm C, when the auditor is required to conduct the audit of the holding company as well as of its subsidiaries, the firm has issued a single engagement letter, clearly distinguishing the names of the holding company and the subsidiary companies, in the same engagement letter.

However, in the engagement letter issued by firm C to a holding company, the names of three subsidiary companies where other component auditors had been involved were also mentioned. Two of such subsidiaries are listed companies audited by other component auditors. This arrangement results in causing firm C to assume inappropriate responsibility.

#### 4.2.2 Scope and Time of Audit

The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit.

**(SLAuS 260, P 15)**

Communication regarding the planned scope and timing of the audit could assist TCWG to understand the purview and the extent of the auditor's work, and the auditor to obtain a better understanding of the entity and its environment.

Therefore, the auditor needs to communicate how he proposes to address the significant risks of material misstatements, whether due to fraud or error, provide the auditor's approach to internal controls relevant to audit and of the application of the concept of materiality.

In addition, the auditor needs to discuss with TCWG, the other planning matters such as matters that require attention of TCWG during the audit, appropriate persons to communicate different types of matters, and actions of TCWG in response to the developments in accounting standards and other applicable regulations.

#### **Methods of Communication**

Based on the audit files, firms have used the following means to communicate the aforesaid matters.

- Except in all audit engagements of firm E and in 2 audit engagements of firm C, all the auditors have presented the audit plan to TCWG as a PowerPoint presentation at the planning meeting had with TCWG.
- In the 2 audit engagements of firm C referred to above, the firm has not presented the audit plan nor has had a meeting with TCWG at the planning stage of the audit.

Following were observed in relation to the above two audit engagements of firm C:

- Firm C has had a meeting with the Managing Director (MD) and Group Chief Financial Officer (GCFO) of one audit engagement to discuss the planned scope and timing of the audit. However, MD is a non-independent executive member of the Board of Directors.

Though, firm C had determined the Audit Committee and Board of Directors as the appropriate persons to be considered as TCWG for the above audit engagement, the above practice fail to serve the objective since none of the independent Directors or any Audit Committee members have attended such meeting.

Based on the auditor's perception, delivering a detailed audit plan to this company had not been necessary since it is a family owned business listed in the Colombo Stock Exchange (CSE).

- As per the verbal explanation by the audit team, for the other audit engagement, firm C has sent the audit plan to the management (i.e. Finance Controller and Assistant Finance Controller), via email and had not made a PowerPoint presentation to TCWG. However, such verbal explanation was not evident from the audit file as no other evidence was available in the e-audit file other than the audit plan attached to the e-audit file.

Firm C had determined the Audit Committee as the appropriate persons to be considered as TCWG in respect of the above audit engagement.

- There was no evidence available in the audit files of firm E, regarding any form of communication had with TCWG to communicate the scope and timing of the audits conducted by them.
- Except in one audit engagement, firm A has made available the meeting minutes summarizing the matters discussed at the PowerPoint presentations in the audit file of each of the other four engagements.

As per the auditor's explanation, reason for the absence of a meeting minute in the audit engagement referred to in the preceding paragraph was due to the fact that TCWG had discussed all matters at the Board Meeting held at the group level. Therefore, a summary of meeting minutes were said to be available in the audit file of the holding company.

- Firm B has submitted a detailed audit plan to TCWG explaining the audit approach, summary of significant risks, communication process, timing of communication, deliverables, and audit time plan etc., for 4 of its audit engagements.

For the audit engagement for which a detailed audit plan had not been submitted, a copy of the PowerPoint presentation regarding the planning matters of the audit had been delivered to the Audit Committee members.

- The aforesaid detailed audit plans and the copy of the PowerPoint presentation have been delivered

to the Audit Committees prior to the presentation dates by firm B.

- Firm D has made available the meeting minutes summarizing the matters discussed at the PowerPoint presentations in the audit file of two engagements. However, such good practice was not evident from the other audit engagement of firm D.

