



**International Federation of Accountants**

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## Agenda Item

# 2

**Committee:** IAASB  
**Meeting Location:** Brussels  
**Meeting Date:** December 8-11, 2008

### **Communicating Deficiencies in Internal Control**

#### **Objective of Agenda Item**

1. To review and approve as a final standard proposed ISA 265, “Communicating Deficiencies in Internal Control.”

#### **Task Force**

2. The members of the Task Force are:
  - Phil Cowperthwaite – Chair, IAASB Member
  - Dr. Mohammed Bahjatt – INTOSAI Representative
  - Caithlin McCabe – IAASB Member (assisted by Tania Sergott –Technical Advisor)
  - Dan Montgomery – IAASB Technical Advisor
  - Jianhua Tang – IAASB Member

#### **Activities since Last IAASB Discussions**

3. The Task Force met via teleconference in October 2008 to discuss the significant comments received from the IAASB on the first-read draft (post-exposure) at the September 2008 meeting and to develop a revised draft of the proposed ISA. This revised draft was circulated to the IAASB for comment on October 15, 2008. The Task Force held a conference call in November 2008 to consider the comments received from the IAASB on the revised draft and to finalize the wording of the final draft now being presented.

#### *Comment Letter Received After September 2008 IAASB Meeting*

4. The Task Force also considered a comment letter from a respondent (NIVRA) that, due to a technical transmission issue, was received only after the agenda papers for the September 2008 IAASB meeting had already been posted. The Task Force is of the view that the matters raised by this respondent are broadly similar to those that other respondents had raised, and have been appropriately addressed as part of the agenda papers presented for the September

meeting. The IAASB is, nevertheless, asked to consider the comment letter<sup>1</sup> as it reviews the agenda papers now presented.

### Main Issues

5. The following summarizes the main issues raised at the September 2008 IAASB meeting and the task force's preliminary views and recommendations in the light of comments received from IAASB participants on the October 15<sup>th</sup> revised draft.
  - A. DEFICIENCIES IN INTERNAL CONTROL THAT ARE CLEARLY INCONSEQUENTIAL
6. Paragraph 9 of the exposure draft proposed that the auditor be required to communicate to management all deficiencies in internal control (other than those that are clearly trivial) identified during the audit. A number of respondents were concerned about the potential scope of this requirement. They were of the view that the requirement could lead to numerous minor deficiencies being communicated, particularly in view of the implicit emphasis on quantitative considerations through the use of the term 'clearly trivial' (which is tied to the evaluation of misstatements in ISA 450 (Revised and Redrafted)).<sup>2</sup> The respondents felt that this outcome would not be justifiable in cost-benefit or audit quality terms.
7. In response to these concerns, the Task Force proposed at the September 2008 IAASB meeting that the ISA address 4 separate categories of deficiencies in internal control, i.e.:
  - (a) Significant deficiencies that should be reported to those charged with governance;
  - (b) Deficiencies that are not inconsequential and are of sufficient importance to merit management's attention;
  - (c) Deficiencies that are not inconsequential but are not of sufficient importance to merit management's attention; and
  - (d) Deficiencies the potential financial effects of which are clearly inconsequential.
8. The Task Force intended that with the introduction of category (c), the auditor would be provided with an element of flexibility to determine which deficiencies among those that are not inconsequential would not need to be brought to management's attention.
9. A number of IAASB members, however, expressed concern about the introduction of this fourth category of deficiencies. They were of the view that this could create further inconsistency in reporting, and confusion as to what is intended. Further, it was questioned whether it would be in the public interest for the auditor to have identified a deficiency that is not inconsequential and then not report it to anyone. It was noted that the determination of what is inconsequential is where the application of the auditor's judgment truly becomes key. Thus, if the auditor has concluded, based on professional judgment, that a deficiency is inconsequential, the auditor would not communicate it. It was suggested that if the scope of the requirement to communicate to management were to be viewed in that light, it would be

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<sup>1</sup> The comment letter from NIVRA can be accessed on the IAASB website at <http://www.ifac.org/Guidance/EXD-Comments.php?EDID=0100&Group=Member+Bodies>.

<sup>2</sup> ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit."

important for the ISA to explain how the auditor would make the judgment as to whether a deficiency is inconsequential.

