

**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)

**[CLEAN DRAFT]****CONTENTS**

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Proposed International Standard on Auditing (ISA) 265, "Communicating Deficiencies in Internal Control" should be read in conjunction with 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<sup>1</sup> that the auditor has identified in an audit of financial statements. This ISA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of ISA 315 (Redrafted) and ISA 330 (Redrafted).<sup>2</sup> ISA 260 (Revised and Redrafted)<sup>3</sup> 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.<sup>4</sup> 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 stage of the audit. Knowledge of those deficiencies is likely to be 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.
3. Nothing in this ISA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

### Effective Date

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

### Objective

5. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified

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<sup>1</sup> 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."

<sup>2</sup> ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

<sup>3</sup> ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance."

<sup>4</sup> ISA 315 (Redrafted), paragraph 12. Paragraphs A56-A61 provide guidance on controls relevant to the audit.

during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

## 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 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
    - (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
  - (b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

## Requirements

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. In making this determination, the auditor shall seek to agree the relevant facts and circumstances of the auditor's findings with the appropriate level of management, unless it would be inappropriate to do so in the circumstances. (Ref: Para. A1-A4) **ISSUE C]**
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 in internal control. (Ref: Para. A5-A11)
9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A30)
10. The auditor shall include in the written communication of significant deficiencies in internal control:
  - (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A19)
  - (b) Sufficient information to enable those charged with governance to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A20-A21)
    - (i) 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 are of sufficient importance to merit being reported to those charged with governance.
- 11. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A22, A30)
  - (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A23-A24)
  - (b) Other deficiencies in internal control identified during the audit that have not otherwise been already communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A25-A27)
- 12. If the auditor has communicated to management deficiencies in internal control other than significant deficiencies in internal control, the auditor shall inform those charged with governance of that fact unless all of those charged with governance are involved in managing the entity. (Ref: Para. A28-A29)

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## **Application and Other Explanatory Material**

### **Determination of Whether Deficiencies in Internal Control Have Been Identified** (Ref: Para. 7)

- A1. The level of management with whom it is appropriate to discuss the findings is one who is familiar with the internal control area concerned and who has the authority to take remedial action on any identified deficiencies in internal control. Discussing the relevant facts and circumstances of the auditor's findings with the appropriate level of management 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. In rare circumstances, it may not be appropriate to discuss the findings directly with management, for example, when the findings appear to call management's integrity or competence into question (see paragraph A23). **[ISSUE C]**
- A2. In 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.
  - Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.

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

#### *Considerations Specific to Smaller Entities*

- A3. 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 necessary 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.
- A4. 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. In the smaller entity context, however, the higher level of management oversight needs to be balanced against the greater potential for management override of controls. Accordingly, while the higher level of management oversight in a smaller entity may compensate for, and therefore reduce the severity of, certain deficiencies in internal control, it does not mitigate the higher risk of material misstatement arising from the greater opportunity that management has to override controls.

#### **Definition of Significant Deficiency in Internal Control and Determination of Whether Identified Deficiencies in Internal Control Constitute Significant Deficiencies in Internal Control** (Ref: Para. 6(b), 8)

- A5. The significance of a deficiency or a combination of deficiencies in internal control, and therefore whether it is of sufficient importance to merit the attention of those charged with governance, depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies in internal control may therefore exist even though the auditor has not identified misstatements during the audit.
- A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency in internal control include:
- Whether the deficiencies are likely to lead to material misstatements in the financial statements in the future.
  - The susceptibility to loss or fraud of the related asset or liability.
  - The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
  - 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.

A7. Indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified risks (e.g., absence of controls over a significant risk of material misstatement).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- 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.