### ***Substance of Communication***

During this inspection, specific focus was also made on the other matters communicated at the planning stage of the audit including materiality, significant risks and insights provided by TCWG.

Based on the observations, except in one audit engagement, firm A had communicated audit materiality details to TCWG at the planning stage of the audits.

In all 5 audit engagements of firm B, details of audit materiality had not been communicated to TCWG. The reason for this was that firm B considers communication of details of materiality to TCWG would possibly facilitate in concealing any errors, misappropriations or frauds by the entity.

Firm C has communicated audit materiality details to TCWG at the planning stage of 2 audit engagements. In one such engagement, materiality details have been communicated in the PowerPoint presentation and has not been included in the audit plan delivered to TCWG. However, in the other audit engagement, materiality details had been communicated in the audit plan sent via email. In relation to the audit engagement where the firm C has had a planning meeting with the Managing Director and Group CFO, evidence of communication of materiality details were not available.

A consistent basis of communicating details of audit materiality could not be identified from the audit files of firm D.

All the auditors have addressed the significant audit risks identified in the audit plan or in the PowerPoint presentations made, other than in one audit engagement of firm A and firm C. However,

firm A informed that they had mentioned significant audit risks at the planning meeting of such audit engagement though it was not included in the PowerPoint presentation.

As discussed under the “Methods of communication” section herein, no evidence was available in the audit files of firm E regarding the method of communication to assess of any of the focused matters in relation to the audits conducted by them.

Further, insights provided by TCWG regarding the planned scope and timing of audits in the audit engagements subjected to this inspection were noted to be few.

### 4.2.3 Significant Findings from Audits

SLAuS 260 requires the auditor to communicate the following with TCWG:

- a) Auditor’s views about significant qualitative aspects of the entity’s accounting practices;
- b) Significant difficulties, if any, encountered during the audit;
- c) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management and written representations requested by the auditor; and
- d) Other matters which are significant to the oversight of the financial reporting process.

#### 4.2.3.1 Communication during the Audit

The communication of 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.

**(SLAuS 260, P A16)**

Our inspections mainly focused on the matters identified by the auditors as significant during the course of the respective audits and communications had with TCWG in relation to such matters.

In an audit engagement of firm A, the auditor had identified that there were events and conditions which cast significant doubt on the entity’s ability to continue as a going concern.

The auditor has obtained management’s plans to address the doubt on going concern and has concluded that use of the going concern assumption was appropriate in the circumstances.

As informed by the auditor during the audit inspection, this has been a regular matter discussed at Board Meetings and at Audit Committee Meetings.

However, SLAASMB observed that the summary of the minutes of the Board Meetings and of Audit Committee Meetings extracted by the auditor had not referred to any discussions in relation to the going concern ability of the entity.

In an audit engagement of firm B, an Interim Issues Memorandum had been issued to communicate the issues identified during the audit. This document had been discussed with the management (Chief Financial Officer and Senior Finance Manager) and their comments had been obtained via email. Any matters which had remained unresolved had been taken into the Summary of Unadjusted Differences and Management Letter, accordingly.

Matters identified during the execution phase of one of the audit engagements of firm D have been communicated to the Chief Financial Officer.

Firm E has discussed issues identified during the audit mainly with the management. Accordingly, as evident from audit files, they have had a progress meeting with Directors and Assistant General Manager (Finance) in one audit engagement, and discussed the audit issues with the management in another audit engagement.

Firm C has not identified significant matters to be discussed with TCWG during the course of the three audit engagements.

#### 4.2.3.2 Communication at the Conclusion Stage

Formal communication with the Audit Committee or Board of Directors at the conclusion stage of the audit was evident only from the audit files of firms A, B and C.

Firm E has had meetings with management at the conclusion stage of 2 audit engagements. They had considered management as appropriate persons to be considered as TCWG in one of those 2 audit engagements. In respect of the other audit engagement, they have verbally informed that the management letter discussion had been held with the Audit Committee. However, the said fact was not evident from the audit file in the absence of a meeting minute or any other corroborative audit evidence.

