



Sri Lanka Accounting and Auditing Standards Monitoring Board

Thematic Inspection on Communication with Those Charged with Governance

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1. Background and Scope

1.1 Background

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) introduced thematic inspections, in addition to the routine audit inspection program, in 2017.

The aim of a thematic inspection is to focus at firms' policies and procedures in respect of a specific area or aspect of the audit, by inspecting selected audit engagements of such firm. This enables comparisons among firms with a view to identifying both good practices and areas of common weaknesses in relation to the selected theme or specific area.

The thematic inspections are narrow in scope by nature, and are chosen to focus on an aspect of the audit of a firm's procedures in greater depth than is generally possible in the normal inspections of audits.

This report sets out the principal findings of the second thematic inspection undertaken by the SLAASMB in 2017.

The auditor's communication with TCWG is an important 'output' produced from an audit process.

Accordingly, the second thematic inspection considered the auditor's communication with Those Charged with Governance (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 recognizing the importance of two-way communication in an audit of financial statements, SLAuS 260 - Communication with Those Charged with Governance and SLAuS 265 - Communicating Deficiencies in Internal Control to Those Charged with Governance provide an overarching framework for the auditor. Such framework also identifies some specific matters to be communicated with TCWG.

This report intends to foster better communication with TCWG and discusses how this can support to enhance the audit quality.

The objectives that the auditor will achieve by communicating with TCWG during an audit of financial statement 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)

For the purpose of evaluating the communication the auditor had with

TCWG to achieve the intended objectives and the application of such requirements in Sri Lanka, SLAASMB inspected a sample of fifteen (15) audit engagements carried out by six (6) firms that perform majority of audits of economically significant listed entities as depicted in Table 1.1 below:

Firm	Number of audit engagements
Firm A	3
Firm B	3
Firm C	3
Firm D	3
Firm E	1
Firm F	2
Total	15

Table 1.1

1.2 Overview

Communication with TCWG 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 15 audit engagements inspected representing 6 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 promote communication with TCWG, by highlighting the importance of good interaction between 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 6 firms that were subjected to inspection, 3 audit firms had drawn special attention to 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 help to improve the overall audit quality.

The principal findings arising from the inspection are set out in Section 2 and the detailed suggestions to improving qualitative aspects are set out in Section 3 of the report.

2. Principal Findings

2.1 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 organization structure of the audited entity. Therefore, the same firm has identified TCWG at different capacities for different audit engagements conducted by them as depicted by following table.

Firm	Number of Engagements			
	AC only	BODs only	AC+ BOD	Mgt +AC+ BOD
A			1	2
B	2	1		
C	1	1	1	
D	1			2
E	1			
F	1		1	
Total	6	2	3	4

Table 2.1¹

Audit Committee being the appropriate sub group mainly responsible for supervision of the financial reporting function of an entity, communicating with

¹ AC – Audit Committee
BOD – Board of Directors
Mgt - Management

the Audit Committee is a key element in the auditor's communication with TCWG. As reflected from the above table, except in one audit in each of firms B and C, the auditor has identified Audit Committee as the appropriate level to communicate with, in the capacity of TCWG.

2.2 Matters to be Communicated

SLAuS 260 identifies following as the 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 in the audit engagements inspected is given below.

2.2.1 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.

When the auditor has provided services other than the statutory audit services to the same client, such facts were clearly differentiated in the engagement letters. However, it was observed that taxation services provided separately by firm E had

not been mentioned in the engagement letter under the caption ‘other services’.

When the auditor was required to conduct the audit of a holding company as well as of its subsidiaries, firm C has issued a single engagement letter, clearly distinguishing the names of the holding company and the subsidiary companies in the same engagement letter.

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. These indicate 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.

2.2.2 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 shall assist TCWG to understand the consequences of the auditor’s work, and the auditor to obtain a better understanding of the entity and its environment.

Therefore, the auditor shall communicate how he proposes to address the significant risks of material misstatements, whether due to fraud or error, auditor’s approach to

internal control relevant to audit, and application of the concept of materiality.

In addition, auditor shall discuss with TCWG, on 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 developments in accounting standards and other applicable regulations.

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

- Firm A has sent a detailed audit plan explaining the audit approach, summary of significant risks, communication process, timing of communication, deliverables, audit time plan etc., for all 3 audit engagements.
- Firm B has communicated only by making PowerPoint presentations to TCWG in all 3 audit engagements.

Respective audit files contained PDF version of the said presentations. However, the slides contained only a summary of points that were discussed at the planning meeting. Accordingly, the auditor has not been able to demonstrate the extent and level of effectiveness of the communication had with TCWG.

- Firm C has conducted PowerPoint presentations while providing detailed audit plans for all 3 audit engagements. Audit plan provided details of the deliverables of the financial statement audit, approach to

audit, risks identified by the auditor, audit scope for each business process, and audit approach, etc.

- Firm D has had a meeting with the Audit Committee in one audit engagement carried out by them and they have had communications only with management regarding the audit plan in the other two audit engagements. In one instance, TCWG had not been co-operative to have a planning meeting, despite several requests made by the auditor.
- No evidence were available in the audit files of firms E and F regarding any form of communication they have had with TCWG to communicate the scope and timing of audits.

2.2.3 Significant Findings from the Audit

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
- d) Other matters which are significant to the oversight of the financial reporting process.

