

# KAEG-I [INTL VERSION 2024]: ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

## Contents

## KAEG-I [INTL VERSION]: ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management [ISA | KAEGISA265]

ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

### **Introduction, Objective and Definitions**

International Standards on Auditing: ISA 265.01-06

### **Evaluating Identified Deficiencies in Internal Control**

International Standards on Auditing: ISA 265.07-08

ISA Application and Other Explanatory Material: ISA 265.A1-A11

How do we comply with the standards?

[1 Identify and evaluate control deficiencies](#)

[1.1 Determine whether a deficiency in ICFR exists and describe it](#)

[1.2 Evaluate the severity of the deficiency individually](#)

[1.2.1 Evaluate the severity of process control activity deficiencies](#)

[1.2.2 Evaluate the severity of general IT control \(GITC\) deficiencies](#)

[1.2.3 Evaluate the severity of CERAMIC control deficiencies](#)

[1.3 Evaluate the severity of similar deficiencies in aggregate](#)

### **Communication of Deficiencies in Internal Control**

International Standards on Auditing: ISA 265.09-11

ISA Application and Other Explanatory Material: ISA 265.A12-A30

How do we comply with the standards?

[1 Communicate control deficiencies](#)

[1.1 Determine what control deficiencies to communicate to whom](#)

[1.2 Determine when to communicate control deficiencies](#)

[1.3 Determine form of communications about control deficiencies](#)

# ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

[View the Full Chapter for this Standard](#)

## *ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

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

### Introduction, Objective and Definitions

### International Standards on Auditing: ISA 265.01-06

#### Introduction

#### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control<sup>1</sup> that the auditor has identified in an audit of financial statements. This ISA does not impose additional responsibilities on the auditor regarding obtaining an understanding of the entity's system of internal control and designing and performing tests of controls over and above the requirements of ISA 315 (Revised 2019) and ISA 330.<sup>2</sup> ISA 260 (Revised)<sup>3</sup> establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.

---

<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraphs 4 and 12

<sup>2</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>3</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

2. The auditor is required to obtain an understanding of the entity's system of internal control when identifying and assessing the risks of material misstatement.<sup>4</sup> In making those risk assessments, the auditor considers the entity's system of 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. The auditor may identify control deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This ISA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

---

4ISA 315 (Revised), paragraph 12. Paragraphs A68 - A73 provide guidance on controls relevant to the audit.

3. Nothing in this ISA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

## 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 those charged with governance and management deficiencies in internal control 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 - This exists when:

(i) 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; or

(ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

(b) Significant deficiency in internal control - A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

## Evaluating Identified Deficiencies in Internal Control

## International Standards on Auditing: ISA 265.07-08 Requirements

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-A4)

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. A5-A11)

# ISA Application and Other Explanatory Material: ISA 265.A1-A11

## Application and Other Explanatory Material

### **Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: Para. 7)**

A1. In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion 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. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management, for example, if the findings appear to call management's integrity or competence into question (see paragraph A20).

A2. In discussing 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 information technology (IT) controls.
- A preliminary indication from management of its response to the findings.

### *Considerations Specific to Smaller Entities*

A3. While the concepts underlying controls in the control activities component in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of controls are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed controls.

A4. Also, smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

### **Significant Deficiencies in Internal Control (Ref: Para. 6(b), 8)**

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

A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- 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 with related parties.
  - 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 with other deficiencies in internal control.

A7. Indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, 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.
- Evidence of management's inability to oversee the preparation of the financial statements.

A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements.<sup>5</sup> For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. 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 balance or disclosure, assertion, or component of the entity's system of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

---

5 ISA 315, paragraph A74

A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.

A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this ISA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this ISA to be communicated to those charged with governance.

A11. The requirements of this ISA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

## How do we comply with the Standards?

[ISA | KAEGHDWC]

### 1 Identify and evaluate control deficiencies [ISA | 7652]

#### What do we do?

Identify and evaluate control deficiencies.

#### Why do we do this?

During our audit, we may identify one or more deficiencies in internal control. If we ignore the identified deficiencies or improperly evaluate them, we may not achieve our audit objectives.

#### Execute the audit

## How do we identify and evaluate control deficiencies? [ISA | 7652.13337]

We perform the following these three steps to identify and evaluate control deficiencies:

- [Determine whether a deficiency in ICFR exists and describe it](#)
- [Evaluate the severity of the deficiency individually](#)
- [Evaluate the severity of similar deficiencies in aggregate](#)

## 1.1 Determine whether a deficiency in ICFR exists and describe it [ISA | 1408]

### What do we do?

Determine whether, based on the audit work performed, one or more deficiencies in internal control over financial reporting have been identified AND if so, describe it correctly.

### Why do we do this?

During our audit, we may identify one or more deficiencies in internal control. If we ignore the identified deficiencies or improperly evaluate them, we may not achieve our audit objectives. This starts with correctly identifying and describing the control deficiencies so we can understand their true impact and consider any other relevant matters that can factor into their severity or impact on the audit.

## Execute the Audit

### What is a deficiency in internal control? [ISA | 1408.1300]

A deficiency in internal control (also referred to as a 'control deficiency') exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

When a control deficiency exists, a control is either missing, designed inappropriately or not operating effectively.

### What are the possible sources where we may identify control deficiencies? [ISA | 1408.13273]

The table below sets out the possible sources where we may identify control deficiencies and how we may identify a deficiency from each possible source.

Possible source	How we may identify a deficiency from the possible source
Information we become aware of during our planning and risk assessment procedures, including our walkthrough and evaluation of the design and implementation of controls.	<p>As part of understanding the business process, process risk points, and internal controls during risk assessment, we may identify deficiencies in the design of controls, including missing controls.</p> <p>For example, we may identify that a process risk point is not addressed by a properly designed, implemented and effective control.</p>

<p>A cybersecurity incident occurred during the period</p>	<p>When obtaining an understanding of management's cybersecurity risk assessment, we evaluate the impact of a cybersecurity incident, if one occurs, on our audit approach. As part of that evaluation, we may identify control deficiencies related to the cybersecurity incident. Refer to activity '<a href="#">Understand cybersecurity risks and incidents</a>' for additional guidance.</p>
<p>Our tests of operating effectiveness</p>	<p>We may identify control deviations when we test the operating effectiveness of the controls. Once we identify a control deviation, we determine whether a control deficiency exists.</p> <p>See activity '<a href="#">Perform relevant procedures when control deviations are identified</a>' and its sub-activities for further information on what we do when we identify control deviations.</p>
<p>Our substantive procedures</p>	<p>Misstatements identified during our substantive procedures may be the result of control deficiencies. See activity '<a href="#">Evaluate the nature of and reasons for the misstatements</a>' for further information about evaluating misstatements identified to determine whether they are the result of a control deficiency.</p> <p>Further, there may be instances where a transaction we are testing evidences a deviation from our understanding of the entity's process. Regardless of whether a misstatement has occurred, we consider deviations from the process, as they may indicate that we either have not sufficiently understood the process or that a control deficiency exists.</p> <p>For example, we may select a revenue transaction as part of our control testing and identify a deviation because it is recorded outside the normal process. This may prompt us to update our understanding of the revenue process, identify process risk points and identify and test the controls that address the process risk points related to these revenue transaction types.</p>
<p>Other auditors involved in the audit</p>	<p>In a group audit, the other auditors involved in the audit may report deficiencies that they identified at the components.</p>



	See activity ' <a href="#">Obtain, review and retain documentation of work performed by component auditors</a> ' for further information.
Management's risk assessment or monitoring processes	<p>We obtain all deficiencies in ICFR identified by management during the period under audit.</p> <p>There are many ways in which management identifies internal control deficiencies, including the entity's monitoring of controls, applicable examinations of controls at a service organization relevant to the entity's ICFR and external parties that provide input about the presence and functioning of internal control components.</p>
Management's assessment of ICFR (integrated audits)	We obtain all deficiencies in ICFR that management identified during the period through its assessment of ICFR.
Internal auditors or other internal entity sources	Internal auditor's reports or other internal entity sources may identify a deficiency in a control that is relevant to the audit.
Service organization reports	Service organization reports can identify a deficiency in a control at the service provider on which the entity is relying for financial reporting. Since service organizations may be a part of the entity's internal controls, these can be relevant to our audit.
External sources including regulatory reports (i.e. SEC comment letters)	<p>Regulatory inspections and communications may indicate deficiencies in internal control.</p> <p>For instance, the entity may receive a comment letter from a regulatory body questioning whether the entity properly accounted for or presented certain transactions. Even if no change results from the comment letter, management's response to the comment letter could indicate that there are possible control deficiencies.</p>
Prior period misstatements identified in the current period, regardless of whether they result in a restatement	Misstatements identified, even if they relate to prior periods, may be caused by control deficiencies. See activity ' <a href="#">Evaluate the nature of and reasons for the misstatements</a> ' for further information about evaluating misstatements identified to determine whether they are the result of a control deficiency.