Communication had with TCWG at the conclusion stage of the audit was not evident in the audit working paper files of all 3 audit engagements carried out by firm D.

When there were no significant matters to be communicated in relation to the items mentioned in (a) to (d) of section 4.2.3, the auditors have used the following forms of communications at the conclusion stage of the audits.

#### **(a) Letters of Representations (LoR)**

The auditor shall communicate with those charged with governance the written representations the auditor is requesting unless all of TCWG are involved in managing the entity.

**(SLAuS 260, P 16 (c) (ii))**

Letters of representations (LoR) signed by representatives of TCWG have been obtained by all the firms, acknowledging management's responsibility for preparation and presentation of the financial statements. This indicates completeness of information provided by the management of the entity including significant accounting policies applied, significant estimates made and assumptions used while ensuring the availability of all relevant disclosures for the purpose of the statutory audit.

In one audit engagement of firm C, LoR had been presented at the Audit Committee meeting. However, such good practice was not evident in any of the other engagements inspected.

#### **(b) Summary of Findings**

- Firm A has used PowerPoint presentations to communicate findings of all 5 audit engagements.

- Firm C has used PowerPoint presentations to communicate the findings in 2 audit engagements and has had a meeting for the other audit engagement.
- Firm B has had meetings to communicate the findings in 3 audit engagements and has had PowerPoint presentations for 2 audit engagements. In one of the audit engagements where firm B has had a meeting with the Audit Committee, a letter on Financial Audit Summary Results had also been delivered to TCWG.

#### **(c) Management Letter**

Either the final management letters issued with management comments or the draft management letters were available in the audit files of all 19 audit engagements inspected.

Accordingly, all the auditors have used the management letter as the means to communicate deficiencies in internal controls as required by SLAuS 265.

#### **(d) Uncorrected Misstatements**

When there were uncorrected misstatements, which are immaterial individually and in aggregate to the financial statements as a whole, auditors had obtained a summary of uncorrected misstatements, from the management as part of the LoR.

#### **4.2.4 Auditor Independence**

The auditor shall communicate in writing with TCWG regarding auditor independence when required by paragraph 17 of SLAuS 260.

**(SLAuS 260, P 20)**

Firms A and D have used the Engagement Letter as the tool to communicate auditor independence in all 5 and 3 audit engagements respectively carried out by them. In addition, they have specifically mentioned about the auditor independence at the PowerPoint presentations made at the planning stage of 2 audit engagements of each of the two firms.

Firm B has issued a separate independence declaration addressed to the Board of Directors of the respective company in all 5 engagements. However, in relation



to group audits, firm B has issued the said declaration to the ultimate parent company instead of issuing to each of the subsidiaries. Firm B had addressed the auditor independence either at the planning or conclusion meetings in 4 of its audit engagements.

Firm C has agreed to issue a statement of auditor's independence in all 3 audit engagement letters. In addition, they have addressed auditor independence at the planning meeting of one of the audit engagements.

Firm E has addressed auditor independence in the engagement letters by agreeing to accompany the audit report with a statement of the existence of any relationship in the company being audited and details of audit and non-audit fees as required by Section 163(3) of the Companies Act. However, copies of such statements were not available in the audit files.

#### 4.3 The Communication Process

The auditor shall communicate with TCWG the form, timing and expected general content of communication.

**(SLAuS 260, P 18)**

Establishing the communication process with TCWG through communication of the form, timing and expected general content of communications, at the planning stage of the audit, could ensure the effective two-way communication.

Accordingly, firms A, B and C have communicated the deliverables of the statutory audit and their form with the expected timelines for such deliverables at the planning meetings with TCWG.

As such when the purpose of communication is clear, the auditor and TCWG are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process. Thereby, the auditor deserves an effective feedback from TCWG.

