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Basis for Conclusions: ISA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

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International Federation of Accountants

BASIS FOR CONCLUSIONS:

ISA 265, COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management," which was unanimously approved by the IAASB in December 2008.[1]

Background

1. 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:

   - The requirement under the European Union's Statutory Audit Directive for auditors to report identified material weaknesses in internal control ("material weaknesses") 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.[2]

2. In addition, it was recognized that the current definition of the term "material weakness" within the extant ISAs is rather general[3] 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 those charged with governance and management.

3. As the project evolved and new considerations emerged during debate at a number of meetings of the IAASB and the IAASB Consultative Advisory Group (CAG), the original aim of the project to develop a revised definition of material weakness shifted to a focus on developing a clear definition of the threshold of significance at which deficiencies in internal control should be communicated to those charged with governance. The IAASB published its proposals in an exposure draft (ED or ED-ISA 265) in December 2007.

4. The comment period for ED-ISA 265 closed on April 30, 2008. The IAASB received 50 comment letters from various respondents, including IFAC member bodies, national

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1 See minutes of the December 8-11, 2008 IAASB meeting at http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0166.

2 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."

3 ISA 315, "Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement," footnote 4, defines a material weakness as one that could have a material effect on the financial statements.

standard setters, firms, regulators, and government organizations. This Basis for Conclusions explains the more significant issues raised by respondents to the ED, and how the IAASB has addressed them.

5. The IAASB has discussed this project with its Consultative Advisory Group (CAG) on six separate occasions.

Definition of Significant Deficiency

6. ED-ISA 265 proposed to replace the term "material weakness" in the extant ISAs with the term "significant deficiency," and to define the latter term as follows:

> 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.

The majority of respondents supported this proposal.

7. However, a significant minority of respondents raised a number of concerns as follows:

- Some disagreed with the proposed withdrawal of the term "material weakness" on the grounds that, although the term is not precisely defined in the ISAs, it is actually well understood, intuitive and long-established. They suggested that the abolition of the term and the introduction of the new term would result in an overwhelming increase in the communication of trivial matters.
- One respondent commented that ED-ISA 265 did not clearly explain the relationship between significant deficiencies and material weaknesses. It felt that in the context of the Statutory Audit Directive in the European Union (EU), there could be confusion about the obligations of management and the auditor as a result of the proposals in the ED. In particular, the respondent was of the view that paragraph A8 of the ED[4] appeared to imply no difference between the concepts of material weakness and significant deficiency, or alternatively two totally different concepts. It suggested that the ISA should clarify that the concept of a significant deficiency is broader than that of a material weakness (as defined or practiced in the U.S. or in 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. (By contrast, a representative on the IAASB CAG indicated that material weaknesses in its jurisdiction are considered as being less severe than significant deficiencies).
- A few of the respondents disagreed with the IAASB's rationale that if the ISA were to define the term "material weakness" differently from the PCAOB standard, there could be confusion and attempts at reconciling the different meanings for various reporting purposes. They were of the view that as the IAASB's definition would be

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[4] Paragraph A8 of ED-ISA 265 stated the following:

> 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.

directed at communication with those charged with governance within the entity, there would be no need for reconciliation in practice. They felt that by leaving it to regulators to define material weakness for their own purposes, there would be greater confusion and inconsistency in practice. Accordingly, the respondents suggested that it would be in the public interest for the IAASB to take the lead and provide a definition of material weakness that could be used globally, thus avoiding a proliferation of definitions in practice.

- A few other respondents questioned the appropriateness of the proposed definition of a significant deficiency, which they felt was tautological and circular. Another respondent commented that by adopting the term "significant deficiency" and fundamentally the same definition as in the PCAOB standard, there would be a strong legal presumption in those jurisdictions that adopt the ISA that the IAASB definition has the same meaning as in the PCAOB standard. The respondent suggested that this would effectively result in the adoption of the PCAOB's definition of material weakness on the basis that the PCAOB standard defines the relationship between a significant deficiency and a material weakness. In the respondent's view, this outcome would not be acceptable to many jurisdictions (including some in the EU) where the concept of material weakness is incorporated into law or regulation. The respondent further suggested that if the PCAOB definition of significant deficiency were to be applied in the ISA, the threshold for reporting deficiencies to those charged with governance would be too low, resulting in the reporting of many deficiencies not of governance interest.