	<p>Prior period misstatements usually indicate a deficiency in internal controls that existed during that period, but we also consider whether the deficiency continues to exist in the current period as well.</p>
Operational or compliance deficiencies	<p>Weaknesses in operations or compliance with laws and regulations that come to our attention may indicate a related deficiency in internal control over financial reporting. We carefully consider whether there is a potential effect on ICFR and are mindful that we do not quickly dismiss them as "operational or compliance" only.</p>
Work performed by specific team members or employed KPMG specialists	<p>Specific team members or employed KPMG specialists may identify issues with or recommended improvements to management's process or controls.</p> <p>Discussing potential deficiencies with specific team members and/or employed KPMG specialists, can be helpful in determining whether a deficiency exists and correct identifying and describing the deficiency.</p>
Management's failure to remediate a deficiency for an extended period	<p>Failure to remediate a deficiency in ICFR for an extended period may indicate a broader issue, such as a control deficiency in one or more CERAMIC components. We can usually determine whether a broader issue exists by considering the reasons why the entity has failed to remediate a control deficiency.</p> <div style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p>For example:</p> <ul style="list-style-type: none"> <li>• management may not have the right attitude or a philosophy or operating style that promotes effective internal controls, or</li> <li>• the entity may not communicate control deficiencies in a timely manner to those responsible for taking corrective action.</li> </ul> </div> <p>However, there may be some situations when a longer remediation period is not an indicator of a broader issue.</p> <div style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p>For example, when a control deficiency relates to an IT system that is being upgraded or replaced, management may decide to rely on compensating</p> </div>

controls instead of making changes in the current IT system to remediate the deficiency.

#### What types of deficiencies may we identify? [ISA | 1408.13275]

We may identify the following types of deficiencies:

- process control activities
- general IT controls (GITCs), or
- CERAMIC.

#### How do we correctly describe a control deficiency? [ISA | 1408.13276]

We correctly describe a control deficiency by identifying:

- the situation where we found the deficiency;
- the deficient control, including the type of control;
- type of deficiency - i.e. control is missing, not designed correctly or not operating effectively;
- significant account or disclosure affected;
- relevant assertion affected;
- component(s) of internal control affected (and principle of the component, when COSO 2013 is used and considered); and
- the component of the group affected by the deficiency (in group audits).

For example:

Situation	Control	Deficiency	Component of internal control	Component in the group audit
The entity does not have a formal code of conduct.	Management has a formal code of conduct against which it can evaluate employee actions.	Control is missing	Control Environment	Parent entity
Analysis and review of significant unusual transactions is not performed.	Significant unusual transactions are reviewed by management.	Control is missing	Control Activities or Monitoring	Parent entity
Although designed appropriately,	Bank reconciliations	Control is not	Control Activities	Mexico

bank reconciliations are not performed timely.	are performed timely.	operating effectively		
There does not appear to be communication between in-house counsel and the accounting department to properly accrue for and disclose legal contingencies.	Key information is provided from in-house counsel to the accounting department so that the accrual and disclosure of legal contingencies can be made based on appropriate information.	Control is missing or designed inappropriately	Information and Communication	Parent entity

## Examples

### Does a control deficiency exist? [ISA | 1408.1800]

Scenario 1: Deficiency in ICFR identified through an operational or compliance deficiency

#### Fact pattern

An entity's internal auditor detects a manufacturing defect in recently produced products, which may increase the number of units returned during the manufacturer's warranty period. The report indicates an operational deficiency in the manufacturing process, which will be addressed so that future products do not contain the same defect.

#### Analysis

Although this appears operational in nature, it may indicate a potential deficiency related to the processes and controls that enable the personnel responsible for recording the entity's warranty reserve to have accurate and up-to-date information to properly calculate and record the warranty reserve.

Scenario 2: Business combinations

#### Fact pattern

An entity with a calendar year-end acquires a business in early December. Management has initiated its processes to estimate the fair value of acquired assets and assumed liabilities in the business combination and has designed and documented relevant internal controls over process risk points identified in the process. Management's specialists performed a reasonable preliminary analysis given the information available from the date of acquisition to the date of the report.

#### Analysis

In this example, the engagement team may conclude that there is not a deficiency. It is not reasonable to expect that management's controls over the fair value estimates are designed and operating at a higher level of precision than the relevant accounting framework requires of the estimates themselves.

Nonetheless, management must have some controls operating at an adequate precision over the preliminary purchase price allocation disclosed. Because the engagement team concluded that those are in place for this year, there is no control deficiency.

Scenario 3: Internal audit findings

#### **Fact pattern**

We find that the entity's inventory cycle count program excludes certain categories of inventory from the counts.

#### **Analysis**

The finding indicates a control deficiency in ICFR because it has an impact on the entity's controls related to the existence, completeness and accuracy of inventory.

[What is an appropriate and inappropriate description of a control deficiency? \[ISA | 1408.13277\]](#)

#### **Fact pattern**

We identify a misstatement in the entity's tax provision calculation.

The description of the control deficiency is: "There was an error in the operating effectiveness of controls related to the income tax provision."

#### **Analysis**

This description is insufficient because it does not identify the specific control or controls that are deficient (missing, designed inappropriately or operating ineffectively). It only describes that the control relates to the income tax provision.

## 1.2 Evaluate the severity of the deficiency individually [ISA | 1413]

### What do we do?

Evaluate the severity of control deficiencies individually taking account of compensating controls if relevant.

### Why do we do this?

Once deficiencies are identified, we evaluate each one individually to determine its severity. The severity of the deficiency will inform the types of communications that we make to management and those charged with governance. Management may point to compensating controls that mitigate the severity of the identified deficiency. If we do not properly evaluate the effect of compensating controls, we might reach an incorrect conclusion about the severity of the deficiency, which could impact our communications.

## Execute the Audit

### What are the categories of control deficiencies based on severity? [ISA | 1413.1400]

We categorize control deficiencies based on severity as follows:

- Significant deficiency
- Deficiency

### What is a significant deficiency? [ISA | 1413.1600]

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that, in our judgment, is important enough to merit the attention of those charged with governance.

### Do we evaluate the severity of deficiencies the same way for all types of controls? [ISA | 1413.1800]

No. We evaluate the severity of deficiencies differently depending on the type of deficient control:

- [Evaluate the severity of process control activity deficiencies](#)
- [Evaluate the severity of general IT control \(GITC\) deficiencies](#)
- [Evaluate the severity of CERAMIC control deficiencies](#)

### What determines that a deficiency is a significant deficiency? [ISA | 1413.2200]

When we evaluate the severity of a deficiency, we determine that the deficiency is a significant deficiency when:

	Severity: significant deficiency
<b>Likelihood of potential misstatement</b>	There is a reasonable possibility (more than a remote possibility) that a misstatement will occur.
<b>Magnitude of the potential misstatement</b>	<p>The potential misstatement is material, or otherwise large enough to merit the attention of those charged with governance.</p> <p>We consider the potential misstatement, not the actual misstatement. A significant deficiencies can exist even in the absence of an actual misstatement.</p>

Examples of matters that we may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- 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.
  - Control activities over significant transactions with related parties.
  - Control activities over significant transactions outside the entity's normal course of business.
  - Control activities over the period-end financial reporting process (such as control activities 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 with other deficiencies in internal control.

In addition, there are some specific indicators of significant deficiencies. If a deficiency is the result of one of these indicators, the deficiency is ordinarily a significant deficiency. However, the absence of these indicators does not mean the deficiency is not a significant deficiency.

Indicators of significant deficiencies include:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that we would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).
- Misstatements detected by our procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Restatement of previously issued financial statements for a material misstatement due to error or fraud.
- Evidence of management's inability to oversee the preparation of the financial statements.
- Ineffective oversight of the entity's financial reporting and ICFR by those charged with governance.

#### What are compensating controls? [ISA | 1413.6211]

Compensating controls are controls that address the same objective (e.g. process risk point(s) or risks arising from IT) as a deficient control and address the period of time that the control is deficient - i.e., until the deficient control is remediated.

Compensating controls may be:

- different controls that were already in place and operating throughout the period and cover the same objective (e.g. process risk points or risks arising from IT) as the deficient control - i.e. redundant or duplicative controls; or
- 'ad hoc' controls management puts in place on a timely basis to respond to the identified deficiency and determine whether the deficiency caused a material misstatement during the period.

