

For the attention of Jim Sylph  
International Federation of Accountants  
545 Fifth Avenue, 14th Floor  
New York, NY, 10017  
USA

29 May 2008

Dear Sir

**IAASB Exposure Draft ISA 265 – “Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs”**

We appreciate the opportunity to comment on the IAASB’s Proposed ISA 265, *Communicating Deficiencies in Internal Control*, and on the related conforming amendments to other ISAs.

Following extensive consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on this Exposure Draft. “PricewaterhouseCoopers” refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

**Overall comments**

With the exception of the proposed threshold for communicating matters to management, we support the proposed ISA.

The ISA’s overall aim to ensure that deficiencies in internal control identified in the course of the audit are communicated to those parties within an entity who can competently deal with them on a timely basis is sound and in the public interest.

We agree that there is a need to develop a clear definition of the threshold of significance at which deficiencies in internal control should be communicated to management and to those charged with governance. Given regulatory and standard-setting developments around the world regarding internal control-related matters, the lack of definition in the ISAs to guide the application of the requirement to communicate “material weaknesses” has become a significant gap.

We strongly support the principle that auditors should be allowed to exercise judgment in prioritizing identified deficiencies so that the communication can be targeted to the right people in the organisation and at a level of detail that will facilitate their ability to fulfil their respective responsibilities. We believe that the focus on “significant deficiencies”, as defined, is appropriate and are comfortable that the term “material weakness” will no longer be used in the ISAs. We are pleased that the proposed definition of significant deficiencies is consistent with the PCAOB’s Auditing Standard No. 5 (AS 5) definition and agree with the Board’s proposal that, consistent with AS 5, the definition of the significance of a deficiency depends not only on whether a misstatement has occurred, but also on the *risk* that a misstatement could occur and the *potential magnitude* of the misstatement.

As explained more fully in our letter, however, we disagree with the wording of the requirement that the auditor communicate *all* deficiencies, other than those that are *clearly non-trivial*, to management. We agree that the auditor should be required to communicate all *significant deficiencies* identified to both management and those charged with governance. However, for other deficiencies, we believe the proposed objective in

the Exposure Draft defines the responsibility appropriately – enabling auditors to use judgment to determine which of the identified deficiencies are of sufficient importance to merit management’s attention. Although the principle underlying the objective has been reflected in the requirement regarding communications to those charged with governance, it is not reflected in the proposed requirement for communications to management. Our reasons for our position on this matter are explained more fully below in the section entitled, “Significant concerns”. We also offer suggested revised wording for the requirement and related application material in the Appendix to this letter.

We have responded to the requests for comments below. In the Appendix we also offer suggestions on other specific paragraphs for the IAASB’s consideration in finalising the wording of the ISA.

### **Request for comments on the application of the Clarity drafting conventions**

#### ***Are the objectives to be achieved by the auditor, stated in the proposed ISA, appropriate?***

We believe that the proposed objective is appropriate. In particular, we strongly support the focus on auditors exercising judgment to determine those deficiencies that are of sufficient importance to merit the respective attentions of management and those charged with governance. This sets an appropriate threshold of significance at which deficiencies in internal control should be communicated.

#### ***Have the criteria for requirements been applied appropriately and consistently?***

Subject to the comments set out below, we believe that the proposed requirements are appropriate responses to the objectives.

### **Request for specific comments**

We support the proposal that the auditor needs to obtain sufficient evidence about the operating effectiveness of other controls that management asserts would prevent, or detect and correct misstatements arising from identified deficiencies. If the auditor has not tested the operating effectiveness of such other controls, the auditor can still acknowledge the existence of compensating/mitigating controls when communicating the identified deficiencies, as long as the auditor indicates that, because they have not been tested, the auditor cannot determine whether or not they are effective. In many engagements, particularly larger engagements, we anticipate that the auditor will often identify and test compensating/mitigating controls. However, *requiring* the auditor to do so would significantly expand the scope of an ISA audit, particularly in the audits of smaller entities when a more substantive approach to obtaining audit evidence is adopted. The proposed approach allows for transparency and is appropriate in the context of the scope of an ISA audit.

### **Significant concerns**

#### ***Communication of deficiencies to management***

We strongly oppose the requirement in paragraph 9 that the “*auditor shall communicate all deficiencies in internal control (other than those that are clearly trivial)*” because, in our view, it sets the reporting threshold too low and constrains the exercise of judgement.

#### ***Allowing greater judgment in deciding which deficiencies to report***

It is important that *all significant deficiencies* that are communicated to those charged with governance should also be communicated to management.

