

PROPOSED INTERNATIONAL STANDARD ON AUDITING XXX

COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL

~~NOTED IN AN AUDIT~~

(Effective for audits of financial statements for periods beginning on or after [~~date~~December 15, 2009])^{*}

[MARK-UP DRAFT]

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^{*} ~~See footnote 3.~~

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 ~~reportable~~ deficiencies in internal control¹ that have come to the auditor's attention ~~has noted~~ 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. The requirements and guidance in this ISA relate to the financial reporting objective of internal control⁴ only. They This ISA does not address deficiencies in internal control the potential financial effects of which the auditor would judge to be clearly trivial.⁵ Nothing in this ISA precludes the auditor from communicating ~~to management and those charged with governance~~ further control matters that are not relevant to the audit relating to the other objectives of internal control, i.e., those regarding effectiveness and efficiency of operations, and compliance with applicable laws and regulations (see [proposed] ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance"). **ISSUE D1**

Identifying Reportable Deficiencies under the ISAs

- ~~2. As set out in [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," the overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. During the audit, the auditor may become aware of deficiencies in the design or operation of controls relevant to financial reporting that the auditor judges to be of sufficient importance to merit the attention of management and those charged with governance.~~
- ~~3. ISA 315 (Redrafted) requires the auditor to obtain an understanding of internal control relevant to the audit for the purpose of identifying and assessing the risks of material misstatement in the financial statements. This ISA requires the auditor to communicate reportable deficiencies that have come to the auditor's attention during the course of the audit~~

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 ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment," defines the terms "internal control" and "controls," and provides further guidance on internal control relevant to the audit of the financial statements.

⁵ See [p]Proposed] ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit," paragraph [A1], describes for a description of the meaning of "clearly trivial."

~~but does not require the auditor to plan and perform specific audit procedures to search for deficiencies in internal control or to form an opinion on the effectiveness of internal control.~~

Effective Date

42. This ISA is effective for audits of financial statements for periods beginning on or after [December 15, 2009]~~date~~.⁶

Objective

53. 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 D1**

Definitions

64. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Deficiency in internal control – ~~A deficiency in internal control. This~~ exists when a control is designed, implemented or operated in such a way ~~that as to prevent the control from enabling management or employees, in the normal course of performing their assigned functions, it is unable~~ to prevent, or detect and correct, misstatements in the financial statements on a timely basis; ~~and. In this respect:~~
 - ~~A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met;~~
 - ~~A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively; and~~
 - (b) Reportable-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 & D1**

Requirements

Confirmation of the Auditor's Understanding of Deficiencies Noted

- ~~7. When the auditor becomes aware of deficiencies in internal control, the auditor shall confirm the auditor's understanding of the underlying facts and circumstances of the deficiencies with management or, where appropriate, those charged with governance. (Ref: Para. A1-A3)~~

⁶ ~~This date will not be earlier than December 15, 2008.~~

Consideration-Identification of, and Conclusion on, Deficiencies in Internal Control-Noted

85. The auditor shall ~~consider the deficiencies in internal control~~ determine whether, on the basis of the audit work performed, the auditor has ~~noted-identified one or more deficiencies in internal control~~ during the audit and shall conclude which of those deficiencies, either individually or in combination, constitute reportable deficiencies. (Ref: Para. A14-A34) **ISSUE A1**
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 A1**

Communication of Reportable 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 B1**
89. The auditor shall communicate ~~reportable-significant~~ deficiencies ~~the auditor has noted identified~~ during the audit to those charged with governance in writing and on a timely basis. (Ref: Para. A12-A17, A23) **ISSUE B1**
- (a) ~~To management; and (Ref: Para. A12)~~
- (b) ~~At a level of detail considered appropriate in the circumstances, to those charged with governance. (Ref: Para. A13)~~
- The auditor shall make such communication in writing and on a timely basis, and shall include an explanation of the potential effects of the reportable deficiencies on the financial statements (Ref: Para. A14-A17)
940. The auditor's ~~shall include in the written communication of reportable-significant deficiencies to management and those charged with governance shall include:~~
- (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, statements to the effect that: In particular, the auditor shall explain that: (Ref: Para. A19-A22)
- (a) ~~The matters being reported are deficiencies in internal control that have come to the auditor's attention during the audit and which the auditor has concluded should be reported;~~
- (b) ~~The purpose of the audit was for the auditor to express an opinion on the financial statements and not to provide assurance on the effectiveness of internal control;~~
- (ie) 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]
- (d) ~~Had the auditor performed more extensive audit procedures on internal control, the auditor might have noted more deficiencies to be reported or concluded that some of the deficiencies being reported need not, in fact, have been reported; and~~
- (e) ~~The communication is intended solely for the purposes of management, those charged with governance and, where appropriate, relevant other parties, and may not be suitable for other purposes. (Ref: Para. A18-A20)~~

