



**International Federation of Accountants**

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

**Agenda Item**

**2**

**Committee:** IAASB

**Meeting Location:** Washington DC

**Meeting Date:** December 10-14, 2007

**Communicating Deficiencies in Internal Control**

**Objectives of Agenda Item**

1. To review and approve for exposure the proposed ISA XXX, *Communicating Deficiencies in Internal Control*, and related conforming amendments.

**Task Force Composition**

2. The members of the task force are as follows:
  - Philip Ashton (Chair, IAASB Technical Advisor and former IAASB Member)
  - Dr. Mohammed Bahjatt (INTOSAI Representative)
  - Phil Cowperthwaite (IAASB Member)
  - Makoto Shinohara (IAASB Member)
  - George Tucker (former IAASB Technical Advisor)

**Activities since Last IAASB Discussions**

3. The task force met in October 2007 to consider the significant comments received from the IAASB and the IAASB CAG on the first-read draft in September 2007. Task force members subsequently liaised via e-mail to finalize the wording of the revised draft of the ISA.

**Significant Issues**

- A. IDENTIFICATION OF DEFICIENCIES IN INTERNAL CONTROL
4. In the first-read draft of the ISA, the task force had proposed that the ISA require the auditor to consider the deficiencies in internal control the auditor has noted during the audit and to conclude which of those deficiencies, either alone or in combination, constitute reportable deficiencies. At the September 2007 IAASB meeting, it was noted that this requirement did not appear to fully reflect the intention behind the corresponding ISA 315 requirement that the auditor evaluate whether, *on the basis of the audit work performed*, the auditor has identified a material weakness in the design, implementation or maintenance of internal control. It was suggested that the proposed requirement seemed to presume that the auditor had already identified such deficiencies, whereas ISA 315 imposes a rather more active obligation on the

auditor to step back and ask himself or herself, in light of the work the auditor has performed, whether the auditor has identified one or more of these deficiencies.

5. The task force agreed that it would be appropriate to retain the essence of the ISA 315 requirement. The task force, however, noted that the IAASB has previously agreed that a requirement to make an *evaluation* in this context could be seen as implying a greater level of work effort than necessary, and that it would not be appropriate to reflect this in the objective. Accordingly, the task force proposes that the auditor be required to make a simple determination (after having confirmed the relevant findings with management or those charged with governance) as to whether, based on the audit work performed, the auditor has identified one or more deficiencies (see paragraphs 5 and A1).<sup>1</sup>
6. At the September 2007 meeting, the IAASB agreed that the term “reportable deficiency” should be replaced by the term “significant deficiency” to denote the type of deficiency that the auditor should report to those charged with governance. In line with this, the task force proposes that if the auditor has identified one or more deficiencies, the auditor should determine whether, individually or in combination, they constitute significant deficiencies for purposes of reporting to those charged with governance (see paragraph 6).
7. The IAASB also agreed at the previous meeting that the definition of significant deficiency in the ISA should be aligned with that of the same term in the PCAOB’s Auditing Standard 5.<sup>2</sup> Accordingly, the task force has defined the term in the ISA to mean “a deficiency or a 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 management and those charged with governance” (see paragraph 4(b)). This definition, however, differs in one respect from the PCAOB’s in that it addresses internal control *relevant to the audit* as opposed to internal control *over financial reporting*, given that ISAs deal more broadly with controls relevant to the audit (see Issue D below).

B. COMMUNICATION OF DEFICIENCIES IN INTERNAL CONTROL

8. In relation to other non-trivial deficiencies that do not reach the same level of importance as significant deficiencies, there was a general view at the September 2007 IAASB meeting that to retain best practice, the ISA should *encourage* but not require the auditor to communicate those other deficiencies to management. Firstly, given that ISAs do not deal with matters that have clearly trivial effects, the task force believes that it would be appropriate to simply use the term “deficiencies in internal control” to refer to the broader range of deficiencies (including significant deficiencies) that would merit management’s attention, and not define another term for that purpose. Secondly, the task force concluded that it would not be appropriate to merely encourage the auditor to communicate such deficiencies, as it would not be in the public interest for the auditor to have the option of withholding the information from management if the auditor already had knowledge of the deficiencies. Accordingly, the task force proposes that the auditor be required to communicate all deficiencies (including

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<sup>1</sup> Paragraph numbers refer to the revised draft of the ISA.

