GAO
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United States Government Accountability Office
Washington, DC 20548

April 30, 2008

International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017

Subject: International Auditing and Assurance Standards Board (IAASB) December 2007 Exposure Draft: ISA 265, *Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the IAASB's proposed ISA 265.

While overall we support the proposed ISA, we disagree with the IAASB's decision to not require explicit identification of material weaknesses when communicating deficiencies in internal control. We acknowledge that paragraph A8 of the proposed standard provides guidance for auditors in jurisdictions with laws or regulations that establish requirements for the auditor to communicate material weaknesses; however, we believe that all auditors have a responsibility to convey such information by notifying management and those charged with governance of those significant deficiencies that the auditor considers material due to their nature or extent. Based on substantial experience in the U.S., we believe that such a requirement makes management and those charged with governance more accountable to stakeholders and other financial statement users.

The Board has asked respondents to comment on specific questions regarding the application of the clarity drafting conventions and the proposed conforming amendments. We provide comments on those questions in this letter and recommend specific wording changes in the related attachment.

Request for Specific Comments

The IAASB has taken the view that audit evidence regarding the effective design and implementation of other [compensating] controls is not in itself sufficient to support a conclusion that a deficiency does not exist. Do you (GAO) agree with this guidance?

Response/Comment:

Yes, we agree with this position. We also agree that when the auditor has obtained sufficient appropriate evidence about operating effectiveness of the other control, the auditor need not report the deficiency.

Request for Comments on the Application of the Clarity Drafting Conventions

We identified no specific concerns on the application of the clarity drafting conventions.

Special Considerations in the Audit of Public Sector Entities

Paragraph A22 of the proposed ISA discusses additional responsibilities of public sector auditors to communicate internal control deficiencies. Some government audit offices are also responsible for reporting on controls over compliance with legislative authorities, regulations, or provisions of contracts or grant agreements. We recommend adding this to the guidance in Paragraph A22.

Additional Proposed Revisions

- Management's ability to prepare, or oversee preparation of, the entity's financial statements is fundamental to management's responsibility to be accountable to those charged with governance and other stakeholders. Therefore, we recommend adding to paragraph A6 an additional indicator of significant deficiencies relating to management's inability to prepare, or oversee the preparation of, financial statements and related disclosures.

- We recommend adding magnitude and likelihood to the listing in paragraph A7 of matters to consider in determining whether a deficiency constitutes a significant deficiency. These factors are important in determining if a deficiency merits the attention of those charged with governance.

- Paragraph A13, discussing conditions when it may be inappropriate to communicate identified deficiencies to management, could provide additional useful guidance by including a reference to ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*.

We thank you for considering our comments on these important issues.

McCoy Williams

McCoy Williams
Managing Director
Financial Management and Assurance

Attachment

cc: Mr. James M. Sylph, Technical Director
International Auditing and Assurance Standards Board

The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

Mr. Kjell Larsson, Public Member
International Auditing and Assurance Standards Board

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

Mr. Harold Monk, Chair
Auditing Standards Board

ATTACHMENT TO GAO COMMENT LETTER TO IAASB:
GAO's Proposed Changes to ISA 265

International
Auditing
and Assurance
Standards Board

Exposure Draft
December 2007
Comments are requested by April 30, 2008

Proposed International Standard on Auditing

ISA 265, Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs

International Federation
of Accountants

REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 265, "Communicating Deficiencies in Internal Control" for publication in December 2007. This proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **April 30, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, proposed International Standard on Auditing (ISA) 265, "Communicating Deficiencies in Internal Control," approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in December 2007.

