CONFORMING AMENDMENTS TO OTHER STANDARDS AS A RESULT OF ISA 265, COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHANGED WITH GOVERNANCE AND MANAGEMENT

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 appropriate 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, ISA 265[1] 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);~~

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

        (~~i~~ii) 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

[1] ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management."

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.

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 as required by ISA 265.[2]
- …

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~~]~~
- ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" – 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 and action taken to address them.
- …

[2] ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management," paragraphs 9 and A14.

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 (Ref: Para. 9)

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.

A11. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

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.[3]

~~**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.~~

[3] ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management," 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~~ deals with 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.[4]

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 to 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~~ determine which identified deficiencies in internal control to communicate to those charged with governance and group management in accordance with ISA 265.[5] ~~aware, on a timely basis and at an appropriate level of responsibility, of~~ In making this determination, the group engagement team shall consider:

[4] ISA 315 (Redrafted), paragraph 16.

[5] ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management."

(a) ~~Material weaknesses in the design or operating effectiveness of~~Deficiencies in group-wide internal control~~s~~ that the group engagement team has identified;

(b) ~~Material weaknesses~~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~~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~~.

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.

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 control~~s~~ 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.

ISRE 2410, "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.