



International Federation of Accountants

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Agenda Item

B.4

Committee: IAASB Consultative Advisory Group

Meeting Location: Basel

Meeting Date: March 3-4, 2008

Report Back—Communicating Deficiencies in Internal Control

Objectives of Agenda Item

1. To provide a brief report back on the September 20-21, 2007 proposals of Representatives on the proposed ISA 265, “Communicating Deficiencies in Internal Control.”
2. The IAASB approved an exposure draft (ED) of this proposed ISA at its December 2007 meeting.

September 20-21, 2007 CAG Proposals

3. Below is an extract from the minutes of the September 2007 CAG meeting¹ and an indication of how the IAASB Task Force or the IAASB responded to the Representatives’ comments.

Representatives’ Comments	Task Force/IAASB Response
<p>APPROACH TO DEFINITIONS</p> <p>[Extract from minutes to provide background:</p> <p>At the April 2007 IAASB meeting, the IAASB’s discussions focused on how to define the term “material weakness” in the ISAs. The IAASB concluded that the way forward would depend on which of the three options should be chosen. The three options were included in the IAASB CAG Paper distributed for that meeting.</p> <p>Given that the term “material weakness” is also used in the European Union’s Statutory Audit Directive but is undefined, the IAASB agreed that the views of the European Commission should be sought on this issue. If ISAs were to be adopted in the European Union, it would be desirable for any definition of “material weakness” established in the ISAs to be acceptable to the European Commission for the purposes of the Statutory Audit Directive. Accordingly, John Kellas wrote to the European Commission on behalf of the IAASB. Mr. Ashton noted that the European Commission’s response indicated a preference for Option 3.</p> <p>Option 3 proposes that the requirement in the ISAs for the auditor to communicate material weaknesses be adjusted to a requirement for the auditor to communicate reportable weaknesses. This option would effectively mean that the term “material weakness” would not need to be defined in the ISAs. However, it would leave individual jurisdictions with the flexibility to define the term for their own purposes.]</p>	

¹ The minutes will be approved at the March 2008 IAASB CAG meeting.

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Mr. Rabine clarified that the European Commission is not driving the project. He noted that the European Commission did not support the proposal for the IAASB to commence a project to define the term "material weakness." He noted that, if the IAASB does not put the current project to develop an ISA on communicating deficiencies in internal control on hold, the European Commission will support Option 3.	Representative's comment provided clarification, and was supportive in this area.
Messrs. Johnson and Ray supported Option 3.	Representatives' comments were supportive in this area.
Mr. Sekiguchi noted that due process requires that the views of other stakeholders also be considered. He noted that Option 3 may have a significant effect in Japan.	The Task Force agrees that the views of other stakeholders must also be considered. The exposure process provides an opportunity for stakeholders to voice any concerns they may have. The closing date for comment on the ED is April 30, 2008.
The Representatives responded as follows:	
<ul style="list-style-type: none"> Mr. Morris, reporting on behalf of the IAASB CAG Working Group, noted that the Working Group questioned the proposal not to define the term "material weakness." If not defined, the PCAOB definition may be adopted, while it may not be appropriate as the scope of the audit may be different from that of a listed company in the U.S. It may also give rise to different definitions being developed by different jurisdictions. 	<p>The IAAB believes that the proposals in the ED are appropriate in the context of an audit under the ISAs. The ED requires the auditor to communicate "significant deficiencies" to those charged with governance, and defines significant deficiencies in much the same way as the PCAOB defines the same term in its Auditing Standard 5,² i.e. "a deficiency or combination of deficiencies in internal control relevant to the audit that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance."</p> <p>This has the benefit of being consistent with the approach taken by the PCAOB in relation to the requirement to communicate significant deficiencies to those charged with governance. It</p>

² Auditing Standard 5, "An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements."

