PROPOSED INTERNATIONAL STANDARD ON AUDITING 265
COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL

(Effective for audits of financial statements for periods beginning on or after [December 15, 2009])

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Proposed International Standard on Auditing (ISA) 265, “Communicating Deficiencies in Internal Control” should be read in conjunction with [proposed] ISA 200 (Revised and Redrafted), “Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”
Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor’s responsibility to communicate appropriately to management and those charged with governance deficiencies in internal control relating to financial reporting [ISSUE B] that the auditor has identified in an audit of the financial statements. This ISA does not address deficiencies in internal control the potential financial effects of which are clearly trivial [ISSUE D]. It also does not apply where the auditor has been engaged to express an opinion on the effectiveness of internal control. ISA 260 (Revised and Redrafted) establishes further requirements and provides guidance regarding the auditor’s responsibility to communicate with those charged with governance in relation to the audit.

Rationale for Communicating Deficiencies in Internal Control

2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stages of the audit. Knowledge of those deficiencies that relate to financial reporting in internal control is relevant to management and those charged with governance in fulfilling their respective responsibilities in relation to the financial reporting process. This ISA therefore establishes communication responsibilities for the auditor regarding identified deficiencies in internal control relating to financial reporting [ISSUE B].

3. Nothing in this ISA precludes the auditor from communicating other internal control matters that the auditor has identified during the audit that are not relevant to the audit but that the auditor considers important [ISSUE B].

Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

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1 ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment,” paragraph 4, defines the terms “internal control” and “controls.”

2 [Proposed] ISA 450 (Revised and Redrafted), “Evaluation of Misstatements Identified during the Audit,” paragraph [A1], describes the meaning of “clearly trivial.”

3 ISA 260 (Revised and Redrafted), “Communication with Those Charged with Governance.”
Objective

5. The objective of the auditor is to communicate appropriately to management or, where appropriate, those charged with governance deficiencies in internal control relevant to the audit relating to financial reporting 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. [ISSUE B]

Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:

   (a) Deficiency in internal control – This exists when:

      (i) 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; or [ISSUE C]

      (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

   (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. [ISSUE B]

Requirements

Identification of Deficiencies in Internal Control

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)

8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A8)

Communication of Deficiencies in Internal Control

9. The auditor shall communicate in writing significant deficiencies identified during the audit to both management and those charged with governance in writing and on a timely basis. (Ref: Para. A10-A17, A25) [ISSUES E, H]

10. The auditor shall include in the written communication of significant deficiencies:

   (a) A description of the deficiencies and an explanation of their potential effects on the financial statements; and (Ref: Para. A18)

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The considerations established by ISA 260 (Revised and Redrafted), paragraph 9, regarding communication with those charged with governance when all of them are involved in managing the entity, are equally applicable to the requirement in paragraph 9.
(b) Sufficient information to enable management and those charged with governance to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A19-20-A21)

(iii) The purpose of the audit was for the auditor to express an audit opinion on the financial statements, and the auditor has not performed audit procedures to obtain reasonable assurance, and is not providing any assurance, on the effectiveness of internal control;

(ii) The auditor did not plan and perform the audit with a view to identifying all deficiencies in internal control that might exist; and

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded should be reported to management and those charged with governance.

119. The auditor shall also 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 other deficiencies in internal control identified during the audit that, in the auditor’s professional judgment, are of sufficient importance to merit management’s attention, unless: (Ref: Para. A9-A22-A252) [ISSUES D, E, H]

(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; or (Ref: Para. A9-A12) [ISSUE G]

(b) It would be inappropriate to communicate directly to management in the circumstances. (Ref: Para. A13)

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Application and Other Explanatory Material

Identification of Deficiencies in Internal Control (Ref: Para. 7)

Determination of Whether Deficiencies Have Been Identified (Ref: Para. 7)

A1. Deficiencies in internal control may be identified at any stage of the audit. In determining whether the auditor has identified one or more deficiencies, the auditor may seek to agree the relevant facts and circumstances of the auditor’s findings with management (including, where appropriate, management responsible for the internal audit function). Doing so also provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware.

