

# IAASB CAG PAPER



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

## Agenda Item

# H

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** New York

**Meeting Date:** April 2-3, 2007

### Material Weaknesses in Internal Control

#### Objectives of Agenda Item

1. The objective of this agenda item is:
  - (a) To report the task force's responses in relation to significant comments received from Representatives at the September 2006 CAG meeting on the significant issues to be addressed in this project;
  - (b) To report on the discussion of these issues at the October 2006 IAASB meeting; and
  - (c) To obtain the Representatives' views on the task force's recommendations as reflected in the first draft of the proposed ISA XXX, "Control Deficiencies Noted in an Audit."
2. **Agenda Item H.1, the first draft of the proposed ISA, is provided as a CAG Reference Paper. It has not yet been reviewed and commented upon by the IAASB.**

#### Significant Issues

- A. CONTROL DEFICIENCIES TO BE REPORTED
3. At the July 2006 IAASB meeting, the IAASB had concluded that it would not be in the public interest for the ISAs to limit the requirement to communicate control matters the auditor has noted to the reporting of only the most serious ones (i.e. material weaknesses). The IAASB agreed that there should be two levels of control conditions that should be reportable, i.e. material weaknesses and other reportable conditions of lesser significance.
4. At the September 2006 CAG meeting, the CAG Working Group expressed support for having two levels of reportable conditions. The Working Group was, however, unclear as to whether the auditor should be required to report all identified reportable conditions or be allowed to use judgment to decide whether to communicate reportable conditions other than material weaknesses. A Representative felt that the auditor should be required to report material weaknesses and encouraged to report other deficiencies as well. Another Representative believed that the reporting of other identified reportable conditions should be left to the auditor's professional judgment.
5. The Working Group took the view that the auditor should report all identified reportable conditions to those charged with governance. This view was supported by two other Representatives who emphasized the importance of open and clear communication, and the need to report the matter to those charged with governance when in doubt about its

## IAASB CAG PAPER

### IAASB CAG Agenda (April 2007)

#### Agenda Item H

#### Material Weaknesses

significance. A Representative questioned whether this should be a two-step report, i.e. one to management and another one to those charged with governance, on the ground that it is important to distinguish between reporting to management and reporting to those charged with governance.

6. The IAASB debated this latter question at its October 2006 meeting. It was noted that those charged with governance would likely want some prioritization of the control issues reported by the auditor. It was suggested there would be benefit in distinguishing the reporting requirement so that material weaknesses would be reported to those charged with governance and reportable conditions more generally to management. It was generally agreed that those charged with governance should not be overwhelmed with large volumes of undifferentiated information. Some IAASB members noted that responsibilities and interests of those charged with governance vary. They argued that it is important that restrictions not be placed on auditors regarding what they may communicate in relation to identified control deficiencies. The IAASB asked the task force to consider the principle that the auditor should report control matters to those specific individuals within the entity who are empowered to deal with them.
7. In light of these comments from the CAG and the IAASB, the task force is proposing that the auditor should communicate:
  - (a) The most serious control issues noted, i.e. material weaknesses, to those charged with governance (**Refer Agenda Item H.1, paragraph 12(b)**); and
  - (b) A broader set of control issues noted (which the task force proposes to be called “reportable weaknesses”), to management (**Refer Agenda Item H.1, paragraph 12(a)**). (This broader set includes material weaknesses).
8. The communication of the broader set of control issues to management reflects the principle that such matters should be brought to the attention of those within the entity who are responsible for the day-to-day operations of the entity and who have the authority to take the action necessary to address the issues (**Refer Agenda Item H.1, paragraph A13**). The task force also agreed that the auditor should be permitted, but not required, to communicate some of the control matters in this broader set (other than material weaknesses), as well as other control-related matters, to those charged with governance if the auditor believes it would be appropriate to do so (**Refer Agenda Item H.1, paragraph A15**). This allows the auditor some flexibility to communicate certain control matters of lesser significance than material weaknesses to those charged with governance if the auditor believes such matters should also deserve their attention in the circumstances.
9. However, 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 task force agreed that the auditor should notify those charged with governance that the auditor has done so and inform them of the general nature and significance of these matters. This acknowledges the view expressed during the October 2006 IAASB discussions that those charged with governance may be interested in knowing

## IAASB CAG PAPER

### IAASB CAG Agenda (April 2007)

#### Agenda Item H

#### Material Weaknesses

the nature of the other matters the auditor has communicated to management but not necessarily all the details. Informing those charged with governance in this way gives them the opportunity to make inquiries of management into these matters if they consider it appropriate to do so **(Refer Agenda Item H.1, paragraph 13)**.

