

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

G

Committee: IAASB Consultative Advisory Group

Meeting Location: Toronto

Meeting Date: September 4-5, 2008

Note to IAASB CAG

This paper contains extracts from the September 2008 IAASB issues paper regarding those significant comments received on exposure to which the Task Force believes the IAASB CAG Representatives should pay particular attention.

Control Deficiencies—ISA 265

Objectives of Agenda Item

1. The objectives of this agenda item are:
 - (a) To review a summary of the significant comments received on the most significant issues raised on the exposure draft of proposed ISA 265, “Communicating Deficiencies in Internal Control” (ED-ISA 265); and
 - (b) To obtain the Representatives’ views on the task force’s preliminary recommendations in response to those comments.
2. The IAASB will consider all the significant comments received and the task force’s preliminary recommendations at its September 15-19, 2008 meeting. **Approval of the final ISA is planned for the December 2008 IAASB meeting.**

IAASB Task Force

3. The members of the Task Force are:
 - Phil Cowperthwaite (Chairman, IAASB Member)
 - Dr. Mohammed Bahjatt (INTOSAI Representative)
 - Caithlin McCabe (IAASB Member)
 - Dan Montgomery (IAASB Technical Advisor)
 - Jianhua Tang (IAASB Member)

Background

4. The IAASB commenced this project in October 2005 in response to regulatory and standard-setting developments around the world regarding internal control-related matters, including, in particular:

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

- The requirement under the European Union’s Statutory Audit Directive for auditors to report identified material weaknesses in internal control to audit committees; and
 - The U.S. Public Company Accounting Oversight Board’s (PCAOB’s) issue of an auditing standard addressing an audit of internal control over financial reporting.¹
5. In addition, it was recognized that the current definition of the term “material weakness” within the ISAs is rather general² and that there is a need to clarify its meaning in order to improve the consistency with which auditors treat identified weaknesses in internal control as material, and how such matters are reported. Accordingly, the IAASB set out to develop a revised definition of material weakness for the purposes of the ISAs. In doing so, the IAASB acknowledged the need also to clarify the auditor’s responsibilities in relation to the evaluation and communication of internal control-related matters identified during the audit to management and those charged with governance.
6. As the project evolved and new considerations emerged during debate at a number of meetings of the IAASB and the IAASB CAG, there was a shift from the original aim to develop a revised definition of material weakness to a current focus on issuing a new ISA setting out a clear definition of the threshold of significance at which deficiencies in internal control should be communicated both to those charged with governance and management.
7. ED-ISA 265 was issued in December 2007. The comment period for the exposure draft (ED-ISA 265) closed on April 30, 2008. A total of 48 comment letters were received. (ED-ISA 265 and the comment letters are available at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0100>).
8. Respondents were generally supportive of the proposals, although a minority expressed strong concerns over the proposal to no longer use and define the term ‘material weakness’ in the ISAs. The following section summarizes the significant comments received from respondents on the most significant issues and the task force’s preliminary views on how these should be addressed.

Significant Comments

DEFINITIONS OF ‘MATERIAL WEAKNESS’ AND ‘SIGNIFICANT DEFICIENCY’

9. The approach proposed in ED-ISA 265 in relation to the definition (or non-definition) of the key terms ‘material weakness’ and ‘significant deficiency’, and the proposal to establish a new ISA, drew strong comments from a number of respondents.

¹ Auditing Standard 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements” subsequently superseded by Auditing Standard 5, “An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements.”

² The extant ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” defines a material weakness as one that could have a material effect on the financial statements.

