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Board
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Re: Exposure Drafts ISA 265 and 402

Dear Mr Sylph,

The Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) are pleased to submit their joint comments on the following Exposure Drafts:

- Proposed International Standard on Auditing 265 (New) - Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs;
- Proposed International Standard on Auditing 402 (Revised and Redrafted) – Audit consideration relating to an entity using a third party service organization.

If you have any further questions about our views on these matters, please do not hesitate to contact us.

Yours faithfully,

Jean-Pierre ALIX
President of CSOEC

Vincent BAILLOT
President of CNCC

Envoyer obligatoirement toute correspondance aux deux adresses ci-dessous :

Re: Exposure Draft – Proposed International Standard on Auditing 265 (New) – Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs

The Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) are pleased to comment on the Exposure Draft of Proposed new ISA 265 - Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs.

1. Overall Comments

We understand and appreciate the IAASB's efforts to strive improving the auditor's communication to management and to those with governance on deficiencies in internal control. In this context, the IAASB decided to create a new standard, the proposed ISA 265 – Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs. For this, the IAASB retained the approach to no longer use the term “material weakness” in the ISAs. This approach resulted in a change in the requirement in the ISAs for the auditor to communicate “material weaknesses” to those charged with governance to a requirement for the auditor to communicate “significant deficiencies”.

However, we have some concerns about the approach retained. Please find hereafter the rationale for our concerns:

- The EU has adopted in 2006 the Directive 2006/43/EC of the European Parliament and of the Council. This directive is to be transposed before 29 June 2008 by the Member States. Article 41 (4) sets the following requirement :

*“The statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on **material weaknesses** in internal control in relation to the financial reporting process.”*

The concept of “material weaknesses” is not defined in the body of the directive. Moreover, there is no definition otherwise in the Community law of what material weaknesses in internal control are. Instead it is left to the professional judgment of the auditor to identify material weaknesses in internal controls when auditing financial statements.

- The existing ISA 260 – Communications with those charged with governance - states in paragraph 12 (c) (i):

“The auditor shall communicate with those charged with governance:

(c) Unless all of those charged with governance are involved in managing the entity:

*(i) **Material weaknesses**, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management as required by ISA 315 (Redrafted), or ISA 330 (Redrafted);”*

The concept of “material weaknesses” is not defined in the body of the standard.

- The proposed ISA 265 withdraws in its conforming amendment the requirement of paragraph 12 in ISA 260 to communicate “**material weaknesses**” to those charged with governance. As explained here above, the proposed standard removed the term “material weakness” from the proposed standard and henceforth uses only the two following concepts “deficiency in internal control, except those that are clearly trivial” and “significant deficiency”.

Paragraphs 9 and 10 states the following

- § 9 “*The auditor shall communicate all **deficiencies** in internal control (other than those that are clearly trivial) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless (...)*”
- § 10 “*The auditor shall communicate **significant deficiencies** identified during the audit to those charged with governance in writing and on a timely basis*”.

We understand that the rationale for not retaining and consequently not defining the concept of “material weakness” in the proposed ISA 265 is the following:

- The concept of “material weakness” is defined in the PCAOB’s Auditing Standard 5. The PCAOB definition, however, is intended to represent a threshold for purposes of reporting publicly on the effectiveness of internal control, as required by the Sarbanes-Oxley Act in the USA. That threshold is higher than that defined for the purposes of reporting to those charged with governance. The IAASB concluded that this definition would not be appropriate for the ISAs as they contain no requirement for a report on the effectiveness of internal control and in the absence of such a requirement a further categorization of deficiencies would place an unnecessary evaluation burden on auditors to no purpose.
- The IAASB also decided not to develop a definition of material weakness that would be different from that set out in the PCAOB’s Auditing Standard 5, since the co-existence of two different definitions of the same term in IAASB and PCAOB standards could potentially
 - generate confusion amongst practitioners and users of financial statements around the world, and;
 - lead to attempts at reconciling their meanings for varying reporting purposes.

The IAASB believes that this outcome would not be in the public interest.