- Management's failure to implement remedial action on significant deficiencies in internal control previously communicated, without rational explanations.
- A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements.<sup>5</sup> For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency in internal control. However, a combination of deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency in internal control.
- A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency in internal control and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement. **[ISSUE B]**
- A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this ISA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies in internal control required by this ISA to be communicated to those charged with governance. **[ISSUE B]**
- A11. Except to the extent that law or regulation requires the auditor to use specific terms or definitions when communicating certain deficiencies in internal control to those charged with governance or to other relevant parties, the requirements of this ISA remain applicable. Accordingly, all matters required by this ISA to be communicated to those charged with governance are communicated by the auditor as part of, or in addition to, those matters communicated in accordance with law or regulation. **[ISSUE B]**

## Communication of Deficiencies in Internal Control

### *Communication of Significant Deficiencies in Internal Control to Those Charged with Governance* (Ref: Para. 9)

- A12. Communicating significant deficiencies in internal control in writing to those charged with governance reflects the importance of these matters to the financial reporting process, and

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<sup>5</sup> ISA 315 (Redrafted), paragraph A62.

assists those charged with governance in fulfilling their oversight responsibilities. ISA 260 (Revised and Redrafted) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.<sup>6</sup>

- A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, 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 in internal control forms part of the final audit file, the written communication is subject to the overriding requirement<sup>7</sup> for the auditor to complete the assembly of the final audit file on a timely basis. ISA 230 (Redrafted) 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.<sup>8</sup>
- A14. Regardless of the timing of the written communication of significant deficiencies in internal control, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to 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 internal control in writing, as this ISA requires.
- A15. The level of detail at which to communicate significant deficiencies in internal control 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 of the entity. For instance, the communication required for a public interest entity may be different from that for a non-public interest entity.
  - The size and complexity of the entity. For instance, the communication required for a complex entity may be different from that for an entity operating a simple business.
  - The nature of significant deficiencies in internal control that the auditor has identified.
  - The entity's governance 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.
  - Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

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<sup>6</sup> ISA 260 (Revised and Redrafted), paragraph 9.

<sup>7</sup> ISA 230 (Redrafted), "Audit Documentation," paragraph 14.

<sup>8</sup> ISA 230 (Redrafted), paragraph A21.

- A16. Management and those charged with governance may already be aware of significant deficiencies in internal control 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 in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.
- A17. The fact that the auditor communicated a significant deficiency in internal control to those charged with governance and management 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 a previously communicated significant deficiency in internal control remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency in internal control has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency in internal control.

#### Considerations Specific to Smaller Entities

- A18. 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 electronic mail rather than a formal letter or report.

#### *Content of Written Communication of Significant Deficiencies in Internal Control* (Ref: Para. 10)

- A19. In explaining the potential effects of the significant deficiencies in internal control, the auditor need not quantify those effects. The significant deficiencies in internal control may be grouped together for reporting purposes where it is appropriate to do so. 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.
- A20. 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 procedures on internal control, the auditor might have identified more deficiencies in internal control to be reported, or concluded that some of the reported deficiencies in internal control need not, in fact, have been reported.
  - An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.
- A21. Law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies in internal control to appropriate

regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

*Communication of Deficiencies in Internal Control to Management* (Ref: Para. 11)

A22. Ordinarily, the appropriate level of management to whom to communicate is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies in internal control, the appropriate level is the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

*Communication of Significant Deficiencies in Internal Control to Management* (Ref: Para. 11(a))

A23. 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 fraud or intentional non-compliance with law or regulation by management, 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 in internal control. Accordingly, paragraph 9 requires the auditor to communicate them to those charged with governance.

A24. ISA 250 (Redrafted) 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.<sup>9</sup> ISA 240 (Redrafted) establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.<sup>10</sup>

*Communication of Other Deficiencies in Internal Control to Management* (Ref: Para. 11(b))

A25. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies in internal control but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies in internal control. Where the auditor judges that a deficiency in internal control does not merit management's attention, that

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<sup>9</sup> ISA 250 (Redrafted), "Consideration of Laws and Regulations in an Audit of Financial Statements," paragraphs 22-28.

<sup>10</sup> ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraph 41.

deficiency in internal control is inconsequential. Accordingly, inconsequential deficiencies in internal control need not be communicated to management. **[ISSUE A]**

- A26. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. 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, the auditor may find it helpful to document the discussions with management, including the nature of the matters discussed.
- A27. If the auditor has communicated deficiencies in internal control other than significant deficiencies in internal control 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. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as internal auditors or regulators. It may, however, be appropriate for the auditor to re-communicate 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. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency in internal control requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.