#### 4.4 Adequacy of Communication

The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose.

**(SLAuS 260, P 22)**

Based on the evidence available in 19 audit engagements inspected, firms A, B, C and D have had formal communications with TCWG. However, the evidence available in relation to firm E was not sufficient to conclude them having effective communication with TCWG in relation to the audits carried out by them.

Based on the summary of the meeting minutes had with the Audit Committee, in one audit engagement of firm B, engagement partner had not participated in the planning meeting with TCWG. Instead, the Engagement Quality Control Reviewer (EQCR) of the prior year audit, who is not the EQCR in the current year audit, has participated at the planning meeting with the Audit Manager. Accordingly, the non-involvement of engagement partner in the communication process hinders the effectiveness of two-way communication.

Auditors' communication with the Audit Committee without the presence of the management was duly evident from only 4 audit engagements of firm A and 2 audit engagements of firm B out of 19 audit engagements inspected. However, conducting of such meetings were not evident from all the audit files of firms C, D and E.

All the auditors have had communications with TCWG regarding the key audit matters (KAM) when the KAM was initially applicable for the audits. However, the audit file of one audit engagement of firm C did not provide evidence of discussing the specific KAMs applicable to the particular engagement as the auditor had only provided a general understanding of the KAMs.

Firms A, B and C have considered new regulations to be effective in the future that would have an impact on financial reporting and auditing such as, new Inland Revenue Act, Sri Lanka Accounting



Standards SLFRSs 9, 15, 16 and 17 etc., as part of their communication with TCWG. Accordingly, they have provided insights to TCWG regarding the way such regulations and standards would impact the entity's financial reporting process.

#### **4.5 Documentation**

Audit documentation in relation to the communication had with TCWG were available in the respective sections/phases of the audit files, based on the timing of communication that had taken place. Further, evidence of such communication were available in both physical and electronic forms.

However, the auditor failing to maintain adequate minutes of the meetings had with TCWG was found to be a common finding.

Majority of documentation provided evidence regarding the information communicated by the auditor to TCWG. However, most of the communication TCWG have had with the auditors were not evident in the audit files. (Eg; insights in relation to the audit, requests for additional work, solutions to problems encountered etc). Therefore, due to this reason, SLAASMB was not in a position to evaluate the adequacy of the two-way communication.

Further, it was noted that a summary of matters discussed at Board Meetings and Audit Committee Meetings etc., had been documented by the auditor. Based on the minutes of such meetings, an evaluation on the effect of such matters on the financial statements and proper link to the relevant working papers where such matters have been addressed, were not properly documented/ presented in the audit files.

Based on the explanation by the auditor, in one audit engagement of firm D, the company has not maintained minutes of the Board meetings and of the Audit Committee meetings. Accordingly, the auditor was unable to extract a summary of matters discussed at the said meetings.

## 5. Insights from Discussions with Audit Committees

In fulfilling the purposes of Audit Committees in relation to preparation and presentation of audited financial statements, Corporate Governance Code identifies the following duties and responsibilities of the Audit Committee;

- To make recommendations to the Board, pertaining to appointment, re-appointment and removal of external auditors and to approve the remuneration and terms of engagement of the external auditors
- To develop and implement policy on the engagement of the external auditor to supply non-audit services
- To review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration the relevant Sri Lankan professional and regulatory requirements
- To discuss the audit plan, key audit issues, their resolution and management responses
- To review the company's annual audited financial statements and quarterly financial statements with management and the auditor
- To review significant financial reporting judgements
- To hold meetings separately, periodically, with the management, auditors and internal auditors

These responsibilities can be considered to coincide with the requirements of SLAuSs 260 and 265. Therefore, SLAASMB mainly focused on discharging the above responsibilities by the Audit Committees of the respective companies of which audit engagements were selected for this inspection. During the discussions had with seventeen (17) representatives of Audit Committees, SLAASMB focused on the above responsibilities and obtained their responses on how they had been involved in or addressed such responsibilities. Of the representatives one person represented two separate audit engagements selected for inspections.

