

IAASB CAG REFERENCE PAPER
IAASB CAG Agenda (April 2007)
Agenda Item H.1
Material Weaknesses in Internal Control – Proposed ISA – April 2007 IAASB Agenda Item 2-A

PROPOSED INTERNATIONAL STANDARD ON AUDITING XXX

CONTROL DEFICIENCIES NOTED IN AN AUDIT

(Effective for audits of financial statements for periods beginning on or after [date])

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Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate to management and those charged with governance deficiencies in internal control, other than those that are clearly trivial,¹ that have come to the auditor's attention during the audit of the financial statements. The requirements and guidance in this ISA relate to the financial reporting objective of internal control² only. Nothing in this ISA precludes the auditor from communicating to management and those charged with governance further control matters relating to the other objectives of internal control regarding effectiveness and efficiency of operations, and compliance with applicable laws and regulations (see [proposed] ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance").

Identifying Reportable Weaknesses under the ISAs

2. As set out in [proposed] ISA 200, ["Overall Objective of the Independent Auditor, and Concepts Relevant to an Audit of Financial Statements,"] the overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. During the audit, the auditor may become aware of deficiencies in the design or operation of controls relevant to financial reporting that the auditor judges to be of sufficient significance to merit the attention of management and those charged with governance. **ISSUE C]**
3. The auditor has no responsibility under the ISAs to plan and perform specific audit procedures to search for control deficiencies, nor to form an opinion on the effectiveness of internal control. To be able to conclude that the entity's internal control is effective, the auditor would need to perform procedures to obtain reasonable assurance that no material weaknesses exist in such internal control. The procedures that the auditor performs in relation to internal control in an audit conducted in accordance with ISAs are not intended to, and do not by themselves, provide sufficient appropriate audit evidence to enable the auditor to form an opinion on the effectiveness of internal control. Accordingly, the reportable weaknesses (including material

¹ As [proposed] ISA 450 (Redrafted), "Evaluation of Misstatements Identified during the Audit," explains, "clearly trivial" is not another expression for not material. Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality used in planning and performing the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are "clearly trivial," the matter is considered not "clearly trivial."

² ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment," defines the terms "internal control" and "controls," and provides further guidance on internal control relevant to the audit of the financial statements.

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weaknesses) that this ISA requires the auditor to communicate as part of the audit are only those that have come to the auditor's attention during the course of the audit. **[ISSUE C]**

Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after [date].³

Objectives

5. The objectives of the auditor are:
- (a) To evaluate control deficiencies that have come to the auditor's attention during the audit; and
 - (b) Based on that evaluation, to determine the appropriate communication to management and those charged with governance.

Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) "Control deficiency" – 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 misstatements in the financial statements on a timely basis;
 - (b) "Deficiency in design" – A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met;
 - (c) "Deficiency in operation" – A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively;
 - (d) "Material weakness" – A control deficiency, or combination of control deficiencies, that gives rise to a reasonable possibility that a material misstatement of the current financial statements being audited will not be prevented or detected. A material weakness is, by definition, also a reportable weakness; and **[ISSUE C]**
 - (e) "Reportable weakness" – A control deficiency, or combination of control deficiencies, that, in the auditor's professional judgment, is of sufficient importance to merit the attention of management and, where appropriate, those charged with governance. **[ISSUE B]**

³ This date will not be earlier than December 15, 2008.

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Requirements

Confirmation of the Auditor's Understanding of Identified Control Deficiencies

7. When the auditor becomes aware of any control deficiencies other than those that are clearly trivial during the audit, the auditor shall confirm with management or, where appropriate, those charged with governance on a timely basis the auditor's understanding of the deficiencies and their potential consequences. (Ref: Para. A1-A2)

Evaluation of Control Deficiencies Noted

8. The auditor shall evaluate the control deficiencies noted, either individually or, where appropriate, in combination. (Ref: Para. A3)
9. In evaluating a control deficiency or a combination of control deficiencies, the auditor shall evaluate:
 - (a) The likelihood that the deficiency or combination of deficiencies could give rise to a misstatement in the financial statements; and
 - (b) The materiality of such potential misstatement. (Ref: Para. A4-A7)
10. In evaluating the likelihood that a control deficiency or combination of control deficiencies could give rise to a misstatement of the financial statements, the auditor shall consider the mitigating effects of compensating controls that are operating effectively if the auditor has tested such controls as part of the financial statement audit. (Ref: Para. A8)
11. The auditor shall treat a control deficiency or combination of control deficiencies as a material weakness if, in the auditor's professional judgment, it is reasonably possible that the deficiency or combination of deficiencies could give rise to a misstatement that is material to the current financial statements being audited. (Ref: Para. A9-A12)