Background

The IAASB commenced this project in October 2005 in response to regulatory and standard-setting developments around the world regarding internal control-related matters, including, in particular:

- The requirement under the European Union's Statutory Audit Directive for auditors to report identified material weaknesses in internal control ("material weakness") to audit committees; and
- The U.S. Public Company Accounting Oversight Board's (PCAOB's) issue of an auditing standard addressing an audit of internal control over financial reporting.[1]

In addition, it was recognized that the current definition of the term "material weakness" within the ISAs is rather general[2] and that there is a need to clarify its meaning in order to improve the consistency with which auditors treat identified weaknesses in internal control as material, and how such matters are reported. Accordingly, the IAASB set out to develop a revised definition of material weakness for the purposes of the ISAs. In doing so, the IAASB acknowledged the need also to clarify the auditor's responsibilities in relation to the evaluation and communication of internal control-related matters identified during the audit to management and those charged with governance.

As the project has evolved and new considerations have emerged during debate at a number of meetings of the IAASB and the IAASB Consultative Advisory Group (CAG), there has been a shift from the original aim to develop a revised definition of material weakness to a current focus on developing a clear definition of the threshold of significance at which deficiencies in internal control should be communicated to those charged with governance.

The IAASB believes that the proposed ISA provides clearer guidance regarding the relevant internal control-related matters to be communicated in an audit of financial statements, which will enhance the consistency of auditor performance in this area. The proposed ISA has been drafted in accordance with the IAASB's clarity drafting conventions.

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1 Auditing Standard 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" subsequently superseded by Auditing Standard 5, "An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements."

2 ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" defines a material weakness as one that could have a material effect on the financial statements.

Significant Matters

Definition of Significant Deficiency

The IAASB believes that the most important public interest consideration for the wide range of audits covered by the ISAs is to ensure that the auditor communicates identified non-trivial deficiencies in internal control ("deficiencies") to those parties within the entity who can competently deal with them on a timely basis. This is consistent with current practice under the ISAs whereby auditors have historically applied their judgment to determine broadly the control matters that they would consider to be "material weaknesses" for reporting to management and those charged with governance (without being required to perform specific evaluations of the level of severity of such matters).

Having established this principle, the IAASB took the view that it would be inappropriate to require the auditor to communicate all the relevant deficiencies identified during the audit to those charged with governance to the same extent as to management. This is because the range of deficiencies that the auditor might judge to be non-trivial could be quite large and, while potentially important for management to be aware of them all, the attention of those charged with governance will rightly be directed at the more significant deficiencies only. The IAASB therefore agreed that some prioritization of the identified deficiencies for purposes of communication with those charged with governance is necessary, based on the auditor's judgment.

The IAASB determined that the term "significant deficiency" should be defined for this purpose, consistent with the term used in the PCAOB's Auditing Standard 5 to define those deficiencies meriting the attention of those overseeing the financial reporting process.[3] To avoid creating an unnecessary difference in definitions internationally, the IAASB also decided that the definition of significant deficiency in the ISAs should be closely aligned with that in the PCAOB's Auditing Standard 5. The proposed ISA therefore establishes the following definition of a significant deficiency:

> A deficiency or combination of deficiencies in internal control relevant to the audit[4] that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (See paragraph 6(b).)

Communication of Significant Deficiencies to Those Charged with Governance

The IAASB determined that the auditor should be required to communicate significant deficiencies identified during the audit to those charged with governance on a timely basis. The IAASB also decided that this communication should be in writing to recognize the importance of the deficiencies being communicated (see paragraph 10).

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3 The PCAOB's Auditing Standard 5 defines a significant deficiency as a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

4 This is consistent with the requirement in paragraph 12 of ISA 315 (Redrafted) for the auditor to obtain an understanding of internal control relevant to the audit.

To accommodate different circumstances in practice, proposed guidance in the application and other explanatory material explains that the level of detail at which significant deficiencies should be communicated to those charged with governance varies with the engagement circumstances. Paragraph A17 sets out relevant factors the auditor may consider in this regard.

In addition, guidance in the proposed ISA indicates that the auditor may also communicate *other* identified deficiencies to those charged with governance, whether in summarized form or as otherwise agreed (see paragraph A18).

