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August 27, 2008

Mr. James M. Sylph  
Executive Director, Professional Standards  
International Auditing and Assurance Standards Board  
International Federation of Accountants  
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Email address: [Edcomments@ifac.org](mailto:Edcomments@ifac.org)

***Re: Proposed Redrafted International Standard on Auditing 265, "Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs"***

Dear Mr. Sylph:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (SC 1) appreciates the opportunity to comment on the Exposure Draft of proposed redrafted international standard on auditing ISA 265, Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs (the ED). As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing, and professional standards.

Members of SC 1 seek to further IOSCO's mission through thoughtful consideration of accounting, auditing and disclosure concerns, and pursuit of improved global financial reporting. As we review proposed auditing standards, our concerns focus on whether the standards are sufficient in scope and adequately cover all relevant aspects of the area of audit being addressed, whether the standards are clear and understandable, and whether the standards are written in such a way as to be enforceable.

Our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1; however, they are not intended to include all comments that might be provided by individual members on behalf of their respective jurisdictions.

We welcome the IAASB's (the Board's) effort to clarify how deficiencies in internal controls should be evaluated and communicated to management and those charged with governance. We see some changes in the proposed ISA that we believe will be helpful. We also note some

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matters of concern. Principal matters that we believe should be further addressed are discussed in this letter. The appendix to this letter outlines our responses to the Board's request for specific comments.

### **Scope and Orientation of this ISA, and the Definitions of “Material Weakness” and “Significant Deficiency”**

The ED's Explanatory Memorandum notes that this project was originally launched to clarify the term “material weakness,” in order to improve consistency in the way that auditors identify weaknesses as material and how such matters are reported. The Board also sought to clarify the auditor's responsibilities in relation to the evaluation and communication of internal control matters identified during the audit to management and those charged with governance. The Explanatory Memorandum further states that the project has evolved from this original aim to a current focus on developing a clear definition of a threshold of significance at which deficiencies in internal control should be communicated to those charged with governance. As part of this, the Board now proposes to eliminate use of the term material weakness in ISAs, not just in ISAs 260 and 265, but also in the risk assessment and response to risk assessment ISAs 315 and 330, and to introduce the notion of “significant deficiency” instead. The Board also proposes to define “significant deficiency” as “A deficiency or combination of deficiencies in internal control relevant to the audit that, in the auditor’s judgment, is of sufficient importance to merit the attention of those charged with governance.”

The proposal to replace the notion of “material weakness” with the notion of “significant deficiency” wherever the former is used in several ISAs has created a concern among some of our members that this might in some way alter the scope of the audit, or 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 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. As the ED notes, one jurisdiction defines a significant deficiency as “a deficiency, or a combination of deficiencies, that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.” Among our IOSCO members, some note that 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.

Because the term “significant deficiency” is already used in many jurisdictions to convey a different threshold of significance than defined by the IAASB, and because of anticipated translation difficulties, we are 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. We request that the Board 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.

We believe that either approach would help avoid confusion and facilitate more consistent communication of internal control deficiencies.

## **Conforming Amendments to ISAs 315 and 330**

As to the issue of whether there might be any potential effect on the scope of the audit, under extant ISAs 315 and 330 auditors are required to evaluate deficiencies in internal control (any deficiencies) to determine whether a material weakness exists and if so, to discuss the weakness with management and those charged with governance. We could not identify any other incremental auditor performance obligations within ISAs 315 and 330 based upon whether a deficiency in internal control is classified as a “material weakness” and therefore, the use of the term “material weakness” in ISAs 315 and 330 appears to be included solely as a reminder to the auditor of the communication requirements associated with such deficiencies in internal control. Accordingly, our remaining comments within this letter are written with that understanding. If this understanding is correct, then we believe that ISAs 315 and 330 would be clearer if the purpose of the classification of deficiencies (i.e., to determine the parties to whom communication should occur) were made more explicit in those ISAs, however the classification is ultimately defined.

However, if the IAASB believes that ISAs 315 and 330 currently require additional auditor performance obligations, beyond the communication requirement, as a result of deficiencies in internal control that rise to the level of a “material weakness” as opposed to “weaknesses” or “deficiencies” in general, then we believe the IAASB should evaluate whether there could be any unintended consequences or effects, on the audit of 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).