Application and Other Explanatory Material

Confirmation of the Auditor's Understanding Identification of Deficiencies in Internal Control ~~Noted~~ (Ref: Para. ~~5-67~~)

- 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, ~~where appropriate,~~ those charged with governance to agree on the relevant facts and circumstances of the auditor's findings, ~~and for~~ 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 ~~concern~~ involve management; ~~directly, such as for example,~~ difficulties in the preparation of adequate financial statements ~~that 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 ~~with management or those charged with governance,~~ the auditor may obtain other relevant information for further consideration, such as:
- The understanding that of management or those charged with governance ~~have~~ of the actual or suspected causes of the deficiencies.
 - Exceptions arising from the deficiencies that management or those charged with governance may have noted ~~during the period, 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 ~~bring to inform~~ the auditor's ~~attention the existence~~ of controls not previously known to the auditor that they believe would prevent, or detect ~~and correct, the~~ potential misstatements ~~that would not addressed be caught~~ by the ~~deficient~~ control(s) ~~giving rise to the deficiencies~~. The existence of these other controls does not eliminate the fact that ~~the auditor has noted~~ deficiencies in ~~certain internal~~ controls ~~have come to the auditor's attention~~. ~~Although This ISA does not require~~ the auditor ~~is not required to search for or 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 ~~doing so obtaining and evaluating additional audit evidence in concluding whether to communicate the deficiencies noted~~.

Consideration of, and Conclusion on, Deficiencies Noted (Ref: Para. 8)

- A4. ~~As ISA 315 (Redrafted) indicates, c~~Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, material misstatements.⁷ For example, controls in an IT subsystem may consist of ~~a combination 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 ~~reportable significant~~ deficiency. However, ~~combining the deficiency with other a combination of~~ deficiencies affecting the same account or disclosure, relevant financial statement assertions, or component of internal control may increase the risks of material misstatement to such an extent as to give rise to ~~may result in their potential effects becoming sufficiently important that the deficiencies would, in the auditor's professional judgment, constitute a significant reportable deficiencies~~.
- A5. The ~~importance 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 whether a the risk that a material misstatement could occur and the materiality of the misstatement, and not on whether a misstatement has actually occurred. Reportable Significant deficiencies may therefore exist even though the auditor has not identified material misstatements during the audit.
- A6. The assessment of the risk that Whether 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. This involves a consideration of the risks and uncertainties arising from the deficiencies to the extent that such deficiencies affect the particular underlying financial statement assertions. Examples of factors that affect this risk whether deficiencies could give rise to misstatements in the financial statements include:
- The nature of the financial statement accounts, disclosures and assertions (for example, related party disclosures ordinarily involve greater risk than other disclosures).

⁷ ISA 315 (Redrafted), paragraph A62.

- 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.

~~A7. Examples of factors that affect the materiality of misstatements that could occur include:~~

- The financial statement amounts exposed to the deficiency~~iesy~~.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies ~~that has occurred or could occur~~.
- ~~The nature of the specific element, account, or item of the financial statements affected by the deficiency.~~

A87. In ~~concluding 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 ~~that would prevent or detect the potential misstatements not addressed by the deficient controls~~ if the auditor has obtained sufficient appropriate audit evidence regarding their operating effectiveness ~~of such controls as part of the financial statement audit~~.

A89. Deficiencies in the following areas are ordinarily of sufficient importance to be ~~reportable 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).

A949. Indicators of ~~reportable 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, ~~involving management~~ that was not identified by the entity's internal control.

A104. 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 ~~has noted~~ during the audit, and may define terms such as "material weakness" for this purpose.

Communication of Reportable Deficiencies in Internal Control (Ref: Para. ~~97-940~~)

~~A12. For the purposes of communicating reportable deficiencies, management are those individuals within the entity empowered to authorize and approve changes necessary to the design and operation of controls to correct the reported deficiencies. These individuals ordinarily include the entity's chief executive officer and chief financial officer (or equivalent).~~

A114. ~~The auditor may find it appropriate to also communicate other control-related matters that do not give rise to potential misstatements in the financial statements if the auditor judges such matters to be of sufficient importance to merit the attention of management or, where appropriate, those charged with governance. 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. An~~ For example, it is appropriate to communicate to management, in accordance with paragraph 7, a deficiency in ~~of such a matter is control that did not detect~~ the use of a superseded price list by the entity's computerized sales system, resulting in the entity under-billing its customers for its products or services lower margins than would be expected.