We also accept that the level of deficiencies that may be relevant to management’s responsibilities will be broader than those that merit the attention of those charged with governance. However, we believe that the requirement in paragraph 9 is cumbersome in setting a requirement to communicate “all” deficiencies, but then identifying two exceptions. We believe it would be preferable to establish the principle that the auditor should communicate to management other deficiencies that, in the auditor’s professional judgment, merit management’s attention. The related application material could provide guidance on matters that may be considered in forming that judgment.

In addition to the two exceptions identified in paragraph 9, we believe auditors should not be required to communicate matters that have already been brought to the attention of management through other means, such as from relevant work done by internal auditors. We accept that the auditor needs to be satisfied that management is aware of the deficiency, but if, for example, the auditor knows that management has received and read an internal audit report identifying certain deficiencies, it is unnecessary for the auditor to have to communicate those deficiencies again. Indeed, this approach would be consistent with the focus in the objective on the deficiencies “that *the auditor* has identified during the audit”.

*Clearly trivial*

The reference to deficiencies “other than those that are clearly trivial” is also confusing. Whilst “clearly trivial” is a phrase used elsewhere in the ISAs, it is always used in other ISAs in the context of misstatements. For example, Proposed Redrafted and Revised ISA 450 explains the concept in relation to designating an *amount* below which misstatements need not be accumulated because the auditor expects that the “accumulation of such amounts clearly would not have a material effect on the financial statements”. Although ISA 450 acknowledges that such matters will be clearly inconsequential whether judged by any criteria of size, nature or circumstances, it is primarily viewed as a quantitative threshold. Using the same term in the context of deficiencies is confusing because the evaluation of the significance of control deficiencies necessarily involves consideration of qualitative characteristics as well (i.e., both risk and potential magnitude).

Therefore, we recommend that the phrase “clearly trivial” should be eliminated to put less emphasis on quantitative considerations and to allow scope for more judgment.

In the appendix to this letter, we offer proposed wording for the requirements in paragraphs 9 and 10 and the related application material that would better describe the auditor’s responsibilities for reporting to management.

We would be happy to discuss our views further with you. If you have any questions regarding this letter, please contact Roger Marshall (+44 20 7804 4866) or Alun Richards (+44 20 7804 2706).

Yours faithfully,

PricewaterhouseCoopers

PROPOSED ISA 265

Paragraph	Comment on paragraph
	<b>Requirements</b>
Paragraph 1	<p>The final sentence explains that “this ISA does not address deficiencies in internal control the potential financial effects of which are clearly trivial”. As the ISA discusses deficiencies that are “clearly trivial”, it does in fact address such deficiencies. We suggest that a better wording for this sentence is:</p> <p><i>“This ISA <del>does not address</del> <b>is not intended to apply to</b> deficiencies in internal control the potential financial effects of which are clearly trivial.”</i></p>
Paragraph 6(a)	<p>The definition of a deficiency in internal control focuses on an individual <i>control</i> either being missing or designed, implemented or operated in such a way that <i>it</i> is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis.</p> <p>As is noted in paragraph A4, controls may be designed to operate individually <i>or in combination</i> to effectively prevent, or detect and correct, misstatements. Thus, we question how the definition is to be applied when a control is designed to operate in combination with other controls.</p> <p>Also, reference is made to controls designed to either <i>prevent</i> misstatements, or <i>detect and correct</i> misstatements. There may be controls that are designed to detect misstatements, whilst other controls correct them and, therefore, we question always referring to “prevent and detect” together.</p> <p>The following wording would address these matters:</p> <p><i>“Deficiency in internal control – A control that is either missing or is designed, implemented or operated in such a way that it is unable to <u>fulfil its role in preventing, or detecting and or correcting</u>, misstatements in the financial statements on a timely basis.”</i></p>
Paragraphs 9 and 10	<p>We recommend switching the order of paragraphs 9 and 10, so that the auditor would be, in the first instance, required to communicate all significant deficiencies identified to both management and those charged with governance. The wording of paragraph 9 should then be amended as follows. Subparagraphs (a) and (b) can be incorporated into the application guidance on the matters to be considered in making a judgment as to whether the deficiency merits management’s attention rather than in the body of the requirement (see proposal for paragraph A9 and A10 below).</p> <p><b><i>“The auditor shall communicate significant deficiencies identified during the audit to <u>both management and those charged with governance in writing and on a timely basis.</u></i></b></p> <p><b><i>The auditor shall <u>also communicate to management at an appropriate level of responsibility on a timely basis all other deficiencies in internal control (other than those that are clearly trivial) identified during the audit that, in the auditor’s professional judgment, are of sufficient importance to merit management’s attention.</u></i></b>  <del><i>to management at an appropriate level of responsibility on a timely basis, unless:</i></del>  <b><i>(a) <del>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; or</del></i></b>  <b><i>(b) <del>It would be inappropriate to communicate directly to management in the circumstances.</del></i></b></p>
Proposed new application guidance	<p>We believe that it would be useful to strengthen the link between the proposed ISA and the principles contained within ISA 260 <i>Communication with those Charged with Governance</i>. This could be achieved by clarifying in the application guidance to paragraph 7 that the</p>