Communication of Identified Deficiencies to Management

In relation to non-trivial deficiencies that are not judged to be significant deficiencies, the IAASB determined that these should be communicated to management. Accordingly, the proposed ISA requires the auditor to communicate all non-trivial deficiencies (including significant deficiencies) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless:

(a) The auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies; or

(b) It would be inappropriate to communicate directly to management in the circumstances. (See paragraph 9).

This would then result in the auditor duly informing those who are responsible for the relevant control matters so that they may take appropriate action.

However, the IAASB believes that requiring the auditor to communicate all identified deficiencies formally to management in *writing* could place an undue and excessive documentation burden on the auditor, particularly in smaller entity audits. Accordingly, the IAASB agreed that the communication to management need not be in writing.

Rationale for not Defining Material Weakness

The IAASB considered establishing a definition similar to the definition of material weakness set out in the PCAOB's Auditing Standard 5, which would have had the benefit of harmonizing the definition of material weakness internationally. The PCAOB definition, however, is intended to represent a threshold for purposes of reporting publicly on the effectiveness of internal control, as required by the Sarbanes-Oxley Act in the USA. That threshold is higher than that defined for the purposes of reporting to those charged with governance. The IAASB concluded that this definition would not be appropriate for the ISAs as they contain no requirement for a report by auditors on the effectiveness of internal control, and in the absence of such a requirement a further categorization of deficiencies would place an unnecessary evaluation burden on auditors to no purpose.

The IAASB also decided against developing a definition of material weakness that would be different from that set out in the PCAOB's Auditing Standard 5. The co-existence of two different definitions of the same term in IAASB and PCAOB standards could potentially generate confusion amongst practitioners and users of financial statements around the world, and lead to attempts at reconciling their meanings for varying reporting purposes. The IAASB believes that this outcome would not be in the public interest.

Guidance on Material Weakness

In light of the above decisions, the IAASB proposes that the term "material weakness" no longer be used in the ISAs and that appropriate conforming amendments be made to the relevant ISAs (see pages 18-24). However, to highlight the fact that there may be legal or regulatory requirements for the auditor to communicate such control matters as "material weaknesses," the IAASB proposes the following guidance in paragraph A8 of the application material:

> Law or regulation in some jurisdictions may establish requirements for the auditor to communicate 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.

The IAASB believes that the approach to the definitions as explained above achieves the aim of clarifying what control-related matters the auditor should communicate to management and those charged with governance based on the audit work performed, and how these should be determined.

Further, by not defining the term "material weakness," the IAASB has avoided an unnecessary inconsistency with the standards of the PCAOB, while leaving it open to other regulators to define the term appropriately within the context of their environments.

Determining When Identified Deficiencies Constitute Significant Deficiencies

The proposed ISA notes that significant deficiencies may exist even though the auditor has not identified misstatements during the audit. It further explains that the significance of a deficiency or combination of deficiencies depends not only on whether a misstatement has actually occurred, but also on the *risk* that a misstatement could occur and the *potential magnitude* of the misstatement (see paragraph A5). The IAASB believes that these are ultimately matters of the auditor's professional judgment in the circumstances of the engagement. Nevertheless, to assist auditors in making the determination as to whether a deficiency or combination of deficiencies constitutes a significant deficiency, the IAASB proposes guidance on indicators of significant deficiencies (see paragraph A6), and on other matters the auditor may consider in making that determination (see paragraph A7).

Objective and Orientation of the Proposed ISA

As indicated earlier, the original aim of this project was to clarify the meaning of the term "material weakness" as defined in ISA 315 (Redrafted), and the auditor's responsibility to evaluate whether material weaknesses have been identified based on the audit work performed.[5] Accordingly, the IAASB's initial presumption was that the clarified requirements and guidance on material weaknesses would be contained in a companion ISA to ISA 315 (Redrafted).

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[5] ISA 315 (Redrafted), paragraph 31.