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

10. A few respondents questioned the need for an entirely new ISA on the grounds that the original purpose of the project was simply to clarify the meaning of the term ‘material weakness’. They felt that the proposed new ISA may cause confusion (for both auditors and management) by introducing new terminology, and could have a negative impact on smaller audits by increasing the number of deficiencies reported and thereby cause additional costs. Accordingly, they suggested that the IAASB study in more detail the impact of the proposed ISA on smaller audits, and retain the current requirements regarding communication of material weaknesses in ISA 260 (Revised and Redrafted),³ ISA 315 (Redrafted)⁴ and ISA 330 (Redrafted).⁵ Commenting from the perspective of the European Union, one respondent (the European Commission) suggested that the IAASB postpone the adoption of the ISA until after the Clarity project and after the IAASB has given further thought to the goals it aims to achieve through a new standard. The respondent noted that the consequences of replacing the concept of ‘material weakness’ with that of ‘significant deficiency’ are as yet unclear within the EU.
11. Significant concerns were expressed by several respondents regarding the IAASB’s approach and rationale with respect to the definitions. They are as follows:
 - Some respondents disagreed with the proposed withdrawal of the term ‘material weakness’. One respondent felt that although this term is not precisely defined in the ISAs, it is actually well understood, intuitive and long-established. It noted the lack of research evidence to support the IAASB’s view that inconsistency occurs at such a level as would make it a public interest consideration. It suggested that the abolition of the term and its extant definition,⁶ together with the use of the proposed new terms, would result in an overwhelming increase in the communication of trivial matters.
 - One respondent (the EC) commented that ED-ISA 265 did not clearly explain the relationship between significant deficiencies and material weaknesses, and therefore, EU companies and their auditors could be confused about what their obligations are under the EU Statutory Audit Directive and what they are under the ISAs. The respondent noted that paragraph A8 of ED-ISA 265⁷ could be read as implying no differences between the two concepts, or two totally different concepts. It suggested that

³ ISA 260 (Revised and Redrafted), “Communication with Those Charged with Governance.”

⁴ ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.”

⁵ ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks.”

⁶ See footnote 3.

⁷ Paragraph A8 of ED-ISA 265 states:

Law or regulation in some jurisdictions may establish requirements for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) details of specific types of deficiencies in internal control that the auditor has identified during the audit, and may define terms such as ‘material weakness’ for this purpose.

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

the ISA should at least clarify that the concept of a significant deficiency is broader than that of a material weakness (as defined or practiced in the US or the EU), and that the auditor should be required to include material weaknesses defined under domestic regulations or practiced in the markets when reporting significant deficiencies to those charged with governance.

- A few respondents disagreed with the IAASB's rationale that if two different definitions of the term 'material weakness' were to co-exist in IAASB and PCAOB standards, this could generate confusion among practitioners and users of financial statements around the world, and lead to attempts at reconciling their meanings for varying reporting purposes. The respondents noted that since the IAASB's definition would be directed at communication with those charged with governance, no "reconciliation" of the definitions would ever occur in public. They felt, instead, that allowing other regulators to define the term within the context of their environments would create more confusion than having an IAASB definition different from that of the PCAOB. Another respondent further argued that the proposed ISA could cause confusion for auditors, regulators and the public because of the co-existence of different concepts (i.e. 'material weakness', 'significant deficiency', and 'deficiency') in the ISAs, the EU Statutory Audit Directive, and local laws and regulations. Accordingly, these respondents suggested that it would be in the international public interest for the IAASB to take the lead and provide a definition that could be used globally, thus avoiding a proliferation of definitions in practice.
 - A few respondents questioned the appropriateness of the proposed definition of a significant deficiency. Some commented that the definition seemed to be tautological and circular as the deficiencies to be communicated to those charged with governance would be those "that are of sufficient importance to merit the attention of those charged with governance." One respondent commented that by using the same term (i.e., 'significant deficiency') and adopting fundamentally the same definition as that used by the PCAOB, there would be a strong legal presumption in those jurisdictions adopting ISA 265 that the IAASB definition has the same meaning as the PCAOB's. It added that, because of this, those jurisdictions adopting ISA 265 would also be effectively adopting the PCAOB definition of material weakness since the PCAOB standard defines the relationship between a significant deficiency and a material weakness. The respondent suggested that this would not be acceptable to many jurisdictions (including some in the EU) where the concept of material weakness is incorporated into local law or regulation. The respondent further expressed the view that if the PCAOB definition of significant deficiency were to be applied in ISA 265, the threshold for reporting deficiencies to those charged with governance would be too low based upon the respondent's interpretation of the meaning of that definition, which would lead to the reporting of many deficiencies that are not of governance interest.
12. Two of the respondents suggested that the IAASB should define the term 'material weakness' but that this definition should not be the same as the PCAOB's. One of them was

