



International Federation of Accountants

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# Agenda Item

## C.4

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Dubai

**Meeting Date:** March 9 – 10, 2009

### Report Back—Communicating Deficiencies in Internal Control – ISA 265

#### Objective of Agenda Item

1. The objective of this Agenda Item is to provide a brief report back on proposals of Representatives on proposed ISA 265, “Communicating Deficiencies in Internal Control,” discussed at the September 4-5, 2008 CAG Meeting.

The IAASB approved the proposed ISA as a final standard with a revised title, “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management,” at its December 8-11, 2008 meeting.

#### September 4 - 5, 2008 CAG Proposals

2. Below is an extract from the draft minutes of the September 2008 CAG meeting<sup>1</sup> and an indication of how the IAASB Task Force or the IAASB responded to the Representatives’ comments.

Representatives’ Comments	Task Force/IAASB Response
SMALLER ENTITIES AND THE PERCEIVED EMPHASIS OF THE ISA ON THE USE OF TYPE A AND TYPE B REPORTS	
Mr. Sekiguchi indicated that IOSCO has expressed concern that the proposal in the exposure draft of proposed ISA 265 to replace the notion of “material weakness” with the notion of “significant deficiency” wherever the former is used in several ISAs might create confusion in countries where one or both of these terms have been and continue to be used in established law and regulation and auditing literature. This is because the terms “material weakness” and “significant deficiency” are	Point not accepted.  The IAASB noted that the essential meaning of a significant deficiency should not depend on the nature of the engagement (i.e., whether the auditor has been engaged to express an opinion on the effectiveness of internal control, as in an integrated audit under PCAOB standards, or whether the auditor has been engaged to audit the financial statements). The IAASB also noted that while there may be a need to establish a further category of deficiencies in

<sup>1</sup> The minutes will be approved at the March 2009 IAASB CAG meeting.

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<p>presently used in a number of jurisdictions around the world, with varying definitions or without definition, and are part of many established auditing and legal frameworks. For example, while one jurisdiction may define a significant deficiency as a deficiency that is less severe than a material weakness, in some countries the reverse may be true, where a “significant deficiency” is understood to be more serious than a “material weakness.” Others point out that the two terms would essentially be translated the same way in certain languages. IOSCO is therefore concerned that the use of this term may not achieve the goal of the IAASB to create consistency of auditor performance in communicating relevant internal control-related matters. Mr. Sekiguchi explained that IOSCO has suggested that the IAASB explore two remedies: (1) develop a more appropriate term, one that does not conflict with embedded terms in long-standing use; or (2) not create a new term and instead replace the term with its definition wherever appropriate in the ISAs. In regard to the latter option, Ms. Koski-Grafer further explained that IOSCO recognizes the challenge of the IAASB in trying to establish a single defined term. Mr. Cowperthwaite indicated that the Task Force has explored both options and found that they introduced a degree of complexity that significantly reduced the clarity of the ISA.</p>	<p>internal control to accommodate a legal or regulatory requirement (e.g., a public reporting requirement in an audit of internal control), that should not in itself create a need for a different definition of the term “significant deficiency.” The IAASB reaffirmed its view that retaining the proposal in the ED would help further the goal of international convergence, especially given that the same term and definition are already used in the United States for audits of both listed and unlisted entities.</p>
<p>Ms. Koski-Grafer was of the view that it would be helpful if the introduction section of the ISA included a statement that acknowledges that control deficiencies exist in a broad range of severity and alert the auditor that the legal frameworks of different jurisdictions may use definitions that differ from those in the ISA and/or impose additional obligations on the auditor.</p>	<p>Point not accepted.</p> <p>The Task Force concluded that the key message in the introductory part of the standard should be that the auditor may identify deficiencies in internal control not only during the risk assessment process but also at any other stage of the audit. Further, the Task Force felt that the point was already implicit in the introduction through the statement to the effect that the ISA specifies <i>which</i> identified deficiencies the auditor is required to communicate to those charged</p>

