

CONTROL DEFICIENCIES – PROPOSED CONFORMING AMENDMENTS**Proposed ISA 210 (Redrafted)****Example of an Engagement Letter**

You have requested that we audit the financial statements of ...

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements 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 the entity's internal control. However, we ~~expect to provide will communicate to you in writing with a separate letter~~ concerning any ~~material weaknesses~~ significant deficiencies ~~in the design or implementation of~~ internal control ~~over financial reporting relevant to the audit of the financial statements~~ that come to our attention during the audit ~~of the financial statements~~....

ISA 240 (Redrafted)

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 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-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)

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)¹, or ISA 330 (Redrafted),²;~~

¹ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph 32.

² ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks," paragraph 19.

- (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management (Ref: Para. A23); and
- (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 communicate ~~material weaknesses in the design, implementation or operating effectiveness of significant deficiencies in~~ internal control that have come to the auditor's attention as soon as practicable.
- 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 315 (Redrafted)

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 control environment ~~weaknesses~~ deficiencies. (Ref: Para. A65-A74)
16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to

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

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

~~Material Weakness in Internal Control~~

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

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

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

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

- A99. Risks at the financial statement level may derive in particular from a weak control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, ~~weaknesses~~ deficiencies such as management's lack of

competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A119. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a significant deficiency ~~material weakness~~ 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

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

ISA 300 (Redrafted)

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 deficiencies ~~weaknesses~~ and action taken to address them.

ISA 330 (Redrafted)

~~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.

Proposed ISA 540 (Revised and Redrafted)

- A19. 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)~~ XXX, “Communicating Deficiencies in Internal Control,” provides guidance when the auditor identifies a ~~material weakness~~ significant deficiency in the entity’s risk assessment processes.

ISA 600 (Revised and Redrafted)

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~~ Significant deficiencies in group-wide controls;
 - (b) ~~Material weaknesses~~ Significant deficiencies that the group engagement team has identified in internal controls at components and judges are of significance to the group; and
 - (c) ~~Material weaknesses~~ Significant deficiencies that component auditors have identified in internal controls at components and brought to the attention of the group engagement team that the group engagement team judges are of significance to the group.
- A20. As required in ISA 210, the terms of engagement identifies 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

- ~~Material weaknesses~~ Significant deficiencies in controls that have come to the attention of the component auditor 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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