### 5.1 Appointment of Auditors and Approval of their Remuneration and Terms of Engagement

Most of the auditors of the selected sample of companies had been reappointed by the respective entity for a number of years with rotation of engagement partners after a certain number of years. Therefore, during these discussions, involvement of Audit Committees in the appointment of auditors could be ascertained only in respect of two entities. Those two entities had followed a formal process to appoint the incoming auditors.

When the same auditor has been continuing for a number of years, the Audit Committees have not been considered the importance of their involvement in the re-appointment of auditors' for the ensuing year due to familiarity and confidence placed on the audit firm.

Except in one entity audited by firm B, Letters of Engagement of other entities have been presented to the respective Audit Committees. Audit Committees of sixteen (16) entities selected for this thematic inspection have been noted to have adopted the practice of reviewing the terms of the audit engagement letter. Therefore, it indicates that Audit Committees are aware of the terms specified in the Letters of Engagement.

The discussions had with Audit Committees revealed that Audit Committees approve the audit fees for a particular year consequent to incorporating a reasonable increment in comparison with that of the previous year. However, there was no strong evidence of the Audit Committees paying adequate attention to the resources (i.e. time, skills, level of experience etc.) allocation by the auditors, when approving the auditor's remuneration.

Based on the discussions, less than five Audit Committees have had concerns about the composition of the audit teams. However, the importance for Audit Committees to be aware about the sufficiency of resources (i.e. manpower and others such as information technology, expert knowledge) allocated for the audit and alertness on whether the auditors allocate a reasonable time on the audit was observed to be needing more focus.

Audit Committee representative of an insurance company audited by firm A highlighted the importance of the auditors to have competent staff who possess specialized knowledge of industries such as insurance, bank, and plantation and of the long term continuity of such staff who would contribute to increase the effectiveness of the audit process. In the above context, he highlighted the necessity of paying a sufficient audit fee to compensate for the engagement of such skills.

## **5.2 Development and Implementation of a Policy on the Engagement of the External Auditor to Supply Non-audit Services**

During the inspection of audit files it was observed that in most instances the statutory auditor provides other services. A few of the Audit Committee representatives were able to explain about such other services provided by the statutory auditor. However, representatives of the Audit Committees of certain companies were not aware of the other services provided by the auditor when in fact such services were being provided.

One of the finance companies audited by firm B, had implemented the good practice of obtaining Audit Committee recommendation in relation to the other services provided by the auditor.

## **5.3 Reviewing and Monitoring the External Auditor's Independence, Objectivity and the Effectiveness of the Audit Process**

Based on the responses received, there was no evidence of TCWG paying necessary attention

towards auditor's independence and objectivity when appointing the auditor to obtain services other than the statutory audit. Further, availability of pre-determined benchmarks/ indicators to evaluate the effectiveness of the audit process was not evident from any of the entities inspected.

TCWG were of a common view that the reputation of the auditor could inherently factor the quality and effectiveness to the audit. Based on the discussions it was indicated that notwithstanding different levels of interaction and involvement the auditor has had with Audit Committees, the majority of the Audit Committees were satisfied with the services provided by their current auditors.

Audit Committee representative of an entity audited by firm E had concerns regarding the accessibility to interact with the audit Engagement Partner. Based on the said concern, TCWG recognized the importance of direct involvement of the engagement partner with TCWG rather than communicating matters through the other engagement team members.

## **5.4 Discussion of the Audit Plan, Key Audit Issues, their Resolution and Management Responses**

Except for two audit engagements of firm E and one audit engagement of firm C, the auditors have discussed the audit plan with Audit Committees either as a PowerPoint presentation or during a meeting. Representatives of Audit Committees were pleased about such presentations or meetings and the matters addressed at such discussions. However, only very few Audit Committees had provided their insights to the auditor.

