



Committee: IAASB Consultative Advisory Group

Meeting Location: Toronto

Meeting Date: September 11-12, 2006

Material Weaknesses in Internal Control

Objectives of Agenda Item

1. To discuss significant issues to be addressed in the development of enhanced guidance on material weaknesses in internal control, and the comments thereon provided by the IAASB in July; and to obtain the views of the Representatives.

Background

2. The impetus for this project was the need to clarify the meaning of the term “material weakness in internal control” in relation to financial reporting (“material weakness”). The IAASB had acknowledged that the existing definition within the ISAs¹ is rather general and unhelpful, and thus agreed that it would be appropriate to develop guidance to better explain the meaning of the term. The project proposal emphasized that the project would not seek to extend the auditor’s responsibilities beyond those currently set out in the ISAs, and would seek to avoid unnecessary complexity given that ISAs apply to audits of both public interest and non-public interest entities.
3. The task force presented an issues paper at the July IAASB meeting that contained the following main proposals:
 - Guidance should be provided on factors or circumstances the auditor may consider in identifying material weaknesses
 - A number of elements should be considered in developing an enhanced definition of “material weakness,” including the magnitude of the potential misstatement of the financial statements which could arise from the material weakness; the likelihood or risk of material misstatement; and whether individual control deficiencies should be considered in combination to determine whether they give rise to a material weakness.
 - The auditor should be permitted, but not required, to report to those charged with governance other control issues (designated by the task force as “significant deficiencies”) that are more than simply trivial issues but do not constitute material weaknesses, if the auditor judges it appropriate to do so in the circumstances.

¹ The term “material weakness” is currently defined in the ISAs as follows:

“A material weakness in internal control is one that could have a material effect on the financial statements.”

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4. In presenting the issues, the task force highlighted the different responsibilities of the auditor with regard to material weaknesses in an audit of financial statements conducted in accordance with ISAs (an “ISA audit”) compared with an audit of internal control over financial reporting conducted in conjunction with an audit of financial statements pursuant to the standards of the U.S. PCAOB (an “integrated audit”). Specifically, the task force noted that in an ISA audit, the auditor is only required to communicate material weaknesses *that have come to the auditor’s attention*. The ISAs do not explicitly require the auditor to actively search for material weaknesses. The auditor’s responsibility under the ISAs is therefore of a passive nature. By contrast, in an integrated audit, the auditor is required to audit the entity’s internal control over financial reporting to provide an opinion on its effectiveness. This places an active responsibility on the auditor to plan and perform specific audit procedures to obtain reasonable assurance that no material weaknesses exist in the entity’s internal control.
5. A further difference is that in an ISA audit, the auditor is only required to report material weaknesses privately to management and those charged with governance, whereas in an integrated audit, the auditor is required to disclose identified material weaknesses in a public report to shareholders and regulators. The different contexts in which the auditor reports material weaknesses under these two types of audits influence the scope of, and degree of detail in, the work the auditor performs on internal control.

Overall Comments

6. The IAASB generally agreed that it would be helpful to develop enhanced guidance on factors the auditor may consider in identifying material weaknesses. It noted that a discussion of factors to consider could be related more broadly to such aspects as an ineffective control environment, an inadequate risk assessment process within the entity, and errors in the preparation of the financial statements more generally, rather than being limited to consideration of actual misstatements identified by the auditor.
7. There were mixed views as to whether a material weakness should be defined in terms of the likelihood of a material misstatement occurring or the risk of a material misstatement not being reduced to an acceptably low level, although the IAASB acknowledged that both approaches would probably lead to the same result. Some members cautioned against trying to define material weaknesses precisely because of the significant amount of judgment the auditor needs to apply in concluding whether a control issue should be classified as a material weakness.
8. The task force would welcome the Representatives’ views on the following two significant issues that arose from the IAASB discussions.

Significant Issues

ISSUE 1: LEVEL AT WHICH CONTROL DEFICIENCIES SHOULD BE REPORTED

9. The task force noted that in their varying definitions or approaches to describing a material weakness, national auditing standard setters generally acknowledge the need for the auditor to evaluate the magnitude of the potential financial effects of a control

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deficiency in determining its severity. They also agree in principle that a material weakness is one that could result in a material misstatement of the financial statements. Accordingly, the task force proposed that a material weakness should continue to be defined in terms of the *potential material misstatement* of the financial statements.