IAASB Decisions

8. Most of the above arguments were considered and debated by the IAASB when it finalized ED-ISA 265. 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 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 U.S. for audits of both listed and unlisted entities. Given the preponderance of views supporting the approach proposed in the ED, the IAASB determined that the terms and definitions in the ED should remain as exposed.

9. As 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 determined that guidance should 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. Accordingly, paragraph A8 of the ED has been amended and expanded to explain that:

- 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 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).[5]
- 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 required by this ISA to be communicated to those charged with governance. (See paragraph A10).

10. The IAASB also determined that the ISA should emphasize that regardless of whether law or regulation requires the auditor to use specific terms or definitions, the requirements of the ISA remain applicable (see paragraph A11).

11. The IAASB believes that this guidance appropriately responds to the concerns regarding the application of the ISA in the context of the EU Statutory Audit Directive, while leaving it to national standard setters to develop any further guidance that may be considered necessary to support the implementation of a legal or regulatory requirement to communicate relevant internal control matters.

Scope of the ISA

12. A few respondents questioned why the objective in ED-ISA 265 was restricted to communications about internal control *relevant to the audit*, particularly given the indication in paragraph 3 of the ED that nothing in the ISA precludes the auditor from communicating control matters that are not relevant to the audit. They were of the view that this restriction implied that the auditor could decide *not* to communicate an identified significant deficiency if it were considered not relevant to the audit, which they did not see as being appropriate. They suggested that the ISA should instead require the communication of any identified non-trivial deficiencies, whether or not relevant to the audit. Accordingly, they suggested that the qualifier “relevant to the audit” should be deleted from the introduction section of the ISA, the objective, the definition of significant deficiency, and other places in the ED where it appeared.

13. A few other respondents commented on an apparent inconsistency in ED-ISA 265 in that the definition of a “deficiency in internal control” did not include the phrase “relevant to

[5] References to specific paragraphs are to those in the final ISA unless otherwise noted.

the audit," which is used in the objective, in the definition of a significant deficiency, and in other parts of the ISA. They suggested that this could cause confusion in practice.

IAASB Decisions

14. In specifying the proposed objective, the IAASB did not seek to restrict the auditor's communication of internal control matters to only those that are relevant to the audit. Indeed, paragraph 3 of the ED made it clear that no such limitation was intended. Rather, the proposed objective sought to place an *obligation* on the auditor to communicate identified deficiencies *only* when these are relevant to the audit.

15. The IAASB, however, accepted that there was some inconsistency in the use of the phrase "relevant to the audit" in the definitions of a deficiency in internal control and a significant deficiency in ED-ISA 265. The IAASB determined that as the definition of a deficiency in internal control already concerned controls related to financial reporting, it was unnecessary to further qualify the scope and objective of the ISA by referring to controls relevant to the audit. Accordingly, the IAASB has deleted the phrase "relevant to the audit" from the Scope section (paragraph 3 of the ED), the objective (paragraph 5 of the ED), and the definition of significant deficiency (paragraph 6(b) of the ED), and made conforming changes to the relevant application material and conforming amendments.

16. For any other internal control matters not related to financial reporting, the IAASB determined that the auditor should remain free to communicate them as considered appropriate – the ISA does not impose any specific communication obligation in that regard (see paragraph 3).

Definition of the Term "Deficiency in Internal Control"

17. A few respondents expressed the view that the proposed definition of a deficiency in internal control in ED-ISA 265 was not entirely consistent with ISA 315 (Redrafted). They noted that ISA 315 (Redrafted)[6] explains that a specific control operating individually or in *combination with other controls* can effectively prevent, or detect and correct, material misstatements. In their view, a control failure can occur when a combination of controls fails to operate as intended. They therefore suggested that the definition of a deficiency in internal control be amended to reflect the possibility of a combination of controls not working effectively, even though the individual controls might be effective in isolation.

IAASB Decision

18. The IAASB did not agree that it would be necessary to amend this definition as suggested. Further, broadening the definition to cover combinations of inter-dependent controls working together would introduce an element of significant complexity to the ISA. The IAASB believes that expanding the definition in this regard would drive the auditor to always consider and investigate whether specified controls were intended to work with other controls, which would entail a significant increase in work effort beyond current

[6] For example, ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment," paragraphs A57 and A62.

practice. Further, the IAASB noted that the term "control" is already defined very broadly in ISA 315 (Redrafted) to mean any aspect of one or more of the components of internal control. Accordingly, the IAASB determined that no change should be made to the definition in this respect.

