

PKF PERSPECTIVES

STATEMENT ON AUDITING STANDARDS NO. 114 The Auditor's Communication with Those Charged with Governance

In December 2006, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards (SAS) No. 114, *The Auditor's Communication with Those Charged with Governance*. It is effective for the audits of financial statements for periods beginning on or after December 15, 2006. For calendar year-end entities, this means for the December 31, 2007 year-end audit.

SAS No. 114, which supercedes SAS No. 61, is applicable to privately-held (non-issuer) entities and is intended to provide a framework for effective communication between the auditor and client in relation to the audit of financial statements.

The following are some of the key elements of this new auditing standard.

Governance

"Those charged with governance" refers to the person or persons responsible for the strategic direction of the entity and the obligations relative to the accountability of such entity, including oversight of the financial reporting process. For entities with a board of directors, the term generally encompasses the board or the audit committee.

The SAS defines "management" as the person or person(s) responsible for achieving the objectives of the entity, with the authority to establish policies and make decisions by which those objectives are to be pursued, and who are responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

The auditor is required to communicate with those charged with governance those 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.

Because governance structures vary by entity, the auditor should determine the appropriate person(s) within the governance structure with whom to communicate. The appropriate person(s) may differ depending on the matter to be communicated. When the appropriate person(s) is not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the governance structure with whom to communicate.

Matters to be Communicated

The auditor should communicate with those charged with governance the following matters:

The auditor's responsibility under generally accepted auditing standards (GAAS)

This includes:

- ▣ The auditor's responsibility for forming and expressing an opinion on 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.
- ▣ The audit does not relieve management or those charged with governance of their responsibilities.

The auditor may communicate these responsibilities through the engagement letter or other form of contract that records the terms of engagement.

Planned scope and timing of the audit

The auditor should communicate an overview of the planned scope and timing of the audit, without compromising the effectiveness of the audit by, for example, communicating the nature and timing of detailed audit procedures.

This communication may, but is not required to, include how the auditor proposes to address significant risks of material misstatement, approach to internal control relevant to the audit, the concept of materiality and the extent to which the auditor will use the work of the entity's internal audit department, if any.

Significant findings from the audit

The following matters should be communicated by the auditor to those charged with governance:

- ▣ The auditor's views about the qualitative aspects of the entity's significant accounting practices, including accounting policies and estimates, and financial statement disclosures.
- ▣ Significant difficulties, if any, encountered during the audit.
- ▣ Uncorrected misstatements, other than those the auditor believes are trivial, if any.
- ▣ Disagreements with management, if any.
- ▣ Other findings or issues, if any, arising from the audit, that are, in the auditor's judgment, significant and relevant to those charged with governance with respect to their oversight of the financial reporting process.

Further, if all individuals charged with governance are not also involved in managing the entity, the auditor should in addition communicate:

- ▣ Material, corrected misstatements that were brought to management's attention as a result of audit procedures.
- ▣ Representations the auditor is requesting from management.
- ▣ Management consultations with other accountants, if any.

- ▣ Significant issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management.

Timing and Form of Communication

The appropriate timing of communications with those charged with governance will vary with the circumstances of the engagement. The significance and nature of the matter requires the auditor to communicate on a sufficiently timely basis to enable those charged with governance to take appropriate action.

The auditor should communicate in writing significant findings from the audit, when in the auditor's judgment, oral communication would not be adequate. Other communications may be oral or in writing and affected by such factors as: whether the matter has been satisfactorily resolved, whether management has previously communicated the matter, etc.

Although SAS No. 114 focuses primarily on communications from the auditor to those charged with governance, it recognizes the importance of effective **two-way** communication between those charged with governance and the auditor. Those charged with governance can assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, in providing information on specific transactions, etc. Further, SAS No. 114 does not relieve management of its responsibility to communicate matters of governance to those charged with governance.

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PKF

**Certified Public Accountants
A Professional Corporation**

29 Broadway ♦ New York, NY 10006
Telephone: (212) 867-8000 ♦ Telefax: (212) 687-4346
www.pkfnewyork.com ♦ E-mail: info@pkfnyc.com

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