- In France, the French commercial code (art. L.225-37) requires that: “*In companies that make public offerings, the chairman of the board of directors describes the preparation and organisation of the board's work and the internal auditing procedures put in place by the company in a report attached to the report referred to in the relevant Articles of the French Commercial Code*”. Furthermore, the professional standards applicable in France, regarding the audit procedures on the chairman of the board of directors’ report concerning the internal control, specifies that the chairman of the board of directors describes the **material weaknesses**, expressed in French as “*déficiences majeures*” in his report. This report is a public document. In practice, based on the requirements of the proposed ISA 265 and as the concept of “**material weaknesses**” is not defined anywhere, this would imply that **all significant deficiencies** communicated to those charged with governance by the auditor should also be reported by the chairman of board of directors in his report concerning the internal control.

Based on these statements,

- we believe that the proposed ISA 265 may cause confusion for the auditors, the regulators and the public because of the co-existence of different concepts, i.e. “**material weakness**”, “**significant deficiencies**”, “**deficiencies**” in the international auditing and assurance standards, the European Directive and the local law and regulation;
- furthermore, in certain countries, such as France, the interconnection between the proposed standard ISA 265, the local law and regulation and the professional standard applicable in France, would imply that the chairman of the board of directors should list in a public document all significant deficiencies identified by the auditor during the audit. This appears not appropriate and unrealistic!

Therefore, we recommend that the IAASB

- do not introduce the concept of “significant deficiencies” in the proposed ISA 265. This would unfortunately have as a consequence that the proposed standard would lose most of its interest and that one could question whether it should not be deleted;
- only use the concept of “material weakness”, as stated in the existing ISA 260 even if this is different from the one developed in the PCAOB’s Auditing Standard 5.

2. Comments on definitions

Paragraph 6

Paragraph 6 (b) provides with a definition of the concept of “significant deficiency”¹. This explicitly refers to the auditor’s professional judgment to identify the significant deficiencies that merit the attention of those charged with governance.

Paragraph 6 (a) provides with a definition of the terms “deficiency in internal control”. This does not include any materiality criteria. We therefore consider that the proposed ISA should specify that the identification of deficiencies in internal control that merit the attention of the management requires the exercise of professional judgment. Thus, we suggest the following amendments in paragraph 6 (a). Please refer the underlined text:

§ 6 “*For purposes of the ISAs, the following terms have the meanings attributed below:*

(a) 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 prevent, or detect and correct, misstatements in the financial statements on a timely basis, and that in the auditor’s professional judgment, is of sufficient importance to merit the attention of the management.”

¹ Paragraph 6 of ISA 265: “*For purposes of the ISAs, the following terms have the meanings attributed below:*

(b) Significant deficiency – A deficiency or combination of deficiencies in internal control relevant to the audit that, in the auditor’s professional judgment, is of sufficient importance to merit the attention of those charged with governance.”

3. Comments on requirements

Paragraph 9

In connection with the amendments proposed for the paragraph 6, we recommend that IAASB amend paragraph 9 of the proposed ISA as follows:

“The auditor shall communicate ~~all~~ deficiencies in internal control (~~other than those that are clearly trivial~~) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless: (...)”.

Paragraph 9 (a)

Paragraph 9 (a) and the related application material paragraphs (paragraph A3 and A12) deal with the communication of deficiencies in internal control to management and states that:

“The auditor shall communicate all deficiencies in internal control (other than those that are clearly trivial) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless:

(a) 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.”

We consider that this requirement unduly increases the work effort compared to ISA 260, since the ISA now requires that auditor has tested the operating effectiveness of alternative controls before he can decide not to communicate the internal control deficiencies to management. We expect an important increase in the volume of communication by the auditor, since a communication to management may in many cases be easier for the auditor than testing the operating effectiveness of controls that may be not directly relevant to the audit.

4. Comments on Application and Other Material Section

Paragraph A5

Paragraph A5 states that: *“Significant deficiencies may exist even though the auditor has not identified misstatements during the audit. The significance of a deficiency or combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the risk that a misstatement could occur and the potential magnitude of the misstatement.”*

We consider that paragraph A5 could complete the definition given in paragraph 6 (a) of “significant deficiencies”. We therefore recommend that IAASB move paragraph A5 to paragraph 6.

Paragraph A9

Paragraph A9 deals with the communication of identified deficiencies to management and states: *"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, it is appropriate to communicate to management, in accordance with paragraph 9, 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."*

We consider that the example given in paragraph A9 is confusing. As a matter of fact, we believe that deficiencies in the price list in the computerized sales system directly relate to the financial reporting objective of internal control.

