



**BASEL COMMITTEE ON BANKING SUPERVISION**

**BANK FOR INTERNATIONAL SETTLEMENTS**

Chairperson

**VIA ELECTRONIC MAIL:  
edcomments@ifac.org**

Mr Jim Sylph  
Technical Director  
International Auditing and Assurance  
Standards Board  
545 Fifth Avenue, 14th Floor  
New York, New York 10017  
USA

25 April 2008

**IAASB exposure draft ISA 265, communicating deficiencies in internal control and related conforming amendments to other ISAs**

Dear Mr Sylph

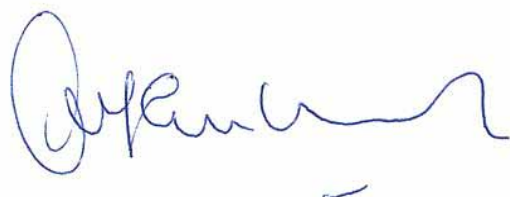
The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on your recent exposure draft. The Committee has a strong interest in high quality and independent audits of banks and has carefully analysed the proposals captioned above.

We appreciate the efforts of the International Auditing and Assurance Standards Board (IAASB) in developing a standard to define an auditor's responsibilities for determining when internal control deficiencies warrant notification to management or those charged with governance and the auditor's responsibilities with respect to that communication. We believe this standard is more than simply a *communication* standard, and it should be enhanced by explicitly defining the criteria that an auditor should consider when determining the magnitude of a deficiency and associating it with a category (eg significant, non-trivial but not significant, and trivial). Furthermore, we appreciate that the standard has been strengthened by lowering the threshold for identifying control deficiencies that must be communicated in writing to those charged with governance and eliminating the concept of a material weakness. However, the definition of *significant deficiency* (a key term in this standard) should be further clarified.

Please find our detailed comments in the attached appendix. These comments have been prepared by the Committee's Accounting Task Force, chaired by Sylvie Mathérat, Director of the Bank of France, and have been approved by the Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Marc Pickeur, who chairs the Audit Subgroup of the Accounting Task Force (+32 2 220 5253), or Linda Ditchkus at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Nout Wellink', with a stylized flourish at the end.

Nout Wellink



## Appendix

### **IAASB exposure draft ISA 265, communicating deficiencies in internal control and related conforming amendments to other ISAs**

#### **1. Introduction**

The Basel Committee on Banking Supervision<sup>1</sup> (Committee) has a strong interest in high quality and independent audits of banks and has carefully analysed the proposed International Standard on Auditing (ISA) pertaining to identifying and communicating deficiencies in internal control in an audit of the financial statements.

We appreciate the efforts of the International Auditing and Assurance Standards Board (IAASB) in developing a standard that defines an auditor's responsibilities for determining when internal control deficiencies warrant notification to management or those charged with governance and the auditor's responsibilities with respect to that communication. We believe this guidance could be enhanced by explicitly defining the criteria that an auditor should consider when determining the magnitude of a deficiency and associating it with a category (eg significant, non-trivial but not significant, and trivial). Furthermore, to enhance clarity, the IAASB should consistently identify the deficiency category when describing which method of communication is required and to whom the communication should be made. Finally, we approve of the IAASB strengthening the ISA by lowering the threshold for identifying control deficiencies that must be communicated in writing to those charged with governance and eliminating the concept of a material weakness from the ISAs. Because of the importance of this development, we suggest the IAASB explicitly mention this change in focus within the ISA. We also suggest that the definition of *significant deficiency* (a key term in this standard) be further clarified.

#### **2. When discussing suspected deficiencies with management, the auditor may be informed by management of the existence of other controls that management may assert would prevent, or detect and correct, misstatements arising from the identified deficiencies. The proposed ISA makes it clear that the auditor is not required to obtain audit evidence regarding the design and**

---

<sup>1</sup> The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

**operating effectiveness of those other controls, although the auditor may choose to do so. Do you agree with this guidance?**

Yes. We believe this guidance is appropriate in not mandating that the auditor obtain additional audit evidence regarding the other controls asserted by management. Nevertheless, this guidance provides the auditor sufficient flexibility to obtain further audit evidence if the auditor deems it appropriate within the circumstances of a particular audit.