Communication of Control Deficiencies Noted During the Audit

12. The auditor shall communicate in writing and on a timely basis:
 - (a) Reportable weaknesses to management; and (Ref: Para. A13-A15, A17-A18)
 - (b) Material weaknesses to those charged with governance, unless all of those charged with governance are also involved in managing the entity and are aware of the matters already communicated by the auditor.⁴ (Ref: Para. A16-A17) **ISSUE A]**

⁴ In accordance with ISA 260 (Revised), "Communication with Those Charged with Governance," where all of those charged with governance are also involved in managing the entity, when matters are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

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13. If the auditor has communicated reportable weaknesses other than material weaknesses, or other control-related matters, to management but not to those charged with governance, the auditor shall:
 - (a) Notify those charged with governance in writing that the auditor has done so, indicating that these other reportable weaknesses or other control-related matters are not material weaknesses; and
 - (b) Inform those charged with governance of the general nature and significance of these other reportable weaknesses or other control-related matters. (Ref: Para. A19-A21) **ISSUE A]**
14. The auditor's written communication of reportable weaknesses to management and material weaknesses to those charged with governance shall include:
 - (a) Definitions of the terms "reportable weakness" and "material weakness," as appropriate;
 - (b) Statements to the effect that:
 - (i) The purpose of the audit was for the auditor to express an opinion on the financial statements and not to provide assurance on the operating effectiveness of internal control;
 - (ii) The auditor did not plan and perform the audit with a view to identifying all reportable weaknesses (including material weaknesses) that might exist; and
 - (iii) Had the auditor performed more extensive audit procedures on internal control, the auditor might have identified more reportable weaknesses, including material weaknesses, or concluded that some of the identified control deficiencies were, in fact, not reportable weaknesses; and
 - (c) A statement limiting the use and distribution of the communication to management, those charged with governance and, where appropriate, relevant other parties. (Ref: Para. A22-A23)

Application and Other Explanatory Material

Confirmation of the Auditor's Understanding of Identified Control Deficiencies (Ref: Para. 7)

- A1. This confirmation provides an opportunity for management or, where appropriate, those charged with governance to agree the relevant facts and circumstances of the auditor's findings, and for the auditor to alert them on a timely basis to the existence of control deficiencies of which it may not have been previously aware. Circumstances in which it may be appropriate for the auditor to obtain confirmation with those charged with governance include situations where the control deficiencies concern management directly, such as

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repeated difficulties in preparing adequate financial statements that raise questions regarding management's competence, or evidence of fraud on management's part. In confirming the relevant matters, the auditor may obtain other relevant information for further consideration, such as:

- The understanding of management or those charged with governance of the actual or suspected causes of the control deficiencies.
- Exceptions arising from the control deficiencies that management or those charged with governance may have noted during the period.
- The preliminary evaluation of management or those charged with governance of possible corrective action that they could take.
- The existence of compensating controls not previously known to the auditor that would prevent or detect misstatements not caught by the deficient controls.

A2. The existence of compensating controls of which the auditor was not previously aware does not eliminate the fact that the auditor has noted deficiencies in certain controls. Although the auditor is not required to test such controls, the auditor is not precluded from considering their existence and operation in determining whether to further evaluate the significance of the control deficiencies noted. However, the requirement in paragraph 12 to communicate reportable weaknesses (including material weaknesses) would apply if the auditor were to choose not to perform specific procedures to obtain evidence of the operating effectiveness of these compensating controls. In such a case, the auditor may acknowledge in the communication to management and those charged with governance the auditor's awareness of the compensating controls, and indicate that the auditor has not tested them.

Evaluation of Control Deficiencies Noted (Ref: Para. 8-11)

A3. As ISA 315 (Redrafted) indicates, controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, material misstatements. For example, controls in a subsystem of an IT system may consist of a combination of automated controls and manual controls designed to operate together to prevent, or detect and correct, misstatements in the relevant account balances that the subsystem supports. A control deficiency on its own may not, in the auditor's judgment, constitute a reportable weakness. However, the effect of combining a deficiency with other control deficiencies noted relating to the same financial statement assertion may significantly increase the likelihood of a misstatement that is other than clearly trivial occurring. Accordingly, this situation may give rise to a reportable weakness, including possibly a material weakness. Therefore, the evaluation of those control deficiencies that have come to the auditor's attention involves a consideration of the identified deficiencies individually and, where their potential effects can be linked to the same financial statement assertions, in combination.