Paragraphs A10 and A11

Paragraphs A10 and A11 deal with the communication of identified deficiencies in Internal control to management. These state that *"How the auditor communicates a deficiency may be influenced by whether the auditor has communicated it in a previous audit, or whether management already has knowledge of it. If the auditor has previously communicated 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 management already had knowledge of the deficiency through other means (such as from relevant work done by internal auditors), does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken"*.

We consider that this guidance is too restrictive, particularly in smaller entities. For example, once the owner manager has considered a deficiency but decided not to change anything, he may wish to continue to rely on close personal supervision instead of extensive controls or be unable to institute good segregation of duties or consider instituting a change in may not be cost-effective, future reporting to management of the same issue in writing will add extra cost for the auditor for no benefit.

We therefore recommend that IAASB delete such guidance.

Paragraph A12

Please refer to our comments on paragraph 9 (a).

Paragraph A20

Paragraph A20 deals with the content of written communication of significant deficiencies and states: *“The auditor may consider it appropriate to include the following information as additional context for the communication:*

An indication that if the auditor had performed more extensive audit procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.” (...)

We suggest deleting “audit” in the first bullet point, since such extensive procedures on internal control may be performed not only for the purpose of the audit.

5. Response to IAASB’s Request for Response on Questions

5.1 Do you agree with the guidance in paragraphs A1 to A3 and paragraph A12 in relation to paragraph 9 that audit evidence regarding the effective design and implementation of other controls is not in itself sufficient to support a conclusion that a deficiency does not exist?

Refer to our comments made above.

Re: Exposure Draft – Proposed International Standard on Auditing 402 (Revised and Redrafted) – Audit consideration relating to an entity using a third party service organization.

The Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) are pleased to comment on the Exposure Draft of Proposed ISA 402 (Revised and Redrafted) – Audit consideration relating to an entity using a third party service organization.

Our main comments about the proposed ISA 402 are set out below as overall comments. Our other comments which follow would, we believe, further enhance the standard.

1. Overall Comments

We have some concerns about the respective weight of the proposed standard between the risk assessment procedures, through obtaining an understanding of the internal control, and the response to the assessed risks.

We consider that the proposed ISA 402 over-emphasizes the aspects of the user entity's internal control and its understanding by the user's auditor compared to the aspects of obtaining other audit evidence in response to the assessed risks which is dealt with in only one paragraph, i.e. paragraph 18. We therefore believe that more emphasis should be put on paragraph 18 "*other audit evidence considerations regarding service organizations*". Thus, we believe that paragraph 18 could be further developed and be placed before the paragraphs 13 to 15. This consists in:

- placing paragraph 18 as a first option to respond to identified risks and
- moving paragraphs 13 to 15, which emphasize the use of type A or B reports, after paragraph 18.

We believe that the proposed standard over-emphasizes the aspects of the service organization's internal control and tends to "systematize" the obtaining, by the user's auditor, of an assurance report from the service auditor. We consider that using such an assurance report (be it type A or B) is only one (among others) of the audit procedures that the user's auditor can perform when auditing an entity using a third party service organization. For example, we consider that the user auditor could not use such an assurance report when the user entity has designed and implemented relevant controls that relate to the input and output data given and received from the service organization (e.g. in the case when the entire wages department is outsourced to a service organization).

We are concerned that the standard does not give an appropriate response in the case the entire business operations of an entity are outsourced to the service organization. This would be the case when the entity decides to use a shared service center (hereafter "SSC"). Paragraph 4 of the proposed standard only states: "*The focus of this ISA is on an entity's use of a third party service organization, but it may also be applicable, adapted as necessary in*

the circumstances, to situations where an entity uses a shared service center which provides services to a group of related entities.”

We consider that the issues related to the SSC are more extensive than those related to the third party service organisation, mainly due to the extent of the services outsourced. Therefore, when an entity uses a SSC which provides services to a group of related entities, we believe that the user auditor often cannot limit his procedures to those described in the proposed standard. Please refer to our comments in paragraph 5.

Even if the following issues, i.e. the documentation and the compliance with the local law and regulations as described in paragraph 5.1, are particularly important in the context of a SSC, we believe that these should be also developed in the context of a third party service organisation.

2. Comments on definitions

Paragraph 8 defines, among others, the following terms:

- the report on the description and design of controls at a service organization (Type A report) and;
- the report on the description, design and operating effectiveness of controls at a service organization (Type B report).