A2. In agreeing—discussing the facts and circumstances of the auditor’s findings with management, the auditor may obtain other relevant information for further consideration, such as:

- Management’s understanding of the actual or suspected causes of the deficiencies.

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• Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant IT controls.

• A preliminary indication from management of its response to the findings.

A3. Management may also inform the auditor of other controls not previously known to the auditor that it believes would prevent, or detect and correct, potential misstatements that would not be caught by the control(s) giving rise to the deficiencies. The existence of these other controls does not change the fact that the auditor has identified deficiencies in internal control. This ISA does not require the auditor to obtain audit evidence regarding the design and operating effectiveness of these other controls. In concluding whether deficiencies in internal control exist, the auditor is, however, not precluded from obtaining and evaluating additional audit evidence regarding such other controls.

Considerations Specific to Smaller Entities

A4. A relevant consideration when determining whether deficiencies in internal control have been identified in the audit of a smaller entity is that the concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management’s sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities. Also, smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

Determination of Whether Identified Deficiencies Constitute Significant Deficiencies (Ref: Para. 8)

A54. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements. For example, controls in an IT subsystem may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the relevant account balances. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same class of transaction, account balance, or disclosure, relevant assertion, or component of internal control may increase the risks of material misstatement to such an extent as to give rise to a significant deficiency.

A65. 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–likelihood that a misstatement could occur and the potential magnitude of the

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5 ISA 315 (Redrafted), paragraph A62.
misstatement. These factors determine whether the deficiency or combination of deficiencies is of sufficient importance to merit the attention of those charged with governance.

A7. Examples of other matters that the auditor may consider in determining whether a deficiency or combination of deficiencies constitutes a significant deficiency include:

- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as those involving fair values.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:
  - General monitoring controls (such as oversight of management).
  - Controls over the prevention and detection of fraud.
  - Controls over the selection and application of significant accounting policies.
  - Controls over significant transactions with related parties.
  - Controls over significant transactions outside the entity’s normal course of business.
  - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency in internal control with other deficiencies in internal control.

A86. Indicators of significant deficiencies include, for example:

- Deficiencies in Evidence of ineffective aspects of the control environment, such as:
  - Ineffective oversight of the financial reporting process Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance, especially in an environment with limited segregation of duties.
  - Identification of management fraud, whether or not material, that was not prevented by the entity’s internal control.
- A deficiency in Evidence of ineffective control over a significant risk, such as indications that significant changes in accounting, legal or regulatory requirements are not being appropriately implemented.
- Material misstatements detected by the auditor’s procedures that were not identified prevented, or detected and corrected, by the entity’s internal control.
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• Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.

• Evidence of management’s inability to oversee the preparation of the financial statements.

A98. Law or regulation in some jurisdictions may impose additional requirements on the auditor (particularly for audits of listed entities) to evaluate the severity of significant deficiencies in order to identify a subset of those as ‘material weaknesses’ to communicating to those charged with governance or to other relevant parties (such as regulators). Details of specific types of deficiencies in internal control that the auditor has identified during the audit, and may define terms such as “material weakness” for this purpose. Where such additional requirements exist, law or regulation may define the specific threshold for categorizing significant deficiencies as material weaknesses. [ISSUE A]

A9. 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.

Communication of Deficiencies in Internal Control

Communication of Identified Deficiencies to Management (Ref: Para. 9)

Communication of Significant Deficiencies to Those Charged with Governance (Ref: Para. 910)

A104. Communicating significant deficiencies to management and those charged with governance in writing reflects the importance of these matters to the financial reporting process, and assists management and those charged with governance in fulfilling their related responsibilities relating to overseeing the financial reporting process. The communication may include details of any proposed remedial action from management, together with a statement as to whether the auditor has undertaken any steps to verify that such action has been implemented.