<sup>2</sup> U.S. Public Company Accounting Oversight Board’s (PCAOB’s) Auditing Standard 5, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements*.

significant deficiencies) identified during the audit to management on a timely basis (see paragraph 7). This then results in the auditor duly informing those who are responsible for the relevant matters so that they may take appropriate action.

9. However, given the potential for large numbers of deficiencies to be identified in many audits, the task force believes that requiring the auditor to communicate all identified deficiencies to management in *writing* could place an undue and excessive documentation burden on the auditor, particularly in smaller entity audits. Accordingly, the task force proposes not to require the communication to management to be in writing. With regard to significant deficiencies, however, the task force believes that it would be appropriate to require these to be communicated to those charged with governance in writing to reflect the greater importance of these matters (see paragraph 8).
- C. DISCLAIMERS IN THE AUDITOR'S WRITTEN COMMUNICATION
10. At the September 2007 meeting, the IAASB asked the task force to reconsider the proposed requirement to include specific disclaimers in the written communication of significant deficiencies to those charged with governance, as these disclaimers made the communication appear overly defensive. It was suggested that the requirement should be worded in such a way as to enable the auditor to explain to the addressees the context of what the auditor has done.
11. The task force agreed to reword the requirement as suggested. Nevertheless, the task force believes that there remains a strong public interest argument for mandating the inclusion of specific disclaimers in the written communication because of the risk that readers who may not be fully informed could misinterpret the scope of the auditor's work on internal control and the degree of assurance on internal control they may derive from that work. This risk is particularly significant in cases where the auditor is required or requested to submit a written communication to those charged with governance even if no significant deficiencies have been identified ("no significant deficiency reporting"). The task force noted that at the September 2007 IAASB CAG meeting, CAG Representatives did not express any concern with the proposed requirement for specific disclaimers in the auditor's written communication.
12. Accordingly, the task force proposes that the auditor be required to include specific statements in the communication to explain the limitations of the auditor's work with respect to internal control, i.e.:
  - i). The auditor did not plan and perform the audit with a view to identifying all deficiencies in internal control that might exist;
  - ii). The matters being reported are limited to those deficiencies that have come to the auditor's attention during the audit and which the auditor has concluded should be reported; and
  - iii). The purpose of the audit was for the auditor to express an audit opinion on the financial statements, and the auditor has not performed audit procedures to obtain reasonable assurance, and is not providing any assurance, on the effectiveness of internal control. (See paragraphs 9(b) and A21).

D. SCOPE OF THE ISA

13. The first-read draft specified that the requirements and guidance in the ISA relate to the financial reporting objective of internal control only. A member of the IAASB noted to the task force after the September 2007 meeting that this was more restrictive than what is currently required under ISA 315. In particular, ISA 315 refers to *relevant controls* and indicates that these will usually be within those on financial reporting but may not be.<sup>3</sup> The reporting obligation in ISA 315 is thus not restricted to material weaknesses in controls over financial reporting only.
14. The task force agreed. Accordingly, the task force has broadened the scope of the ISA to address controls that are relevant to the audit (see paragraph 1). Consequential changes have been made to the objective (paragraph 3) and the definition of significant deficiency (paragraph 4(b)).

**Material Presented**

Agenda Item 2-A (Pages 3067 – 3078)	Proposed ISA XXX, <i>Communicating Deficiencies in Internal Control</i> (Mark-up)
Agenda Item 2-B (Pages 3079 – 3086)	Proposed ISA XXX, <i>Communicating Deficiencies in Internal Control</i> (Clean)
Agenda Item 2-C (Pages 3087 – 3094)	Proposed Conforming Amendments

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

The task force proposes that the **mark-up** version of the revised draft (**Agenda Item 2-A**) be discussed at the meeting.

**Action Requested**

The IAASB is asked to consider the above issues and recommendations of the task force, and to approve the proposed ISA for issue as an exposure draft.

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