Communication with TCWG (Those Charged with Governance): SA 260 and SA 265

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Ice-breaking Questions

When you audit, who do you usually talk to first, the Accountant, the Owner, or the Board?

If you find a mistake in accounts, who should you inform, the persons who made it or the people who oversee them?

If the same mistake keeps happening every year, what does it tell you about the company's controls?

Do you think an auditor should only talk about mistakes, or also about risks and improvements?

Why do you think written communication (a letter) is more powerful than just a verbal discussion?

Communication with Those Charged with Governance [SA 260 (Revised)]

Introduction and Scope 1/2

- **Primary Focus:** Governs the auditor's responsibility to **communicate with those charged with governance (TCWG)** during an audit of financial statements.
- **Applicability:**
  - Relevant for **all entities**, regardless of governance structure or size.
  - Special considerations for **listed entities** and cases where governance and management roles overlap.

Introduction and Scope 2/2

- **Related Standards:** Other SAs (e.g., **SA 265**) mandate additional communications, such as significant deficiencies in internal control.
- **Additional Requirements:** Other matters may need communication if required by:
    - Law or regulation
    - Engagement agreement
    - National professional standards
- **Flexibility:** Auditor may communicate other relevant matters beyond mandated ones.

Objectives

- Clearly explain auditor’s role, scope & timing.
- Obtain relevant information from governance.
- Share timely, significant audit observations.
- Promote effective two-way communication.

Case Study

- Bright Wave Technologies Ltd., a listed manufacturing company, is undergoing its statutory audit for FY 2024–25. The audit is being conducted by XYZ & Co., Chartered Accountants. The Audit Committee represents those charged with governance (TCWG).

During the audit planning meeting:

- The audit partner **explains the scope, timing, and key responsibilities** of the auditor.
- Discusses **areas of higher risk**, including revenue recognition and inventory valuation.
- Requests information on significant contracts and internal control changes.
- The Audit Committee shares details of a recent internal investigation and changes in key management personnel.

During the audit:

- The auditor **communicates early findings** on internal control weaknesses in inventory management.
- Management addresses these weaknesses before year-end.

At the conclusion:

- The auditor presents **significant observations**, including valuation adjustments, and confirms independence.
- The Audit Committee uses this information to strengthen oversight and ensure accurate financial reporting.

Key Takeaways:

- Clear, timely, two-way communication helped identify and address issues before year-end.
- Objectives of SA 260 (Revised) were fully met — clear responsibilities, relevant info exchange, significant observations, and strengthened governance oversight.

Management vs. TCWG

- **Management:** The person(s) with **executive responsibility** for the conduct of the entity's operations. For some entities, management **includes** some or all of those charged with governance;
- **Those charged with governance:** The person(s) with responsibility for overseeing the **strategic direction of the entity** and obligations related to the **accountability of the entity**.
- In case of small organisations like proprietorship firms, partnership firms etc. both Management and TCWG will be under same hands

Layman's understanding

- **Those Charged with Governance (TCWG)**
  - Think of them as the **watchdogs** of the organisation.
  - Their job is to **set the big-picture direction** and **make sure the company is accountable** to stakeholders.
  - They oversee **how well management is doing its job**, especially in **financial reporting**.
  - Examples: Board of Directors, Audit Committee, Trustees.
- **Management**
  - Think of them as the **drivers** of the organisation.
  - They handle the **day-to-day running** of the business — making operational decisions and carrying out plans.
  - Examples: CEO, CFO, department heads, operational managers.

Layman's understanding

Key Difference:

- **TCWG** → Set direction, monitor, and hold management accountable.
- **Management** → Execute plans, run daily operations.

Overlap:

- In small businesses or some organisations, **the same people can be both** (e.g., an owner-manager is both the driver and the watchdog).