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	<p>with governance and management. <i>See paragraph 2 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p> <p>With regard to the point about the possibility of legal frameworks of different jurisdictions using definitions that differ from those in the ISA and/or imposing additional obligations on the auditor, the Task Force concluded that highlighting this in the introduction would unduly detract from the key communication principles the ISA seeks to establish. The ISA nevertheless deals with the matter in the application material. <i>See paragraphs A9-A11 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p>
<p>Mr. Pickeur was of the view that the ISA is confusing, particularly in relation to the difference between significant deficiencies and material weaknesses. He found it difficult to distinguish between the two, and the categorization of control deficiencies to be unclear. He was also of the view that the ISA should be more than just a communication standard. That is, the ISA should establish categories that define what constitutes a significant deficiency or otherwise, and should relate what needs to be reported, to either those charged with governance or management, or both, to those categories. In his opinion, it is simply not clear how the proposed draft will work in practice. He indicated that overall he was not happy with the approach taken in the exposure draft, and that he does not believe the deficiencies therein have been rectified in the revised draft.</p>	<p>Point taken into account.</p> <p>The approach set out in the exposure draft was supported by the overwhelming majority of respondents. The IAASB determined that the categorization of identified deficiencies should be a matter of the auditor's judgment depending on what the auditor believes would merit the respective attentions of those charged with governance and management in the circumstances. The IAASB made a conscious decision that the definitions of the relevant terms in the ISA should not result in a significant expansion of the auditor's work effort regarding the evaluation of the significance of identified deficiencies and their categorization, beyond current practice.</p> <p>Nevertheless, the IAASB has provided appropriate guidance in the ISA to assist the auditor in making the necessary judgments regarding the significance of identified deficiencies. <i>See paragraphs A5-A7 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p>
<p>Mr. Diomeda was also of the view that the proposed ISA does not clearly explain the</p>	<p>Point taken into account.</p> <p>The IAASB has provided guidance in the ISA to</p>

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<p>relationship between significant deficiencies and material weaknesses. In his opinion, this is of fundamental importance to an understanding of the effect of the ISA on European Union (EU) companies and their auditors in regard to their obligations are under the EU Statutory Audit Directive and those under the ISAs. Mr. Robberecht agreed with this comment, and noted that the EC would prefer to see the finalization of ISA 265 deferred and excluded from the suite of clarified ISAs to come into effect in 2009. In response, Mr. Ju indicated that the proposed ISA is helpful in the context of China which has just issued regulation dealing with internal control of business enterprises and the required auditor's report on such internal control.</p>	<p>address situations where law or regulation has established specific terms for deficiencies in internal control that the auditor should communicate. <b>See paragraphs A9-A11 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</b></p>
<p>Mr. Roussey suggested that the Task Force should consider developing and incorporating in the ISA a pictorial depiction that illustrates the categories of deficiencies and how the notion of material weaknesses fits within the categories.</p>	<p>Point not accepted.</p> <p>The Task Force did not agree that this would be necessary or appropriate, particularly given that the ISA does not use the term "material weakness."</p> <p>The IAASB has considered the use of detailed pictorials in the context of the redrafting of other ISAs (e.g. ISA 710 (Redrafted), "Comparative Information—Corresponding Figures and Comparative Financial Statements") and concluded that these would be more appropriate for implementation guidance outside of the standards.</p>
<p>Mr. Johnson was of the view that it would be helpful to include the content of paragraph A9 of the proposed ISA, which explains that a material weakness is a subset of a significant deficiency, in the introduction section or as essential explanatory material. This would more clearly set the stage for the definition of significant deficiency and why material weakness is not defined, and would provide context to the requirements of the ISA. Ms. Koski-Grafer agreed with these suggestions.</p>	<p>Point not accepted.</p> <p>The Task Force did not agree that this would be appropriate as it would give undue prominence to an issue that is jurisdiction-specific.</p> <p>The IAASB has, nonetheless, agreed to provide guidance on the matter in the final ISA. <b>See paragraphs A9-A11 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</b></p>