Sometimes, an entity may have redundant or duplicative controls that address the same process risk point(s) for an RMM, or as part of remediating control deficiencies during the period, the remediation actions constitute ad-hoc controls that cover the period that the deficiency existed and provide management, from a control perspective, with sufficient information to determine no material misstatement existed in the period where the deficiency existed. The following may also help us determine an appropriate assessment of control risk:

Do management have reasonable assurance that the deficiency didn't cause a material misstatement?

Situation 1:

A deficiency in the access termination control (an untimely removal of access at the time of termination) was identified during the monthly access review by the CIO. Immediately after the identification of the inappropriate system access, the access was removed and, management performed their own procedures and determined that the person(s) who had inappropriate access did not, in fact, use that access. The monthly review control serves as a compensating control for the deficient access termination control that allows us assess control risk as "Controls Reliance" for the entire period.

Do management have reasonable assurance that the deficiency didn't cause a material misstatement?

Situation 2:

A bank reconciliation during the year was determined to not be performed timely, but subsequent to that instance the bank reconciliation was performed timely. The nature of the bank reconciliation control, which will determine the appropriateness of reconciling items from periods during and after the deficiency, is such that a control risk assessment of "Controls Reliance" for the entire period is appropriate.



<p>Do management have reasonable assurance that the deficiency didn't cause a material misstatement?</p>	<p>However, we keep in mind that the timeliness of bank reconciliations may undermine the reliability of monthly management accounts.</p> <p>Situation 3:</p> <p>A deficiency was identified in a control that is designed to approve payment for returned goods, which was remediated during the period. Management doesn't think that there was a material misstatement in the period where the control was deficient, but has only performed a high-level trend analysis that shows a small fluctuation in payments for returns between the remediated and unremediated periods. Because there was not a process control activity performed by management at an appropriate level of precision, we are likely to assess control risk as "No Controls Reliance" for the period with a deficiency, and "Controls Reliance" for the period without a deficiency.</p>
--	--

#### How do we identify compensating controls? [ISA | 1413.6212]

We may identify compensating controls by looking to other control activities at the entity that are capable of achieving the same objective as the deficient control. For process control activities, we also consider whether the control operates at the appropriate level of precision. In some cases, management may identify compensating controls based on their own analysis of the deficiency.

#### Do we evaluate compensating controls when evaluating the severity of all control deficiencies? [ISA | 1413.6213]

We may evaluate the effect of compensating controls when they exist and effectively mitigate the deficiency.

In cases where the deficiency is not very severe - for example, a control deficiency that is not a significant deficiency - we may choose not to consider compensating controls as part of our evaluation, unless we choose to rely on the compensating control to support a control reliance control risk assessment.

#### When are compensating controls able to mitigate a deficiency? [ISA | 1413.6214]

Effective compensating controls address the same objective (e.g. process risk point(s)/risks arising from IT) as the deficient control(s) and cover the period of time the deficient control(s) were deficient. For a compensating control to effectively mitigate a deficiency in a process control activity, the control is designed to operate at a level of precision that would prevent, or detect and correct a material misstatement.

For example, high-level analytical procedures and other monitoring activities rarely make effective compensating controls.

To limit the severity of a deficiency, it is not necessary for a compensating control to be as precise as the deficient control, as long as it achieves the same control objective as the deficient control and, for process control activities, operates at a level of precision that would prevent, or detect and correct a material misstatement.

Compensating controls cannot lower the potential misstatement below the actual known misstatement, or the "floor", for purposes of evaluating the severity of a deficiency.

#### Can a compensating control eliminate the control deficiency? [ISA | 1413.6215]

No. A compensating control might limit the severity of a deficiency and prevent it from being a significant deficiency, but does not eliminate the deficiency. The presence of a compensating control does not change the fact that a deficiency exists in the original control. However, such a compensating control may result in us being able to continue to assess control risk as Controls Reliance.

#### What do we do when we identify a compensating control that appears to mitigate the severity of a significant deficiency? [ISA | 1413.6216]

When we identify a compensating control that appears to mitigate the severity of a deficiency, we may evaluate its design and implementation and, when we tested the operating effectiveness of the deficient control, test its operating effectiveness.

We evaluate the design and implementation and test the operating effectiveness of compensating controls in the same manner as for any other control. This confirms our understanding of the compensating control, particularly whether it operates at the right level of precision (if applicable), and allows us to obtain sufficient appropriate evidence to support the assertion that a properly designed compensating control is effective and mitigates the severity of the deficiency.

Management representations regarding the design and operating effectiveness of a compensating control do not constitute sufficient appropriate evidence.

#### What if there is a combination of several compensating controls? [ISA | 1413.6217]

When a combination of controls is necessary to compensate for the deficiency, we evaluate the design and implementation and, when relevant, test the operating effectiveness of each of those controls.

#### What if we only evaluated the design and implementation of the original deficient control? [ISA | 1413.6218]

If we only evaluated the design and implementation of the original deficient control, we may only evaluate the design and implementation of the compensating control(s).

## 1.2.1 Evaluate the severity of process control activity deficiencies [ISA | 7650]

### What do we do?

Evaluate the severity of process control activity deficiencies.

## Why do we do this?

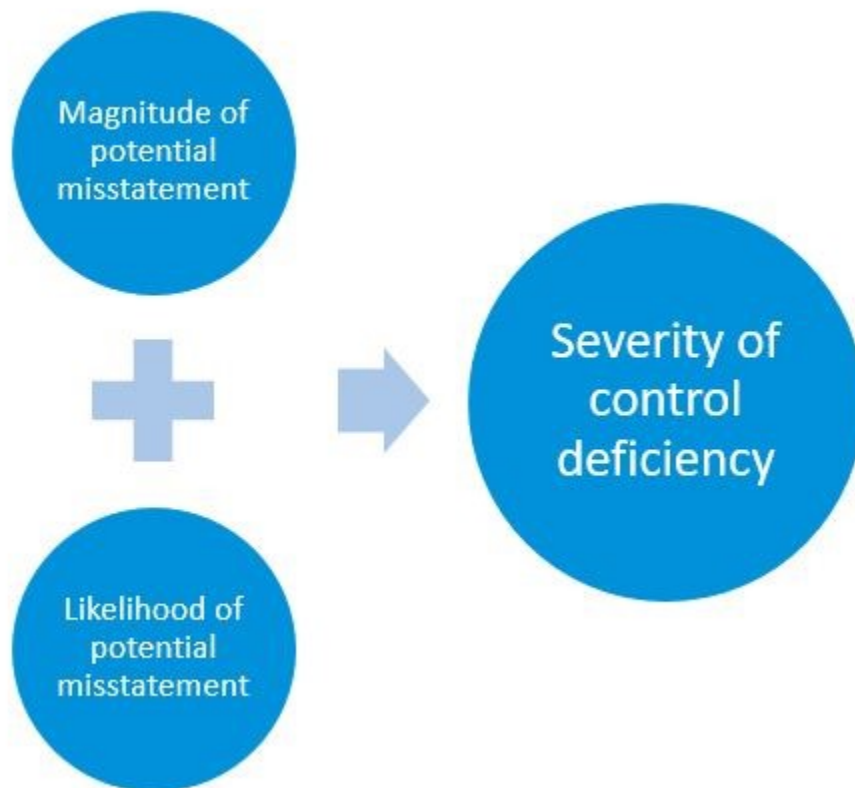
Once we identify control deficiencies related to process control activities, we evaluate each one individually to determine its severity. The severity of the deficiency will inform the types of communications that we will make to management and those charged with governance.

## Execute the audit

[How do we evaluate the severity of a control deficiency over process control activities?](#) [ISA | 7650.13286]

We evaluate the severity of a deficiency by evaluating:

- whether there is a reasonable possibility that the entity's controls will fail to prevent or detect a misstatement of an account balance or disclosure (i.e. likelihood of potential misstatement); and
- the magnitude of the potential misstatement resulting from the deficiency or deficiencies.



[How do we evaluate the magnitude of the potential misstatement?](#) [ISA | 7650.13288]

To evaluate the magnitude of the potential misstatements, we think about several factors. Those factors include, but are not limited to, the following:

- the financial statement amounts or total of transactions exposed to the deficiency; and
- the volume of activity (in the current period or that is expected in future periods) in the account balance or class of transactions exposed to the deficiency that has occurred.

This analysis takes into consideration qualitative and quantitative factors. Note that the possible future consequences of the deficiency is one of the qualitative considerations.

[What are the maximum and minimum amounts of the potential misstatement?](#) [ISA | 7650.13289]

In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger.

The minimum amount of the potential misstatement is the misstatement that has occurred, if any. In fact, the magnitude of the potential misstatement can, in many cases, be greater than the amount of any misstatement that actually occurred.