2.2.3.1 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 B, the auditor had identified an issue relevant to significant qualitative aspects of the entity's accounting practices, in relation to assumptions made in estimating the allowance for impairment for customers in default, and had communicated the same to TCWG.

The auditor had relied upon the explanation/ information provided by the entity in response to the query raised by the auditor, without obtaining further audit evidence to validate such response.

However, SLAASMB observed the basis of conclusion provided by TCWG to be not appropriate. In this instance, the said observation was communicated by SLAASMB to the relevant company as well.

2.2.3.2 Communication at the Conclusion Stage

When there were no significant matters to be communicated in relation to the items mentioned in (a) to (d) of section 2.2.3, the auditors have used the following forms of communications at the conclusion stage of the audits.

Summary of Findings

- Firm A has sent a summary of findings of the audits in the form of a letter (in all 3 audit engagements).
- Firm B had conducted meetings to communicate the findings in 2 audit engagements and had a PowerPoint presentation for the other audit engagement.
- Firm C has used both PowerPoint presentations and letters to communicate issues.
- Firm D had conducted meetings for 2 audit engagements while conducting a PowerPoint presentation for one of such audit engagements. In the other audit engagement no evidence was available regarding the communication had with TCWG at the conclusion stage of the audit.
- Communication had with TCWG at the conclusion stage of the audit was not evident in the audit working paper files of audit engagements carried out by firms E and F.

Management Letter

The audit files of 13 audit engagements inspected, except for 2 audit engagements of firm B, included the final management letters issued with management comments or draft management letters. In the 2 audit

engagements of firm B, the management letters were not available for verification at the time of the inspection of the audit working paper file.

When deficiencies in internal controls were identified by the auditor, all the auditors have used the management letter as the means to communicate such deficiencies complying with SLAuS 265.

Uncorrected Misstatements

When there had been unadjusted misstatements which were identified during the audit, auditors had obtained a summary of uncorrected misstatements which are immaterial individually and in aggregate to the financial statements as a whole. They had attached the said summary as part of the letter of representation (LOR).

However, in two audit engagements carried out by firm D, the summary of uncorrected misstatements attached to the LOR was different from the audit working papers prepared by the auditor to evaluate the effect of such uncorrected misstatements.

2.2.4 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)

In 2 audit files of firm A and 1 audit file of firm C, separate independence declarations had been issued by the auditor to the Board of Directors of the company.

2.3 Adequacy of Communication

Based on the evidence available in 15 audit engagements inspected, firms A, B, C and D have had formal communications with TCWG. However, the evidence available in relation to firms E and F was not sufficient to conclude that they have had effective communication with TCWG in relation to the audits carried out by them.

As explained by firm D, in one instance, they have had communication only with the management due to lack of co-operation by the TCWG of the said engagement. In such a situation, the auditor should have evaluated whether the two-way communication between the auditor and TCWG is adequate for the purpose of the audit. If it is not, the auditor should have taken appropriate action to make the communication process effective.

Firms A, B and C have considered new regulations on financial reporting and auditing to be effective in the future such as, new auditor's report, Non Compliance with Laws and Regulations (NOCLAR), Sri Lanka Accounting Standards SLFRSs 9, 15 and 16 etc., as part of their communication with TCWG. Accordingly, they have provided insights to TCWG regarding how such regulations and standards would impact the entity.

2.4 Documentation

Audit documentation in relation to the communication had with TCWG were available in the respective sections/phases of the audit file, based on the timing of communication that had taken place.

Further, evidence of such communication were available in both physical and electronic forms.

Failure by the auditor to maintain adequate minutes of the meetings with TCWG was observed as a common finding.

Majority of the documentation provided evidence regarding the information communicated by the auditor to TCWG. However, most of the communications 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). Due to this reason, SLAASMB was unable to evaluate the adequacy of the two-way communication.

A summary of matters discussed at Board Meetings and Audit Committee Meetings etc., have been documented by the auditor. Based on the minutes of such meetings, an evaluation on the effect of such matters to 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.

3. Way Forward

comments received from appropriate levels of TCWG.

- Auditor could encourage active involvement of TCWG, specially the Audit Committee, through effective communication with them.

Following are some of the areas the auditor could obtain insights from TCWG.

- Inputs to the risk assessment performed by the auditor.
 - Understanding the entity and environment
 - Significant audit issues from the perspective of TCWG.
- Auditor needs to evaluate the effect of the matters being discussed at the Board Meetings and Audit Committee Meetings etc., to the financial statements and to the auditor's risk assessment.
 - Auditor needs to 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 needs to take appropriate action when the communication with TCWG is ineffective.
 - The audit file should include the finalised management letter (i.e including internal control deficiency letter) communicated to TCWG on a timely basis, together with the

4. Plan for 2018

Based on the findings during the 2017 inspections, considering the importance of the effective two-way communication between the auditor and TCWG and its contribution towards enhancing the capital market development, SLAASMB has decided to continue the thematic inspection on the theme ‘Communication with TCWG’ for the year 2018 as well.

Accordingly, 19 audit engagements of 5 firms that audit the majority number of economically significant listed companies will be subjected to inspection this year.

Such inspections will mainly focus on the application of requirements of SLAuS 260 and 265 across industries of banking, finance, insurance and other listed entities by different audit firms.

Further, as a part of this exercise, SLAASMB plans to seek feedback of the Audit Committee chairs of the auditee, regarding the timeliness and effectiveness of the two-way communication between the auditor and TCWG in relation to the aforesaid audit engagements.