

May 15, 2008

Mr. James Sylph
Executive Director, Professional Standards, IAASB
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017

Re: Exposure Draft: *Proposed International Standard on Auditing (ISA) 265*, “Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs”

Dear Mr. Sylph:

The American Institute of Certified Public Accountants (AICPA) is pleased to comment on the above referenced exposure draft. We commend the International Auditing and Assurance Standards Board (IAASB) on its proposed International Standard on Auditing (ISA) 265, which establishes the auditor’s responsibilities for and provides guidance on communicating deficiencies in internal control to management and those charged with governance in an audit of financial statements. The Auditing Standards Board (ASB) supports the issuance of the ISA and believes that the objective and requirements in the standard are appropriate. We offer the following suggestions for your consideration:

Objective

We believe that evaluating the severity of identified deficiencies is a significant step in determining which matters are to be communicated to management and those charged with governance. As such, we suggest that the following additional objective be inserted as the first of two objectives in paragraph 5 of the proposed ISA. We also suggest that the term “appropriately” be replaced with the term “clearly,” to align the language in the objective with the language used in ISA 260 (Revised and Redrafted), “Communication with Those Charged with Governance.”

5. The objectives of the auditor ~~are~~is to:

(a) Determine the severity of the deficiencies in internal control relevant to the audit that the auditor has identified during the audit.

(b) Communicate ~~appropriately~~ clearly to management or those charged with governance deficiencies in internal control relevant to the audit that the auditor has identified during the audit and that, in the auditor’s professional judgment, are of sufficient importance to merit their respective attentions.

Compensating controls

Paragraph 9 (a) of the proposed ISA requires the auditor to test the operating effectiveness of “other controls” (hereinafter referred to as *compensating controls*) in order for the auditor to consider their mitigating effects on the severity of a deficiency. We do not believe the auditor should be required to test the operating effectiveness of compensating controls in every instance to support his or her judgment that a deficiency is less severe than if there were no compensating controls. We do believe, however, that:

- The auditor should be required, in all circumstances, to determine that compensating controls are designed effectively and implemented before he or she can consider their mitigating effects.
- If the compensating controls are designed effectively and implemented, tests of operating effectiveness should be required if the auditor intends to rely on the operating effectiveness of the compensating controls in the assessment of risk (and thereby reduce substantive procedures based on the reliance on such controls).

Further, we believe paragraph 9 (a) is inconsistent with paragraph A3, which stipulates that a compensating control does not eliminate a deficiency. By positioning the testing requirement in paragraph 9(a) and not in paragraph 10, which addresses the communication of significant deficiencies, auditors may fail to communicate deficiencies that are not significant deficiencies to management. In this regard, we suggest that the tests of compensating controls be associated with significant deficiencies (such as in paragraph 10) and that paragraph A3 be revised as follows.

A3.This ISA does not require the auditor to obtain audit evidence regarding the design and operating effectiveness of these other controls. In concluding whether **significant** deficiencies in internal control exist, the auditor is, however, not precluded from obtaining and evaluating additional audit evidence regarding such other controls.

Differentiation of the parties to whom communication is made

Paragraph 9 indicates, in part, that the communication of all deficiencies in internal control should be made to “management at an appropriate level of responsibility.” We believe that the term “all deficiencies” includes significant deficiencies, and that the proposed ISA could be clearer in that regard. Accordingly, we suggest that paragraph 10 be revised to indicate that the parties to whom written communication of significant deficiencies should be made are management and those charged with governance.

Restricted use paragraph

We recommend that the ISA be modified to require the auditor to include a paragraph in the written communication restricting its use to management and those charged with governance (and regulators when applicable) because of the matters identified in paragraph 11 (b) (i-iii). Although paragraph A20 permits the use of such a paragraph, we believe the written communication, which is a byproduct of the audit rather than the objective of the audit, should be restricted as to use to avoid the potential for misinterpretation of the limited degree of assurance such communications provide. At a minimum, the requirement in paragraph 11 can be enhanced to require an “intended use” paragraph (i.e., the second bullet in paragraph A20).