**3. The IAASB has taken the view that audit evidence regarding the effective design and implementation of other controls that would prevent, or detect and correct, misstatements arising from an identified deficiency is not in itself sufficient to support a conclusion that a deficiency does not exist; and this is the case even though the auditor's view that there is a deficiency may be based solely on evidence about the design or implementation of a control. Do you agree with this guidance?**

Yes. We believe this guidance appropriately emphasises that evidence regarding the operating effectiveness of these other controls is necessary to conclude that an identified deficiency in internal control does not exist. This guidance essentially acknowledges that despite effective design and implementation, any particular control is successful in preventing, or detecting and correcting, misstatements arising from the identified deficiency only if effective in actual operation.

**4. Other comments**

The ISA is somewhat confusing because "clearly trivial" deficiencies are scoped out of the ISA in paragraph 1 but paragraph 9 provides guidance that distinguishes between deficiencies that are clearly trivial and those that are not. If the IAASB chooses to include guidance for three categories of control deficiencies, we believe a more understandable approach is to have a clear description of internal control deficiencies categorised as: (1) significant deficiencies (which need to be communicated in writing to those charged with governance and to management); (2) non-trivial, non-significant deficiencies (which need to be communicated in writing to management); and (3) trivial (which should be documented by the auditor but for which there is no need to communicate). Alternatively, if the IAASB chooses to scope out clearly trivial deficiencies, then the guidance should be limited to just the first two categories of deficiencies.

We believe a clear and consistent use of the three categories above would enhance the clarity and effectiveness of the ISA.

## Comments on specific paragraphs

By replacing the term “material weakness”<sup>2</sup> with the term “significant deficiency” (ie in ISA 265 and other ISAs through the conforming amendments), we believe the IAASB intends to lower the threshold for identifying and communicating internal control deficiencies. We agree with this proposed strengthening of the standard and suggest (to avoid confusion amongst practitioners) that the IAASB explicitly mention this change in focus within the ISA. This clarification would be particularly helpful in explaining the consequences of this change within the conforming amendments.

The definition of “significant deficiency” in paragraph 6(b) is not sufficiently clear and creates unnecessary burden on the auditor to determine what those charged with governance might consider important. Furthermore, the level of importance of a deficiency would likely vary from one audit client to another depending upon the *risk appetite* of those charged with governance, which would be an inappropriate consequence of the proposed definition. We suggest that a clearer definition of “significant deficiency” would include the *criteria* that an auditor should consider in making a determination of the magnitude of the deficiency. Additionally, the IAASB should consider enhancing the list of examples provided in paragraph A6 to include illustrations of the risk of misstatement and risk of harm to business assets or staff.

The requirements section in paragraphs 7 and 8, the application material (ie paragraphs A1 – A8) and the conforming amendments infer a scope for ISA 265 beyond merely “communication” of deficiencies. However, the scope of ISA 265 (as identified in paragraphs 1 – 3) is oriented toward a communication objective. To enhance clarity and fulfill the IAASB’s objectives, as stated in the Background material, we believe the scope and requirements of this ISA should describe the auditor’s responsibilities in an audit of the financial statements for: 1) identifying internal control deficiencies, 2) determining the magnitude of the identified deficiencies and 3) communicating identified deficiencies to either those charged with governance or to management, as appropriate.

While we agree with the approach taken in paragraph 9(a), this first exception to the standard’s communication requirement is not clear without also reading paragraph A3. We suggest redrafting paragraph 9(a) to include descriptive information provided in paragraph A3.

In addition to describing the second exception to the standard’s communication requirement in paragraph 9(b), we believe the ISA should be strengthened by specifying alternative follow-up actions in cases where this exception is applied. One way to partially address this suggestion is to require the auditor to communicate the deficiency in writing to those charged with governance in cases where the circumstances of paragraph 9(b) apply and those charged with governance are not the same persons as management.

We believe the last sentence of paragraph A10 should be included in the definition of a deficiency. A failure to act on a previously identified non-trivial deficiency elevates the magnitude of the audit finding.

---

<sup>2</sup> The identification of a control deficiency that is a “material weakness” triggers specific responsibilities within regulatory guidance from the US Public Company Accounting Oversight Board (PCAOB) and the 8th European Directive.