

PROPOSED INTERNATIONAL STANDARD ON AUDITING XXX**COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL**

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

[CLEAN DRAFT]**CONTENTS**

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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 control¹ that have come to the auditor's attention in an audit of the financial statements. The auditor is required² to obtain an understanding of internal control relevant to the audit³ when identifying and assessing the risks of material misstatement 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. This ISA does not address deficiencies in internal control the potential financial effects of which the auditor would judge to be clearly trivial.⁴ Nothing in this ISA precludes the auditor from communicating control matters that are not relevant to the audit. **[ISSUE D]**

Effective Date

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

Objective

3. The objective of the auditor is to communicate appropriately to management and those charged with governance deficiencies in internal control relevant to the audit that have come to the auditor's attention during the audit and which, in the auditor's professional judgment, are of sufficient importance to merit their attention. **[ISSUE D]**

Definitions

4. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Deficiency in internal control – This exists when a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; and
 - (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 management and those charged with governance. **[ISSUES A & D]**

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 ISA 315 (Redrafted), paragraph 12.

³ ISA 315 (Redrafted), paragraphs A56-A61, provides guidance on controls relevant to the audit.

⁴ [Proposed] ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit," paragraph [A1], describes the meaning of "clearly trivial."

Requirements

Identification of Deficiencies in Internal Control

5. 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) **[ISSUE A]**
6. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A4-A10) **[ISSUE A]**

Communication of Deficiencies in Internal Control

7. The auditor shall communicate all deficiencies in internal control identified during the audit to management at an appropriate level of responsibility on a timely basis. (Ref: Para. A11-A13, A23) **[ISSUE B]**
8. The auditor shall communicate significant deficiencies identified during the audit to those charged with governance in writing and on a timely basis. (Ref: Para. A12-A17, A23) **[ISSUE B]**
9. 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. A18)
 - (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. A19-A22)
 - (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 have come to the auditor's attention during the audit and which the auditor has concluded should be reported; 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. **[ISSUE C]**

Application and Other Explanatory Material

Identification of Deficiencies in Internal Control (Ref: Para. 5-6)

- A1. The determination of whether the auditor has identified one or more deficiencies in internal control based on the audit work performed initially involves confirmation of the auditor's understanding of the underlying facts and circumstances of the deficiencies with management or those charged with governance. This confirmation provides an opportunity for

management or those charged with governance to agree on the relevant facts and circumstances of the auditor's findings. It also enables the auditor to alert them on a timely basis to the existence of deficiencies in internal control of which they may not have been previously aware. Circumstances in which it may be appropriate for the auditor to confirm the facts and circumstances of the auditor's findings directly with those charged with governance include situations where the deficiencies in internal control involve management; for example, difficulties in the preparation of adequate financial statements may raise doubt about management's competence, or there may be evidence of fraud on management's part.

[ISSUE A]

- A2. In confirming the facts and circumstances of the auditor's findings, the auditor may obtain other relevant information for further consideration, such as:
- The understanding of management or those charged with governance of the actual or suspected causes of the deficiencies.
 - Exceptions arising from the deficiencies that management or those charged with governance may have noted, for example, misstatements that were not prevented by the relevant IT controls.
 - A preliminary indication from management or those charged with governance of their response to the findings.
- A3. Management or those charged with governance may also inform the auditor of controls not previously known to the auditor that they believe 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 eliminate the fact that deficiencies in internal control have come to the auditor's attention. 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.
- A4. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, material misstatements.⁵ 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 material misstatement to such an extent as to give rise to a significant deficiency.
- A5. The significance of a deficiency or combination of deficiencies in internal control depends not only on whether a material misstatement has actually occurred, but also upon the risk that a material misstatement could occur. Significant deficiencies may therefore exist even though the auditor has not identified material misstatements during the audit.

⁵ ISA 315 (Redrafted), paragraph A62.