A115. In determining when to issue the written communication to those charged with governance, the auditor may consider that whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Further, for listed entities in certain jurisdictions, those charged with governance may need to receive the auditor’s written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor’s written communication of significant deficiencies forms part of the final audit file, the written
communication is subject to the overriding requirement\(^6\) for the auditor to complete the assembly of the final audit file on a timely basis.\(^7\)

A126. Regardless of the timing of the written communication of significant deficiencies to those charged with governance, the auditor may communicate these orally in the first instance to management and, when the auditor considers it appropriate to do so, to those charged with governance. This may assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing to those charged with governance, as paragraph 940 requires.

A127. The level of detail at which to communicate significant deficiencies to those charged with governance is a matter of the auditor’s professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature and size of the entity. For instance, the communication need not be as detailed for a smaller entity operating a simple business as for a large entity operating in a complex industry.
- The nature and volume of significant deficiencies that the auditor has identified.
- The entity’s governance structure composition. For instance, more detail may be needed if those charged with governance include members who do not have significant experience in the entity’s industry or in the affected areas.
- The nature of the oversight responsibilities of those charged with governance.
- The preferences of those charged with governance.
- Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.
- Whether the significant deficiencies were communicated to those charged with governance 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.

A128. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement for the auditor to communicate significant deficiencies to management—them applies regardless of cost or other

\(^7\) ISA 230 (Redrafted), paragraph A21, states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor’s report.
considerations that management may consider relevant in determining whether to remedy such deficiencies. [ISSUE F]

A150. 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. The fact that the auditor communicated a significant deficiency to management and those charged with governance in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If the auditor has a previously communicated the matter to management significant deficiency remains, the current year’s communication may include repeat the same description of the deficiency as from the previously communicated, or simply reference the previous communication. 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. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency. [ISSUE F]

A12. Unless 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, the auditor does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. Audit evidence regarding the effective design and implementation of such other controls is not in itself sufficient to support such a conclusion.

A163. It may be inappropriate to communicate identified deficiencies directly to management in limited situations that call into question the integrity or competence of management. For example, there may be evidence of actual or suspected fraud or intentional non-compliance with laws or regulations by on management’s part, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management’s competence. By virtue of their nature, these deficiencies merit the attention of those charged with governance. They are therefore significant deficiencies. Accordingly, paragraph 9 requires the auditor to communicate them to those charged with governance. [ISSUE I]

Considerations Specific to Smaller Entities

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8 ISA 250 (Redrafted), “Consideration of Laws and Regulations in an Audit of Financial Statements,” paragraphs 22-28, establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws or regulations, including when those charged with governance are themselves involved in such non-compliance.

9 ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements,” paragraph 41, establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.
A17. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities. For example, in some circumstances the requirement to communicate in writing may be satisfied by setting out the matters in an e-mail rather than a formal letter or report.

Content of Written Communication of Significant Deficiencies (Ref: Para. 10)

A18. In explaining the potential effects of the significant deficiencies on the financial statements, the auditor need not quantify those effects. The significant deficiencies may be categorized for reporting purposes where it is appropriate to do so instead of being communicated separately. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management’s actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management’s responses have been implemented.

A19. 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.

- An indication that such communication has been provided for the purposes of management and those charged with governance, and that it may not be suitable for other purposes.

A20. Where management has informed the auditor, or the auditor otherwise knows, of the existence of other controls that would prevent, or detect and correct, misstatements that may arise from the significant deficiencies, the auditor may acknowledge that fact in the written communication and indicate whether or not the auditor has tested the operating effectiveness of such other controls. [ISSUE G]

A21. Laws or regulations may require the auditor or management to furnish a copy of the auditor’s written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor’s written communication may identify such regulatory authorities.