Consistency between the Communication Requirement and the Objective

19. Several respondents commented that the requirement to communicate identified deficiencies to management in paragraph 9 of ED-ISA 265 was inconsistent with the proposed objective. They were of the view 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 the ED effectively removed that judgment by requiring the auditor to communicate *all* identified deficiencies to management (other than those that are clearly trivial). The respondents argued that this would set the reporting threshold too low, resulting in too many deficiencies being reported to management.

20. The respondents suggested that a more reasonable threshold should be established. One respondent 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 different definitions 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 this 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.

IAASB Decisions

21. On the strength of these concerns, the IAASB accepted that there was a need to reconsider the original requirement. Accordingly, the IAASB resolved to amend paragraph 9 of ED-ISA 265 so that, instead of requiring the communication of all deficiencies identified during the audit to management, it should require the communication of:

    (a) Significant deficiencies that the auditor has communicated or intends to communicate to those charged with governance (see paragraph 10(a)); and

    (b) Other deficiencies identified during the audit that, in the auditor's professional judgment, are of sufficient importance to merit management's attention, consistent with the objective (see paragraph 10(b)).

22. The IAASB believes that this appropriately responds to the concerns that the communication requirement not be unduly burdensome and impractical, yet preserves a robust requirement to communicate significant deficiencies to those charged with governance.

Reference to the Term "Clearly Trivial"

23. Paragraph 1 of ED-ISA 265 stated the following:

> This ISA does not address deficiencies in internal control the potential financial effects of which are clearly trivial.

ED-ISA 265 then included a cross-reference to paragraph A1 of the exposure draft of proposed ISA 450 (Revised and Redrafted),[7] which explained the meaning of the term "clearly trivial" in relation to misstatements.

24. One respondent disagreed with this reference in ED-ISA 265. It noted that the term "clearly trivial" is always used in the ISAs as a quantitative threshold in the context of misstatements, and that using this term in the context of deficiencies in internal control would be confusing because the evaluation of the significance of such deficiencies also involves qualitative considerations. The respondent suggested that the phrase "other than of relatively minor significance" be used instead to allow for more judgment and less emphasis on quantitative considerations.

25. Another respondent commented that the need to assess the potential financial effects of a deficiency may make it difficult for the auditor to classify the deficiency as clearly trivial because its financial effects are uncertain. The respondent noted that the exposure draft of proposed ISA 450 (Revised and Redrafted) stated that "when there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial." The respondent added that while any control over small cash balances could be considered to be clearly trivial, no control over a material transaction stream or asset or liability could be considered to be clearly trivial. The respondent was therefore of the view that this would result in minor deficiencies being communicated, which it felt would not be justifiable in cost-benefit or audit quality terms.

26. A further respondent commented that although paragraph 1 of ED-ISA 265 scoped out clearly trivial deficiencies, paragraph 9 of the ED (regarding the requirement to communicate all deficiencies other than those that are clearly trivial) appeared to bring them back in by distinguishing between deficiencies that are clearly trivial and those that are not. The respondent was of the view that this would create confusion as to whether the proposed ISA deals with three different categories of deficiencies.

IAASB Decision

27. The IAASB's original intention was to set the threshold for communication to management at the "non-trivial" level. The overwhelming majority of respondents did not disagree with this proposal. However, the IAASB was persuaded by the comments above that there could be potential for confusion if the term "clearly trivial" were interpreted as described in ISA 450 (Revised and Redrafted). The IAASB did not believe that the phrase "of relatively minor significance" as suggested above would be appropriate as it is unclear against what benchmark this threshold would be measured, and how the term "minor" should be interpreted. Given the clarification of the requirement in paragraph 10(b) to communicate

[7] This paragraph is now paragraph A2 in the final ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit."

deficiencies other than significant deficiencies to management (see immediately preceding issue above), the IAASB determined that it would be unnecessary to explicitly scope out deficiencies that are "clearly trivial" or to replace that term with any other term. Instead, the IAASB concluded that it should be sufficient to highlight the fact that the determination as to which deficiencies (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 (see paragraph A22).

28. Accordingly, the references to deficiencies that are "clearly trivial" in paragraphs 1 and 9 of ED-ISA 265 have been deleted.

Unqualified Requirement to Communicate Deficiencies

29. Paragraphs A10 and A11 in ED-ISA 265 emphasized that the requirement to communicate identified deficiencies to management was unqualified in the following respects:

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."