It is the potential misstatement, not the actual misstatement, or lack thereof, that drives the severity of a control deficiency. Moreover, a control deficiency can exist even when a misstatement has not occurred.

While we evaluate the severity of each deficiency, we devote more attention to evaluating those deficiencies that have the potential to merit the attention of those charged with governance.

[How do we obtain the information to appropriately evaluate the severity of a control deficiency over a process control activity?](#) [ISA | 7650.13290]

We obtain the information to appropriately evaluate the severity of a control deficiency in a process control activity from our audit work, including inquiries of management. One of the objectives of our earlier steps in evaluating a control deficiency is to obtain this information: what caused the deficiency and whether the deficiency suggests that other control deficiencies exist.

This information will be valuable as we further evaluate the severity of the deficiency.

[Why and how do we take into account the volume of activity in both the current period and in future periods?](#) [ISA | 7650.13291]

We evaluate the volume of activity in both the current period and future periods because the potential misstatement may not be material in the current period, but it may become material in the future. The

severity of a deficiency that has the potential of becoming a bigger issue in the future is greater than that of another deficiency whose potential misstatement will never be material.

Therefore, assessing the magnitude of the potential misstatement involves projecting what could happen in the future.

For instance:

- If an account balance exposed to a deficient control has gradually increased each period as the entity grew in size, we take into account the projected continued growth in that account balance.
- We have identified a deficiency related to insufficient knowledge of international tax accounting at a pharmaceutical entity. In considering the severity of the deficiency, it may be prudent to take into consideration their near term plans for expanding internationally when evaluating the magnitude of the potential misstatement.

In making these assessments, we may put more weight on our past experience with an account that is objective and verifiable and less weight in considering future projections that are inherently more subjective.

[Can we net the various potential misstatements to determine the severity of the deficiency?](#) [ISA | 7650.13292]

It depends. When evaluating the magnitude of the potential misstatement, we may net the various potential misstatements only in those instances in which the internal control design dictates that failure of a specific process control activity will result in offsetting (in total or in part) potential misstatements in the same financial statement account or disclosure, or in closely related financial statement accounts or disclosures.

For example, a deficiency in placing construction-in-progress fixed assets (CIP) in service may result in offsetting errors to CIP and other fixed asset types, as well as errors to depreciation expense. It may be appropriate to offset the CIP and fixed asset errors (if we conclude that the individual fixed asset line item disclosures are not relevant to users of the financial statements), but not to offset those errors with depreciation expense.

Although revenue and expense "offset" in the statement of income, it would not be appropriate to offset revenue and expenses when evaluating the severity of a deficiency if users of the financial statements consider revenue or any of the other impacted financial statement line items to be individually relevant.

[May we factor indirect effects of the potential misstatement to determine the severity of the deficiency?](#) [ISA | 7650.13294]

Yes, we may factor indirect effects of the potential misstatement to determine the severity of the deficiency. Indirect effects of a potential misstatement may be relevant when evaluating the magnitude of such potential misstatement.

For example, the level of revenues may affect complying with debt covenants, calculating an earn-out on a business combination, or attaining a performance-based stock award or bonus program, each of which could affect the evaluation of the severity of the deficiency.

[What materiality levels do we use to evaluate the magnitude of the potential misstatement?](#) [ISA | 7650.13295]

We evaluate the magnitude of the potential misstatement against materiality for the financial statements as a whole or lower materiality for particular accounts or disclosures. Those materiality levels will help us determine whether the potential misstatement is material.

For example, if we determine that an amount in interest expense that is less than materiality for the financial statements as a whole would likely influence the reasonable investors, we establish a lower materiality for that specific account. When we are evaluating the control deficiencies (evaluating the magnitude of the potential misstatement) identified in the entity's process control activities related to the interest expense account, we use the lower materiality for that specific account to determine whether the potential misstatement is material.

[Group Audit | In a group audit, what materiality levels do we use to evaluate the magnitude of the potential misstatement?](#) [ISA | 7650.13296]

We, as the group auditor, evaluate the magnitude of the potential misstatement against group materiality for the financial statements as a whole or lower group materiality for particular accounts or disclosures, even for those deficiencies identified in specific components. We do not use component materiality to evaluate the severity of a deficiency in a component.

[How do we evaluate the likelihood of the potential misstatement?](#) [ISA | 7650.13298]

We evaluate the likelihood of the potential misstatements by evaluating several risk factors to determine whether there is a reasonable possibility that a deficiency will result in a misstatement of an account balance or disclosure. Reasonable possibility means more than a remote possibility, which is a **low** threshold.

Those risk factors can include:

- the possibility of the deficiencies leading to material misstatements in the financial statements in the future
- the susceptibility to loss or fraud of the related asset or liability
- the subjectivity, complexity and extent of judgment involved in determining estimated amounts, such as fair value accounting estimates
- the nature of the financial statement accounts, disclosures and assertions involved
- the interaction or relationship of the process control activity with other control activities, including whether they are interdependent or redundant
- the cause and frequency of the exceptions detected as a result of the deficiencies in the process control activities
- the interaction of the deficiency with other deficiencies in internal control
- the importance of process control activities, such as the following, to the financial reporting process:

- controls over the prevention and detection of fraud
- controls over the selection and application of significant accounting policies or principles
- controls over significant transactions with related parties
- controls over significant unusual transactions
- controls over the period-end financial reporting process (such as process control activities over nonrecurring journal entries)

For example, there may be instances when the severity of the deficiency may increase because the potential misstatement involves related party transactions.

In many cases, the probability of a small misstatement is greater than the probability of a large misstatement.

The evaluation of whether a control deficiency presents a reasonable possibility of a misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

## Examples

[How do we evaluate the magnitude of a deficiency?](#) [ISA | 7650.13299]

### **Control deficiency related to the overstatement of the legal accrual**

#### **Fact pattern**

An entity overstates a legal accrual by \$2 million. The deficient control is identified before determining its severity. In this case, the control deficiency relates to the process control activity's design—specifically, the legal department did not inform the finance department of a positive development surrounding a particular legal matter. The legal department has a practice of immediately communicating negative developments and discussing the ramifications of those developments on the legal accrual. In this case, because the development was positive, the legal department thought it was being "conservative." The entity has several legal matters outstanding with a total legal accrual of \$15 million.

#### **Analysis**

The "floor" of the potential magnitude is the actual \$2 million overstatement. The potential magnitude, or "ceiling," would only be evaluated for overstatements, because there is evidence that the process control activity is operating effectively for upward adjustments to the legal accrual.

Our evaluation includes the potential for overstatement of the legal accrual related to all legal matters, not just the legal matter that led to the error.

An overstatement of the entire legal accrual would be \$15 million. But say that of the \$15 million accrued, \$11 million relates to legal matters that are close to settlement and, in fact, the entity has made offers to the plaintiffs equal to the \$11 million. The entity has a demonstrable history that, once making a settlement offer to the plaintiff, the payouts approximate the settlement offers. The other \$4 million of accrual is management's best estimate of probable loss. In such a scenario, the likely potential magnitude may be closer to \$4 million than \$15 million.

[How do we evaluate the magnitude and likelihood of a deficiency?](#) [ISA | 7650.13300]

### **Control deficiency related to the understatement of the warranty accrual**



### **Fact pattern**

An entity understates its warranty accrual by \$1 million. The error was a result of the underlying warranty claim data used by management in its calculation and review of the warranty accrual balance. Once the report was generated, it was put into an editable spreadsheet where manual adjustments were made to present the claim data in a specific format to calculate the warranty accrual. An error was made in the manual adjustments which resulted in the understatement in the warranty accrual.

Management performed an analysis to understand what caused the deficiency and determined that the deficiency was related to a missing control activity over end-user computing in the editable spreadsheet. Management concluded that the control activity over the warranty accrual would have operated appropriately if accurate underlying claim data was used.

The warranty accrual, after correction for the \$1 million understatement, was \$20 million at period end. The warranty accrual has fluctuated between \$15 million and \$20 million over the last three years but has gradually increased as the entity has grown and sales have increased, and is expected to continue with similar growth prospectively.

### **Analysis**

The "floor" of the potential magnitude is the actual misstatement of \$1 million. The potential magnitude, or "ceiling," is more difficult to evaluate in this circumstance because of the understatement risk associated with the warranty accrual and the nature of the deficiency could result in either an overstatement or understatement of the balance. Because of that understatement risk, the potential magnitude is not necessarily limited by the balance of the warranty accrual. Our assessment also considers the fact that the warranty accrual has increased in recent years.