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

of the view that the PCAOB's definition of material weakness is flawed on the grounds that this scopes in deficiencies with *remote* risks of not preventing, or detecting and correcting, material misstatements, which the respondent believes sets too low a threshold. Accordingly, the respondent suggested the following alternative definitions of material weakness and significant deficiency:

Material weakness – A deficiency in internal control relevant to the audit that does not reduce to an acceptably low level the risk that a material misstatement in the financial statements will not be prevented, or detected and corrected.

Significant deficiency – A deficiency, in internal control relevant to the audit, that is of governance interest because the deficiency is a material weakness, or close to being a material weakness, or would become a material weakness when reasonable changes in circumstances occur.

13. One respondent suggested that as the definitions of the terms 'deficiency' and 'significant deficiency' in the proposed ISA are closely aligned with those of the PCAOB standard, the definition of 'material weakness' in the ISA should also be closely aligned with that standard. The respondent argued that this would help avoid unnecessary differences in definitions internationally.

Preliminary Task Force Views and Recommendations

14. Many of the above arguments were considered and debated by the IAASB when it finalized its proposals for ISA 265. During its deliberations, the IAASB consulted the EC on the possible approaches regarding whether or not to define the term 'material weakness', and the EC had indicated that it would not object to the ISA not using and defining that term if the project went ahead.
15. Clearly, however, there are a minority of respondents who strongly believe that the public interest would be better served by having a definition of material weakness in the ISA, even if that is different from the PCAOB's definition. This view is also strongly supported by a member of the Task Force. Further, based on the EC's formal response to the exposure draft, the EC now seemed to have concluded that if the ISA were to use and define the concept of 'significant deficiencies', it should also treat material weaknesses (however defined under domestic regulations or used in practice) as a subset of those to be included when reporting significant deficiencies to those charged with governance.
16. The Task Force noted that the overriding objective of the ISA is communication as a by-product of the audit. All but one member of the Task Force is of the view that if the ISA were to address the categorization of material weaknesses within the broader subset of significant deficiencies, this could force a more rigorous evaluation process than was originally intended by the ISAs and extend the process of reporting deficiencies beyond that of a communication by-product of an audit. The majority of the Task Force believes that this outcome would represent a significant extension of the auditor's responsibilities under the existing standards, which the IAASB had agreed should not be the purpose of this project.

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

Given the preponderance of respondents supporting the approach taken in ED-ISA 265, the majority of the Task Force believes that this approach should be retained.

17. Nonetheless, the Task Force agreed that clarification could be provided in the guidance to recognize the fact that domestic law or regulation may impose *additional* requirements on the auditor (particularly for audits of listed entities) to evaluate the severity of significant deficiencies in order to identify a subset of those as material weaknesses for reporting purposes. Such law or regulation may define the relevant threshold for that purpose. Accordingly, the Task Force proposes to amend the guidance in paragraph A8 of ED-ISA 265 to that effect. (*See paragraph A9 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*).
18. Regarding the issue of whether a separate ISA is needed for the topic, the Task Force does not believe that arguments of a ‘fatal flaw’ nature have been raised by the few respondents who argued against a separate ISA. The Task Force believes that there is insufficient ground for the IAASB to reconsider this proposal. Accordingly, the Task Force recommends that the separate ISA approach be retained.