## **The interaction of proposed ISA 265 with ISA 260**

We note the Board has scoped this project to specialize on communicating control deficiencies to management and those charged with governance but we do not see any references within the proposed ISA 265 to ISA 260 “Communications with those Charged with Governance.” This raises the question of whether ISA 260’s emphasis on two-way communication is applicable to this proposed standard and/or whether there should be explicit reference thereof. It also raises the question of whether other guidance in ISA 260 would be applicable to matters not also discussed in the proposed ISA 265. We encourage the Board to clarify these matters in ISA 265.

## **Objective**

The objective of the ISA does not seem to adequately reflect the auditor’s responsibility to evaluate the significance of all internal control deficiencies and to “communicate all deficiencies in internal control (other than those that are clearly trivial) identified during the audit to management,” as described in paragraphs 7- 9. The requirements paragraphs (with which we agree) seem stronger than the objective.

## **Definitions**

### ***Definition of “deficiency in internal control”***

In addition to our earlier general comments on the definitions of “material weakness” and “significant deficiency”, we have two further technical concerns with the definition of the term “deficiency in internal control” as stated in paragraph 6(a).

First, while we agree that a deficiency in internal control exists when a control that is intended to *detect* a misstatement fails to do so, we do not believe that a deficiency necessarily exists when a control detects a misstatement but the control fails to *correct* it, as the definition suggests. Requiring a control to detect *and* correct misstatements suggests that all misstatements are attributable to control deficiencies – even if those misstatements are inconsequential. Further, we question how this definition should be applied to automated detective controls (and perhaps some manual detective controls) that are not capable of correcting misstatements without separate human intervention or the interaction of other controls – would these controls represent deficiencies by definition?

Second, the definition suggests that any missing or non-operative control represents a deficiency, irrespective of whether the control is actually needed to prevent, detect or correct misstatements in the financial statements on a timely basis. In some circumstances, a “missing” control may be one that management decided not to create or implement because another control has been designed and implemented that achieves the same control objective. In these circumstances, the “missing” control would not appear to be a deficiency in internal control.

We suggest replacing “and correct” with “or correct” in the definition, so that the definition would read “Deficiency in internal control – A necessary control that is either missing or is designed, implemented, or operated in such a way that it is unable to prevent, detect, or correct misstatements in the financial statements on a timely basis”. Conforming changes would also be necessary in paragraphs, 9(a), A3, A4, A12, A62 (ISA 315 amendment), 46a(i) (ISA 600 amendment), and A64 (ISA 600 amendment).

## **Requirements**

### ***Communication of deficiencies in internal control - paragraph 9***

The proposed ISA states in paragraph 9 that “The auditor shall communicate all deficiencies in internal control (other than those that are clearly trivial) to management at an appropriate level of management on a timely basis...”. The term “an appropriate level of management” is left undefined, and is not discussed in the Application Material, and as a result is unclear as to meaning in the proposed standard. If it is intended to mean the CEO or CFO of the company, as the level of management with ultimate authority regardless of the size of audited entities, we wonder if the proposed requirement is realistic or suitably beneficial, especially in audits of large multinational companies. If it is intended to refer to individuals whose responsibilities for controls are at much lower operating levels, it would be helpful to elaborate on this.

Acknowledging that there are varying degrees of importance regarding deficiencies in internal control, may we suggest that a definition of “those with the responsibility to ensure that the relevant internal control is designed, implemented and/or operating effectively” would better reflect the Board’s intent in some areas. For example, under an integrated audit framework of one IOSCO member jurisdiction, a “material weakness” needs to be communicated to both those charged with governance and management, while other deficiencies are required to be communicated only to those with appropriate operating and supervisory authority. Without clarifying what constitutes an “appropriate level of management,” we are concerned that auditors will interpret “clearly trivial” too broadly and as a result, deficiencies will not be communicated to all appropriate individuals.

***Need for written communication to management - paragraph 9***

We believe that the ISA should require the auditor to communicate to management, *in writing*, all deficiencies in internal control (other than those that are clearly trivial). We do not agree with the Board (as explained in the Explanatory Memorandum accompanying the ED) that such a requirement “could place an undue and excessive documentation burden on the auditor.”

First, deficiencies and evidence of their communication to management are already required to be documented as part of the audit work papers in accordance with ISA 230. So long as the ISA does not prescribe the form of the written communication, compiling the auditor’s documentation of these deficiencies for management should not be onerous. Second, the ISA already requires significant deficiencies to be communicated in writing to those charged with governance, so there should be no additional burden on the auditor if these deficiencies are also required to be communicated in writing to management.