"Audit Matters" to be communicated

Just Remember: SPAM MAIL

- S = Scope of the auditor's duties – systematic & independent;
- P = Selection and application of Accounting Policies;
- A = Audit Adjustments arising out of auditor's observations;
- M = Management Judgements leading to any judgemental mis-statement;
- M = Modifications expected in Auditor's Report;
- A = Audit Procedure – compliance and substantive procedures applied by the auditor
- I = Intricacies (i.e. difficulty) faced during the audit by the auditor like limitation on scope
- L = Legal Requirements applicable to the entity – see SA 250

Case Study

- Galaxy Textiles Ltd., a listed garment manufacturer, appointed MNP & Co., Chartered Accountants, as their statutory auditors for FY 2024–25. The company's Audit Committee represents Those Charged with Governance (TCWG).
- **Scenario & Actions:**
- **Auditor's Responsibilities:** At the initial meeting, the audit partner **explained** that:
    - The auditor's role is to **form and express an opinion** on financial statements prepared by management under TCWG oversight.
    - The audit does **not** remove management's or TCWG's responsibilities for fair reporting.

- **Planned Scope & Timing:** Auditor shared a **timeline** and discussed areas of focus:
    - Significant risks: revenue recognition in export sales, valuation of slow-moving inventory.
    - Planned interim testing before year-end to expedite final audit.
- **Significant Findings:** During the audit, the auditor reported:
    - **Accounting practices:** Inventory valuation method acceptable under standards but less suitable for the company's current market volatility — recommended change for next year.
    - **Difficulties:** Delay in receiving foreign sales documentation from one overseas branch.
    - **Matters discussed with management:** Adjustments to trade receivables provision and new lease disclosures.
    - **Written representations:** Confirmation of related party transactions and compliance with export regulations.
    - **Other matters:** Disclosure of a pending customs duty litigation.

- **Auditor Independence**
  - Provided a written statement of compliance with ethical requirements.
  - Disclosed audit fees and separate non-audit tax consultancy fees, along with safeguards to avoid threats to independence.
- **Communication Process**
  - Agreed on **monthly status updates** and a final written communication of key findings.
  - Timely reporting ensured the Audit Committee could address issues before finalising the financial statements.
- **Outcome:**
  - TCWG gained **clear understanding** of audit scope, key risks, and significant findings.
  - Independence disclosures helped maintain trust.
  - Timely communication allowed management to correct issues before year-end, reducing the risk of a modified opinion.

Timing of Communication

- **Timing Depends on** significance and nature of the matter and the action expected from TCWG.
- **Examples:**
  - Planning matters → communicated early, often during engagement setup.
  - Significant audit difficulties → communicated promptly to seek assistance or address possible opinion modification.
  - Internal control deficiencies → may be discussed orally before formal written communication (per SA 265).
  - Key audit matters (SA 701) → preliminary views shared during planning; further discussions during findings.
  - Independence issues → discussed when significant judgments arise and at final discussions.
  - Audit findings on accounting practices → often at concluding stage.

Timing of Communication

- **Other Factors Influencing Timing:**
  - Entity size, structure, control environment, and legal framework.
  - Legal deadlines for communication.
  - TCWG expectations and scheduled meetings.
  - When issues are identified (e.g., late detection may still allow remedial action).

Adequacy of Communication Process

- **Responsiveness** of TCWG to auditor's communication;
- **Apparent openness** of TCWG to auditor's communication;
- **Willingness** of TCWG to auditor's communication;
- **Comprehension ability** of TCWG;
- Difficulty of **mutual understanding** with TCWG

Case Study –
Evaluating Two-Way Communication

- Bright Wave Technologies Ltd., a mid-sized IT services company, engaged RST & Associates as statutory auditors for FY 2024–25. The company's Audit Committee represents TCWG.
- **Scenario:**
- **During the Audit**
  - The auditor noted **delays** in receiving requested documents, even after multiple reminders.
  - In previous years, the auditor had raised concerns about weak IT access controls but these had not been addressed despite management's assurances.
  - Some Audit Committee members were reluctant to meet without senior management present, limiting open discussion.