10. The task force proposes that the communication of reportable weaknesses to management and material weaknesses to those charged with governance should be made in writing to establish a record of the control matters that the auditor has reported to them. The task force believes that the requirement to communicate in writing appropriately reflects the importance of the matters communicated. In the task force's view, oral communication alone is insufficient and would not be in the public interest as the matters communicated may become lost with the passage of time. Nevertheless, the requirement to communicate in writing does not preclude the auditor from also communicating the relevant matters orally to management and those charged with governance at the appropriate time.
11. The task force noted that the IFAC SMP Committee had suggested the adoption of a differential approach to the reporting requirement whereby:
  - (a) For a public interest entity, the auditor should report all "control weaknesses" that have come to the auditor's attention (other than those that are clearly trivial); and
  - (b) For other entities, the auditor should use judgment to determine what to report beyond material weaknesses.
12. The task force did not agree with this suggestion because it believes significant control issues, including material weaknesses, should be reported for non-public interest entities just as for public interest entities. Not having a requirement to communicate such matters in the case of the former will likely lead to inconsistent reporting around the world and would not be in the public interest.

#### Matters for CAG's Consideration

- Q1. Do Representatives agree with the task force's proposal to differentiate the communication requirement, i.e. material weaknesses to those charged with governance and reportable weaknesses to management?
- Q2. Do Representatives agree with the task force's proposal to allow the auditor the flexibility to also communicate certain reportable weaknesses that are not material weaknesses to those charged with governance if the auditor judges it appropriate in the circumstances?
- Q3. Do Representatives agree with the task force's proposal that the communication of reportable weaknesses to management and material weaknesses to those charged with governance should be in writing?

## IAASB CAG PAPER

### IAASB CAG Agenda (April 2007)

#### Agenda Item H

#### Material Weaknesses

##### B. THRESHOLD FOR REPORTABLE WEAKNESSES

13. At the September 2006 CAG meeting, Representatives agreed that professional judgment plays an important role in determining which control deficiencies are matters that the auditor should report. During the subsequent IAASB discussions in October 2006, however, it was questioned whether reliance on professional judgment alone in determining which control matters should be reported would provide a sufficient basis for ensuring consistent reporting among auditors. It was therefore argued that some consideration of factors such as likelihood and magnitude of outcome might appropriately form part of the evaluation framework. Another view expressed at the IAASB meeting was that as the emphasis is on reporting non-trivial control matters of which the auditor has become aware, the reporting threshold could be set by defining what is considered a trivial control matter that need not be reported. It was also suggested that the definition of the reporting threshold could be linked to the level of assurance that the auditor is able to obtain on the audited financial statements, i.e. in terms of a control deficiency that leads to a greater than acceptably low level of risk of a material misstatement occurring in the financial statements being audited. However, not all IAASB members agreed that the level of assurance influences the definition.
14. In light of these comments, the task force gave further consideration to the approach to setting the reporting threshold. The task force agreed that for the category of material weaknesses, the auditor should apply specific criteria in the evaluation of which control deficiencies fall into that category because these are the most serious control issues that would necessitate remedial action from management and those charged with governance as soon as practicable. (See further discussion on the definition of material weakness below).
15. However, for the broader category of reportable weaknesses that the auditor should report to management, the task force felt that this should be more loosely defined, consistent with the view expressed during the previous IAASB discussions that the auditor should not be restricted in what the auditor may deem appropriate to communicate, and provided such matters are not trivial. The task force agreed that for this broader category, establishing specific evaluative criteria to determine which control deficiencies fall into the category would be inappropriate as this would be aiming for a degree of precision that would not be warranted in the circumstances of an audit performed under the ISAs.
16. Accordingly, the task force proposes to define a reportable weakness as a control deficiency,<sup>1</sup> 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 (**Refer Agenda Item H.1, paragraph 6(e)**). The task force did not believe it necessary to define the meaning of triviality because proposed ISA 450 (Redrafted), "Evaluation of Misstatements Identified During the Audit," already provides an explanation of the term "clearly trivial" (**Refer Agenda Item H.1, footnote 1**).
17. Consistent with this more flexible approach to control matters that the auditor may deem appropriate to communicate, the task force also agreed that the guidance should highlight

<sup>1</sup> A definition of the generic term "control deficiency" is proposed in paragraph 6(a) of Agenda Item I.1.

## IAASB CAG PAPER

### IAASB CAG Agenda (April 2007)

#### Agenda Item H

#### Material Weaknesses

that the auditor may also communicate control-related matters that do not give rise to potential misstatements in the financial statements (i.e. matters that are not reportable weaknesses, including material weaknesses) if the auditor judges such matters to be of sufficient importance to merit the attention of management and, where appropriate, those charged with governance. An illustration of such a matter would be a systemic pricing error in the entity's billing system that the auditor may have noted but that does not in itself give rise to misstatements in the financial statements (*Refer Agenda Item H.1, paragraph A14*). This proposal responds in some way to the view expressed at the September 2006 CAG meeting that "material weaknesses" should not be limited to only those deficiencies that could result in a material misstatement of the financial statements.

#### Matters for CAG's Consideration

- Q4. Do Representatives agree with the task force's approach to setting the reporting threshold?
- Q5. Do Representatives agree with the guidance proposed in relation to the communication of control-related matters that do not give rise to misstatements in the financial statements?