*Informing Those Charged with Governance of the Communication of Other Deficiencies in Internal Control to Management* (Ref: Para. 12)

- A28. Informing those charged with governance of the communication of other deficiencies in internal control to management assists those charged with governance in fulfilling their oversight responsibilities. In some circumstances, those charged with governance may wish to be made aware of the details of all these other deficiencies in internal control or may prefer to be briefly informed of the nature of the other deficiencies in internal control. Where this is the case, the auditor may report orally or in writing to those charged with governance as appropriate.
- A29. ISA 260 (Revised and Redrafted) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.<sup>11</sup>

*Considerations Specific to Public Sector Entities* (Ref: Para. 9 and 11)

- A30. 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 in internal

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<sup>11</sup> ISA 260 (Revised and Redrafted), paragraph 9.

control 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.

## PROPOSED CONFORMING AMENDMENTS TO OTHER STANDARDS

### 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:

- ...
- 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~~ deficiencies in internal control.
- ...

#### Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise ~~weak~~ deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential ~~weakness~~ deficiency in internal control since there is an opportunity for management override of controls.

#### Other Matters Related to Fraud (Ref: Para. 42)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- ...
- A failure by management to appropriately address identified ~~material weaknesses~~ significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- ...

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

#### *Opportunities*

...

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

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

*Attitudes/Rationalizations*

- ...
- Management failing to ~~correct~~ remedy known ~~material weaknesses~~ significant deficiencies 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.

*Attitudes/Rationalizations*

- ...
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to ~~correct~~ take remedial action on known deficiencies in internal control ~~deficiencies~~.
- ...

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

Problematic or unusual relationships between the auditor and management, including:

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

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

3. Recognizing the importance of effective two-way communication during an audit of financial statements, this ISA provides an overarching framework for the auditor’s communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the

requirements of this ISA, are identified in other ISAs (see Appendix 1). In addition, [proposed] ISA 265<sup>12</sup> establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. Further matters, not required by this or other ISAs, may be required to be communicated by laws or regulations, by agreement with the entity, or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body. Nothing in this ISA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A28-A31)

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).

*Supplementary Matters* (Ref: Para. 3)

A29. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, ~~significant deficiencies in~~ issues regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorization.

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<sup>12</sup> [Proposed] ISA 265, "Communicating Deficiencies in Internal Control."

*Timing of Communications* (Ref: Para. 17)

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:

- ...
- 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 orally to those charged with governance as soon as practicable 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 as soon as practicable, prior to communicating these in writing on a timely basis as required by [proposed] ISA 265.<sup>13</sup>
- ...

**Appendix 1 – Specific Requirements in ISQC 1 (Redrafted) and Other ISAs that Refer to Communications with Those Charged With Governance**

- [Proposed] ISA 250 (Redrafted), “The Auditor’s Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements” – paragraphs [12, 14, 17 and 21-23]
- [Proposed] ISA 265, “Communicating Deficiencies in Internal Control” – paragraph [9]
- ~~ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” – paragraph 32~~
- ~~ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks” – paragraph 19~~

**ISA 300 (Redrafted), “Planning the Audit of Financial Statements”**

**Appendix – Considerations in Establishing the Overall Audit Strategy**

**Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements**

- ...
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified ~~weaknesses~~ deficiencies in internal control and action taken to address them.
- ...

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<sup>13</sup> [Proposed] ISA 265, “Communicating Deficiencies in Internal Control,” paragraphs [9 and A13].

### **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 determine if there is a ~~material weakness~~ significant deficiency in internal control with regard to 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 determine whether it represents a ~~material weakness~~ significant deficiency in the entity’s internal control. (Ref: Para. A76)
22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates ~~corrective~~ remedial actions to deficiencies in its controls. (Ref: Para. A94-A96)

#### **~~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)~~

*Information Obtained in Prior Periods*

A10. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

*Nature and Extent of the Understanding of Relevant Controls* (Ref: Para. 13)

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.

*Effect of the Control Environment on the Assessment of the Risks of Material Misstatement*

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.

*Components of Internal Control—Monitoring of Controls* (Ref: Para. 22)

A94. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary ~~corrective~~ remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

### Considerations Specific to Smaller Entities

A96. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to corrective remedial action to the control.

### *Assessment of Risks of Material Misstatement at the Financial Statement Level* (Ref: Para. 24 (a))

A99. Risks at the financial statement level may derive in particular from a weak deficient 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.