Matters for IAASB CAG Consideration

1. In the light of the responses, do the Representatives agree that:
 - (a) The approach proposed in ED-ISA 265 remains appropriate and should be retained; and
 - (b) Clarifying guidance should be provided to explain that law or regulation may impose additional requirements on the auditor to evaluate the severity of significant deficiencies in order to identify a separate class as material weaknesses?
2. Do the Representatives agree that the current approach of developing a separate ISA on the topic should be retained?

CONSISTENCY BETWEEN COMMUNICATION REQUIREMENT AND THE OBJECTIVE

19. Paragraph 9 of ED-ISA 265 proposed to establish the following requirement:

The auditor shall communicate all deficiencies in internal control (other than those that are clearly trivial) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless:

 - (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.
20. Several respondents commented that this requirement was inconsistent with the proposed objective in ED-ISA 265:

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

The objective of the auditor is to communicate appropriately to management or those charged with governance deficiencies 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.

21. The respondents noted that while the objective explicitly recognized the essential role of the auditor's professional judgment in determining whether an identified deficiency is of sufficient importance to be communicated to management, paragraph 9 of ED-ISA 265 effectively removed the auditor's ability to exercise that judgment by requiring the auditor to communicate *all* identified deficiencies to management (other than those that are clearly trivial). The respondents argued that the requirement would set the reporting threshold too low, resulting in, firstly, far too many deficiencies being identified and reported to management, and secondly, constraining the exercise of judgment. They added that management might not have an interest in all non-trivial deficiencies. One of the respondents also suggested that this could lead to an implicit requirement for the auditor to identify any missing control, even if not relevant to the audit.
22. Accordingly, the respondents felt that a more reasonable threshold would be desirable. One of the respondents suggested that the threshold specified in the objective would be appropriate, i.e., those deficiencies that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. Another respondent suggested, in the context of its proposal for a different definition of the terms 'material weakness' and 'significant deficiency', that management would be interested in "those deficiencies that are significant deficiencies, close to being significant deficiencies or that would become such significant deficiencies when reasonable changes in circumstances occur." This respondent justified its proposal on the basis that management may need to take action to mitigate those deficiencies that are material weaknesses, prevent other significant deficiencies from becoming material weaknesses, and prevent the other deficiencies from becoming significant deficiencies.

Preliminary Task Force Views and Recommendations

23. Given the strong concerns raised by the respondents, the Task Force believes that there is a need to reconsider the threshold for communicating identified deficiencies to management. The IAASB's intent in proposing the requirement in paragraph 9 of ED-ISA 265 was for the auditor to communicate to management *all* non-trivial deficiencies that the auditor has identified during the audit to enable management to take appropriate action on them, on the grounds that this would serve the public interest. However, after further reflection in the light of the comments, the Task Force agreed with some of the respondents that a requirement to communicate all identified deficiencies to management could be unduly burdensome and impractical. The Task Force agreed with the respondents that the auditor

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

should be given flexibility to exercise judgment to determine which deficiencies are of sufficient importance to merit being brought to management's attention.⁸

24. With regard to significant deficiencies, however, the Task Force believes that these should be automatically communicated to management as part of the requirement to communicate them to those charged with governance (*See paragraph 9 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*).
25. Accordingly, the Task Force proposes that paragraph 9 of ED-ISA 265 be amended so that, rather than requiring the communication of all deficiencies identified during the audit to management, it should require the communication of deficiencies that the auditor judges to be of sufficient importance to merit management's attention (*See paragraph 11 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*).