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- A4. The significance of a control deficiency depends upon the potential for a misstatement to occur and not on whether a misstatement has actually occurred. Consequently, the fact that the auditor's procedures did not detect actual misstatements in the relevant financial statement assertions is not reason for the auditor to conclude that control deficiencies the auditor has noted during the audit are not reportable weaknesses.
- A5. Evaluating the likelihood that a control deficiency or combination of control deficiencies could give rise to a misstatement in the financial statements is a matter of professional judgment. It involves a consideration of the risks and uncertainties arising from the deficiencies to the extent that such deficiencies affect the particular underlying financial statement assertions. In this respect, there is a reasonable possibility of a misstatement occurring in the financial statements as a result of a control deficiency or combination of control deficiencies when there is a greater than acceptably low risk of the controls not preventing or detecting the misstatement on a timely basis. **[ISSUE C]**
- A6. Examples of factors that affect likelihood include:
- The nature of the financial statement accounts, disclosures and assertions (for example, related party disclosures ordinarily involve greater risk than other disclosures).
 - The susceptibility to loss or fraud of the related asset or liability.
 - The subjectivity and complexity of determining estimated amounts, such as those involving fair values.
 - The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
 - The relationship of the control with other controls, such as monitoring controls.
 - The interaction of the control deficiency with other control deficiencies.
- A7. Likewise, evaluating the materiality of a potential misstatement in the circumstances is a matter of professional judgment. Examples of factors that affect materiality include:
- The financial statement amounts exposed to the control deficiency.
 - The volume of activity in the account balance or class of transactions exposed to the control deficiency
 - The nature of the specific element, account, or item of the financial statements affected by the control deficiency.
- A8. If the auditor has tested the operating effectiveness of relevant compensating controls for the purpose of determining the nature, extent and timing of the auditor's procedures in the audit of the financial statements, it is appropriate for the auditor to consider the mitigating effects of such controls when evaluating the significance of control deficiencies noted. The auditor,

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however, has no responsibility to search for compensating controls and to test them to determine whether they effectively compensate for those control deficiencies.

- A9. A control deficiency, or combination of control deficiencies, that, in the auditor's professional judgment, is of sufficient importance to merit the attention of management and, where appropriate, those charged with governance is a reportable weakness and may also be a material weakness. The determination of whether a reportable weakness is a material weakness is made in the context of the current financial statements being audited because the evaluation of whether the potential misstatement could be material depends upon the materiality criteria established for the current period financial statements.
- A10. However, in evaluating whether a control deficiency or combination of control deficiencies is a reportable weakness, the auditor may consider whether the deficiencies could have effects that are other than clearly trivial on the financial statements in the future, in light of the auditor's understanding of the entity's current business and future prospects. For example, although a component of the entity may be immaterial in the current period, such a component may become significant if management has planned to inject material assets into it in the following period. It is therefore appropriate for the auditor to communicate a control deficiency or combination of control deficiencies affecting the component in the current period as a reportable weakness if the auditor believes such deficiencies would be of sufficient importance in the future to merit the attention of management and, where appropriate, those charged with governance. **ISSUE C]**
- A11. Deficiencies in the following areas are ordinarily at least reportable weaknesses:
- Controls over the selection and application of appropriate accounting policies where significant alternatives exist.
 - Controls over the prevention and detection of fraud.
 - Controls over significant transactions outside the normal course of business.
 - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- A12. Examples of strong indicators that material weaknesses may exist include:
- An ineffective control environment, such as an inadequately resourced IT function if the entity operates a large and complex business, or if management has little regard for establishing adequate internal control.
 - Ineffective oversight of the financial reporting process by those charged with governance, especially in an environment of limited segregation of duties.
 - Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.

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- Material misstatements detected by the auditor's procedures that were not identified by the entity's internal control.
- Identification of fraud involving management.

Communication of Control Deficiencies Noted During the Audit (Ref: Para. 12-14)