- A6. The assessment of the risk that a material misstatement could occur as a result of a deficiency or deficiencies in internal control is a matter of the auditor's professional judgment in the circumstances. Examples of factors that affect this risk include:
- The nature of the financial statement accounts, disclosures and assertions (for example, related party disclosures ordinarily involve greater risk than other disclosures).
 - 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 cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
 - The relationship of the control with other controls, such as monitoring controls.
 - The interaction of the deficiency in internal control with other deficiencies in internal control.
 - 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.
- A7. In assessing whether a deficiency or combination of deficiencies in internal control could give rise to a material misstatement in the financial statements, the auditor may consider the mitigating effects of other controls if the auditor has obtained sufficient appropriate audit evidence regarding their operating effectiveness.
- A8. Deficiencies in the following areas are ordinarily of sufficient importance to be significant:
- Controls over the selection and application of appropriate accounting policies.
 - Controls over the prevention and detection of fraud.
 - 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).
- A9. Indicators of significant deficiencies include, for example:
- Ineffective oversight of the financial reporting process by those charged with governance, especially in an environment of limited segregation of duties.
 - Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
 - Material misstatements detected by the auditor's procedures that were not identified by the entity's internal control.
 - Identification of management fraud, whether or not material, that was not identified by the entity's internal control.

- A10. Law or regulation in some jurisdictions may establish an additional requirement 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 have come to the auditor's attention during the audit, and may define terms such as "material weakness" for this purpose.

Communication of Deficiencies in Internal Control (Ref: Para. 7-9)

- A11. 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 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 7, 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.
- A12. Management may already be aware of deficiencies that have come to the auditor's attention 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 requirements for the auditor to communicate deficiencies to management, and significant deficiencies to those charged with governance, apply regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.
- A13. The fact that the auditor communicated a deficiency to management or a significant deficiency to those charged with governance in the previous audit, or that they already had knowledge of it through other means (such as from 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 in the current period. If the auditor has previously communicated the matter to management or those charged with governance, 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. The auditor may ask management or those charged with governance 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.
- A14. Communicating significant deficiencies to those charged with governance in writing reflects the importance of the matters being communicated, and assists them in fulfilling their responsibility for the oversight of the preparation of the financial statements. The communication may include details of any proposed remedial action from management.
- A15. 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 have come to the auditor's attention.
- The entity's governance structure.
- The nature of the oversight responsibilities of those charged with governance.
- The preferences of those charged with governance.
- Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.

A16. 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 brief descriptions of the nature of the other deficiencies.

A17. It may often be appropriate for the auditor to first orally communicate significant deficiencies that have come to the auditor's attention to management and those charged with governance as soon as practicable. This can 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 to those charged with governance in writing, as paragraph 8 requires.

A18. In explaining the potential effects of significant deficiencies, the auditor need not quantify those effects.

A19. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive audit procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
- An indication that such communication has been provided for the purposes of management and those charged with governance, and that it may not be suitable for other purposes.

A20. 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, such as those in the financial services industry. Where this is the case, the auditor's written communication may identify such regulatory authorities.

A21. The requirements of paragraph 9(b) apply even when the auditor has not identified any significant deficiencies during the audit, but the auditor has been requested by those charged with governance or required by law or regulation to provide a written communication to those charged with governance stating that no significant deficiencies came to the auditor's attention during the audit. The requirements of paragraph 9(b) are important in such

situations, because of the risk that such type of communication could be misinterpreted as giving a degree of assurance on internal control. [ISSUE C]

- A22. The timing of the auditor's written communication on significant deficiencies to those charged with governance does not affect the auditor's ability to state compliance with the ISAs in the auditor's report, if the audit file can demonstrate that such communication was delivered.

Considerations Specific to Public Sector Entities

- A23. Public sector auditors may have additional responsibilities to communicate deficiencies in internal control that have come to their attention 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, the potential effects of which would otherwise be regarded as clearly trivial. 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.