Matter for IAASB CAG Consideration

3. **Do the Representatives agree with the Task Force's proposal regarding the revised communication threshold for reporting other identified deficiencies to management?**

UNCONDITIONAL REQUIREMENT TO COMMUNICATE

26. Paragraphs A10 and A11 in ED-ISA 265 made two statements that effectively render the requirement to communicate identified deficiencies to management unconditional:
 - Para A10: ... the fact that the auditor communicated a deficiency to management in a previous audit, or that management already had knowledge of the deficiency through other means (such as from relevant work done by internal auditors), does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken.
 - Para A11: ... the requirement for the auditor to communicate deficiencies to management applies regardless of cost or other considerations that management may consider relevant in determining whether to remedy such deficiencies.
27. Several respondents expressed concerns regarding this unconditional stance:
 - Some of them commented that for some entities, particularly smaller entities, once management has considered a deficiency but decided not to remedy it, management may wish to continue relying on close personal supervision instead of instituting extensive controls that management may not consider cost-effective. These respondents argued that in these circumstances, reporting the same issues to management would represent

⁸ The effect of this is to create 4 categories of deficiencies instead of the original 3: significant deficiencies; other deficiencies that merit management's attention; other deficiencies that do not merit management's attention; and deficiencies that are clearly inconsequential. The Task Force does not believe that deficiencies that do not merit management's attention will necessarily be deficiencies that are clearly inconsequential.

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

extra cost for the auditor to no benefit. They also highlighted the risk that automatic re-communication of deficiencies would harm the auditor's relationship with the client. The respondents suggested, however, that if there has been a change in management, or if new information were to come to the auditor's attention (e.g., the discovery of material misstatements or significant loss to the entity as a result of a deficiency), then it might be appropriate to repeat the communication.

- A few respondents took the view that the auditor should not be required to communicate matters that have already been brought to management's attention through other means, such as from relevant work done by internal auditors. They argued that if the auditor knows that management has received and read an internal audit report identifying certain deficiencies, it would be unnecessary to require the auditor to re-communicate those deficiencies. They noted that this approach would be consistent with the focus in the objective on those deficiencies "that *the auditor* has identified during the audit."
- Two other respondents commented that a requirement to re-communicate to management deficiencies that are *not significant* would be unnecessary and onerous. They suggested that the ISA should allow the auditor to exercise judgment in determining whether a re-communication is necessary.

Preliminary Task Force Views and Recommendations

28. The Task Force noted that the IAASB's rationale for proposing to require the auditor to communicate identified deficiencies regardless of cost or other considerations, or to re-communicate deficiencies that have not yet been remedied, was that it would be in the public interest for the auditor to make management aware of control matters that need, or continue to need, management's attention. Further, there is the possibility that management would resort to justifying inaction on the grounds of cost even though it might be cost-beneficial to remedy the identified deficiencies.
29. Given the force of the concerns expressed by the above respondents, however, the Task Force believes that a degree of flexibility would be warranted in relation to the communication or re-communication of deficiencies that are *not significant*, i.e., the auditor should be permitted to exercise judgment in the circumstances in deciding when to communicate or re-communicate such deficiencies. In particular, it should not be necessary for the auditor to repeat information about deficiencies that are not significant if such information has been included in previously issued written communications, whether made by the auditor, internal auditors, or others within the entity.
30. For significant deficiencies, however, the Task Force is of the view that it would be in the public interest that the requirement to communicate or re-communicate them be unconditional because of the importance of these matters. The Task Force also agreed with the respondents' suggestion that deficiencies that should be communicated should be those that *the auditor* has identified during the audit and not those that management or those charged with governance became aware of through other means.

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

31. Accordingly, the Task Force recommends that:

- The requirement to communicate *significant* deficiencies should apply regardless of cost or other considerations that management and those charged with governance may consider relevant in determining the need for remedial action (*see paragraph A14 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*);
- With regard to deficiencies that are not significant and that the auditor has already communicated to management in a prior period, guidance be provided to explain that the auditor need not repeat the communication in the current period if management has chosen not to remedy them for cost or other reasons, or if the information is already included in previously issued written communications to management. (*see paragraph A23 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*);
- The guidance dealing with re-communication in ED-ISA 265 be amended to focus only on significant deficiencies (*see paragraph A15 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*); and
- The reference to deficiencies that management has become aware of through other means (such as from internal auditors' work) be deleted from the guidance originally proposed in ED-ISA 265 (*see paragraph A15 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*).

