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Mr. Jim Sylph  
Executive Director Professional Standards  
International Auditing and Assurance Standards Board (IAASB)  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, New York 10017  
USA

By email

Dear Mr Sylph

**PROPOSED ISA 265 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL**

The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to comment on proposed International Standard on Auditing 265 published by IAASB in December 2007.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

**We broadly support the proposed standard and consider it a useful addition to current standards; however, we have some reservations about specific points within the standard.**

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

Katharine E Bagshaw FCA  
Manager, Auditing Standards  
ICAEW Audit and Assurance Faculty  
T + 44 (0)20 7920 8708  
F + 44 (0)20 7920 8708  
E: [kbagshaw@icaew.com](mailto:kbagshaw@icaew.com)

## Scope of the ISA

1. Paragraph 2 makes the general point that deficiencies in internal control are relevant to management and those charged with governance. By way of preamble to this, it refers solely to the requirements of ISA 315 to obtain an understanding of internal control relevant to the audit when identifying and assessing the risk of material misstatement. While accepting that the paragraph does not attempt to assert that deficiencies can be identified only at this stage we consider the paragraph would be improved by clarifying that deficiencies can be identified at any stage of the audit.

This could be done by either adding a sentence simply stating that deficiencies can be identified at any stage, or by making clear that identification of deficiencies during risk assessment is just one example of how deficiencies may be identified. We note that paragraph A1 is entirely clear on this matter and it may be useful to move the first sentence of paragraph A1 to paragraph 2 and then to note that one of the stages where deficiencies could be identified is during risk assessment. The remainder of the paragraph would then flow more effectively.

## Objective

2. While we agree with the objective of the proposed ISA, it should refer to both management 'and' those charged with governance, rather than 'or'. The current construction of the sentence is such that this change would require no further grammatical changes.

We agree with the omission of any reference to material weakness in both the objective and definitions.

## Definitions

3. *We do not agree with the definition of deficiencies in internal control.*

The definition refers to individual controls, and is not entirely consistent with ISA 315. In paragraph 91 of ISA 315, for example, specific reference is made to how a control activity. '...individually, or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures.'

The draft refers to, 'A control that is either missing or is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis.' It makes no reference to combinations of controls. This emphasis on individual controls (or control activities) leads to some of the other problems in the draft, particularly in paragraph 9 (a), dealt with below.

We therefore suggest that paragraph 6 (a) be redrafted as follows to reflect the possibility of controls working effectively in combination, and therefore giving rise to no deficiency, even though they would not be effective in isolation.

*Controls, or combinations of controls, that are either missing or are designed, implemented or operated in such a way that they are unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis.*

The same issue does not affect the definition of significant deficiencies, since it refers to, 'A deficiency or combination of deficiencies...'. This clearly means that where an auditor identifies a deficiency, as currently defined, the existence of compensating controls without deficiencies would be relevant in determining whether there is a significant deficiency.

4. *We do not agree with the definition of significant deficiencies.* In particular, we do not agree with the reference to the auditor's professional judgment because:
  - (a) the reference adds nothing to the definition. While we accept entirely that judgment is involved, we cannot see how the definition could lead to any different result were this reference omitted. On this basis, the reference is superfluous;
  - (b) using this definition renders the first part of paragraph 10 circular. Paragraph 10 means that auditors are required to report to those charged with governance those matters they have judged necessary to report to those charged with governance.

We suggest that the reference to the auditor's professional judgment be removed from the definition. An additional sub-paragraph could then be added to paragraph 6 noting that the identification of a deficiency as significant is a matter for the auditor's professional judgment.

#### **Identification of Deficiencies in Internal Control**

5. The word 'determine' in paragraph 8 should not be used and should be replaced with a weaker term such as 'consider'.

We are concerned that the term 'determine' implies a greater degree of objectivity than is actually achievable. As noted in paragraph 6, and despite our objections to the use of the term in the definition itself, the identification of a deficiency as significant is a matter of professional judgment.

We have no similar objection to the use of the phrase when dealing with deficiencies in paragraph 7. While there is certainly some judgment involved in deciding whether a deficiency exists, we consider that this is substantially less than in determining whether a deficiency is significant. We further note that paragraph 9 does not require the reporting of deficiencies which are clearly trivial.

#### **Communication of Deficiencies in Internal Control**

6. *Further clarification of paragraph 9 (a) would be helpful.*

We are concerned that the order in which matters are identified may have undue impact on the reporting of matters to management. This is particularly likely to

arise during SME audits due to the decreased likelihood of tests of control being used by the auditor.

For example, an auditor identifies what appears to be a deficiency in internal control. It later becomes clear that there is an additional control, of which the auditor was not previously aware, which compensates for the apparent deficiency. However, the newly identified control is not (and is not required to be) tested for operating effectiveness by the auditor. Paragraph 9 (a) appears to require the deficiency to be reported to management. However, had the auditor been aware of both controls initially, no deficiency would have been identified, given that the combination of controls would have been considered adequate. No report to management would be made, even if the auditor had chosen not to test the operating effectiveness of either of those controls.

Paragraph A3 appears to reinforce this reading of paragraph 9 (a). We also question the statement in the second sentence of A3; in some cases, the existence of other controls *does* change the fact that the auditor has identified a deficiency in internal control. The auditor has in such cases identified that his understanding of the control system was not entirely accurate. The second sentence also appears to be contradicted by the fourth sentence. We therefore consider that the second sentence should be deleted.

Paragraph 9 (a) could result in the auditor reporting deficiencies which do not in fact exist, simply because the auditor did not identify a compensating control during risk assessment and it was later brought to his attention by management.

At the same time, we also accept that there may be cases where management may state that there is a compensating control which, in fact, is ineffective. If the auditor was allowed to consider the impact of the control without testing it, the auditor might fail to report a genuine deficiency.

On balance, we suggest that auditors should be required to test the operating effectiveness of compensating controls where they are brought to the attention of the auditor by management in responding to the auditor's initial identification of a deficiency. This minimises the risk that auditors will either:

(a) report deficiencies which do not in fact exist; and

(b) fail to report genuine deficiencies by accepting untested management assertions concerning compensating controls.

7. While we agree with the content of paragraph 9 (b), it is not clear what the auditor should do where such circumstances arise. Paragraph A13 should state that where such circumstances arise, the matter should always be considered significant and therefore reported to those charged with governance.
8. Paragraph A18 mentions that those charged with governance may wish to be informed of matters that are not significant deficiencies and that such communication may be in summary form. Paragraph A18 should make it clear that communication of such matters may be made orally, with documentation

covering the matters included in the auditors' working papers only, as is explicitly permitted under ISA 260 in analogous circumstances.

### **Special Considerations in the Audit of Smaller Entities**

9. Point 6 above is likely to be of particular relevance to the audits of smaller entities.

We also note that for many smaller entities the same people may be management and those charged with governance. While we do not consider that this has any impact on the standard, it may be useful to point out in the application material that in such a situation the implication is that all non-trivial deficiencies must be reported orally, and those that are significant then followed up in writing. This could be added to paragraph A16, since this paragraph already deals with this possibility, but does not make explicit that one of the situations where it may be 'appropriate to do so' is where management and those charged with governance are the same people.