Communication of Other Deficiencies to Management (Ref: Para. 11)

A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies. The auditor need not communicate such matters to management in writing but may do so orally. Where the auditor has discussed the facts and circumstances of the auditor’s findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently. However, ISA 230 (Redrafted) requires the auditor to document the discussions with management where the auditor judges the identified deficiencies to be significant.
matters.\textsuperscript{10} For identified deficiencies that are not considered significant matters, the auditor may nevertheless find it helpful to document the discussions with management, including the nature of the matters discussed. \textbf{[ISSUE H]}

\textbf{A23.} If the auditor has communicated deficiencies in internal control that are not significant to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. It is also not necessary for the auditor to repeat information about such deficiencies if it has been included in previously issued written communications, whether made by the auditor, internal auditors, or others within the entity. It may, however, be appropriate for the auditor to re-commuincate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. \textbf{[ISSUE F]}

\textbf{A24.} The auditor may also communicate other control deficiencies to those charged with governance, whether in summarized form or as otherwise agreed. For example, in some circumstances, those charged with governance may prefer to be informed of all any other deficiencies communicated to management,\textsuperscript{4} and in other circumstances, those charged with governance may wish to be made aware of the details of all these deficiencies or may prefer only brief descriptions or summaries of the nature of the other deficiencies. Where this is the case, the auditor may report orally or in writing to those charged with governance as appropriate.

\textit{Considerations Specific to Public Sector Entities}

\textbf{A25.} Public sector auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this ISA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Legislation may also mandate that public sector auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require public sector auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this ISA, for example, controls related to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

\footnote{\textsuperscript{10} ISA 230 (Redrafted), “Audit Documentation,” paragraph 10.}
PROPOSED CONFORMING AMENDMENTS

ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control.

- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Appendix 1 – Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).

- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.

- Accounting and information systems that are not effective, including situations involving material weaknesses in internal control.

Attitudes/Rationalizations

- Management failing to correct known material weaknesses in internal control on a timely basis.

Risk Factors Arising From Misstatements Arising From Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures,
opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses other deficiencies in internal control that is not effective may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Appendix 3 – Examples of Circumstances that Indicate the Possibility of Fraud

- An unwillingness to address identified weaknesses significant deficiencies in internal control on a timely basis.

ISA 260 (Revised and Redrafted), “Communicating with Those Charged with Governance”

12. The auditor shall communicate with those charged with governance (Ref: Para. A20):

   (a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity (Ref: Para. A21);

   (b) Significant difficulties, if any, encountered during the audit (Ref: Para. A22);

   (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);

      (ii) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management (Ref: Para. A23); and

      (iii) Written representations the auditor is requesting; and

   (d) Other matters, if any, arising from the audit that are, in the auditor’s professional judgment, significant to the oversight of the financial reporting process (Ref: Para. A24).

A44. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
• It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, it may be appropriate to the auditor may communicate material weaknesses in the design, implementation or operating effectiveness of significant deficiencies in internal control that have come to the auditor’s attention the auditor has identified orally in the first instance to those charged with governance as soon as practicable, prior to communicating these in writing on a timely basis as required by [proposed] ISA 265. 11

• Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, e.g., when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor’s views about the qualitative aspects of the entity’s accounting practices.

• When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

ISA 300 (Redrafted), “Planning the Audit of Financial Statements”
Appendix – Considerations in Establishing the Overall Audit Strategy
• Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified weaknesses deficiencies and action taken to address them.

ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”
14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
   (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
   (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment weaknesses. (Ref: Para. A65-A74)

16. If the entity has established such a process (referred to hereafter as the ‘entity’s risk assessment process’), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that

the auditor expects would have been identified by the entity’s risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or if there is a material weakness significant deficiency in the entity’s risk assessment process.

17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or represents a material weakness significant deficiency in the entity’s internal control. (Ref: Para. A76)

Material Weakness in Internal Control

31. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control. (Ref: Para. A124-A125)

32. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by ISA 260, “The Auditor’s Communication with Those Charged with Governance,” with those charged with governance (unless all of those charged with governance are involved in managing the entity). (Ref: Para. A126)

A62. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness significant deficiency in the entity’s internal control.

A70. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, weaknesses deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management’s failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in ISA 330 (Redrafted), the control environment also influences the nature, timing, and extent of the auditor’s further procedures.