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<p>Mr. White was of the view that the definition of significant deficiency is tautological and circular. He was also of the view that the absence of a clear and definitive definition for the term will lead to divergence in practice.</p>	<p>Point not accepted.</p> <p>As indicated above, the IAASB determined that the categorization of identified deficiencies should be a matter of the auditor's professional judgment depending on what the auditor believes would merit the respective attentions of those charged with governance and management in the circumstances. The IAASB concluded that a more objective definition of significant deficiency would likely necessitate significant additional work effort by the auditor beyond current practice in evaluating identified deficiencies to determine whether they meet the objective criteria in the definition.</p> <p>Nevertheless, the IAASB has provided guidance in the final ISA that will assist the auditor in making the necessary judgments about which identified deficiencies are significant deficiencies. <b><i>See paragraphs A5-A7 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></b></p>
<p>Mr. Sekiguchi noted that in Japan the auditor is required to perform an audit of internal control over financial reporting similar to the US PCAOB's Auditing Standard 5, "An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements" (AS No. 5), but to perform an audit of the financial statements based on Japanese GAAS which is substantially identical to ISAs. He was of the view that the proposals in the draft ISA in relation to communication of significant deficiencies may create practical difficulties and confusion when the auditor is also communicating in accordance with AS No. 5. Mr. Cowperthwaite explained that proposed ISA 265 does not apply where the auditor has been engaged to express an opinion on the effectiveness of internal control.</p>	<p>Point not accepted.</p> <p>As indicated above, the IAASB agreed that the essential meaning of a significant deficiency should not depend on the nature of the engagement (i.e., whether the auditor has been engaged to express an opinion on the effectiveness of internal control, as in an integrated audit under PCAOB standards, or whether the auditor has been engaged to audit the financial statements). The IAASB also agreed that while there may be a need to establish a further category of deficiencies in internal control to accommodate a legal or regulatory requirement (e.g., a public reporting requirement in an audit of internal control), that should not in itself create a need for a different definition of the term "significant deficiency."</p>
<p>Ms. Koski-Grafer urged to Task Force to review</p>	<p>Point accepted.</p>

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<p>carefully the proposed conforming amendments to the others ISAs arising from the revised draft of the standard, and to evaluate whether there could be any unintended consequences or effects on the scope of an audit by replacing the references to “material weakness” with the new term “significant deficiency” (which is defined differently and appears to represent a different threshold of significance).</p>	<p>The IAASB reviewed the conforming amendments in detail prior to approving the final standard.</p>
COMMUNICATION OF DEFICIENCIES	
<p>Mr. Hallqvist was of the view that the auditor should communicate with those charged with governance (in particular, the audit committee) all deficiencies in internal control identified during an audit. A complete list is essential in order for the audit committee to understand the extent of deficiencies present in the system of internal control. The audit committee can then judge what is, or is not, significant and determine what should be done. Mr. Johnson, Ms. Koski-Grafer and Ms. Sucher did not agree with Mr. Hallqvist. They were of the view that it is more effective for the auditor to draw to the audit committee’s attention those matters the auditor believes are significant, together with an explanation of why in the auditor’s professional judgment they are considered to be significant. While the audit committee has the right to ask the auditor to provide it with a complete list of all deficiencies identified, this is a matter to be agreed between audit committee and the auditor and not a matter for an auditing standard. Ms. Koski-Grafer suggested, however, that the Task Force might consider adding a statement that the auditor’s judgment about additional matters to be communicated is made in the context of any specific information requested by the audit committee.</p>	<p>Point taken into account.</p> <p>The IAASB agreed that the requirement to communicate to those charged with governance should only be in respect of significant deficiencies.</p> <p>However, the IAASB agreed to include guidance to the effect that the auditor may report as appropriate to those charged with governance if the latter wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies.</p> <p><b><i>See paragraph A25 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></b></p>