We believe that it is important to specify in the proposed standard that the scope of the assurance report issued by the service auditor is “all transactions” under the responsibility of the service organization, regardless of the user entities.

Concerning the type B report, we would like the IAASB to confirm whether a type B report issued in accordance with SAS 70 is equivalent with a type B report issued in accordance with ISA 402. We have some doubts since we understand that based on paragraph 42 of AU 324, the description, prepared by management of the service organisation, is covering only the design and implementation of controls and not their operating effectiveness throughout a specified period, as mentioned in paragraph 8 (h) (i) of the proposed ISA 402.

3. Comments on requirements

Paragraph 9 (c)

Paragraph 9 (c) states “:

“When obtaining an understanding of the entity in accordance with ISA 315 (Redrafted), the user auditor shall obtain an understanding of how a user entity uses a service organization in its operations, including: (...)

(c) The nature of the relationship between the user entity and the service organization, including the contractual terms for the relevant activities undertaken by the service organization.”

Paragraph A5 adds: *“The contract or service level agreement between the user entity and the service organization may provide for matters such as:*

- (...)
- *The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them; (...)*”

We consider that the second bullet point of paragraph A5 should be elevated to a requirement and be placed at the end of paragraph 9 (c).

Paragraph 11

Paragraph 11 states: *“The user auditor shall determine whether a sufficient understanding of the user entity’s internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement. If the user auditor is unable to obtain that understanding from information on the service organization available at the user entity, the user auditor shall obtain audit evidence from one or more of the following procedures: (...)*”

We believe that the structure of the paragraph 11 should be further clarified for a better understanding. We therefore recommend that IAASB

- divide the paragraph into two specific paragraphs (i.e. a first paragraph including the first sentence of paragraph 11 and a second paragraph including the second sentence of paragraph 11);
- lay stress on the following:
 - when the user auditor has obtained a sufficient understanding of the user entity’s internal control relevant to the audit to provide a basis for the identification and assessment of risks of material misstatement, the user’s auditor stops applying the proposed standard and continues with ISA 330 “The Auditor’s Responses to Assessed Risks”;
 - paragraphs 11 (2nd sentence) to 17 are only conditional requirements.

Furthermore, we suggest to

- re-order the bullet points of the second sentence of paragraph 11 as follows: (b), (d), (c) and (a), since we consider that obtaining a type A or B report is not the first option that the auditor shall retain;
- for clarification purposes, specify in the first sentence of paragraph 11 the underlined text: *“The auditor shall determine whether a sufficient understanding of the user entity’s internal control over services provided by the service organization relevant to the audit has been obtained ...”*;
- further clarify in the application material what is meant by “*necessary information*” in paragraph 11 (c). As a matter of fact, this states: *“If the user auditor is unable to obtain that understanding from information on the service organization available at the user entity, the user auditor shall obtain audit evidence from one or more of the following procedures: (...) (c) Requesting that a service auditor be engaged to perform procedures that will provide the necessary information; or (...)”*.

It is unclear whether the user auditor should request a Type A or Type B report, or some other information. We therefore recommend that IAASB further clarify these terms.

Paragraph 12

Paragraph 12 is entitled “*Assessing the risks of material misstatements*”. However, we believe that the content of paragraph 12 relates more to “responding to the risk of material misstatements” rather than “assessing the risks of material misstatement”.

We therefore recommend that IAASB amend the title of the paragraph. We also suggest that paragraph 12 (a), i.e. obtaining a type B report, be placed at the end after paragraph 12 (c), since we consider that obtaining a type B report is not the first procedure to be performed by the user auditor.

Paragraph 15

Paragraph 15 states: *“In determining the sufficiency and appropriateness of the audit evidence provided by a Type A or Type B report in support of the user auditor’s opinion, the user auditor shall be satisfied as to the service auditor’s professional reputation, competence and independence.”*

We suggest that it should be placed before paragraph 13 under the sub-heading “*Using an Assurance report from a Service Auditor*”, since we consider that it is more logic in terms of timing.

Paragraphs 16 and 17

These paragraphs state:

“The user auditor shall not refer to the work of a service auditor in the user auditor’s report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor’s report shall indicate that the reference does not diminish the user auditor’s responsibility for the audit opinion.

If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor’s opinion, the user auditor’s report shall indicate that such reference does not diminish the user auditor’s responsibility for that opinion.”