Matter for IAASB CAG Consideration

4. Do the Representatives agree with the Task Force's recommendations on this issue?

COMPENSATING CONTROLS

32. Subparagraph 9(a) of ED-ISA 265 proposed that the auditor be required to communicate all identified deficiencies in internal control to management *unless* 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.
33. Several respondents interpreted this proposal as implying a requirement for the auditor to test the operating effectiveness of the compensating controls to support a determination as to whether a deficiency exists in every instance, even though the IAASB had made its intention clear in paragraph A3 of ED-ISA 265⁹ that there is no such obligation. A few of these respondents took the view that subparagraph 9(a) of ED-ISA 265 improperly implied that compensating controls can eliminate a deficiency from being communicated to management. They suggested that this subparagraph should be deleted on the grounds that

⁹ Paragraph A3 of ED-ISA 265 stated: "This ISA does not require the auditor to obtain audit evidence regarding the design and operating effectiveness of these other controls."

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

communication of deficiencies in internal control is a by-product of the audit and, therefore, those charged with governance can best understand the context of the communication if they are informed of *all* deficiencies identified by the auditor during the audit, regardless of the operation of compensating controls. In this regard, they pointed out that paragraph A3 of ED-ISA 265 already stated that the existence of compensating controls does not change the fact that the auditor has identified deficiencies in internal control.

34. A few other respondents suggested the need for clarification to the wording of subparagraph 9(a) in relation to the guidance in paragraph A3 of ED-ISA 265. One of them suggested that the ISA make clear that the requirement in subparagraph 9(a) relates to situations where management is already aware of the deficiencies identified by the auditor and has made the auditor aware of other controls that mitigate those deficiencies. This respondent felt that if management is not aware of the deficiencies identified by the auditor, then the auditor should inform management of them even if the auditor identifies mitigating controls.

Preliminary Task Force Views and Recommendations

35. The Task Force believes that in the first instance a clarification is needed to paragraph A12 of ED-ISA 265 in relation to the statement that “unless 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, the auditor does not have sufficient audit evidence to conclude that a deficiency in internal control *does not exist*.” As some of the respondents have alluded to, there is an inherent inconsistency between this statement and the statement in paragraph A3 of ED-ISA 265 that the existence of compensating controls does not change the fact that the auditor has identified deficiencies in internal control. The Task Force believes that instead of an effective compensating control affecting the determination of whether a deficiency *exists*, it should affect the determination of whether *any misstatements* in the financial statements could arise as a result of the deficiencies. This is because a deficiency that has been identified remains a deficiency regardless of whether other controls compensate for the failing of the underlying control, but these other controls may fully compensate for the deficiency by preventing, or detecting and correcting, any resulting misstatements.
36. The question that then arises is whether the auditor should communicate an identified deficiency to management and, where appropriate, those charged with governance, if other controls can compensate for the failed control. Two of the respondents above suggested that identified deficiencies should be communicated regardless of compensating controls, while one other respondent suggested a variation to this, i.e., that if management is not aware of the identified deficiencies, the auditor should inform management of them even if the auditor identifies mitigating controls.
37. After further reflection in the light of the comments received, the Task Force has concluded that the overriding principle should be that identified deficiencies should be communicated regardless of the existence and operation of compensating controls. This is because a compensating control does not eliminate the fact that the auditor has identified a deficiency,

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

although it may mitigate the effects of that deficiency. Consequently, the auditor should simply communicate this deficiency to management and, where appropriate, those charged with governance on the basis that it would need their attention.