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<p>Mr. Uchino noted that it is management that is in the best position to identify and rectify deficiencies in internal control. He was therefore of the view that the ISA should emphasize the importance of effective and substantial communication between management and the auditor.</p>	<p>Point taken into account.</p> <p>The final ISA includes a requirement that the auditor communicate to management (a) significant deficiencies in writing; and (b) other deficiencies in internal control. The IAASB determined that the communication of the other deficiencies to management need not be in writing so as to encourage effective oral dialogue between the auditor and management. <i>See paragraph 11 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p> <p>Also, recognizing that management is in the best position to rectify deficiencies, the IAASB included guidance in the final ISA to the effect that the auditor may include in the written communication of significant deficiencies suggestions for remedial action on the identified deficiencies. <i>See paragraph A28 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p> <p>Finally, there is a more general emphasis in ISA 315 (Redrafted) on the need for the auditor to discuss internal control-related matters with management through the requirement for the auditor to obtain an understanding of the entity's internal control relevant to the audit. ISA 315 (Redrafted) requires that this understanding be obtained through risk assessment procedures that include inquiries of management.</p>
<p>Mr. Sekiguchi agreed with this point, and suggested also that it would be helpful to clarify whether the term 'management' is intended to refer to senior level management or those at a lower level that have direct responsibility for a particular control. While it may not be necessary to communicate in writing to senior-level management all deficiencies noted by the auditor, deficiencies should be reported in writing to the respective levels of management who will have the responsibility to</p>	<p>Point accepted.</p> <p>Guidance has been provided in the final ISA. <i>See paragraph A19 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p>



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deal with them.	
In addition, Mr. Sekiguchi believes that the auditor should be required to communicate with those charged with governance whether management has been informed of deficiencies noted by the auditor.	<p>Point taken into account.</p> <p>The IAASB determined that it would not be appropriate to impose such a requirement as this could be interpreted as implying that these other deficiencies are now also significant deficiencies. Further, the IAASB believes that imposing such a requirement in every case would be excessive.</p> <p>Instead, the IAASB agreed that guidance on this point should be provided to the effect that in some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. <b>See paragraph A25 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</b></p>
Mr. Peyret was of the view that, in a group audit situation, the auditor should communicate with those charged with governance the result of local audits that have a qualified report, including the basis for the qualification, and how the matters have been resolved in the group context.	<p>Point not accepted.</p> <p>This is outside the scope of ISA 265 as the matter does not relate to the communication of deficiencies in internal control. The matter is instead covered by the requirement in ISA 260 (Revised and Redrafted), paragraph 12, for the auditor to communicate significant findings from the audit to those charged with governance.</p>
Mr. Kottvedgaard was of the view that there should be clear linkages between ISA 265 and ISA 315 (Redrafted), <sup>2</sup> ISA 330 (Redrafted) and ISA 260 (Revised and Redrafted), <sup>3</sup> in particular in relation to	<p>Point taken into account.</p> <p>There is no obligation in the ISAs for the auditor to <i>identify</i> significant deficiencies in internal control, in</p>

<sup>2</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

<sup>3</sup> ISA 260 (Revised and Redrafted), "Communicating with Those Charged with Governance."



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<p>the underpinning obligation on the auditor to identify significant deficiencies in internal control.</p>	<p>the sense of searching for them. The obligation is for the auditor to determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control, and, if so, to determine their significance and to communicate them to the appropriate parties within the entity. This obligation, which was originally in ISA 315 (Redrafted), has been moved to the final ISA. <i>See paragraph 7 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p> <p>The obligation to communicate deficiencies the auditor has identified, which was originally in both ISAs 315 (Redrafted) and 330 (Redrafted), has been moved to the final ISA through conforming amendments. <i>See paragraphs 9 and 10 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p> <p>With regard to ISA 260 (Revised and Redrafted), an appropriate link has been provided to that standard in the final ISA in relation to the auditor's general responsibility to communicate with those charged with governance in relation to the audit. <i>See paragraph 1 of Updated Agenda Item 2-C for the text of the ISA as approved by the IAASB.</i></p> <p>Also, a link back to ISA 265 has also been provided in ISA 260 (Revised and Redrafted) through a conforming amendment to the latter regarding the auditor's responsibility to communicate significant deficiencies the auditor has identified during the audit to those charged with governance. <i>See paragraph 3 of the conforming amendments to ISA 260 (attached to Updated Agenda Item 2-C) as approved by the IAASB.</i></p>

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### **Material Presented – IAASB CAG REFERENCE PAPERS ONLY**

Updated Agenda Item 2-C - Final wording of  
ISA 265 as approved by the IAASB in  
December 2008

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4451>

Related conforming amendments as approved by  
the IAASB in December 2008

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4452>