10. Material weaknesses, however, form only a subset of control deficiencies that might broadly exist at any given time within the entity. While the ISAs require the auditor to always communicate material weaknesses, the task force recognized that a further, broader subset could exist comprising *significant* control deficiencies that are not material weaknesses. These deficiencies would be sufficiently significant that the auditor might wish to report them to management and those charged with governance; however, the magnitude of their potential effects would not qualify them as material weaknesses that should always be communicated.
11. The task force proposed that the determination of whether control deficiencies (individually or in combination) are significant deficiencies but not material weaknesses should be a matter of the auditor's judgment. In addition, the task force's view was that ISAs should not go so far as to formally establish significant deficiencies as a separate category of control deficiencies, as doing so would necessitate a definition of this category, complete with thresholds. Given the auditor's limited responsibilities towards material weaknesses in an ISA audit, the task force felt that a precise definition of significant deficiencies would be inappropriate as it could result in the development of a complex framework. Accordingly, the task force proposed that only general guidance should be provided to the effect that the auditor may judge some control deficiencies to be more significant than others but not so significant as to be deemed material weaknesses. In these circumstances, the auditor might judge it appropriate to also communicate those significant deficiencies to management and those charged with governance. The task force proposed that guidance on factors to consider in evaluating significance in this context could be provided.
12. During the discussion of this issue, the IAASB noted the experience of the AICPA's Auditing Standards Board (ASB) in implementing its standard on reporting material weaknesses.² Specifically, the ASB had in the past created a category of control deficiencies called "reportable conditions" that auditors were required to report at a lower threshold than material weaknesses. This was based on the research evidence that indicated that auditors were not reporting material weaknesses because these were considered extreme events. Reportable conditions then became significant deficiencies when the ASB recently revised its standard.
13. In view of this, the question arose within the IAASB as to whether there was a need to define material weaknesses. It was noted that since ISAs do not establish an external reporting requirement for material weaknesses, the IAASB could consider avoiding

² AU 325, "Communication of Internal Control Related Matters Noted in an Audit" (prior to its recent revision to adopt certain terms used in the PCAOB's Auditing Standard 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements).

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defining the term “material weakness” and, instead, consider defining the point at which there is an internal requirement to communicate reportable conditions to management and those charged with governance. The expectation would then be that auditors would communicate control issues at a level somewhat lower than material weaknesses, leaving the latter to be reported only where a public reporting requirement exists.

14. One argument in favor of this approach was that it would not be in the public interest for the ISAs to require the reporting of only those weaknesses at the very serious level that would be reported externally were there to be a public reporting standard. It was noted that for internal reporting purposes, the more important consideration would be to ensure that the matter gets reported to the responsible parties rather than on which side of the line it falls. Further, it was argued that in practice, because material weakness reports (or “management letters”) are private and not public reports under the ISAs, auditors have tended to report more rather than less, without unduly debating the classification issue. It would therefore appear undesirable if such practice were discontinued because the matters on which auditors have been reporting in the past would no longer meet the higher threshold of a revised definition of material weakness.
15. The IAASB acknowledged that changing the reporting level would be viewed as a change in the scope of this project. Also, it was noted that if the term “material weakness” were no longer to be defined and used in the ISAs, regulators and others around the world would step in and create varying definitions of that term for their own purposes, which would not be in the public interest.
16. Accordingly, the IAASB was generally in favor of lowering the reporting threshold to ensure that reportable conditions that come to the auditor’s attention get communicated to management and those charged with governance. It also agreed that material weaknesses should be treated as a subset of reportable conditions and should be defined to ensure consistency of practice. However, it was of the view that the communication of material weaknesses should be left to the auditor’s judgment.
17. In light of these discussions, the task force concluded that the original proposal of not precluding the auditor from reporting significant deficiencies would not be sufficiently strong and, accordingly, a requirement should be imposed. The task force therefore believes that the ISAs should establish a clear obligation on the auditor to communicate matters in the nature of reportable conditions that have come to the auditor’s attention. This would enable the auditor to report more than just serious control issues, and would be seen as adding greater value from a client-service perspective.
18. The task force is further of the view that, for the purposes of issuing a private report to management and those charged with governance under an ISA audit, the auditor *may* separately identify reportable conditions that are material weaknesses but only where the potential effects of such matters are clearly material. While this would still be a matter of judgment, the auditor would be able to flag these as material weaknesses without necessarily extending the scope of the auditor’s work. However, in borderline cases where there is uncertainty regarding whether a reportable condition is in fact a material

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weakness, the auditor would simply report the matter under the reportable condition rubric and not identify it as a material weakness. This retains a light-touch approach to the reporting of material weaknesses and avoids the potential complication and additional work involved in evaluating each and every reportable condition to determine whether it should be classified as a material weakness. This approach would also retain the term “material weakness” (suitably defined) in the ISAs, allowing the auditor to meet the reporting needs of both public interest and non-public interest entities.