Indicators of Significant Deficiencies

In our jurisdiction, the matters identified in paragraph A6 are indicators of a material weakness, yet this proposed standard positions them as indicators of a significant deficiency. Because the IAASB proposes to eliminate the material weakness category, we are concerned that some auditors may believe that paragraph A6 sets the “bar” for what constitutes a significant deficiency when, in actuality, that “bar” is lower.

Matters to consider in evaluating deficiencies

Paragraph A7 of the ISA provides examples of matters the auditor may consider in evaluating whether a deficiency or combination of deficiencies constitutes a significant deficiency. We believe the examples in paragraph A7 assist the auditor in evaluating deficiencies but believe that consideration of the likelihood and

magnitude of the misstatement that could occur as a result of the deficiency are relevant criteria for making this evaluation. Likelihood and magnitude are briefly described in paragraph A5. In this regard, we suggest moving paragraph A7 prior to paragraph A6 and expanding on the concepts of likelihood and magnitude in paragraph A5.

Explanation for not remediating deficiencies

We suggest that the last two sentences in paragraph A10 be incorporated in paragraph A11, as shown below, because (1) paragraph A11 focuses on management's explanation for not remediating deficiencies, and (2) to indicate to the reader that management's failure to remediate a deficiency because of cost considerations generally would be viewed as a "rational explanation," as that term is used in paragraph A10.

~~A10.The auditor may 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.~~

A11. Management may already be aware of deficiencies that the auditor has identified during the audit and may have chosen not to remedy them. ***The auditor may ask management why the deficiency has not yet been remediated. Management may indicate that the because of cost of implementing the remedial action exceeds the benefits or may have provide other rational explanations for not implementing the remedial action*** considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management. Accordingly, ~~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. ***Management's failure to remediate a deficiency, in the absence of a rational explanation, may in itself represent a significant deficiency.***

Level of detail in the communication

Paragraph A17 lists examples of factors the auditor may consider when determining the appropriate level of detail for the communication. Many of these factors need to be clarified because, as written, they are subject to misinterpretation as to why the auditor might vary the level of detail in the communication. The misinterpretation that might result from these bullets is shown below:

The nature and size of the entity

A reader might conclude that those charged with governance of a smaller entity are less able to comprehend a detailed explanation of the deficiencies, even when such detail may be necessary to clearly communicate the severity of the deficiencies.

The nature and volume of significant deficiencies that the auditor has identified

An entity may have identified many significant deficiencies. This bullet could be interpreted to mean that the existence of many significant deficiencies provides a rationale for a less detailed explanation.

The entity's governance structure

A reader might conclude that an entity with a simple governance structure has less need for, or is less able to understand, a detailed explanation of the deficiencies.

The nature of the oversight responsibilities of those charged with governance.

This factor would affect to whom the communication is made rather than the level of detail in the communication.

The preferences of those charged with governance.

The preferences of those charged with governance should not dictate the level of detail in the communication. The level of detail in the communication provides support for the work performed by the auditor as well as the conclusions reached; it also affects the auditor's ability to completely and clearly communicate significant deficiencies to those charged with governance.

Whether the significant deficiencies were communicated to those charged with governance in previous audits

Each audit should stand on its own by either repeating the communications from a prior year or referencing such communications in the current year's written communication. The auditor has no way of knowing whether those charged with governance will retain information communicated in previous audits.

Whether those charged with governance already had knowledge of the significant deficiencies through other means, such as from relevant internal audit reports.

It would not be in the auditor's best interest to rely on assumptions about the extent of knowledge those charged with governance have with respect to communications about significant deficiencies made through other means. However, with regard to deficiencies that do not rise to the level of a significant deficiency, the auditor should be able to rely on such communications to either reduce the level of detail in communicating such deficiencies to management or to eliminate the communication altogether.

Thank you for the opportunity to comment on this exposure draft. If you have any questions regarding the comments in this letter, please contact Judith Sherinsky at +1-212-596-6031, jsherinsky@aicpa.org.

Respectfully submitted,



/s/ Harold Monk, Jr.
Chair, Auditing Standards Board