- A13. For the purposes of communicating reportable weaknesses, management are those individuals within the entity empowered to authorize and approve changes necessary to the design and operation of controls to correct the reported deficiencies. These individuals ordinarily include the entity's chief executive officer and chief financial officer (or equivalent). **[ISSUE A]**
- A14. The auditor may find it appropriate to also communicate control-related matters other than reportable weaknesses that do not give rise to potential misstatements in the financial statements if the auditor judges such matters to be of sufficient importance to merit the attention of management. For example, the auditor may become aware of such a matter if the entity's computerized sales system continues to use an old price list that has been superseded as of a certain cut-off date, resulting in the entity under-billing its customers for its products or services. **[ISSUE B]**
- A15. In some circumstances, the auditor may consider it appropriate to also communicate certain reportable weaknesses other than material weaknesses, as well as other control-related matters, to those charged with governance if the auditor believes these matters should be brought to their attention because of their particular significance to the entity or because of their particular relevance to the oversight responsibilities of those charged with governance. **[ISSUE A]**
- A16. As [proposed] ISA 260 (Redrafted) indicates, it may often be appropriate to communicate material weaknesses that have come to the auditor's attention as soon as practicable to those charged with governance if they are able to assist in the timely implementation of corrective action. Although such communication may be made orally during the audit, the requirement to communicate the material weaknesses in writing reflects the importance of the matters being communicated and assists those charged with governance in fulfilling their oversight responsibility for the financial statement preparation process.
- A17. Management may already be aware of the existence of reportable weaknesses that have come to the auditor's attention during the audit. Management may have intentionally chosen not to correct such reportable weaknesses, and to accept the reasonable possibility that these could lead to misstatements in the financial statements that are other than clearly trivial, because of cost or other considerations. It is management's, and not the auditor's, responsibility to evaluate the costs and benefits of correcting the reportable weaknesses the auditor has noted. Accordingly, the requirement for the auditor to communicate reportable weaknesses to management and material weaknesses to those charged with governance applies regardless of

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cost or other considerations that management and those charged with governance may consider relevant in determining whether such weaknesses should be corrected.

- A18. The fact that the auditor communicated a reportable weakness to management in the previous audit, or that management already knew about it through other means (such as from work done by internal audit), does not eliminate the need for the auditor to repeat the communication if management has not yet taken corrective action in the current period. If the auditor has previously communicated the matter to management, the current year communication may include the same description of the reportable weakness as the auditor previously communicated, or a specific reference to the previous communication. The auditor may inquire of management to understand why the reportable weakness has not yet been corrected. A lack of timely and appropriate action to correct reportable weaknesses, in the absence of rational explanations from management, may indicate a deficiency in the control environment and, in consequence, possibly the existence of a material weakness.
- A19. If the auditor expects to issue a written communication of material weaknesses to those charged with governance, the notification of the existence of other reportable weaknesses or other control-related matters communicated to management may be included in that communication to those charged with governance.
- A20. This notification alerts those charged with governance to the fact that the auditor has also noted reportable weaknesses and other control-related matters beyond material weaknesses during the audit. By informing those charged with governance of the general nature and significance of these other matters, the auditor is able to assist them in considering whether, in the context of their responsibilities for the oversight of the financial reporting process, they need to pursue these matters with management, including determining what action management proposes to take in response.
- A21. The auditor will be deemed to have complied with the requirement in paragraph 13 if the auditor considers it appropriate to communicate to those charged with governance the same reportable weaknesses (including material weaknesses) or other control-related matters that the auditor has communicated to management, and does so. This may be the case, for example:
- When the reportable weaknesses of which the auditor has become aware are relatively few and it would be efficient for the auditor to communicate them to management and those charged with governance at the same time.
 - When the reportable weaknesses affect relatively high level controls (such as regarding supervision or segregation of duties) and, although not necessarily all material weaknesses, are sufficiently significant to merit the attention of those charged with governance.

It may, however, be inappropriate for the auditor to communicate to those charged with governance an unduly voluminous list of reportable weaknesses or other control-related

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matters that are of lesser significance than material weaknesses, as this would detract from their consideration of the most serious control deficiencies.

- A22. Laws or regulations may establish requirements for the auditor or management to furnish a copy of the auditor's written communication of reportable weaknesses (including material weaknesses) to appropriate regulatory authorities. Where this is the case, the auditor's written communication may include a specific reference to such regulatory authorities.
- A23. The auditor may be expected, or may have agreed with the entity, to submit a written communication on material weaknesses to those charged with governance at the completion of each audit, regardless of whether the auditor has noted any material weaknesses. For example, the entity may operate in a regulated industry where the regulator requires the entity to submit a copy of the auditor's communication on material weaknesses to those charged with governance after each audit. In such a case, if the auditor has not become aware of any material weaknesses during the audit, it may be necessary for the auditor to provide a written communication to those charged with governance stating that no material weaknesses were identified during the audit. Because there is a risk that such type of communication could be misinterpreted as giving a degree of assurance on internal control, the auditor may consider it appropriate to include a disclaimer in the communication to the effect that the auditor has not performed procedures to obtain reasonable assurance, and is not providing any assurance, on the effectiveness of internal control.