38. The Task Force as a whole believes that this is the appropriate level of responsibility to establish given that:

- The extant ISAs do not impose any obligation, whether stated or implied, on the auditor to consider or test compensating controls when considering material weaknesses; and
- The communication of identified deficiencies is a by-product of the audit that should not require evaluation hurdles to be cleared in relation to compensating controls, i.e. deficiencies that have come to the auditor's attention during the audit should simply be brought to the attention of management and, where appropriate, those charged with governance for their consideration.

(One member of the Task Force, however, felt that not requiring the auditor to test compensating controls when management has brought these to the auditor's attention would not serve the profession well, as this may potentially damage the auditor's working relationship with management.)

39. Accordingly, the Task Force recommends that the precondition in subparagraph 9(a) of ED-ISA 265, and consequently the associated guidance in paragraph A12 of ED-ISA 265 and the last two sentences of paragraph A3 of ED-ISA 265, be deleted. This would eliminate the apparent confusion felt by some respondents regarding whether there is a requirement to test the operating effectiveness of compensating controls before the auditor communicates identified deficiencies.
40. Nevertheless, in relation to significant deficiencies, the Task Force agreed that where the auditor has been informed by management, or otherwise knows, of the existence of compensating controls, the auditor may acknowledge this fact in the written communication of significant deficiencies and indicate whether or not the auditor has tested the operating effectiveness of such compensating controls (*see paragraph A20 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*).

Matters for IAASB CAG Consideration

5. Do the Representatives agree with the Task Force's proposed revised approach to compensating controls in the ISA, and the proposed amendments noted above?
6. Do the Representatives agree with the guidance proposed in paragraph A20 of the revised draft?

COMMUNICATING IN WRITING TO MANAGEMENT

41. The explanatory memorandum to ED-ISA 265 explained that the IAASB did not propose that the auditor be required to communicate all identified deficiencies formally to

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

management in writing as this could place an undue and excessive documentation burden on the auditor, particularly in smaller entity audits.

42. A small minority of respondents questioned whether communicating such deficiencies in writing to management would place an excessive burden on the auditor. The respondents were of the view that the auditor would normally document any such communication with management in the auditor's working papers anyway. They argued that communication of such deficiencies to management (and significant deficiencies to management and those charged with governance) is an important subsidiary outcome of the audit. Thus, they added, having a written record for management and auditors of what has been communicated would not only be useful for both management and auditors, but would also add value from a public interest perspective. The respondents also suggested that the communication need not be "formal," as implied in the explanatory memorandum, but could simply be a copy of the auditor's own documentation.
43. Another respondent suggested that oral communication alone would not be sufficient and would not be in the best interest of the entity as management would have no record of the matters raised and would not appreciate that the auditor expects the deficiencies to be remedied.
44. One respondent suggested that the proposed ISA should clarify that significant deficiencies also need to be communicated, preferably in writing, to management unless those significant deficiencies involve management. Another respondent suggested switching the order of paragraphs 9 (communication to management) and 10 (communication to those charged with governance) in ED-ISA 265, so that the auditor would, in the first instance, be required to communicate all significant deficiencies identified to both management and those charged with governance, and then any other identified deficiencies to management.
45. One respondent noted that the communication of deficiencies will take place at the time management responds by providing information on other controls. Accordingly, given that such communication would already have taken place, the respondent disagreed with the proposed requirement that the auditor communicate to management as identified deficiencies those suspected deficiencies that management asserts are compensated by other controls.

Preliminary Task Force Views and Recommendations

46. The IAASB debated at length the issue of whether to require the auditor to communicate all identified deficiencies to management in writing. As noted in the explanatory memorandum, the IAASB took the view that imposing such a requirement would place an excessive and unreasonable documentation burden on the auditor, especially given that many of the matters identified for communication may not be significant deficiencies. This view seems to have been supported by the vast majority of the respondents. Further, the Task Force

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

notes that ISA 230 (Redrafted)¹⁰ only requires the auditor to document discussions of *significant matters* with management. To the extent that the auditor judges certain identified deficiencies not to be significant matters (and the Task Force believes that not all identified deficiencies will necessarily be significant matters), there would be no requirement to document these deficiencies.

