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## Organizational Governance and the Independent Auditor

*New guidance for the auditor and those charged with governance*

In the wake of emerging developments in corporate governance and in light of increasing expectations by those who rely on audited financial statements the Auditing Standards Board recently published new standards associated with auditor communications. Among other things, Statement on Auditing Standards No.114 establishes a requirement for the auditor of financial statements to communicate certain significant matters related to the audit to those charged with governance. The matters include items that have been addressed in prior standards, as well as certain new requirements. The Statement also provides additional guidance on the communication process including, for example (this list is not all inclusive):

- the importance of effective two-way communication
- situations where management is involved with governance, especially in small organizations
- the adequacy of communications between the auditor and those charged with governance

Our purpose with respect to this article is to outline some of the new standards and how they affect those charged with governance. We believe it is important for each member of an organization's governing body to recognize his/her responsibilities as well as the responsibilities of the independent auditor.

### Definitions

The new standard clearly draws a distinction between *those charged with governance* and the *management* of the organization. The following definitions are outlined in the new standard:

- *Those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. For entities with a board of directors, this term includes the *audit committee* or similar subgroup.
- *Management* means the person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

### Communication principles

With regard to communication, the new standard points to three principle purposes. It indicates that the auditor:

1. Communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the scope and timing of the audit.
2. Obtain from those charged with governance information relevant to the audit.
3. Provide those charged with governance with timely observations.

### Importance of two-way communications

While the standard is primarily focused on communication from the auditor to those charged with governance, it also indicates the importance of effective two-way communications. The new standard indicates that two-way communication assists those charged with governance in understanding matters related to the audit, important transactions, sources of supportive documentation, and in satisfying their obligation to oversee the financial reporting activities. The standard goes on to point out that poor two-

way communication might be an indication of the lack of an adequate control environment, which might influence the auditor's assessment of risk, and consequently the scope of the audit procedures.

According to the new standard, the auditor must assess the effectiveness of such communications and whether it adequately fulfills the auditor's responsibilities. Based upon that assessment, the auditor may determine that to fulfill his/her responsibility he/she must communicate directly to the governing body, a right the auditor always maintains.

To assess the effectiveness of communications with those charged with governance the standard indicates that the auditor may look to numerous indicators. For example the auditor may:

- Evaluate the appropriateness and timeliness of action taken by those charged with governance in response to matters communicated by the auditor.
- Consider the openness of those charged with governance in their communications with the auditor.
- Assess the apparent ability of those charged with governance to meet without the presence of management.
- With regard to situations in smaller organizations where management may also be involved with governance, evaluate the awareness of how matters discussed with the auditor affect their broader governance responsibilities, along with their responsibilities as managers.

The standard points out that good governance implies that the auditor should have access to the audit committee or its subgroup, that the auditor actually meet with the committee periodically, and the committee should meet with the auditor without the presence of management at least annually.

If, in the judgment of the auditor, the two-way communication is not adequate, the standard indicates that the auditor may have to ultimately withdraw from the engagement. The position makes it clear that the Auditing Standards Board views two-way communication as a very component of the audit.

#### **Effective date**

Statement on Auditing Standards No.114 is effective for audits of financial statements for periods beginning on or after December 15, 2006.

We encourage you to share this article with your associates, especially those who are charged with governance. Organizations, whether for-profit or nonprofit, are better served if management as well as those charged with governance have a clear understanding of the auditor's responsibilities.

Questions about this article may be directed to Vincent Ruocco, LLC, CPA at 203.932.2931.

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