Assessing likelihood in this scenario involves judgment. Because the review over the warranty accrual was otherwise designed and operating effectively, with the exception of the completeness and accuracy of the underlying data, it is reasonable to expect that as the size of the misstatement increases, the reviewer will eventually detect the error irrespective of the issues in the underlying claim data. We consider at what dollar threshold it becomes remote that an error would not be identified through the review, despite the deficient control activities over the underlying data, and whether that amount is greater than an amount considered material to users of the financial statements.

## **1.2.2 Evaluate the severity of general IT control (GITC) deficiencies** [ISA | 7654]

### **What do we do?**

Evaluate the severity of general IT control (GITC) deficiencies.

### **Why do we do this?**

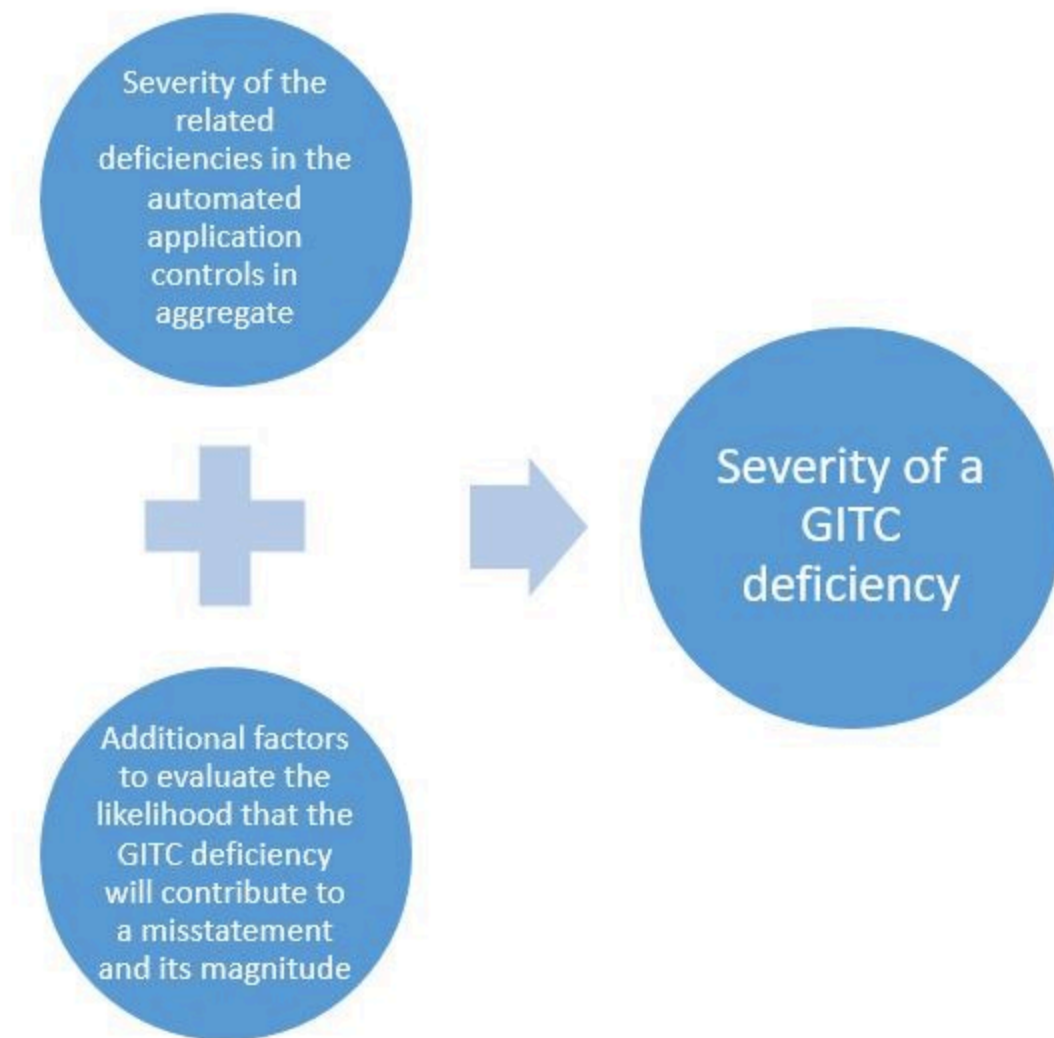
Once we identify control deficiencies related to GITCs, we evaluate each one individually to determine its severity. The severity of the deficiency will inform the types of communications that we will make to management and those charged with governance.



## Execute the audit

How do we evaluate the severity of general IT control (GITC) deficiencies? [ISA | 7654.13352]

We evaluate the severity of GITC deficiencies similar to how we evaluate the severity of other control deficiencies. However, the primary difference is that we think about how the GITC deficiency impacts the related automated controls and also several additional factors to evaluate whether there is a reasonable possibility that the GITC deficiency will lead to a material misstatement.



How do we consider the automated controls that rely on the deficient GITC? [ISA | 7654.13353]

When we identify GITC deficiencies, we take into account what automated controls rely on the deficient GITC. This will allow us to identify:

- whether there are automated control deficiencies, and/or
- whether those deficiencies impact the integrity of any information we plan to use in the audit and/or any manual controls that use that information.

As GITCs support the operating effectiveness of automated controls, we identify the automated controls impacted by the GITC deficiency.

When there are no compensating GITCs, including ad hoc controls that address the same RAFIT as the deficient GITC or we have not gained evidence that the RAFIT has not affected the effective operation of the automated control by either testing the control throughout the period or performing additional procedures to gain such evidence then the automated controls are also deficient - see question '[What do we do when we identify a deficiency in a general IT control we intended to rely on?](#)' Each deficient automated control is then evaluated following the evaluation framework for control activities to determine severity.

The severity of a GITC deficiency is usually consistent with our evaluation of the severity of the associated automated control deficiencies (e.g. when we determine the associated automated control deficiency to be a significant deficiency, the GITC deficiency is likely also a significant deficiency).

Specific team members with expertise in IT can be helpful in our evaluation of GITC deficiencies and their effect on the automated controls they support.

[What other factors do we think about in evaluating whether there is a reasonable possibility that a GITC deficiency will lead to a misstatement?](#) [ISA | 7654.13354]

We think about the following additional factors to help evaluate whether there is a reasonable possibility that the GITC deficiency will lead to a material misstatement. We look to these factors, because purely quantitative methods are not necessarily helpful in evaluating deficiencies in GITCs in all circumstances.

Factor	Guidance and helpful questions to ask ourselves
Nature and significance of the deficiency	<p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>• What is the nature of the deficiency and how significant could it be?</li> <li>• For example, does the deficiency relate to a single area in the program change process or is the entire process inadequately controlled?</li> </ul>
Pervasiveness of the deficiency to automated controls and underlying data	<p>The more pervasive the GITC is, the more likely it is that the GITC deficiency will contribute to a misstatement in the financial statements that could be material.</p> <p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>• How many automated controls are linked to the GITC deficiency?</li> <li>• How many automated controls are deficient that are related to or caused by the GITC deficiency?</li> <li>• Does the GITC deficiency impact integrity of information we plan to use as part of our audit?</li> </ul>

The possible future consequences of the deficiency	<p>We do not only consider the severity of the current period deficiencies in the automated controls and controls related to integrity of information that are related to or caused by the GITC deficiency, but we also consider the automated controls linked to the GITC. We do this to determine the possible future implications of the GITC deficiency, including the possibility that the automated controls and controls related to the integrity of information linked to the GITC will not operate effectively as a result of the deficient GITC.</p> <p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>What would be the impact if all automated controls and controls related to the integrity of information we plan to use as part of our audit were affected by the GITC deficiency?</li> </ul>
Complexity	<p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>How complex are the entity's systems and how does the complexity affect the likelihood that the GITC deficiency could adversely affect automated controls?</li> </ul>
Proximity of the GITC to automated controls and data	<p>From the four IT layers - application, database, operating system and network- the application layer is the 'closest' in proximity to the automated controls and data. The network layer is the 'furthest' from the automated controls and data.</p> <p>Deficiencies in the operating system layer are less likely to have a direct impact on automated controls because there may be other compensating controls at the application and database layers. However, deficiencies in the application and database layers are more likely to have a direct impact on the automated controls, which will increase the likelihood that a material misstatement could occur.</p> <p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>How close is the deficient GITC to relevant automated controls and data?</li> </ul>
Susceptibility to loss or fraud	<p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>Does the GITC deficiency relate to automated controls or data associated with significant accounts or disclosures that are susceptible to loss or fraud?</li> </ul>

**What is the impact of GITC deficiencies on the financial statement audit?** [ISA | 7654.13355]

When we take a controls reliance approach that uses evidence from automated process control activities, automated controls depend on GITCs to address risks arising from IT (RAFITs). When a RAFIT is not addressed by an effective GITC, it may cause the automated process control activity

to be deficient, which can impact our control risk assessment and Combined Assessed Risk (CAR) assessment.