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	<p>also avoids the difficulties in trying to define the term “material weakness” for the purposes of the ISAs – the IAASB concluded that the PCAOB definition of “material weakness” would not be appropriate for the ISAs because that definition is intended to establish a “high hurdle” for public reporting purposes; on the other hand, having a definition of material weakness that differs from the PCAOB’s would not be in the public interest.</p>
<ul style="list-style-type: none"> Mr. Roussey noted that the term “reportable deficiency” is considered in the context of communication with management and those charged with governance. However, the existence of a material weakness in internal control affects the scope of the audit (that is, nature, timing and extent of further audit procedures). He suggested that the Task Force consider whether elimination of the term “material weakness” in the ISAs may give rise to unintended consequences. Mr. Ray supported this request. 	<p>The IAASB has considered this question through the conforming amendments being proposed in other ISAs, and believes that the approach proposed in the ED (i.e. a requirement to communicate significant deficiencies to those charged with governance) is consistent, in substance, with the nature of the matters auditors currently report as material weaknesses in practice.</p>
<ul style="list-style-type: none"> Mr. Cassel supported the orientation of the ISA towards a communication objective. He was, however, concerned about the reference to “deficiencies in internal control that have come to the auditor’s attention during the audit.” This may give the impression that the auditor only communicates those deficiencies that he/she has stumbled across. Mr. Ashton explained that the objective and requirements do not override ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.” He referred to ISA XXX.3, which reads as follows: “ISA 315 (Redrafted) requires the auditor to obtain an understanding of internal control relevant to the audit for purpose of identifying and assessing the risks of material misstatement in the financial statements. This ISA requires the 	<p>The IAASB agreed that the phrase “have come to the auditor’s attention” should be replaced by the term “identified” in the ED. This term connotes a more conscious judgment on the auditor’s part as to whether deficiencies in internal control exist based on the audit work performed.</p>

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<p>auditor to communicate reportable deficiencies that have come to the auditor's attention during the course of the audit but does not require the auditor to plan and perform specific audit procedures to search for deficiencies in internal control or to form an opinion on the effectiveness of internal control." Mr. Johnson agreed with Mr. Ashton.</p>	
<ul style="list-style-type: none"> Mr. Roussey asked why the objective refers to "deficiencies" as opposed to "reportable deficiencies." He also suggested that the reference to "internal control" be changed to "internal control over financial reporting." Mr. Ashton agreed to consider this. 	<p>The objective in the ED is stated as follows:</p> <p>"The objective of the auditor is to communicate appropriately to management or those charged with governance <i>deficiencies</i> in internal control relevant to the audit that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions."</p> <p>The ED treats all (non-trivial) deficiencies as reportable: firstly, all of them to management, and secondly, the significant ones to those charged with governance.</p> <p>The IAASB agreed that the scope of the ISA should encompass deficiencies in internal control <i>relevant to the audit</i> (as opposed to internal control over financial reporting), as ISA 315 refers to <i>relevant controls</i> and indicates that these will usually be within those on financial reporting but may not be.³ The current reporting obligation in ISA 315 is therefore not restricted to material weaknesses in controls over financial reporting only.</p>
<ul style="list-style-type: none"> Mr. White was of the view that the definition of the term "reportable deficiency" is circular. He noted that it is not clear how the auditor should determine which deficiencies to report to management and those charged with governance. 	<p>The ED prioritizes the deficiencies to report in that it requires the communication of <i>significant</i> deficiencies to those charged with governance in writing. Which deficiencies should be considered significant deficiencies is a matter of the auditor's</p>

³ ISA 315 (Redrafted), paragraph A58, explains that controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