### Understanding Controls Related to Significant Risks (Ref: Para. 28)

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 Failure by management to implement such controls is an indicator of a significant deficiency in the entity's internal control.<sup>14</sup>

### **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.~~

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<sup>14</sup> ISA 265, "Communicating Deficiencies in Internal Control," paragraph A7.

## Appendix 1 – Internal Control Components

### Monitoring of Controls

12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity’s controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and ~~weaknesses~~ deficiencies in internal control and recommendations for improving internal control.

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

### Conditions and Events that may Indicate Risks of Material Misstatement

- ...
- ~~Weaknesses~~ 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).~~

### Overall Responses (Ref: Para. 5)

- 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.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A ~~weak~~ deficient control environment.
- ~~Weak~~ Deficient monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- ~~Weak~~ Deficient general IT-controls.

Evaluating the Operating Effectiveness of Controls (Ref: Para. 16-19)

A40. A material misstatement detected by the auditor's procedures ~~may indicate~~ is a strong indicator of the existence of a ~~material weakness~~ significant deficiency in internal control.

**Evaluating the Sufficiency and Appropriateness of Audit Evidence** (Ref: Para. 26-28)

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~~ significant deficiency 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 520 (Redrafted), “Analytical Procedures”**

*Suitability of Particular Analytical Procedures for Given Assertions* (Ref: Para. 5(a))

- A9. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor’s assessment of the risk of material misstatement. For example, if controls over sales order processing are ~~weak~~deficient, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

## **ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”**

*Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates* (Ref: Para. 8(b))

- A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. ISA 315 (Redrafted) ~~provides guidance when the auditor identifies a material weakness~~ addresses circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to ~~in~~ the entity’s risk assessment processes.<sup>15</sup>

## **ISA 550 (Revised and Redrafted), “Related Parties”**

*The Entity’s Controls over Related Party Relationships and Transactions* (Ref: Para. 14)

- A18. Controls over related party relationships and transactions within some entities may be ~~weak, ineffective~~ deficient or non-existent for a number of reasons, such as:

- ...

## **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 the group audit. Such communication shall include:
- (g) Description of any identified ~~material weaknesses~~ significant deficiencies in internal control ~~over financial reporting~~ 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~~ Significant deficiencies in group-wide internal controls that the group engagement team has identified, unless it

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<sup>15</sup> ISA 315 (Redrafted), paragraph 16.

would be inappropriate to communicate directly to group management in the circumstances; (Ref: Para. A63a)

- (b) ~~Material weaknesses~~ Significant deficiencies in internal control 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 in internal control 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.

The auditor shall determine whether these matters are significant deficiencies in the group's internal control for purposes of communicating identified significant deficiencies in internal control to those charged with governance in accordance with [proposed] ISA 265.<sup>16</sup>

*Terms of Engagement* (Ref: Para. 14)

A20. As required in ISA 210, the terms of engagement ~~identifies~~ 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.

*Communication with Group Management* (Ref: Para. 46-48)

A63a. [Proposed] ISA 265 provides relevant guidance on the communication of identified deficiencies in internal control, including significant deficiencies in internal control, to those charged with governance and management.

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

Other information

- A request that the following be reported to the group engagement team on a timely basis:
  - ...
  - ~~Material weaknesses~~ Significant deficiencies in internal 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.

<sup>16</sup> [Proposed] ISA 265, "Communicating Deficiencies in Internal Control."

**ISRE 2400, “Review of Interim Financial Information Performed by the Independent Auditor of the Entity”**

15. The procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following:
  - ...
  - Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses significant deficiencies in internal control.
  - ...
18. This understanding enables the auditor to focus the inquiries made, and the analytical and other review procedures applied in performing a review of interim financial information in accordance with this ISRE. As part of obtaining this understanding, the auditor ordinarily makes inquiries of the predecessor auditor and, where practicable, reviews the predecessor auditor’s documentation for the preceding annual audit, and for any prior interim periods in the current year that have been reviewed by the predecessor auditor. In doing so, the auditor considers the nature of any corrected misstatements, and any uncorrected misstatements aggregated by the predecessor auditor, any significant risks, including the risk of management override of controls, and significant accounting and any reporting matters that may be of continuing significance, such as material weaknesses significant deficiencies in internal control.