#### C. DEFINITION OF MATERIAL WEAKNESS

18. At the September 2006 CAG meeting, Representatives took note of the existing definition of material weakness in the U.S. Public Company Accounting Oversight Board's (PCAOB's) Auditing Standard 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." The task force argued that a different definition could be appropriate in an ISA context to emphasize the difference in scope of an audit performed in accordance with ISAs and an audit that includes an audit of internal control ("integrated audit") as performed under PCAOB standards. A Representative noted that it is important that a single international definition of material weakness be developed. The Working Group was also concerned about the co-existence of different definitions of material weakness, which would create problems for preparers, auditors and users around the world. A Representative questioned whether it is the definitions that are different or the way in which a single definition is applied in the different audit scopes.
19. At the October 2006 IAASB meeting, IAASB members generally also agreed with the Representatives that it could be confusing to have a definition of material weakness that is different from definitions of the same term established elsewhere. It was argued that the creation of a new definition should be avoided if one is already available because doing so could inadvertently introduce a new concept where none was intended. Another IAASB member disagreed, however, because the objective and scope of the auditor's work on internal control in an audit performed in accordance with ISAs are different from those of an integrated audit. This member's view was that a more structured definition is needed in an integrated audit because the auditor must form a conclusion and report publicly on the effectiveness of internal control over financial reporting. By contrast, in an audit of financial statements alone, the reporting of control weaknesses identified in an ISA audit of financial

## IAASB CAG PAPER

### IAASB CAG Agenda (April 2007)

#### Agenda Item H

#### Material Weaknesses

statements is part of the auditor's dialogue with those charged with governance. The IAASB concluded that the task force should monitor the PCAOB's current project to revise its Auditing Standard 2 and to consider whether the definitions in the PCAOB's proposed new standard may also be appropriate in an ISA context.

20. In accordance with this direction, the task force has considered the PCAOB's proposed revised definition of the term "material weakness" set out in the PCAOB's December 2006 exposure draft "An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements," which is as follows:

A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

21. The task force notes that the two criteria in this proposed definition, i.e. likelihood and materiality of the potential misstatement, would also be appropriate in an ISA context. Accordingly, consistent with the aim of minimizing differences in definitions, the task force proposes that the same criteria be adopted in the proposed definition of material weakness in this ISA (**Refer Agenda Item H.1, paragraph 6(d)**).
22. The task force believes that a likelihood approach to the definition, as opposed to a risk-based approach, would be appropriate as management would generally think about a material weakness in terms of the likelihood of a material misstatement not being prevented or detected by the entity's internal control. The task force also believes that using the likelihood approach in the definition may help the auditor to better explain to management and those charged with governance the significance of the control deficiencies reported.
23. In relation to the likelihood criterion, the PCAOB's exposure draft describes the meaning of "reasonable possibility" in terms of the likelihood of the event being either "reasonably possible" or "probable,"<sup>2</sup> as those terms are used in the U.S. Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies" (FAS No. 5). However, the task force believes that for the purposes of the ISAs, an explanation of the term "reasonable possibility" should reflect the fact that, insofar as the potential outcome of the underlying control deficiency or deficiencies is concerned, this term has the same meaning as a greater than acceptably low risk of the event occurring (**Refer Agenda Item H.1, paragraph A5**). That is, considering the potential outcome of the control deficiency or deficiencies in terms of the likelihood of the outcome effectively means considering the same potential outcome

<sup>2</sup> Paragraph 3 of FAS No. 5 states:

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

- *Probable*. The future event or events are likely to occur.
- *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- *Remote*. The chance of the future events or events occurring is slight.

## IAASB CAG PAPER

### IAASB CAG Agenda (April 2007)

#### Agenda Item H

#### Material Weaknesses

in terms of the risk of it occurring. This stated equivalency has the benefit of relating the consideration of the potential misstatements in terms of risk, consistent with how auditors would generally approach the audit.

24. The task force also agreed that the definition of material weakness should be related to the *current financial statements being audited* because the evaluation of the materiality of the potential misstatement(s) needs to be made in the context of the materiality parameters determined for the current audit (*Refer Agenda Item H.1, paragraph 6(d)*). Nevertheless, this limitation need not apply in judging whether a control deficiency or combination of control deficiencies represents a reportable weakness other than a material weakness. Consistent with the more flexible approach proposed for the definition of a reportable weakness, and in line with earlier IAASB discussions, the task force agreed that control deficiencies that may be expected to have non-trivial effects on future financial statements should be reported to management and, where appropriate, those charged with governance, even though the potential effects on the current financial statements may not be significant. The task force has proposed an illustration of such a situation in the guidance (*Refer Agenda Item H.1, paragraph A10*).

#### Matter for CAG's Consideration

- Q6. What are Representatives' views regarding the task force's proposed definition of material weakness?

#### Material Presented – FOR CAG REFERENCE PURPOSES ONLY

Agenda Item H.1      Proposed ISA XXX, "Control Deficiencies Noted in an Audit"