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<p>This may result in a large number of deficiencies being reported. Management and those charged with governance may not know how to prioritize them. Mr. Krantz was concerned that the communication of trivial mistakes may devalue the process. Mr. Ashton noted management often prefers to know about mistakes, even though they may be trivial. Messrs. Krantz and Johnson emphasized the importance of judgment in determining which deficiencies to report to management and those charged with governance. Mr. Ashton agreed to consider including something about prioritization in the ISA. He noted that it may be difficult to be specific about how to prioritize, because the nature of entities, their structures and how they make decisions vary.</p>	<p>professional judgment in the circumstances. The ED provides guidance on the factors the auditor may consider in making this judgment.</p> <p>The ED also requires the communication of all (non-trivial) deficiencies (including significant deficiencies) the auditor has identified to management, unless:</p> <ul style="list-style-type: none"> (a) The auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies; or (b) It would be inappropriate to communicate directly to management in the circumstances. <p>In recognition of the fact that the deficiencies the auditor identifies during the audit can be voluminous, the IAASB agreed that the communication to management need not be in writing.</p>
<ul style="list-style-type: none"> • Mr. Ray agreed with the proposal to communicate reportable deficiencies to management and those charged with governance; however, he questioned the detail in which they should be communicated to those charged with governance. Dr. Manabat noted that proposed ISA 260 (Revised and Redrafted) was very clear as to what should be communicated to those charged with governance. Mr. Roussey suggested that the auditor discuss with those charged with governance the level of detail in which the deficiencies should be communicated. Mr. Ashton agreed to consider the matter. 	<p>The ED explains that the level of detail at which to communicate significant deficiencies to those charged with governance is a matter of the auditor's professional judgment in the circumstances. It then provides guidance on factors the auditor may consider in determining an appropriate level of detail for the communication, for example:</p> <ul style="list-style-type: none"> • The nature and size of the entity. • The nature and volume of significant deficiencies the auditor has identified. • The entity's governance structure. • The nature of the oversight responsibilities of those charged with governance. • The preferences of those charged with governance.

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	<ul style="list-style-type: none"> Whether the significant deficiencies were communicated to those charged with governance in previous audits.
<ul style="list-style-type: none"> Dr. Manabat noted that, in some jurisdictions, law or regulation requires the auditor to report deficiencies to regulators. Mr. Ashton suggested that this be dealt with as a supplementary requirement at the national level. 	<p>The ED deals with the point in relation to when it may be appropriate to refer to regulatory authorities in the written communication of significant deficiencies:</p> <p>“Laws or regulations may require the auditor or management to furnish a copy of the auditor’s written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor’s written communication may identify such regulatory authorities.”</p>
<ul style="list-style-type: none"> Mr. Scicluna asked how the ISA is to be implemented in the case of SME audits. 	<p>At the meeting, Mr. Ashton noted that he was of the view that, except for the fact that the communication of the deficiencies has to be in writing, the situation is not different from that today as ISA 315 (Redrafted) applies in the case of SME audits.</p> <p>The Task Force shares Mr. Ashton’s views.</p>
<ul style="list-style-type: none"> Ms. Sucher and Messrs. Koktvedgaard and Scicluna asked whether the Task Force has considered including the requirements and guidance in proposed ISA 260 (Revised and Redrafted). Mr. Koktvedgaard noted that since the auditor obtains an understanding of internal control in accordance with ISA 315 (Redrafted), the requirements and guidance may also be well placed in ISA 315 (Redrafted). Mr. Ashton responded that a decision in this regard still has to be made. However, he was concerned that incorporation of the requirements and guidance in proposed ISA 260 (Revised and Redrafted) or ISA 315 (Redrafted) may result in something being lost. He was also concerned about the length of ISA 315 (Redrafted). 	<p>The IAASB agreed that it would be more appropriate to place all the requirements and guidance relating to communicating deficiencies in internal control in a new ISA, hence the ED of the proposed ISA 265.</p>

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Material Presented – IAASB CAG REFERENCE PAPERS ONLY

Available from
<http://www.ifac.org/Guidance/EXD-Details.php?EDID=0100>

Exposure Draft of Proposed ISA 265,
“Communicating Deficiencies in Internal Control”
published in December 2007