A99. Risks at the financial statement level may derive in particular from a weak control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, weaknesses deficiencies such as management’s lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
A119. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a material weakness significant deficiency in the entity’s internal control.

Material Weakness in Internal Control (Ref: Para. 31)

A124. The types of material weaknesses in internal control that the auditor may identify when obtaining an understanding of the entity and its internal controls may include:

- Risks of material misstatement that the auditor identifies and which the entity has not controlled, or for which the relevant control is inadequate.

- A weakness in the entity’s risk assessment process that the auditor identifies as material, or the absence of a risk assessment process in those cases where it would be appropriate for one to have been established.

A125. Material weaknesses may also be identified in controls that prevent, or detect and correct, error, or those to prevent and detect fraud.

Considerations Specific to Public Sector Entities (Ref: Para. 32)

A126. In the audit of public sector entities, there may be additional communication or reporting requirements for public sector auditors. For example, internal control weaknesses may have to be reported to the legislature or other governing body.

Appendix 2 – Conditions and Events that may Indicate Risks of Material Misstatement

Conditions and Events that may Indicate Risks of Material Misstatement

- Weaknesses Significant deficiencies in internal control, especially those not addressed by management.

ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks”

18. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the operating effectiveness of controls.

19. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility and, as required by ISA 260 (Revised), “Communication with Those Charged with Governance,” with those charged with governance (unless all of those charged with governance are involved in managing the entity).

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor’s overall responses, is affected by the auditor’s understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Weaknesses Deficiencies in the control
environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A40. A material misstatement detected by the auditor’s procedures may indicate the existence of a material weakness in internal control.

A56. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor’s attention that differs significantly from the information on which the risk assessment was based. For example,

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor’s judgment about the risk assessments and may indicate a material weakness in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. ISA 315 (Redrafted) contains further guidance on revising the auditor’s risk assessment.

**ISA 600 (Revised and Redrafted), “Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)”**

41. The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team’s conclusion with regard to the group audit. Such communication shall include:

   (g) Description of any identified material weaknesses in internal control over financial reporting relevant to the audit at the component level;

46. The group engagement team shall make group management aware, on a timely basis and at an appropriate level of responsibility, of:

(a) Material weaknesses in the design or operating effectiveness of all deficiencies in group-wide controls (other than those that are clearly trivial) that the group engagement team has identified, unless:

   (i) The group engagement team has obtained sufficient appropriate audit evidence about the operating effectiveness of other group-wide controls that would
prevent, or detect and correct, misstatements arising from the identified deficiencies; or (Ref: Para. A64)

(ii) It would be inappropriate to communicate directly to group management in the circumstances. (Ref: Para. A65)

(b) Material weaknesses Significant deficiencies that the group engagement team has identified in internal controls at components and judges are of significance to the group; and

(c) Material weaknesses Significant deficiencies that component auditors have identified in internal controls at components and brought to the attention of the group engagement team that the group engagement team judges are of significance to the group.

A20. As required in ISA 210, the terms of engagement identify the applicable financial reporting framework. Additional matters may be included in the terms of a group audit engagement, such as the fact that:

- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on material weaknesses significant deficiencies in internal control, should be communicated as well to the group engagement team.

A64. Unless the group engagement team has obtained sufficient appropriate audit evidence about the operating effectiveness of other group-wide controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies, the group engagement team does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. Audit evidence regarding the effective design and implementation of such other group-wide controls is not in itself sufficient to support such a conclusion.

A65. It may be inappropriate to communicate identified deficiencies directly to group management in situations that call into question the integrity or competence of group management. For example, there may be evidence of actual or suspected fraud on group management’s part, or group management may exhibit an inability to prepare adequate group financial statements that may raise doubt about group management’s competence.

Appendix 5 – Required and Additional Matters Included in the Group Engagement Team’s Letter of Instruction

Other information

- Material weaknesses Significant deficiencies in controls that have come to the attention of the component auditor has identified during the performance of the work on the financial information of the component, and information that indicates the existence of fraud.