When deficient GITCs lead to unaddressed RAFITs, they may instead be addressed by additional evidence gathered by management or ourselves about whether IT systems and/or automated controls were actually compromised during the period of reliance (see activity '[In response to GITC deficiencies, perform procedures or conclude on related automated control\(s\) and/or reliability of information](#)' for further information).

When management performs additional procedures, it may represent a new 'ad hoc' GITC control that could serve as a compensating control to the original GITC deficiency. This could be relevant in assessing the severity of the original deficiency.

In contrast, when we independently perform additional procedures, they may address RAFITs and allow us to rely on automated controls. This can result in allowing us to continue to take a controls reliance approach for the financial statement audit, but it does not reduce the severity of a GITC control deficiency.

## 1.2.3 Evaluate the severity of CERAMIC control deficiencies [ISA | 7651]

### What do we do?

Evaluate the severity of CERAMIC control deficiencies.

### Why do we do this?

Once we identify control deficiencies related to CERAMIC, we evaluate each one to determine its severity. The severity of the deficiency will inform the types of communications that we will make to management and those charged with governance.

### Execute the audit

[Not Integrated Audit | How do we evaluate the severity of deficiencies in CERAMIC](#) [ISA | 7651.8588]

We evaluate the severity of deficiencies in CERAMIC by evaluating the likelihood and magnitude of the potential misstatement, like with any other deficiency. However, we usually cannot evaluate the magnitude of a potential misstatement directly, because deficiencies in CERAMIC usually do not prevent or detect assertion-level RMMs.

Purely quantitative methods to determine the magnitude of the potential misstatements are not necessarily helpful in evaluating deficiencies in CERAMIC because of their pervasiveness. As such, we evaluate likelihood and magnitude by thinking about other factors designed to determine whether there is a reasonable possibility (likelihood) that the deficiency would contribute to circumstances that could result in a misstatement and, if so, the magnitude of the potential misstatement (magnitude).

Factor	Guidance and helpful questions to ask ourselves
--------	---

Pervasiveness of the deficiency across the entity	<p>The more pervasive the CERAMIC control deficiency, the more likely it is that the deficiency will contribute to a misstatement in the financial statements that could be material.</p> <p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>How pervasive is the deficiency across the entity?</li> </ul>
Relative significance	<p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>What is the nature of the deficiency and how significant it is?</li> <li>What is the relative significance of the principle/element to the internal control component? Why is addressing the principle/element important to the entity's ICFR?</li> </ul>
Specific control activities affected	<p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>Are there specific control activities affected by the deficiency in CERAMIC?</li> <li>How many control activities are affected by the deficiency in CERAMIC?</li> </ul>
Severity of control activity deficiencies affected by the CERAMIC control deficiency in aggregate	<p>If there are specific control activities affected by the deficiency in CERAMIC, we evaluate the reasonable possibility that those control activities will fail to prevent or detect a misstatement of an account balance or disclosure and, if so, the magnitude of potential misstatement (i.e. the likelihood and magnitude of the potential misstatements).</p> <p>Depending on the pervasiveness of the CERAMIC control deficiency, a quantitative analysis may not be possible.</p>
Possible future consequences of the deficiency	<p>We do not only consider the severity of the current period deficiencies in the control activities affected by the CERAMIC control, but we also consider all control activities affected by the deficiency in CERAMIC. We do this to determine the possible future implications of the control deficiency, including the possibility that all the control activities affected by the deficiency in CERAMIC will not operate effectively as a result of the CERAMIC control.</p> <p>We might ask ourselves:</p> <ul style="list-style-type: none"> <li>What would be the impact if all control activities affected by the CERAMIC deficiency fail?</li> </ul>
Susceptibility to loss or fraud (including	<p>We might ask ourselves:</p>

the susceptibility to management override of controls)	<ul style="list-style-type: none"> <li>Does the deficiency in the CERAMIC control impact control activities associated with significant accounts or disclosures that are susceptible to loss or fraud?</li> </ul>
--	---

**Not Integrated Audit | Can compensating controls mitigate a CERAMIC deficiency?** [ISA | 7651.8589]

No. Because we identify a CERAMIC deficiency when:

- there are unaddressed principles/elements or
- the entity's set of controls, processes and structures do not appropriately address the principle/element considering the nature and complexity of the entity,

we have already understood any controls that may act as compensating controls as part of our understanding of the entity's set of controls, processes and structures that address the principle/element for which a deficiency was identified.

## Examples

**Not Integrated Audit | What are examples of CERAMIC control deficiencies?** [ISA | 7651.13310]

These scenarios illustrate our consideration of the pervasiveness of CERAMIC control deficiencies and whether there is a reasonable possibility that the entity's control activities will fail to prevent or detect a misstatement.

Fact pattern	Analysis
We identified a deficiency in the control environment component (the organization demonstrates a commitment to integrity and ethical values) that management does not have a process in place to identify, report, and address violations of the entity's code of conduct. This is important to ICFR because without a process in place, personnel do not have an incentive to act ethically while performing their duties.	Because of the pervasive nature of this deficiency across the entire entity, we may conclude this CERAMIC control deficiency is a significant deficiency.
We identified a deficiency in the control environment component (the organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives) related to the entity not having a standard pre-screening process in place to assess the competence of potential new hire candidates. During the year, the entity hired a new controller.	The potential effect of this deficiency is pervasive because the controller has oversight and influence over many control activities. Therefore, we may conclude this CERAMIC control deficiency to be a significant deficiency.

Assume the same information as the scenario above, except that there was an interview of the new controller by the CFO where they:

- reviewed resumes to determine the candidate's background is consistent with the job description
- assessed competence through questions targeted to the candidate's experience
- confirmed references before approving the hire.

In this scenario, the CFO's interview may reduce the severity of the control deficiency created by the lack of a standard pre-screening process performed on candidates.

## 1.3 Evaluate the severity of similar deficiencies in aggregate [ISA | 1419]

### What do we do?

Evaluate the severity of similar control deficiencies in aggregate by considering the magnitude and likelihood of the potential misstatement, including compensating controls.

### Why do we do this?

Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements. A deficiency in internal control on its own may not be sufficiently important to increase the level of severity. However, a combination of deficiencies may provide a different outcome. It is important we perform an appropriate evaluation of deficiencies in the aggregate as this may impact our communications and reporting.

## Execute the Audit

[How do we evaluate the severity of similar deficiencies in aggregate to determine whether there is a significant deficiency?](#) [ISA | 1419.13220]

We evaluate the severity of similar deficiencies in aggregate by looking for commonalities among deficiencies. We specifically determine whether there are deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR. However, there may be other relevant commonalities, such as whether there are deficiencies that relate to the same locations or people involved in the operation of the control.

As part of this process we may also take into consideration whether we tested compensating controls to assess control risk and whether they operate at a level of precision that would prevent or detect a misstatement that could be material.

However, our ability to effectively aggregate is be influenced by how good our understanding of what caused the deficiencies and how well we can step back and analyze the "big picture" of all related deficiencies.

For example, in reviewing the total listing of individual deficiencies, we grouped all of the revenue deficiencies and noted that

- they all related to the same significant class of transaction;
- they all related to the same assertion (existence);
- they all related to the same individual at the organization;
- they all related to period end cut-off, which also was an identified fraud risk;
- the totality of the known misstatements was greater than performance materiality; and
- no compensating controls existed at the entity.

It would be hard to overcome that these would collectively represent a significant deficiency at a minimum.

[What if we evaluated only the design and implementation of the original deficient control?](#) [ISA | 1419.6324]

If we only evaluated the design and implementation of the original deficient control, to mitigate a significant deficiency we may only evaluate the design and implementation of the compensating control(s).

[What if we evaluated the design and implementation as well as the operating effectiveness of the original deficient control?](#) [ISA | 1419.6325]

If we evaluated the design and implementation and tested the operating effectiveness of the original deficient control, to mitigate a significant deficiency we also evaluate the design and implementation and test the operating effectiveness of the compensating control(s).

## Examples

[How do we evaluate the severity of the deficiencies in aggregate?](#) [ISA | 1419.1900]

### Fact pattern

After understanding what caused the control deficiencies we identify three control deficiencies with the potential to impact the income tax account. None of the deficiencies were, individually, considered a significant deficiency.

### Analysis

The aggregate magnitude of the potential misstatements of the three income tax control deficiencies is evaluated. Each one was determined to be approximately half of what we would consider to be a material error. None of the control deficiencies would qualify to offset the others-in other words, all three deficiencies could all happen in the same quarter, and all could be a debit or a credit to the income tax account. When the three control deficiencies are aggregated, the potential magnitude exceeds materiality, and therefore, a significant deficiency exists when evaluating the three individual deficiencies in the aggregate.