30. This proposal elicited a number of concerns on exposure:

- Some respondents were of the view in some entities (particularly small- and medium-sized entities), management may decide not to take remedial action on a deficiency if it considers that doing so would not be cost-effective, choosing instead to continue to rely on close personal supervision. In these circumstances, the respondents felt that reporting the same matters automatically to management would be unproductive and could harm the auditor's relationship with the client. The respondents nevertheless suggested that a re-communication might be appropriate 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).
- A few respondents suggested 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 knew that management had received and read an internal audit report identifying certain deficiencies, it would be unnecessary to require the auditor to re-communicate those deficiencies. The respondents noted that this approach would be consistent with the focus in the objective on those deficiencies "that the auditor has identified during the audit." They also thought that disregarding this aspect would give rise to unnecessary costs and potentially confuse those charged with governance.

- A few 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.

IAASB Decisions

31. The IAASB originally proposed that the requirement to communicate deficiencies should not be qualified with regard to cost or other considerations on the grounds that management should be made aware of control matters that need, or continue to need, its attention. Further, management might resort to justifying inaction on the grounds of cost even though the benefits might outweigh the costs. Given the force of the concerns raised on exposure, however, the IAASB determined that a degree of flexibility would be warranted in relation to the communication or re-communication of deficiencies that are *not* significant. Thus, non-significant deficiencies are exempted from the communication requirement if they have been communicated to management by other parties (see paragraphs 10(b) and A24). In addition, if the auditor has communicated such deficiencies to management in a prior period and management has chosen not to take remedial action on them for cost or other reasons, the auditor need not re-communicate them in the current period (see paragraph A24).

32. For significant deficiencies, however, the IAASB determined that it would be in the public interest that the requirement to communicate or re-communicate not be qualified in those respects because of the importance of these matters (see paragraph 10(a)). The IAASB also amended the guidance dealing with re-communication in paragraph A10 of ED-ISA 265 to focus only on significant deficiencies (see paragraph A17).

33. Finally, the IAASB accepted the point that re-communication of non-significant deficiencies may be appropriate if there has been a change in management or if new information has come to the auditor’s attention that alters the prior understanding of the auditor and management regarding the deficiencies (see paragraph A24).

Compensating Controls

34. 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.

35. 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 it clear in paragraph A3 of ED-ISA 265[8] that there is no such obligation. A few of the 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 communication of

[8] 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.”

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. The respondents noted 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.

36. 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. In particular, one of the respondents suggested that the ISA make clear that the exemption in subparagraph 9(a) only applies 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. The respondent felt that if management is not aware of the deficiencies identified by the auditor, the auditor should inform management of them even if the auditor identifies compensating controls.

37. Paragraph A12 of ED-ISA 265 stated that unless the auditor obtains evidence about the other controls, the auditor does not have sufficient appropriate audit evidence to conclude that a deficiency does not exist. One respondent commented that the auditor would also not have sufficient evidence to conclude that a deficiency *does* exist. The respondent therefore pointed to a risk that the auditor would report deficiencies that do not in fact exist. The respondent suggested that the issue could be addressed by requiring the auditor to test the operating effectiveness of the other controls when management brings them to the auditor's attention, even though this would place an additional burden on the auditor.

IAASB Decisions

38. On further reflection in the light of the comments received, the IAASB determined that it should not seek to address the issue of compensating controls in the ISA as this would result in unnecessary complication in what is intended to be principally a communication standard. The IAASB concluded that the auditor should be given the opportunity to apply professional judgment in the circumstances in considering the relevance of compensating controls when determining the appropriate communication action.

39. Accordingly, the IAASB determined that the ISA should not make any reference to compensating controls. Consequently, the precondition in subparagraph 9(a) and the associated guidance in paragraphs A3 and A12 of ED-ISA 265 have been deleted.

Communicating in Writing to Management

40. The explanatory memorandum to ED-ISA 265 noted that the IAASB did not propose that the auditor be required to communicate all identified deficiencies to management in writing as this could place an undue and excessive documentation burden on the auditor, particularly in smaller entity audits.

41. A small minority of respondents questioned whether this would be true. They 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 the communication of identified deficiencies to management is an important by-product of the audit, and that oral

communication alone would not be sufficient as the auditor and management would have no record of the matters raised. 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.

42. One respondent suggested that the proposed ISA should clarify that significant deficiencies also need to be communicated to management, preferably in writing, unless those significant deficiencies involve management. A further respondent suggested switching the order of paragraphs 9 and 10 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.