The audit engagement of firm C, in which the audit plan had not been discussed, is a family owned group of companies. The aforesaid information revealed from the discussion had with the Audit Committee chairperson aligns with the principal findings under "Methods of Communication" reported in section 4.2.2 above.

### 5.5 Meeting Auditors Separately, Periodically

Audit Committees of regulated entities have had periodical meetings with the external auditors without the presence of the management. However, the duration of such meetings had been very short as observed during these discussions which can be witnessed from the audit files. Accordingly, the main objectives of conducting such a meeting which includes identifying scope limitations imposed by management and evaluating management capabilities etc could not be achieved. As such it was noted as being a mere compliance with the requirement of the Corporate Governance Code.

Audit Committee representative of one of the entities audited by firm D admitted the fact that the company did not conduct proper Audit Committee meetings. This was observed to be a family owned group of companies.

Audit Committee representative of an insurance company audited by firm A informed that the Senior Partner of the firm used to have a meeting with the Audit Committee to obtain feedback about the quality of audit services provided and to discuss any suggestions for improvements. This is a good practice for other auditors to follow since it enables to enhance their audit quality while extending the two-way communication (between the audit engagement team and TCWG) from engagement team level up to firm level.

### 5.6 Reviewing Annual Audited Financial Statements and Quarterly Financial Statements with Management and the Auditor

In an audit engagement of firm C, the Audit Committee had reviewed the quarterly financial statements with the auditor. This is a good practice to be followed by the other entities as well, since it enhances transparency of the financial reporting while improving the auditor's understanding of the entity.

Annual audited financial statements of all the entities had been presented to the Audit Committees for approval at the conclusion meetings held between the Auditor and the Audit Committee.

Based on SLAASMB's findings, the effectiveness of the Audit Committee mainly depends on the governance structure of the entity. It was also found that when a particular entity is engaged in a business which is regulated through an industry specific regulator, the Audit Committees of such entities are conversant with the concerns referred to in 5.1 to 5.6 above compared with the awareness of the Audit Committees of other entities.

Further, SLAASMB observed that in certain audit engagements, the Audit Committees had failed to discharge their responsibilities effectively due to the lack of understanding of Audit Committee's responsibilities, low commitment or lack of sufficient skills of the Audit Committee members.

During the audit inspections as well as during the discussions had with Audit Committees, it was revealed that there were three entities which belonged to groups of companies owned by reputed business families which were lacking in adopting good governance practices. In two of such companies, (though not belonging to the same family), the same Audit Committee representative was identified as being the chairman of the Audit Committee.

Audit Committees chaired by a person with financial acumen were found to be more effective in addressing the concerns referred to in 5.1 to 5.6 above compared with the experts from other fields. However, it was noted that some of the representatives from non-financial backgrounds were more enthusiastic in studying and commenting on financial matters than their counterpart financial experts.

## 6. Way Forward

Maintaining audit quality of individual audit engagements results in enhancing the audit quality environment. This in turn cause to enhance reliability of the financial reporting of the country. Accordingly, audit quality plays a key role in enhancing stakeholder confidence in stewardship function vested on the management. In furthering this need, better communication between the auditor and TCWG can be identified as an important input in the audit process and as a main component in the process of preparation and presentation of audited financial statements.

Based on the principal findings discussed in Section 4 of this report, SLAASMB identified following good practices which can be implemented or improved at the firm level.