# Communication of Deficiencies in Internal Control

## International Standards on Auditing: ISA 265.09-11



9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A27)

10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)

(a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20-A21)

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A22-A26)

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

(a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)

(i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

(ii) The audit included consideration of internal control relevant to the 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 internal control; and

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

## ISA Application and Other Explanatory Material: ISA 265.A12-A30

### Communication of Deficiencies in Internal Control

#### *Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)*

A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. ISA 260 (Revised) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.<sup>6</sup>

---

<sup>6</sup> ISA 260 (Revised), paragraph 13

A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, 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<sup>7</sup> for the auditor to complete the assembly of the final audit file on a timely basis. ISA 230 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.<sup>8</sup>

---

<sup>7</sup> ISA 230, *Audit Documentation*, paragraph 14

<sup>8</sup> ISA 230, paragraph A21

A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to 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, as this ISA requires.

A15. The level of detail at which to communicate significant deficiencies 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 of the entity. For example, the communication required for a public interest entity may be different from that for a non-public interest entity.
- The size and complexity of the entity. For example, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies that the auditor has identified.
- The entity's governance composition. For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.
- Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

A16. Management and those charged with governance may already be aware of significant 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 and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management

or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

### *Considerations Specific to Smaller Entities*

A18. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.

### *Communication of Deficiencies in Internal Control to Management (Ref: Para. 10)*

A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

### *Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))*

A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

A21. ISA 250 (Revised) establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance.<sup>9</sup> ISA 240 establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.<sup>10</sup>

---

<sup>9</sup> ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraphs 22 - 28

<sup>10</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 41

### *Communication of Other Deficiencies in Internal Control to Management (Ref: Para. 10(b))*

A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

A23. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other

deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as the internal audit function or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.

A25. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. In either case, the auditor may report orally or in writing to those charged with governance as appropriate.

A26. ISA 260 (Revised) establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.<sup>11</sup>

---

<sup>11</sup> ISA 260 (Revised), paragraph 13

### *Considerations Specific to Public Sector Entities (Ref: Para. 9-10)*

A27. 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. Law, regulation or other authority 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, for example, controls related to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

### *Content of Written Communication of Significant Deficiencies in Internal Control (Ref: Para. 11)*

A28. In explaining the potential effects of the significant deficiencies, the auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

A29. 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 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 those charged with governance, and that it may not be suitable for other purposes.

A30. Law or regulation 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.

## How do we comply with the Standards? [ISA | KAEGHDWC]

### 1 Communicate control deficiencies [ISA | 4136]

#### What do we do?

Communicate control deficiencies to management and those charged with governance.

#### Why do we do this?

The communications with those charged with governance and management are an integral part of every audit. We perform these communications because they foster improved financial reporting, which benefits stakeholders.

### Execute the Audit

**What are the reasons the communications of control deficiencies matter?** [ISA | 4136.1300]

There are several reasons for which our communications matter:

- Communicating control deficiencies to those charged with governance assists them in fulfilling their oversight responsibilities.
- Our communications with management recognize management's responsibility for the preparation and fair presentation of the financial statements, and for the design, implementation and operating effectiveness of internal controls.
- Our communications make management and those charged with governance aware of the entity's control deficiencies, which gives them a better chance to correct them. Improved financial reporting benefits stakeholders.
- Communications with management and those charged with governance give them the opportunity to explain why the deficiencies occurred so that we are able to obtain additional information and enhance our understanding of the deficiencies and their potential impact on the audit. The audit benefits from robust two-way communications with management and those charged with governance.

**Who are those charged with governance?** [ISA | 4136.1400]

Those charged with governance are the person(s) or organization(s) - e.g. a corporate trustee - with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes oversight of the entity's internal control related to the achievement of the entity's objectives, including reliability of financial reporting, effectiveness and efficacy of operations and compliance with applicable laws and regulations.

Those charged with governance may include management personnel - e.g. executive members of a governance board or an owner-manager.

#### What steps do we take when communicating control deficiencies to management and those charged with governance? [ISA | 4136.1500]

When communicating control deficiencies to management and those charged with governance, we take the following steps:

- [Determine what control deficiencies to communicate to whom](#)
- [Determine when to communicate control deficiencies](#)
- [Determine form of communications about control deficiencies](#)

## 1.1 Determine what control deficiencies to communicate to whom [ISA | 4137]

### What do we do?

Communicate significant deficiencies to management and those charged with governance, and control deficiencies to management.

### Why do we do this?

Different parties within the entity may be more appropriately placed to respond to the control deficiencies. The severity of the deficiency therefore determines the party to which we communicate it.

## Execute the Audit

#### To whom do we communicate each type of control deficiency? [ISA | 4137.1300]

Our conclusion on the severity of the control deficiencies determines to whom we communicate them. The table below shows to whom we communicate control deficiencies depending on their severity.

Severity of deficiencies	Communications to	
	Those charged with governance	Management
Significant deficiencies	X	X

<b>Other control deficiencies that merit management's attention</b>		X
---	--	---

[How do we determine whether a control deficiency merits management's attention?](#) [ISA | 4137.11049]

To determine whether a control deficiency merits management's attention we think about the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

[Do we communicate other control deficiencies to management if others have already communicated those deficiencies?](#) [ISA | 4137.11050]

Not necessarily. It is good practice to communicate all deficiencies that we are aware of to management. However, it is not necessary to communicate deficiencies of a lesser magnitude than a significant deficiency if those have already been communicated to management by internal auditors or others within the entity.

[Can we communicate other control deficiencies to those charged with governance?](#) [ISA | 4137.11051]

Yes. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control we have communicated to management, or be briefly informed of the nature of the other deficiencies.

Alternatively, we may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management.

[What are examples of control deficiencies related to accounting estimates?](#) [ISA | 4137.11052]

Examples of control deficiencies related to accounting estimates include those related to controls over:

- the selection and application of significant accounting policies or principles, and the selection and application of methods, assumptions and data;
- risk management and related systems;
- data integrity, including when data is obtained from an external information source; and
- the use, development and validation of models, including models obtained from an external provider, and any adjustments that may be required.

[Do we communicate control deficiencies that we identified during the audit and that management have already remediated?](#) [ISA | 4137.1400]

Yes. We communicate deficiencies that we identified during the audit regardless of whether they have been remediated.

[Do we communicate control deficiencies that management and those charged with governance do not intend to remediate?](#) [ISA | 4137.1500]

Yes. For control deficiencies identified in the current year audit, management and those charged with governance may have chosen not to remediate them because of cost or other considerations.

Nevertheless, we communicate control deficiencies identified in the current year audit regardless of management's and those charged with governance's intent with respect to the deficiencies.

For deficiencies identified in the prior year audit that management and those charged with governance chose not to remediate, we may choose to not repeat the communication of those control deficiencies in the current period. It may, however, be appropriate for us to re-communicate these if there has been a change in management, or if new information has come to our attention that alters our prior understanding or assessment of the deficiencies.

**Group Audit | What do we consider when determining what control deficiencies to communicate to group management and those charged with governance of the group in a group audit?** [ISA | 4137.1600]

As the group auditor, in making the determination of what control deficiencies to communicate to group management and those charged with governance of the group, we consider:

- deficiencies identified by the group auditor at both the group level and component level; and
- deficiencies at the component level identified by component auditors and communicated to the group auditor in connection with the audit procedures performed.

**Component Audit | When may it be appropriate for us, as the component auditor, to discuss identified control deficiencies with management of the entity or business unit?** [ISA | 4137.159629]

When we, as the component auditor, identify a deficiency in internal control, it may be appropriate for us to discuss the deficiency with component management to obtain information on:

- the cause of the deficiency,
- the factors to evaluate its severity and
- the effect of compensating controls, if any.

Obtaining this information may be helpful in assisting the group auditor to determine the severity of the deficiency in relation to the group audit.

**Component Audit | When may it be appropriate for us, as component auditors, to communicate identified control deficiencies to those charged with governance of the entity or business unit?** [ISA | 4137.159665]

Component auditors performing audit procedures at a component for the purpose of a group audit are not required to communicate control deficiencies identified as a result of performing such procedures with TCWG. However, component auditors may decide to make such communications when:

- they believe the deficiency may be a significant deficiency either to the component or the group,
- when the cause of the deficiency involves component management or
- when the component auditor concludes it would otherwise be helpful to inform those charged with governance of the deficiency.

**Can we communicate other internal control matters to management and those charged with governance?** [ISA | 4137.1700]

Yes. Nothing precludes us from communicating to those charged with governance or management other internal control matters that we have identified during the audit, even if they are not required to be communicated.