	<p>auditor communicates deficiencies because they are significant to oversight of the financial reporting process by those charged with governance – which is consistent with the objective in ISA 260 to “provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process”. This would also help to provide context to the auditor’s judgement as to the deficiencies that the auditor believes are of sufficient importance to merit the attention of those charged with governance.</p>
Paragraph A6	<p>This list is identified as illustrating examples of “indicators of significant deficiencies”. The items in the last two bullets are clearly indicators, but it seems odd that the “deficiencies” identified in the first two bullets are “indicators”. This could be resolved by:</p> <ul style="list-style-type: none"> <li>▪ Elevating the subpoints in the first bullet to be bullets on their own and removing the introductory words (which are unnecessary)</li> <li>▪ Deleting the second bullet. Nothing will be lost in doing so because the examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies constitutes a significant deficiency already include considerations that ISA 315 indicates are relevant when judging whether a risk is a significant risk warranting special audit consideration. Thus, that bullet is redundant.</li> </ul>
Paragraph A8	<p>In the third line, we suggest deleting the words “details of”. Law or regulation is likely to mandate communication of specific types of deficiencies, or set a different threshold for reporting. It is unlikely to require reporting of specific details.</p> <p>We also wonder whether it would be useful to explain that such definitions may set a different threshold for reporting than the “significant deficiencies” as defined in this ISA.</p>
Paragraph A9 – A10	<p>To reflect our recommendations for the requirements in paragraphs 9 and 10, we propose that the application material be rewritten as shown below.</p> <p>A9a <u>The auditor is required to communicate significant deficiencies identified during the audit to both management and those charged with governance in accordance with paragraph 9. The auditor might identify other deficiencies in internal control that are not significant deficiencies but are nevertheless relevant to management in fulfilling its responsibilities. Deficiencies that are clearly inconsequential need not be communicated. Other matters the auditor may consider in deciding whether a deficiency identified is of sufficient importance to merit management’s attention and, therefore, should be communicated to management in accordance with paragraph 10 include:</u></p> <ul style="list-style-type: none"> <li>(a) <u>Whether the deficiency has been communicated to management by others in the organisation, such as by internal audit, or previously by the auditor;</u></li> <li>(b) <u>Whether the auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect or correct, misstatements arising from the identified deficiencies;</u></li> <li>(c) <u>Whether, in the circumstances, there are reasons why it would be inappropriate to communicate directly to management.</u></li> </ul> <p>A9b <i>The auditor may identify deficiencies in certain controls that do not relate directly to the financial reporting objective of internal control. These controls may, nevertheless, be relevant to the audit if they address in particular the completeness and accuracy of information produced by the entity that the auditor intends to use in designing and performing audit procedures. For example, the auditor may conclude that it is appropriate to communicate to management, <del>in accordance with paragraph 9,</del> a deficiency in a control that did not detect the use of a superseded price list by the entity’s computerized sales system, resulting in lower margins than would be expected.</i></p> <p>A10 <u>Whether or how the auditor communicates other deficiencies <del>a deficiency</del> may be influenced by whether the auditor has communicated them in a previous audit, or whether management already has knowledge of them. If the auditor has previously</u></p>

	<p><i>communicated <del>a</del> the matter to management, the current year's communication may include the same description of the deficiency as previously communicated. Alternatively, it may be summarized, specifically referring to the previous communication. However, the fact that the auditor communicated a deficiency to management in a previous audit, or that <u>if</u> management already <del>had</del> <u>has</u> knowledge of the deficiency through other means (such as from relevant work done by internal auditors <u>or</u> because the auditor has communicated the deficiency to management in a <u>previous audit</u>), <del>does not eliminate the need for the auditor to</del> <u>need not</u> repeat the communication <del>if remedial action has not yet been taken</del>. The auditor may <u>nevertheless</u> ask management why the deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency."</i></p>
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