- Auditor could revisit the firm policies and procedures in relation to identification of TCWG, based on the nature of the business, organization structure, and specifically identified legal responsibilities of TCWG etc. Auditor could maintain consistency in identification of TCWG in respect of each audit engagement.
- Auditor should promote a better communication with TCWG during the planning stage of the audit to minimize the audit risk, notwithstanding the ownership structure, management philosophies, and auditor's experience about the audit client etc.
- Auditor needs to ensure effective involvement of persons in the engagement team when communicating with TCWG to enhance the effectiveness of two-way communication.
- Auditor could establish the communication process with TCWG in advance by sharing certain documents (such as meeting agenda, audit plan, summarized technical papers etc.) and encourage active involvement of TCWG, specially the Audit Committee.
- Auditor should evaluate the effects of the matters discussed at the Board Meetings and Audit Committee Meetings etc., to both the financial statements and the auditor's risk assessment.
- Auditor should evaluate the effectiveness of the two-way communication had with TCWG on the significant findings at all stages of the audit and produce clear documentation of the same.
- Auditor should ensure that all members of TCWG are aware of the written representations the auditor has requested from the management in relation to the significant findings of the audit.
- Auditor should take appropriate actions when communication with TCWG is ineffective.
- Auditor could communicate the lapses observed in the maintenance of secretarial documents by the entity audited, through their management letter.
- Auditor could implement a process to minimize the audit expectation gap of TCWG through proper interaction with TCWG. Measures such as obtaining feedback of TCWG regarding their perception about the audit quality of the firm as well as about the engagement team members, their suggestions for future improvements and expectations from the auditor will result in minimizing the audit expectation gap.

Based on the information gathered from the discussions had with the representatives of Audit Committees, as detailed in Section 5 of this report, SLAASMB identified certain good practices which could improve the effective contribution of TCWG, specially at Audit Committee level of entities. They are as follows.

- Understanding the importance of the Audit Committee in the financial reporting process of the entity.
- Appointing an individual with financial acumen as the chairperson of the Audit Committee as it is more effective than appointing an expert from another field. Otherwise, ensuring the knowledge and skills of financial experts in the Audit Committee are effectively utilized.
- Understanding the value of effective two-way communication to obtain a value added service from the auditor and to take measures to enhance the communication with the auditor.
- Systematically discharging the duties and responsibilities of Audit Committees as per the Corporate Governance Code, as it automatically enables achievement of effective two-way communication. Therefore, allocation of sufficient time, continuous learning and development and educating other board members, results in positively contributing towards effective two-way communication.
- Instead of the Audit Committee delegating work to management or relying on management's feedback, active involvement in the process of financial reporting and auditing of the entity, enhances the quality of the financial reporting process.

## 7. Conclusion

The thematic audit inspections carried out by SLAASMB focusing on communication with TCWG during the years 2017 and 2018, revealed that the level of communication between the auditor and TCWG could be further improved in Sri Lanka.

Certain observations noted during audit inspections of the year 2017 were repetitively noted in 2018 as well. Non-availability of proper documentation, failing to conduct a proper communication process, lack of support from TCWG are few of such drawbacks. Further, some improvements were noted from audit files of firms A and B in terms of documentation of board minute summaries and linking to the audit working papers.

Auditors can take remedial actions for any common weaknesses referred to in this report in their future audits. Further, they can also apprise the board members of each and every company which they audit, regarding the auditor's role and of the role of TCWG in the process of auditing the financial statements of the company.

From the discussions had with the representatives of Audit Committees, SLAASMB observed that awareness among Audit Committees of their importance to the financial reporting process is not satisfactory. As a result, the time and the effort devoted towards discharging the duties and responsibilities of the Audit Committees were very minimal. However, the members of Audit Committees possess sufficient skills such as knowledge, experience, expertise to deliver better prospects to the listed entities in Sri Lanka.

Audit Committees can play a major role in further improving the communication between the auditor and TCWG in Sri Lanka. They have to be more involved in the financial reporting process including the audit, to safeguard the assets of the entity, on behalf of its stakeholders.

Based on the observations made through these two thematic inspections conducted in 2017 and 2018, focusing on communication with TCWG, SLAASMB intends to take measures to promote a better communication between the auditor and TCWG as well as communication between the auditor – regulator – TCWG. In this regard, SLAASMB welcomes any suggestions from the audit firms selected for these inspections based on the comments made by SLAASMB in this report and the report published in 2018 on the inspection findings of 2017.