Observations on Communication Quality

- **Timeliness & Action:** Past issues remained unresolved; current year’s matters were slow to receive attention.
- **Openness:** TCWG appeared guarded in discussions, often deferring to management to answer.
- **Understanding:** Some members struggled to grasp technical audit points and rarely questioned recommendations.
- **Mutual Understanding:** Disagreements over the format and timing of reports persisted.

Implications for Audit Risk

- Poor responsiveness raised concerns about the **control environment** and potential **risk of material misstatement**.
- The auditor considered whether enough appropriate audit evidence could be obtained.

Auditor’s Response

- Re-raised unresolved issues in formal written communication.
- Sought a private meeting with independent Audit Committee members.
- Consulted legal counsel regarding obligations under the Companies Act to report serious governance deficiencies.
- Prepared contingency plans, including **possible modification of the opinion** or, if unresolved, **withdrawal from the engagement**

Outcome:

- After legal consultation and further discussions, the Audit Committee committed to an action plan for remediation, and key documents were provided before the reporting deadline.
- The auditor was able to issue an unmodified opinion but included a strong **Emphasis of Matter** paragraph on control weaknesses.

Key Learning:

- Weak two-way communication can signal governance issues and increase audit risk.
- Timely, candid, and informed interaction between auditors and TCWG is essential for audit quality and compliance.

Documentation

- Where **matters have been communicated in writing**, the auditor shall retain a copy of the communication as part of the audit documentation
- **Documentation of oral communication** may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Communicating Deficiencies in Internal Control to TCWG [SA 265]

Objective

- The objective of the auditor is to communicate appropriately to
  - those charged with governance and
  - management
- **<u>deficiencies in internal control that the auditor has identified during the audit</u>** and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions

SA 260 vs. SA 265

Aspect	SA 260 – Communication with TCWG	SA 265 – Communicating Deficiencies in Internal Control
Focus	Communication about the **audit**	Communication about **internal control weaknesses**
Objective	Promote **two-way communication** with TCWG	Ensure **significant deficiencies** are reported
What is Communicated	• Auditor's responsibilities • Scope & timing of audit • Significant findings • Independence issues	• Significant deficiencies (always in writing) • Other deficiencies important for management
Form of Communication	Oral or written (as per judgment)	**Written is mandatory** for significant deficiencies (Letter of Weakness)
Who is Informed	Mainly **Those Charged with Governance (TCWG)**	**Both TCWG and Management**
Example	Auditor tells Board about risk in revenue recognition	Auditor reports payroll handled by one person = high fraud risk

Key Requirements

- **Identify Deficiencies:** Auditor determines if internal control weaknesses exist. Example: BRS not reviewed monthly.
- **Assess if Significant Deficiency:** Assess if one weakness, or a combination, is significant. Example: One person both collects cash and records it = high fraud risk.
- **Communicate to TCWG:** Significant deficiencies must be reported to TCWG on a timely basis. Example: Board must be informed that year-end adjustments are not reviewed.
- **Communicate to Management:**
  - Share with management the same significant deficiencies reported to TCWG.
  - Inform them of **other important deficiencies** not covered elsewhere.
  - Example: Inventory counts not properly supervised.
- **Content of Written Communication:** Description of deficiency + possible impact + Context explanation

Internal Control

- The process designed, implemented and maintained by those charged with governance, management and other personnel:
  - to provide reasonable assurance about the achievement of an entity's objectives
    - ✓ with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

The term "controls" refers to any aspects of one or more of the components of internal control

- **Deficiency in Internal Control:** This exists when:
  1. **<u>Control is unable</u>** to prevent/ detect/ correct misstatements in F.S. on timely bas…
  2. **<u>Control</u>** … misstatem…
- **Significant D…** … deficiency is requ… known as 'Letter of We… significant deficiency is a deficiency o… combination of deficiencies in Internal Control that in **<u>Auditor's Professional Judgement</u>** is of sufficient importance to be communicated to TCWG
- **No remedial action on previous communication – what to do:** If in previous audit, communication of significant deficiency was made, then, the need to repeat the communication is not eliminated if remedial action is not taken

Refers to his <u>Knowledge, Training and Experience</u> in context of accounting, auditing and ethical standards [SA 200R]

Case Study

- Sunrise Electronics Ltd., a consumer electronics manufacturer, is being audited by Apex & Co. During the audit, the auditors identify a significant deficiency in internal control:
  a) There is no proper segregation of duties in the cash payments system.
  b) The same manager can authorize payments and maintain cash records.
  c) This creates a risk of fraud or misstatement.