Matter for Consideration by the IAASB CAG

1. The Representatives are asked for their views on the task force’s recommended approach to communicating matters in the nature of reportable conditions and material weaknesses, in light of the IAASB discussions.

ISSUE 2: WHICH TERMS SHOULD BE USED TO DESCRIBE MATTERS TO BE REPORTED AND HOW SHOULD THEY BE DEFINED?

19. The IAASB was generally of the view that terms that are commonly used by national auditing standard setters should be used if the same meanings are intended, unless there are reasons for ascribing different meanings to these terms.
20. The task force’s view is that three distinct terms would need to be defined for the purposes of this project:
 - a) A generic control issue;
 - b) A significant control issue that is in the nature of a reportable condition; and
 - c) A material weakness
21. In relation to a generic control issue, the task force believes that the term “control deficiency” should be established and defined in the ISAs to indicate a generic control issue, the nature and significance of which the auditor should evaluate to determine whether it should be reported. A number of national auditing standard setters have defined a “control deficiency” in terms of a deficiency in the design or effective operation of a control the effect of which is to cause the control not to achieve its objective relating to the prevention or detection of material misstatements in the financial statements. The task force therefore proposes to define “control deficiency” along these lines.
22. With regard to matters that are in the nature of reportable conditions, the task force is of the view that the term “significant deficiency” should not be used to describe such matters. This is primarily because this term has been defined precisely³ in the PCAOB’s Auditing

³ A “significant deficiency” is defined in the PCAOB’s Auditing Standard 2 as “a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be prevented or detected.”

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Standard 2 for the purposes of an audit of internal control over financial reporting. The task force believes that for the purposes of the ISAs, a looser definition would be more appropriate to reflect to a greater degree the role of professional judgment in the auditor's evaluation of such matters. Further, some issues would arise on translation because in some languages, it would seem difficult to differentiate between the terms "significant deficiency" and "material weakness." Accordingly, the task force proposes to use a term such as "reportable deficiency" or "reportable weakness" to describe control issues that the auditor would be required to report if the auditor judges them to be at the appropriate level of significance.

23. In relation to defining a "reportable deficiency" or a "reportable weakness," the task force is of the view that the definition should reflect the fact that the evaluation of whether a control issue is a reportable condition is largely a matter of professional judgment, depending on such considerations as the nature of the issue, the complexity of the entity, and the items in the financial statements that could be adversely affected. Further, the identification of such control issues for reporting purposes is inherently judgmental given that the auditor is not setting out to obtain a high level of assurance to form an opinion on internal control. Consequently, the task force proposes that the relevant threshold should be loosely defined in terms of an evaluation of whether the control deficiency is significant, but not trivial, in the circumstances. This would be consistent with the IAASB's views that the definition should not incorporate precise criteria to avoid creating an unduly complicated framework for analyzing and categorizing reportable conditions.
24. With regard to the term "material weakness," which the IAASB agreed should be retained in the ISAs and defined, the task force's view is that the meaning of this term in the ISAs differs from that in the PCAOB's Auditing Standard 2. This is because under the ISAs, material weaknesses are only those matters that come to the auditor's notice during an audit of the financial statements, whereas in an integrated audit under PCAOB standards, material weaknesses arise as a result of specific procedures the auditor performs to identify them. Accordingly, although the task force believes that the term "material weakness" should be defined in terms of the potential for material misstatement of the financial statements, the task force's view is that the ISAs should define the term differently from the PCAOB's term.⁴

Matter for Consideration by the IAASB CAG

2. The Representatives are asked for their views on the appropriate terms to use to describe the

As part of a four-point plan to improve auditors' implementation of the internal control reporting provisions of the Sarbanes-Oxley Act of 2002, the PCAOB announced on May 17, 2006 that it would revise Auditing Standard 2 to clarify the definitions of "significant deficiency" and "material weakness."

⁴ The PCAOB's Auditing Standard 2 defines a "material weakness" as "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."

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different reporting thresholds and how these terms should be defined.