10. It was also apparent from comments received from the IAASB CAG and a number of IAASB members that the fact that there were four categories of deficiencies in internal control was not obvious. The confusion indicated that the revisions proposed at the September meeting might have resulted in the ISA being over-engineered.

#### *Task Force Views and Recommendations*

11. In the light of the above discussions, the Task Force agreed that the proposal to introduce a fourth category of deficiencies in internal control in the ISA would create unnecessary confusion. Accordingly, the Task Force recommends that the ISA should address only the following three categories:
  - (a) Significant deficiencies;
  - (b) Deficiencies that are of sufficient importance to merit management's attention; and
  - (c) Deficiencies that are not of sufficient importance to merit management's attention.
12. With regard to the issue of how to draw the line between what is inconsequential and what is not, the Task Force concurred with the views expressed by the IAASB that the determination as to whether a deficiency is inconsequential rests entirely on the auditor's judgment as to whether the deficiency needs to be reported. The Task Force believes that deficiencies that are not of sufficient importance to merit management's attention should be considered inconsequential and not treated as representing a category of deficiencies separate from inconsequential deficiencies. To emphasize this point, the Task Force proposes that:
  - Paragraph 1 of the ISA be amended to remove the reference to inconsequential deficiencies being outside the scope of the ISA; and
  - Paragraph A24 of the revised draft be amended to explain that where the auditor judges that a deficiency in internal control does not merit management's attention, that deficiency is inconsequential.
13. The Task Force is of the view that it would not be practicable to establish comprehensive guidance that would clearly demark when a deficiency in internal control is inconsequential as it will be a matter of the auditor's judgment in the circumstances when a deficiency merits management's attention and when it does not. In addition, establishing bright-line criteria to define when a deficiency is inconsequential could detract from the more important task at hand; i.e., identifying and communicating significant deficiencies to those charged with governance. The Task Force believes that this could result in auditors spending significant time laboring over whether certain matters fit the 'inconsequential' label when they should in fact be concentrating on communicating identified deficiencies in internal control to appropriate parties within the entity.
14. Accordingly, the Task Force proposes that guidance be provided to simply explain that the determination as to which deficiencies in internal control (other than significant deficiencies) merit management's attention is a matter of professional judgment in the circumstances, taking

into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies in internal control (see paragraph A24 of the revised draft).

**Matter for IAASB Consideration**

Does the IAASB agree with the Task Force's recommendations regarding the matter of inconsequential deficiencies?

**B. LEGAL OR REGULATORY REQUIREMENT TO COMMUNICATE MATERIAL WEAKNESSES**

15. At the September meeting, the Task Force recommended that the terminology proposed in the exposure draft (i.e., that the term 'material weakness' in the extant ISAs be replaced with the term 'significant deficiency') should be retained as it had the support of the overwhelming majority of the respondents. A few IAASB members noted that the essential meaning of the concept 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). It was also noted 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 under an integrated audit), that should not in itself create a need for a different definition of the term 'significant deficiency'. It was noted that retaining the proposal in the exposure draft would further the goal of international convergence, as the same term and definition are already used in the United States for audits of both listed and unlisted entities, and that this terminology had travelled well in other jurisdictions such as the UK. Accordingly, the IAASB generally agreed that the terms and definitions in the exposure draft should be carried forward.
16. Given that this approach would not directly address the legal requirement under the EU Statutory Audit Directive for the auditor to communicate material weaknesses in internal control to those charged with governance, the IAASB generally agreed that guidance could be provided to explain how the interpretation of such a legal requirement might be made in the context of the requirements and guidance in the ISA. The IAASB also agreed that the ISA should not make any presumption as to whether material weaknesses under the EU Statutory Audit Directive (or any other term under the applicable legal or regulatory framework) are a subset of significant deficiencies.

*Task Force Response*

17. In the light of these discussions and the IAASB's guidance, the Task Force has amended the relevant guidance as follows:
- Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency in

internal control and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement. (See paragraph A9 of the revised draft).

- Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this ISA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies in internal control required by this ISA to be communicated to those charged with governance. (See paragraph A10 of the revised draft).
18. In addition, to emphasize that the auditor needs to continue to comply with the requirements of the ISA even when law or regulation has established a specific communication requirement, the Task Force proposes to add the following guidance in paragraph A11 of the revised draft:
- Except to the extent that law or regulation requires the auditor to use specific terms or definitions when communicating certain deficiencies in internal control to those charged with governance or to other relevant parties, the requirements of this ISA remain applicable. Accordingly, all matters required by this ISA to be communicated to those charged with governance are communicated by the auditor as part of, or in addition to, those matters communicated in accordance with law or regulation.
19. The Task Force believes that the development of any further guidance that may be considered necessary to support the implementation of a legal or regulatory communication requirement should be the purview of the relevant national standard setters.

#### **Matter for IAASB Consideration**

Does the IAASB agree that the wording of the guidance proposed in paragraphs A9-A11 appropriately addresses cases where law or regulation has established a communication requirement for a certain type of deficiency in internal control?

#### **C. LOCATION OF THE IDENTIFICATION REQUIREMENT**

20. At the September meeting, an IAASB member expressed the view that the proposed ISA did not appear to be solely a communication standard because it seemed to consist of two distinct parts, i.e., a part dealing with the identification of deficiencies in internal control,<sup>3</sup> and a part dealing with their communication. It was noted, in particular, that the guidance relating to the

<sup>3</sup> The requirement relating to the identification part in the September draft of the ISA is as follows:

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)

identification part seemed to be of an operational nature and therefore more suited to being in ISA 315 (Redrafted)<sup>4</sup> than in a communication ISA. It was noted that if the identification requirement were taken out of ISA 315 (Redrafted), it would be unclear how the auditor would identify deficiencies in internal control as part of the risk assessment process. In addition, it was pointed out that while guidance in ISA 330 (Redrafted)<sup>5</sup> indicates that the existence of deficiencies in internal control may lead the auditor to vary the nature, timing and extent of audit procedures, under the proposal there would be no requirement in ISA 330 (Redrafted) for the auditor to evaluate whether such deficiencies exist in the first place. Accordingly, it was suggested that it would be more logical that the requirement relating to identification be moved back to both ISA 315 (Redrafted) and ISA 330 (Redrafted), where it is presently situated.

21. Another IAASB member questioned whether the identification requirement might be the cause of confusion among some readers as to whether this ISA is a performance or a communication standard. It was suggested that the requirement might perhaps be unnecessary given that the same result appears to be achieved through the condition in the immediately succeeding requirement:
8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A9)

#### *Task Force Views and Recommendations*

22. The Task Force discussed at length the above comments and believes that there are sufficient grounds for not amending the current proposal:
- (a) The Task Force noted that the IAASB had agreed during the earlier part of the project that it would be appropriate for all the relevant requirements and guidance relating to the identification and communication of deficiencies in internal control to be brought together under one ISA as opposed to being interspersed among different ISAs (i.e. ISA 315, ISA 330 and ISA 260<sup>6</sup>).<sup>7</sup> The IAASB had agreed that doing so would help auditors more readily understand, in the context of the revised terminology and definitions, what was required of them in this particular area as all the relevant requirements and guidance would be located in one place. Also, from a practical perspective, the IAASB had acknowledged that this would facilitate the development of the requirements and guidance while minimizing the extent of the changes to the other ISAs. This proposal was included in the exposure draft and respondents did not raise any significant concern regarding the location of the requirements.

<sup>4</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

<sup>5</sup> ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks," paragraph A2.

<sup>6</sup> ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance."

<sup>7</sup> See July and October 2006 IAASB meeting minutes: <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0076&ViewCat=0606> and <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0067&ViewCat=0696>; and October 2006 issues paper: <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0081&ViewCat=0644>.