43. A few other respondents commented that the guidance in paragraph A10 in ED-ISA 265, which explained how deficiencies reported in a prior period might be re-communicated in summarized form in the current period, seemed to suggest that the communication to management would *have to be* in writing. They suggested a need for clarification.

44. One respondent noted that the communication of deficiencies will occur at the time management responds by providing information on other controls. Accordingly, 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.

IAASB Decisions

45. The IAASB accepted that, for significant deficiencies, there should be a requirement to communicate to management in writing given the importance of these matters. In practice, this requirement may generally be fulfilled by the auditor providing management with a copy of the written communication to those charged with governance. Accordingly, paragraph 10(a) establishes this requirement.

46. For identified deficiencies that are not significant deficiencies, however, the IAASB reaffirmed its view that imposing a requirement to communicate to management in writing would place an excessive and unreasonable documentation burden on the auditor. This view was supported by the vast majority of the respondents. The IAASB believes that, for this type of deficiency, it is more important not to hinder free and open communication by the auditor to management. Imposing a written communication requirement could present an impediment to such free communication. Accordingly, for deficiencies that are not significant deficiencies, the IAASB determined that the communication to management need not be in writing (paragraph 10(b)). Nevertheless, the general principles in ISA 230 (Redrafted) regarding documentation of discussions with management apply.[9]

47. With regard to the communication requirements proposed in paragraphs 9 and 10 of ED-ISA 265, the IAASB determined that these would be clearer if the ISA were to first require the auditor to communicate significant deficiencies in writing to those charged with governance. This appropriately emphasizes communication to those charged with governance before

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

anything else (see paragraph 9). The ISA then sets out specific requirements to communicate to management (see subparagraphs (a) and (b) of paragraph 10).

48. With regard to the comment that paragraph A10 of ED-ISA 265 seemed to suggest that the communication to management should be in writing, the IAASB believes that this concern has been addressed through a revision of the guidance to limit its context to significant deficiencies only (see paragraph A17).

49. Finally, the IAASB accepted 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 not need repeat the communication subsequently (see paragraph A23).

Deficiencies Involving Management

50. Paragraph 9(b) of ED-ISA 265 proposed that the auditor be required to communicate all "non-trivial" deficiencies identified during the audit to management unless it would be inappropriate to communicate directly to them in the circumstances. Para A13 of the ED proposed guidance on circumstances when it may be inappropriate to communicate directly to management.

51. Several respondents noted that the ED did not explain what the auditor should do when it would be inappropriate to communicate directly to management. In addition, they questioned whether in these circumstances the deficiencies should be treated as significant deficiencies. Some of them suggested that it would be helpful to include a reference to ISA 250 (Redrafted)[10] in relation to the requirement for the auditor to report management's non-compliance with laws or regulations to those charged with governance.

IAASB Decisions

52. The IAASB is of the view that deficiencies that the auditor would consider inappropriate to communicate directly to management are significant deficiencies because they would always merit the attention of those charged with governance. Accordingly, the auditor would be required to communicate these deficiencies to those charged with governance (paragraph 9).

53. Also, the IAASB accepted that a reference to ISA 250 (Redrafted) would be appropriate in relation to describing management's non-compliance with laws and regulations as one type of deficiency involving management that it would be appropriate to communicate to those charged with governance (see paragraph A21).

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[10] ISA 250 (Redrafted), "Consideration of Laws and Regulations in an Audit of Financial Statements."

Follow-up by the Auditor on Deficiencies Communicated in the Prior Period

54. A respondent noted that it was unclear in ED-ISA 265 whether the auditor has any responsibility to follow up in the current period on deficiencies or significant deficiencies communicated in the prior period. The respondent suggested a need for guidance on this matter.

IAASB Decision

55. In the IAASB's view, following up on deficiencies communicated in the prior period is an implicit part of the auditor's risk assessment procedures under ISA 315 (Redrafted). In particular, ISA 315 (Redrafted) requires that "when the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit."[11] The IAASB nevertheless agreed to make this point clear through a conforming amendment to ISA 315 (Redrafted) as follows:

> *Information Obtained in Prior Periods*
>
> A10. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:
>
> - Past misstatements and whether they were corrected on a timely basis.
> - The nature of the entity and its environment, and the entity's internal control <u>(including deficiencies in internal control)</u>.
> - Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

56. Extant paragraph A11 of ISA 315 (Redrafted) then explains the need for appropriate follow-up:

> A11. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

[11] ISA 315 (Redrafted), paragraph 9.