While the IAASB considers that this aim has been achieved in the proposed ISA, it believes that it is appropriate to orientate the ISA towards a communication objective. This reflects the outcome that the auditor should achieve in the public interest, i.e., bringing to the notice of management and those charged with governance, as appropriate, those deficiencies in internal control the auditor has identified. Accordingly, the IAASB proposes an objective for the auditor that reflects this desired communication outcome (see paragraph 5). The IAASB also agreed that the proposed ISA be placed in the communication series as a companion ISA to ISA 260 (Revised and Redrafted).[6]

Effective Date

The current IAASB project timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008. The IAASB has agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The IAASB believes that it should be possible to finalize this standard within that timetable.

Guide for Respondents

The IAASB welcomes comments on all matters addressed in the exposure draft. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

Request for Specific Comments

The IAASB would welcome views on the following:

The proposed ISA recognizes that in discussing the auditor's findings regarding suspected deficiencies with management (see paragraphs A1-A3), the auditor may be informed by management of the existence of other controls that management may assert would prevent, or detect and correct, misstatements arising from the identified deficiencies. The proposed ISA makes it clear that the auditor is not required to obtain audit evidence regarding the design and operating effectiveness of these other controls (unless otherwise necessary for the purposes of the audit), although the auditor may choose to do so (see paragraph A3).

The IAASB determined that, in such cases the auditor should communicate identified deficiencies to management *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 (see paragraph 9(a)). The IAASB believes that, without such audit evidence about the *operating effectiveness* of these other controls, the auditor does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. The IAASB has therefore taken the view that audit evidence regarding the effective design and implementation of such other controls is not in itself sufficient to support a conclusion that a deficiency does not exist (see paragraph A12); and this is the case even though the auditor's view that there is a deficiency may be based solely on evidence about the design or implementation of a control.

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[6] ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance."

Do you agree with this guidance?

Request for Comments on the Application of the Clarity Drafting Conventions

In addition to the matters referred to above, the IAASB is seeking comments on the application of the clarity drafting conventions.[7] Respondents are asked to consider whether the objective for the proposed ISA is appropriate, and whether the proposed requirements are appropriate responses to that objective.

Comments on Other Matters

Recognizing that the final ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

- *Special Considerations in the Audit of Smaller Entities*— Respondents are asked to comment whether, in their opinion, guidance addressing special considerations in the audit of smaller entities should be provided in the proposed ISA. If so, respondents are asked to explain why, and to suggest the nature of any such considerations.
- *Special Considerations in the Audit of Public Sector Entities*—Respondents are asked to comment whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed ISA.
- *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed ISA in a developing nation environment.
- *Translations*—Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed ISA.

To be considered, responses should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. They should be received by **April 30, 2008**.

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[7] The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; or, in the case of circumstances that are reasonably likely to exist or arise in an engagement, the requirement is considered necessary to the consistent application of the ISA and the action specified is expected to be appropriate in virtually all such circumstances; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

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])

CONTENTS

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 Objective 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[1] 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.[2]

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.[3] 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. Knowledge of deficiencies 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.

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

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 management or those charged with governance deficiencies in internal control relevant to the audit 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.

Definitions

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

   (a) Deficiency in internal control – A control that is either missing or is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct misstatements in the financial statements on a timely basis.

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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 315 (Redrafted) paragraph 12. Paragraphs A56-A61 provide guidance on controls relevant to the audit.

(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.

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-A3)

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. A4-A8)

Communication of Deficiencies in Internal Control

9. The auditor shall communicate all deficiencies in internal control (other than those that are clearly trivial) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless: (Ref: Para. A9-A11, A22)

    (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. A3, A12)

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

10. The auditor shall communicate significant deficiencies identified during the audit to those charged with governance in writing and on a timely basis. (Ref: Para. A14-A18, A22)

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

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

        (ii) 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 those charged with governance; and

        (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.

Application and Other Explanatory Material

Identification of Deficiencies in Internal Control (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. 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 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 IT controls.
- A preliminary indication from management of its response to the findings.