***Need for communicating operating ineffectiveness to management – paragraph 9(a)***

Contrary to paragraph 9(a), we also believe that the ISA should require the auditor to communicate deficiencies identified by the auditor to management even if the auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, detect or correct misstatement arising from the identified deficiencies.

Paragraph A3 correctly notes that the existence of these other controls does not change the fact that the auditor has identified deficiencies in internal control. If management is not made aware of these deficiencies, they might decide to eliminate the compensating controls under the false assumption that the controls are redundant. Therefore, if a deficiency exists, we believe it should be communicated to management. Conforming amendments should also be made to paragraph 46(a)(i) of ISA 600.

***Content of written communication to those charged with governance - paragraph 11***

We have two concerns with the contents of a written communication to those charged with governance in paragraph 11.

First, we think that the Board should add as description (c) of paragraph 11 “A statement that the auditor communicated to management all identified deficiencies in internal control (other than those that are clearly trivial),” as this may help discharge the responsibility of those charged with governance.

Second, we encourage the Board to clarify paragraph 11(b)(iii) because in jurisdictions in which integrated audits are performed, including such a description in the written communication could be inconsistent with the purpose of those audits.

**Application and Other Explanatory Material**

***Auditor’s responsibility to identify deficiencies in internal controls (A1)***

In determining whether the auditor has identified one or more deficiencies, paragraph A1 notes that the auditor “may” seek to agree the relevant facts and circumstances of the auditor’s

findings with management. Use of the word “may” suggests that the auditor may alternatively decide not to agree the relevant facts and circumstances with management.

Without reaching such an agreement, we believe that the auditor might not reach the appropriate determination as to whether a deficiency exists, thereby leading to an incomplete understanding of internal controls and possibly ineffective and/or inefficient substantive audit testing. We therefore believe that the auditor should be required to agree the relevant facts and circumstances of the auditor’s findings with management.

***Auditor’s responsibility to obtain audit evidence regarding the design and operating effectiveness of internal control (A3)***

We believe that paragraph A3 is incomplete in its description of the auditor’s responsibility to obtain audit evidence regarding the design and operating effectiveness of compensating controls. In describing the auditor’s responsibility for these controls, paragraph A3 states, “This ISA does not require the auditor to obtain audit evidence regarding the design and operating effectiveness of these other controls.” While we agree that this ISA does not impose such a requirement, paragraph A3 should make clear that the auditor is required to test the operating effectiveness of any compensating controls upon which the auditor intends to rely or when the auditor is required to obtain such evidence under certain other circumstances (e.g., those described in paragraph 13 of ISA 315 (Redrafted) and paragraph 8 of ISA 330 (Redrafted)).

**Determination of Whether Identified Deficiencies Constitute Significant Deficiencies (Paragraph A4 – A8)**

***Sufficient indicators for significant deficiencies (A6)***

We are concerned that the guidance in paragraphs A5-A7 may lead to inconsistencies internationally in identifying deficiencies that should be communicated to those charged with governance. Our concerns are based primarily on the fact that the indicators of a significant deficiency in paragraph A6 appear to have been derived from the guidance in the U.S. PCAOB Standard (AS 5). However, the guidance in AS 5 is intended to assist the auditor in determining whether a deficiency or combination of deficiencies constitutes a material weakness, which under AS 5 is more severe than a significant deficiency.

To promote international consistency in the classification of deficiencies in internal control, we recommend that the Board provide additional examples in paragraph A6 of indicators of deficiencies that should be reported to those charged with governance. Examples of these indicators are currently included in paragraph A10 of this ISA and paragraphs 16, 17 and A119 of the conforming amendments to ISA 315. We also believe that paragraph A7 should include “the possible future consequences of the deficiency” as an example of a matter that the auditor may consider in making this determination.

***Qualitative indicators for significant deficiencies (A5 and A7)***

We believe that the Board should clarify in paragraphs A5 and A7 whether the significance of a deficiency is based solely on the likelihood and magnitude of the actual or potential misstatement (as suggested by these paragraphs), or whether other qualitative factors may also be relevant in determining whether the deficiency is “of sufficient importance to merit the attention of those charged with governance.”

For example, in reaching a determination as to whether a deficiency or combination of deficiencies constitutes a significant deficiency, is it possible the Board believes that the auditor may consider whether experienced auditors and regulatory authorities, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency, taking into account the importance of the affected account(s)? We believe that including such a concept in the ISA would help to clarify the link between paragraphs A5, A7 and the concept of a deficiency that is important enough to require communication to those charged with governance. Clarifying this determination could also facilitate international consistency of application and help to encourage convergence.