Since these paragraphs deal with reporting considerations, we consider that the IAASB should create a specific sub-heading, i.e. “*reporting considerations*” to deal with this issue. Moreover, we propose to transfer these paragraphs after paragraph 19.

Furthermore, we consider that the statement that specifies that “*If such reference is required by law or regulation, the user auditor’s report shall indicate that the reference does not diminish the user auditor’s responsibility for the audit opinion*”, is “excessive”.

This requirement is the same than the one stated in paragraphs 14 and 15 of the proposed standard ISA 620 “Using the Work of an Auditor’s Expert”. We believe that this caveat paragraph should be deleted in the proposed standard and in the proposed ISA 620 for the following reason.

In certain countries, such as France, when the auditor uses the work of an auditor’s expert, he can refer to the work and the conclusions of the auditor’s expert in his report in the other matter section. In France, the aim of the other matter section is to explain, to the users of the audit report, the work performed and the assessments made by the auditor in the context of the audit and that contributed to form his opinion. In this context, we believe that including in the audit report a paragraph specifying that the auditor’s responsibility for the audit opinion issued is not diminished is not necessary and will make heavy the audit report.

4. Comments on Application material

Paragraph A1

Paragraph A1 provides examples of service organisation and lists among others the application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

We consider that these examples are inconsistent with the spectrum of service possibilities defined in paragraph 2 of the proposed ISA, i.e. organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity’s entire business units or functions.

We therefore recommend that IAASB delete these examples from paragraph A1 and from the related appendix in page 24.

Paragraph A16

Paragraph A16 states: “*If the user auditor is unable to obtain an understanding of the user entity’s internal control relevant to the audit by performing the procedures required by paragraphs 9-11 of this ISA, the auditor is required to modify the opinion in the auditor’s report.*”

We consider that this paragraph has no added value since it is redundant with requirements of ISA 705. Accordingly, we believe that it could be deleted.

Paragraph A34

The last sentence of paragraph A34 refers to the aspects of audit documentation and states: *“In these circumstances, it may be useful for the user auditor and the service auditor to agree, prior to the performance of the procedures, to the audit documentation or access to audit documentation that will be provided to the user auditor.”*

We consider that the same sentence should be added in paragraphs A33 and A35 as far as there is the possibility that the service auditor performs procedures at the service organization on behalf of the user auditor.

Otherwise, a better solution could be to create an additional paragraph in order to resolve practical difficulties encountered by the user auditor when he requests service auditor to perform procedures for his benefit. This should specify that the service auditor will

- provide to the user auditor all documentation requested ;
- give access to his audit files.

5. Request for specific comments

5.1 Situations where an entity uses a shared service center which provides services to a group of related entities

We consider that dealing with a third party service provider has some similarities with dealing with internal share service centers within a group of related entities. However, we believe that there is more direct relationship between the user auditors and the service auditor in a group situation, where ISA 600 also applies. Furthermore Type A or B reports are not necessarily issued. There might be different views on the way and the place where to develop further guidance on shared services centers:

- either in the proposed standard;
- or in the proposed ISA 600.
- or in a specific ISA;

However, we favour the first option that consists in extending and adapting the proposed standard to cover the SSC. In this context, we believe that the proposed standard should develop specific issues related to SSC and in particular the issues relating to:

- the compliance with the local law and regulation in terms of book-keeping, documentation and record of the book-keeping;
- the documentation, e.g. : in case of type B report, the proposed standard should confirm whether the user auditor can copy work papers of the SSC auditors' audit files ;
- the materiality level to be used by the SSC auditors when they perform audit procedures for the benefit of the user auditor. As a matter of fact, the SSC auditors use a higher materiality level at group level than the one determined for the statutory audit purposes that is not acceptable for the statutory audit purposes. The statutory auditor is obliged to require additional procedures from the SSC auditors to comply with the GAAS ;
- the additional procedures to be carried out by the user auditor, especially in terms of substantive tests, to be able to issue his report on the statutory accounts. We consider that

such procedures are essential for the user auditor to understand the content of the financial statements and be able to perform the review of the notes to the financial statements;

- ...

5.2 Comments on the Application of the Clarity Drafting Conventions

See our comments above.

5.3 Other matters (audit of smaller entities, public sector entities, developing nations, translations)

No comments.