A126. Management may already be aware of ~~the existence of the reportable~~ deficiencies that have come to the auditor's attention during the audit and may have ~~intentionally~~ chosen not to ~~correct-remedy~~ them because of cost or other considerations. The responsibility for evaluating the costs and benefits of ~~correcting-implementing remedial action the reportable deficiencies the auditor has noted~~ rests with management. Accordingly, the requirements for the auditor to communicate ~~reportable~~ deficiencies to management, and significant deficiencies to those charged with governance, ~~applyies~~ regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies ~~should be corrected~~.

A137. The fact that the auditor communicated a ~~reportable~~ deficiency to management ~~and-or~~ a significant deficiency to those charged with governance in the previous audit, or that they already had knowledge of ~~knew about~~ 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 ~~corrective-remedial~~ action has not yet been taken in the current period. If the auditor has previously communicated the matter to management ~~and-or~~ those charged with governance, the current year's communication may include the same description of the ~~reportable~~

deficiency as ~~the auditor~~ previously communicated, ~~or~~ Alternatively, it may be summarized, ~~with a specifically~~ referring to the previous communication. The auditor may ask ~~inquire~~ ~~of~~ management or those charged with governance ~~to understand~~ why the reportable deficiency has not yet been ~~corrected~~ remedied. A failure to act, in the absence of a rational explanations ~~from management or those charged with governance~~, may in itself represent be a reportable-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.

A153. The level of detail at which to communicate reportable-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 ~~the an~~ appropriate level of detail ~~at which to communicate reportable deficiencies to those charged with governance for the communication~~ include, for example:

- The nature and size of the entity.
- The nature and volume of reportable-significant deficiencies ~~noted 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.
- ~~Whether there has been a specific agreement with those charged with governance as to the nature and extent of the communication on reportable deficiencies.~~
- 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, the auditor may find it appropriate (or may be requested) to communicate to those charged with governance may prefer to know of the same reportable all deficiencies at the same level of detail that the auditor has communicated to management. In other circumstances, the auditor may consider it appropriate to communicate in detail to those charged with governance only those reportable may prefer brief descriptions of the nature of the other deficiencies that the auditor judges to be the most important ones, and include a summary of the other reportable deficiencies communicated to management.

A175. ~~As [proposed] ISA 260 (Revised and Redrafted) indicates, i~~It may often be appropriate for the auditor to first orally communicate reportable-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 if they are able to implement timely corrective 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. Although such communication may be made orally during the audit, the requirement to communicate the reportable deficiencies in writing reflects the importance of the matters being communicated and assists management and those charged with governance, respectively, in fulfilling their responsibilities for the preparation of adequate financial statements and for the oversight of the financial statement preparation process.

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.

A2018. Laws or regulations may ~~establish requirements for~~ the auditor or management to furnish a copy of the auditor's written communication ~~of reportable 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 ~~include a specific reference to~~ such regulatory authorities.

A2119. The auditor may be expected, or may have agreed with the entity, to submit a written communication on reportable deficiencies to those charged with governance at the completion of each audit, regardless of whether the auditor has noted any such deficiencies. For example, the entity may operate in a regulated industry where the regulator requires the entity to submit a copy of the auditor's communication on reportable deficiencies to those charged with governance after each audit. In such a case, if The requirements of paragraph 9(b) apply even when the auditor has not ~~become aware of identified~~ any reportable significant deficiencies during the audit, ~~it may be necessary for 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 reportable significant deficiencies ~~were noted came to the auditor's attention~~ during the audit. The requirements of paragraph 9(b) are important in such situations, Bbecause of the risk that such type of communication could be misinterpreted as giving a degree of assurance on internal control, ~~the auditor may consider it appropriate to include a disclaimer in the communication to the effect that the auditor has not performed procedures to obtain reasonable assurance, and is not providing any assurance, on the effectiveness of 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

A239. Public sector auditors may have additional responsibilities to communicate deficiencies in internal control that have come to their attention ~~noted~~ during the audit, in ways, at a level of detail and to parties not envisaged in this ISA. For example, ~~reportable~~ 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 ~~reportable~~ deficiencies in internal control required to be communicated by this ISA.

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