Situation 1 – Cost vs. Benefit:

- The auditor communicates this deficiency to both Management and Audit Committee (TCWG). Management replied as follows: ***"We know about this issue, but hiring additional staff for segregation of duties will cost too much. We've decided to live with the risk."***
- **Questions:**
- Can management ignore the deficiency just because of cost?
- What is the auditor's duty under SA 265?
- Who is responsible for evaluating costs vs. benefits?
- Should the auditor still communicate the deficiency formally?

Situation 2 – Repeated Deficiency:

- The same issue was reported last year. This year, the auditor finds no corrective action has been taken. Management replied as follows: ***"""Yes, we received your report last year, but since no fraud has occurred, we didn't act."***
- **Questions:**
- Should the auditor repeat the communication this year?
- Can the auditor simply reference last year's communication?
- If management refuses to act, what should the auditor ask?
- Does failure to act itself create another deficiency?

Matters of Significant Deficiency

- **Likelihood of material misstatement in F.S.** - e.g. Sales revenue recorded before shipment;
- **Importance of various controls for F.S.** – e.g. Invoices are processed without proper approval, risking errors in reported expenses;
- **Volume of transactions exposed to deficiency** – e.g. single clerk handles all petty cash payments - exposing a large number of small transactions to risk;
- **Expected loss/ fraud to assets or liabilities** – e.g. Weak inventory controls lead to frequent stock theft in the warehouse;
- **Accounting policies (selection and application)** – e.g. Company changes how it values stock without a good reason, making profits look higher;
- **Transaction with related parties and outside entity's normal course of business** – e.g. Co. sells goods at below-market price to a sister concern;
- **Controls over period end reporting process** – e.g. adjustments at year-end (like depreciation or provisions) are missed since they weren't checked;
- **Harmony of one deficiency with other** – e.g. Late sales returns + weak stock records together increase the overall risk of misstated inventory and revenue

Indicators of Significant Deficiency

- Scrutiny of **transactions with related parties** not being made by the management – e.g. Company sells goods to its sister concern at very low prices, but management never reviews if it's fair;
- Identification of **fraud committed by the management itself –** e.g. The CFO hides company expenses to make profits look higher;
- Management's **failure to implement remedial action** on previously communicated deficiencies;
- **Careless response to identified IR and CR** in the F.S. – e.g. Even after being told that credit sales have high risk of default, management keeps giving credit without checks;
- **Absence of risk assessment process** – e.g. Co. never checks what risks could affect its accounts, like FOREX loss or customer defaults;
- **Carelessness of Management in preparation of F.S**. – e.g. F.S. prepared with typing errors/ missing figures as not reviewed properly;
- Disclosure of **prior period material misstatement** in current year – e.g. Last year's duplicate supplier payment found only this year

Concluding Ice-breaking Questions

- **When you audit, who do you usually talk to first, the Accountant, the Owner, or the Board?** Usually the Accountant (management) first, but important matters must also go to the Owner/ Board (TCWG).
- **If you find a mistake in accounts, who should you inform, the persons who made it or the people who oversee them?** Both — the staff who made it (to correct) and the people who oversee (to ensure it doesn't happen again).
- **If the same mistake keeps happening every year, what does it tell you about the company's controls?** It shows weak or ineffective controls — problems are not being fixed
- **Do you think an auditor should only talk about mistakes, or also about risks and improvements?** Both: mistakes must be reported, but risks and improvements help the company strengthen its processes
- **Why do you think written communication (a letter) is more powerful than just a verbal discussion?** Because it creates a clear record, avoids confusion, and ensures accountability.

Thanks