### **Communication of Identified Deficiencies in Internal Control (Paragraph A9-A13)**

#### ***Timing of communication (A9 -A13)***

We think that the Board should elaborate as to when the communications should be made in the proposed standard. Currently, the requirement in paragraph 9 only says "on a timely basis," and timing is not further discussed in the Application Material. As a result, it is not clear what would be deemed to be a timely communication. In some circumstances, we believe that the communication should occur as soon as the deficiencies are detected, while in others the communication could occur at a later date.

#### ***Situation where deficiencies are affected by the existence of other controls (A12)***

Paragraph A12 appears to be inconsistent with paragraph A3. Paragraph A12 states, "Unless the auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatement arising from the identified deficiencies, the auditor does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist." This seems to suggest that if the auditor has obtained sufficient appropriate audit evidence about these other controls, the auditor can conclude that a deficiency does not exist.

However, paragraph A3 states, "The existence of these other controls does not change the fact that the auditor has identified deficiencies in internal control." We believe that compensating or redundant controls may mitigate the effect of deficiencies in internal control, but do not believe that they should change the auditor's conclusion that a deficiency exists in the original control. We therefore believe that paragraph A12 should be conformed with paragraph A3. Similar changes should also be made in paragraph A64 of the conforming amendments to ISA 600.

#### ***Situation where deficiencies are not communicated to management because of a concern regarding competence or integrity of management (A13)***

Paragraph A13 indicates that it may be inappropriate to communicate identified deficiencies directly to management, for example, when "there may be evidence of actual or suspected fraud on management's part." This guidance appears to be incomplete, however, because it does not provide direction regarding what the auditor should then do.

We believe that paragraph A13 should be modified to indicate that all deficiencies that cannot be communicated directly to management should be communicated to those charged with

governance. Similar guidance should be included in paragraph A65 of the conforming amendment to ISA 600.

### **Conforming Amendments**

In addition to the proposed conforming amendments that accompanied the ED, we noted that other ISAs refer to a “weakness” in internal control, “weak internal controls,” “weak control environment,” “weak monitoring of controls,” and “weak general IT-controls.”

In view of our comments earlier in this letter, we suggest that the Board re-examine the ISAs to ensure that the proposed conforming amendments are necessary and if so, that all have been made in a consistent manner. In addition, we offer the following comments for the Board’s consideration:

ISA 315: We believe that the use of the word “may” in paragraph A119 of ISA 315 inappropriately suggests that the failure by management to implement controls over significant risks of material misstatement might not be a significant deficiency.<sup>1</sup> We believe that failure by management to implement such controls is an indicator of a significant deficiency.

ISA 600: In addition to the comments described above, we believe that paragraph 41(g) should require the component auditor to communicate to the group auditor *all* deficiencies in internal control (other than those that are clearly trivial) relevant to the audit at the component level (i.e., not just “significant deficiencies”). Communication of all such deficiencies will facilitate the group auditor’s consideration of whether the combination of deficiencies at various components represents a deficiency that should be communicated to those charged with governance, and will also help the group auditor fulfill his responsibility under paragraph 9 to communicate all deficiencies in internal control (other than those that are clearly trivial) to management. Similarly, we believe that paragraphs 46(b) and 46(c) should refer to “deficiencies” rather than “significant deficiencies” and the phrase “and judges are of significance to the group” in these paragraphs should be deleted.

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Thank you for the opportunity to comment on this ED. If you have any questions or need additional information regarding this comment letter, you may contact me or Susan Koski-Grafer at 202-551-5300, or any member of the IOSCO Standing Committee No. 1 Auditing Subcommittee.

Sincerely,



Julie A. Erhardt  
Chair

IOSCO Standing Committee No. 1

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<sup>1</sup> Paragraph A119 of ISA 315 states, “In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a significant deficiency in the entity’s internal control.”



## **Appendix A: Responses to Request for Specific Comments in the Exposure Draft**

- 1. Do you agree with the guidance described on page 8 of the Explanatory Memorandum?**

Please see our comments in the appendix on paragraphs 9, A3, and A12.

- 2. Are the objectives to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?**

Please see our comments on objectives in the main body of the letter.

- 3. Are the proposed requirements appropriate responses to the objective?**

Please see our comments in the appendix on paragraph A1.