Examples of other internal control matters are those in which the controls and processes could be improved even if no deficiencies were identified.

**Do we repeat communications about significant deficiencies made in the prior period?** [ISA | 4137.10000]

It depends. If a previously communicated significant deficiency remains, we repeat the communications as part of the current-period audit.

For example, in a previous audit we communicated a significant deficiency to management and those charged with governance regarding the absence of controls over a significant risk related to revenue recognition. If in the current-period audit remedial action has not yet been taken and that significant deficiency remains, we repeat the prior period communication.

However, if the situation for which the significant deficiency relates no longer exists, we do not repeat the communication.

For example, in a previous audit we communicated a significant deficiency to management and those charged with governance regarding the absence of controls in a part of a business that was disposed of in the current period. As the entity no longer operates the business, we do not repeat the prior period communication.

**Why do we repeat the communications made in the prior period if the significant deficiency remains?** [ISA | 4137.159732]

We repeat the communications made in the prior period if the significant deficiency remains because the current-period communications:

- remind management and those charged with governance about the significant deficiency that was previously communicated but not remediated;
- give management the opportunity to explain why they did not remediate the significant deficiency; and
- assists those charged with governance in fulfilling their oversight responsibilities.

A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

**How do we perform the current-period communications?** [ISA | 4137.159733]

The current-period communications may repeat the description from the previous communication, or simply refer to the previous written communications and the date of those communications.

**Can we issue written communications stating that no significant deficiencies were noted during the audit of the financial statements?** [ISA | 4137.1900]

Yes, if not prohibited by law, regulation or member firm policy. If management or those charged with governance request written communication stating that no significant deficiencies were noted during the audit of the financial statements, we may communicate that no significant deficiencies came to our attention.

However, a written communication indicating that no significant deficiencies were identified during the audit does not provide any assurance about the effectiveness of an entity's internal control. Consequently, we include language in the written communication which enables those charged with governance and management to understand the context of the communication.

## 1.2 Determine when to communicate control deficiencies [ISA | 4138]

### What do we do?

Communicate control deficiencies in a timely manner.

### Why do we do this?

Timely and relevant communications may:

- permit management and those charged with governance to correct the deficiencies timely;
- permit us to obtain additional information about the deficiency from management and/or those charged with governance timely; and
- help us to meet client expectations.

## Execute the Audit

**When do we communicate control deficiencies?** [ISA | 4138.1300]

We make our communications of control deficiencies in a timely manner and can occur at any point during the audit depending on significance.

If we communicate the deficiencies at the end of the audit:

- for listed entities, we issue our written communication before the date of approval of the financial statements.
- for other entities, we may issue the written communication at a later date but no later than 60 days from the date of the auditor's report.

**What does "in a timely manner" mean?** [ISA | 4138.11059]

In a timely manner means that we act promptly, at the soonest appropriate time.

For example, if an engagement team identifies a significant deficiency, some considerations related to determining when an appropriate time to communicate this deficiency to those charged with governance include:

- How soon our next planned two-way communication with those charged with governance is planned;
- Whether timely remediation of the significant deficiency is necessary to enable us to place reliance on the control for our current year audit;
- Whether the significant deficiency relates to prevention or detection of fraud or non-compliance with laws and regulations, or whether failure to remedy on a timely basis could result in loss or fraud

## Why might we communicate deficiencies during the course of the audit rather than at the end of the audit? [ISA | 4138.1400]

Communicating the deficiencies to management and/or those charged with governance during the course of the audit rather than at the end of the engagement may enable them to take corrective action as soon as possible. At the end of the engagement, it may be too late.

Consider a situation in which a student is earning poor grades and may fail the class if his performance continues. The teacher may decide that communicating the student's performance to his parents sooner rather than later may be beneficial so that they are able to help their child to improve. Communicating the child's grades to the parents through the report card at the end of the school period may be too late to enable the parents to assist.

Timely communications also help to avoid surprises at period-end. Therefore, the more timely and professional our communications are, the better client relationships we will have.

## How do we determine whether to issue an interim communication? [ISA | 4138.1500]

We base the decision about whether to issue an interim communication on:

- Severity: the relative significance or severity of the matters noted; and
- Urgency for correction: the urgency with which management and/or those charged with governance may need to correct the deficiency.

We may also think of the following factors when we determine whether to issue an interim communication:

- Additional information: whether it is necessary to obtain additional information about the deficiency from management and/or those charged with governance;
- Management's awareness: whether management is already aware of the deficiency and has begun corrective action; and
- Oversight responsibilities: whether the communication will be an important factor in enabling those charged with governance to discharge their oversight responsibilities.

For example, if a significant deficiency calls into question the integrity or competence of management, or there is evidence of fraud or intentional non-compliance with laws and regulations by management, we may:

- decide to communicate in writing with those charged with governance first and
- work with them to determine the timing of communication to management, based on those charged with governance's response and planned actions.

## If we communicate matters at an interim date, do we repeat the communications at the end of the audit?

[ISA | 4138.1600]

Not necessarily. If we communicate control deficiencies during the course of the audit, a communication compiling or summarizing all prior communications of deficiencies at the end of the audit is not necessary. However, we may nevertheless consider it appropriate to provide management and/or those charged with governance with a complete list of control deficiencies, especially if they request us to.

## 1.3 Determine form of communications about control deficiencies [ISA | 4139]

### What do we do?

Determine the form of the communications and, if applicable, prepare the written communications.

### Why do we do this?

Communicating in writing underscores the importance of our communications of control deficiencies.

### Execute the Audit

**What form do our communications of control deficiencies take?** [ISA | 4139.1300]

The form of the communications depends on the severity of the deficiency.

	Form of communication
<b>Significant deficiencies</b>	In writing
<b>Control deficiencies</b>	In writing or orally

Even if the control deficiencies are communicated orally, we document the nature and extent of our conversations in our audit documentation.

We may communicate the significant deficiencies orally in the first instance to assist management and/or those charged with governance in taking timely remedial action. Doing so, however, does not relieve us of the responsibility to communicate the significant deficiencies in writing, even if the entity remediated those deficiencies during the audit.

Although we communicate significant deficiencies in writing and we may communicate control deficiencies in writing as well, having a dialogue with those charged with governance is also a key factor in effective two-way communications.

**What minimum elements do we include in our written communications of significant deficiencies?** [ISA | 4139.1400]

Our written communications of significant deficiencies include:

- a description of the deficiencies and an explanation of their potential effects; and
- a statement explaining that:
  - (i) the purpose of the audit was for us to express an opinion on the financial statements;
  - (ii) the audit included consideration of internal control relevant to the 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 internal control; and

- (iii) the matters being reported are limited to those deficiencies that we have identified during the audit and that we have concluded are of sufficient importance to merit being reported to those charged with governance.

**How do we explain the potential effects of the control deficiencies?** [ISA | 4139.11073]

The potential effects of control deficiencies may be evident from the description of the deficiencies. If that is not the case, we may describe the potential effects in terms of the:

- control objectives and types of errors the control was designed to prevent, or detect and correct; or
- risks of misstatement that the control was designed to address.

In any case, it is not necessary to quantify the potential effects.

**What other elements might we include in our written communication of control deficiencies?** [ISA | 4139.1500]

We may also include:

- a statement that if we had performed more extensive procedures on internal control, we might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported;
- a statement that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes;
- suggestions for remedial action on the deficiencies;
- If management's response is included in a document containing our written communications, a statement as to whether or not we have undertaken any steps to determine whether management's responses have been implemented.

Law or regulation may require us or management to furnish a copy of our written communication on significant deficiencies to appropriate regulatory authorities. When this is the case, our written communication may also identify such regulatory authorities.

**Can management include a written response in a document containing our written communications?**

[ISA | 4139.11074]

Yes. Management may wish to, or may be required by a regulator to, prepare a written response to our communication about control deficiencies identified during the audit.

This response may include:

- a description of corrective actions that the entity took;
- the entity's plans to implement new controls; or
- a statement indicating that management believes the cost of correcting a control deficiency would exceed the benefits.

**Can employed KPMG specialists and/or specific team members be involved in preparing written communications of control deficiencies?** [ISA | 4139.1600]

Yes. When we identify deficiencies in internal control that arise from the work performed by employed KPMG specialists and/or specific team members, we may involve that person in preparing or reviewing the content of the communications to management and/or those charged with governance.

For example, specific team members with expertise in IT may be actively involved in the communications about control deficiencies that relate to information technology.

## Copyright

This document includes extracts from materials owned and published by the International Federation of Accountants (IFAC) in 2023, and is used with permission of IFAC.

International Standards on Auditing and their respective logos are trademarks or registered trademarks of the International Federation of Accountants (IFAC).