47. Accordingly, the Task Force believes that it remains appropriate not to impose a specific requirement that all identified deficiencies be communicated to management in writing. However, the Task Force agreed that it would be appropriate to include a reference to the overarching requirement in ISA 230 (Redrafted) in relation to the documentation of discussions of significant matters with management to draw the auditor's attention to the need to consider whether identified deficiencies, even if not qualifying as significant deficiencies, would nonetheless be significant matters requiring documentation under ISA 230 (Redrafted). For identified deficiencies that are not considered significant matters, the Task Force agreed that guidance be provided to indicate that the auditor may nevertheless find it helpful to document the discussions of such matters with management (*see paragraph A22 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*).
48. With regard to the communication principles in paragraphs 9 and 10 of ED-ISA 265, the Task Force agreed that these would be clearer if the ISA were to first require the auditor to communicate significant deficiencies in writing to *both* management and those charged with governance, and then any *other* identified deficiencies to management, with no requirement that the latter be communicated in writing. (*See paragraphs 9 and 11 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*). The Task Force believes that this restructuring clarifies the original intent of the IAASB and responds to the concerns expressed by some of the above respondents.
49. Finally, the Task Force agreed that where the auditor has discussed the facts and circumstances of the auditor's findings with management to confirm the existence of identified deficiencies, the auditor may consider an oral communication of these deficiencies to have been made to management at the time of the discussions. Therefore, in such circumstances, the auditor would not need to repeat the communication subsequently. (*See paragraph A22 of proposed ISA 265 – Agenda Item 3-B of the September 2008 IAASB meeting material*).

Matters for IAASB CAG Consideration

7. Do the Representatives agree that there should not be a requirement that the auditor communicate identified deficiencies to management in writing?
8. Do the Representatives agree that it would be appropriate to include a reference to ISA 230 (Redrafted) in the guidance in relation to the overarching requirement to

¹⁰ ISA 230 (Redrafted), "Audit Documentation."

IAASB CAG PAPER

IAASB CAG Agenda (September 2008)

Agenda Item G

Control Deficiencies

- document discussions of significant matters with management?
9. Do the Representatives agree that paragraphs 9 and 11 as restructured in the revised draft clarify the communication principles in this ISA?
10. Do the Representatives agree with the further guidance provided in paragraph A22 in the revised draft in relation to treating the requirement to communicate to management as having been discharged at the time the auditor first discusses the identified deficiencies with management?

OTHER SIGNIFICANT COMMENTS

50. *For other significant comments identified by the Task Force, see Agenda Item 3-A of the September 2008 IAASB meeting material:*
- Scope of the ISA – paragraphs 15-22 of Agenda Item 3-A
 - Definition of the term ‘deficiency in internal control’ – paragraphs 23-25 of Agenda Item 3-A
 - Use of the term ‘clearly trivial’ – paragraphs 26-33 of Agenda Item 3-A
 - Deficiencies involving management – paragraphs 66-69 of Agenda Item 3-A
 - Follow-up by the auditor on deficiencies communicated in the prior period – paragraphs 70-73 of Agenda Item 3-A
 - Illustrative reports – paragraphs 74-75 of Agenda Item 3-A

Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY

Agenda Item 3-A of the September 2008
IAASB Meeting – Summary of Significant
Comments and Task Force
Recommendations—Exposure Draft of
Proposed ISA 265

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4109>

Agenda Item 3-B of the September 2008
IAASB Meeting – Proposed ISA 265 (Mark
Up from Exposure Draft)

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4110>

Action Requested

The IAASB CAG is asked to review the significant comments on ED-ISA 265 highlighted in this paper, and to comment on the Task Force’s preliminary recommendations.