A3. Management may also inform the auditor of 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.

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

A4. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements.[4] 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 account 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.

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

A6. Indicators of significant deficiencies include, for example:

- Deficiencies in the control environment, such as

- Management's inability to prepare, or oversee the preparation of, financial statements, including required disclosures.

[4] ISA 315 (Redrafted), paragraph A62.

  - Ineffective oversight of the financial reporting process 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 a control over a significant risk.
- Material misstatements detected by the auditor's procedures that were not identified 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.

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 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.
- The magnitude of misstatements and potential misstatements, including the size of misstatements and potential misstatements and volume of susceptible transactions.
- The likelihood of misstatements and potential misstatements, which considers the probability that a deficiency, or combination of deficiencies could fail to prevent or detect a misstatement of an account balance or disclosure.

A8. Law or regulation in some jurisdictions may establish requirements for the auditor to communicate 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.

Communication of Deficiencies in Internal Control

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

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.

A10. How the auditor communicates a deficiency may be influenced by whether the auditor has communicated it in a previous audit, or whether management already has knowledge of it. If the auditor has previously communicated the matter to management, the current year's communication may include the same description of the deficiency as previously communicated. Alternatively, it may be summarized, specifically referring to the previous communication. However, the fact that the auditor communicated a deficiency to management in a previous audit, or that management already had knowledge of the deficiency through other means (such as from relevant work done by internal auditors), does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. The auditor may ask management why the deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

A11. Management may already be aware of 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. Accordingly, the requirement for the auditor to communicate deficiencies to management applies regardless of cost or other considerations that management may consider relevant in determining whether to remedy such deficiencies.

A12. Unless the auditor has obtained sufficient appropriate audit evidence about the operating 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.

A13. It may be inappropriate to communicate identified deficiencies directly to management in situations that call into question the integrity or competence of management. For example, there may be evidence of actual or suspected fraud on management's part, or management may exhibit an inability to prepare adequate financial statements that may raise doubt about management's competence.

Add footnote reference to ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements.*

Communication of Significant Deficiencies to Those Charged with Governance (Ref: Para. 10)

A14. Communicating significant deficiencies to those charged with governance in writing reflects the importance of these matters, and assists those charged with governance in fulfilling their responsibility 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.

A15. In determining when to issue the written communication to those charged with governance, the auditor may consider that 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[5] for the auditor to complete the assembly of the final audit file on a timely basis.[6]

A16. 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 10 requires.

A17. 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.
- The nature and volume of significant deficiencies that the auditor has identified.
- The entity's governance structure.
- The nature of the oversight responsibilities of those charged with governance.
- The preferences of those charged with governance.

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5 ISA 230 (Redrafted), "Audit Documentation," paragraph 14.

6 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.

- 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.

A18. 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 know of all deficiencies communicated to management. In other circumstances, those charged with governance may prefer only brief descriptions or summaries of the nature of the other deficiencies.

Content of Written Communication of Significant Deficiencies (Ref: Para. 11)

A19. In explaining the potential effects of significant deficiencies, the auditor need not quantify those effects.

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 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.

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.

Considerations Specific to Public Sector Entities

A22. 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.

Insert: For instance, the public sector auditor may also have responsibility to report on controls related to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

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~~ deficiencies 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~~ 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.

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);~~

        (~~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).

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.[14]

- 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

[14] [Proposed] ISA 265, "Communicating Deficiencies in Internal Control," paragraphs [8 and A16].

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~~ <u>significant deficiency</u> 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~~ <u>significant deficiency</u> 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~~ <u>deficiencies</u> 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~~ <u>deficiencies</u> 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~~ <u>significant deficiency</u> 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~~ 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 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~~ 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 control~~s~~ at components and judges are of significance to the group; and

(c) ~~Material weaknesses~~ Significant deficiencies that component auditors have identified in internal control~~s~~ 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 ~~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.

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

o ~~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.

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