- (b) The Task Force notes that the identification requirement in the proposed ISA is not a requirement for the auditor to actively search for deficiencies in internal control. Indeed, the extant ISAs do not place such a responsibility on the auditor. Rather, the requirement is intended to act as a “collation agent” by prompting the auditor to determine, on the basis of the audit work performed, whether deficiencies in internal control exist and, if so, to bring them together for the communication phase. The requirement is overarching in that its application is not limited to the risk assessment phase only but covers the entire audit (as noted in paragraph 2 of the proposed ISA). As such, the Task Force believes that it is appropriate that the requirement should be in one place only and not duplicated in ISA 315 (Redrafted) and ISA 330 (Redrafted) (or other performance ISAs such as ISA 240 (Redrafted),<sup>8</sup> ISA 540 (Revised and Redrafted)<sup>9</sup> and ISA 550 (Revised and Redrafted)<sup>10</sup>). The Task Force believes that the inclusion of this requirement in ISA 265 will not detract from the overall purpose of the ISA, which is communication.
- (c) The Task Force notes that the application of the requirements of the ISAs does not follow a linear path. Accordingly, it is not so much the geography of the requirements as their prominence that should be the predominant concern. Further, the ISAs are not intended to be read in isolation but should be considered as an integrated whole. The Task Force observed that the approach taken in this ISA is similar to the one taken in ISA 450 (Revised and Redrafted), which deals with the evaluation of identified misstatements. In particular, paragraph 5 of ISA 450 (Revised and Redrafted) requires the auditor to “accumulate misstatements identified during the audit, other than those that are clearly trivial.” There is no separate requirement in ISA 330 (Redrafted) or other performance ISAs for the auditor to determine whether, on the basis of the audit work performed, the auditor has identified one or more misstatements in the financial statements. A similar parallel exists with the overarching requirement in ISA 260 (Revised and Redrafted) for the auditor to communicate to those charged with governance significant difficulties encountered during the audit.
- (d) The Task Force did not agree that it would be appropriate to do away with the identification requirement in the proposed ISA because doing so would represent a weakening of the existing standards. The identification requirement places a positive obligation on the auditor to apply some thought to determine whether, on the basis of the evidence obtained from all the work performed, any deficiencies in internal control exist. The Task Force believes that removing this obligation from the ISAs would not be in the public interest.
23. For these reasons, the Task Force believes that the proposal in the exposure draft should remain unchanged. However, the Task Force proposes that the subheading above paragraph 7 in the proposed ISA (i.e., Identification of Deficiencies in Internal Control) be deleted as it

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<sup>8</sup> ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.”

<sup>9</sup> ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”

<sup>10</sup> ISA 550 (Revised and Redrafted), “Related Parties.”

might have generated, or continue to generate, confusion regarding the nature of the auditor's responsibility to identify deficiencies in internal control. The Task Force is of the view that the deletion of this subheading and the other subheading in the Requirements section would not adversely affect the clarity of the ISA as the requirements are few in number and sufficiently clear on their own.

24. Finally, in response to a comment from a respondent (IOSCO) whose comment letter was received shortly before the September IAASB meeting, the Task Force is proposing that the guidance attached to paragraph 7 to the effect that "the auditor may seek to agree the relevant facts and circumstances of the auditor's findings with management" be elevated to a requirement, conditional on it being appropriate to do so in the circumstances (see paragraphs 7 and A1 of the revised draft). The Task Force accepted the respondent's argument that without reaching such an agreement, the auditor might not reach the appropriate determination as to whether a deficiency exists, thereby leading to an incomplete understanding of the matter.

#### **Matters for IAASB Consideration**

Does the IAASB agree with the retention of the identification requirement in ISA 265?

Does the IAASB agree with the proposed elevation of the guidance in paragraph A1 to a requirement?

#### **Consideration of the Need to Re-Expose**

25. Agenda Item 2-B shows the proposed final wording of the ISA, marked from the exposure draft. It is the view of the Task Force that the changes reflected in the proposed final wording are responsive to the comments received on exposure and do not establish new principles or substantively new requirements compared with the exposure draft. Accordingly, the task force believes that the changes do not warrant re-exposure.

#### **Matter for IAASB Consideration**

Does the IAASB agree that re-exposure is not necessary?

#### **Material Presented**

Agenda Item 2-A (Pages 2629 – 2654)	Revised Draft of Proposed ISA 265 (Marked from September 2008 Draft)
Agenda Item 2-B (Pages 2655 – 2668)	Revised Draft of Proposed ISA 265 (Marked from Exposure Draft)
Agenda Item 2-C (Pages 2669 – 2692)	Revised Draft of Proposed ISA 265 (Clean)

**Draft of the ISA to be Discussed at the Meeting**

The Task Force proposes that **Agenda Item 2-A** (marked text from the September 2008 draft) be discussed at the meeting.

**Action Requested**

The IAASB is asked to consider the above issues and approve the revised draft of proposed ISA 265 as a final standard.

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