

IAASB CAG REFERENCE PAPER
IAASB CAG Agenda (September 2007)
Agenda Item G.1
Material Weaknesses — September 2007 IAASB Agenda Item 8-A

PROPOSED INTERNATIONAL STANDARD ON AUDITING XXX
COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL
NOTED IN AN AUDIT

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

CONTENTS

	Paragraph
Introduction	
Scope of this ISA	1-3
Effective Date	4
Objective	5
Definitions	6
Requirements	
Confirmation of the Auditor's Understanding of Deficiencies Noted.....	7
Consideration of, and Conclusion on, Deficiencies Noted	8
Communication of Reportable Deficiencies	9-10
Application and Other Explanatory Material	
Confirmation of the Auditor's Understanding of Deficiencies Noted.....	A1-A3
Consideration of, and Conclusion on, Deficiencies Noted	A4-A11
Communication of Reportable Deficiencies	A12-A20

^{*} See footnote 3.

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate appropriately to management and those charged with governance reportable deficiencies in internal control that the auditor has noted in an audit of the financial statements. The requirements and guidance in this ISA relate to the financial reporting objective of internal control¹ only. They do not address deficiencies in internal control the potential financial effects of which the auditor would judge to be clearly trivial.² 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, i.e., those regarding effectiveness and efficiency of operations, and compliance with applicable laws and regulations (see [proposed] ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance").

Identifying Reportable Deficiencies under the ISAs

2. As set out in [proposed] ISA 200 (Revised and Redrafted), "Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing," the overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. During the audit, the auditor may become aware of deficiencies in the design or operation of controls relevant to financial reporting that the auditor judges to be of sufficient importance to merit the attention of management and those charged with governance.
3. ISA 315 (Redrafted) requires the auditor to obtain an understanding of internal control relevant to the audit for the purpose of identifying and assessing the risks of material misstatement in the financial statements. This ISA requires the auditor to communicate reportable deficiencies that have come to the auditor's attention during the course of the audit but does not require the auditor to plan and perform specific audit procedures to search for deficiencies in internal control or to form an opinion on the effectiveness of internal control.

¹ 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.

² See [proposed] ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit," for a description of the meaning of "clearly trivial."

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

Effective Date

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

Objective

5. The objective of the auditor is to communicate appropriately to management and those charged with governance deficiencies in internal control that have come to the auditor's attention during the audit and which, in the auditor's professional judgment, are of sufficient importance to merit their attention. **[ISSUE A]**

Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Deficiency in internal control – A deficiency in internal control exists when a control is designed or operated in such a way as to prevent the control from enabling 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. In this respect:
 - A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met;
 - A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively; and
 - (b) Reportable deficiency – 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 management and those charged with governance. **[ISSUE B1]**

Requirements

Confirmation of the Auditor's Understanding of Deficiencies Noted

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

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

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

Consideration of, and Conclusion on, Deficiencies Noted

8. The auditor shall consider the deficiencies in internal control the auditor has noted during the audit and shall conclude which of those deficiencies, either individually or in combination, constitute reportable deficiencies. (Ref: Para. A4-A11)

Communication of Reportable Deficiencies

9. The auditor shall communicate reportable deficiencies the auditor has noted during the audit:
 - (a) To management; and (Ref: Para. A12)
 - (b) At a level of detail considered appropriate in the circumstances, to those charged with governance. (Ref: Para. A13) **[ISSUE B2]**

The auditor shall make such communication in writing and on a timely basis, and shall include an explanation of the potential effects of the reportable deficiencies on the financial statements (Ref: Para. A14-A17)

10. The auditor's written communication of reportable deficiencies to management and those charged with governance shall include statements to the effect that:
 - (a) The matters being reported are deficiencies in internal control that have come to the auditor's attention during the audit and which the auditor has concluded should be reported;
 - (b) The purpose of the audit was for the auditor to express an opinion on the financial statements and not to provide assurance on the effectiveness of internal control;
 - (c) The auditor did not plan and perform the audit with a view to identifying all deficiencies in internal control that might exist;
 - (d) Had the auditor performed more extensive audit procedures on internal control, the auditor might have noted more deficiencies to be reported or concluded that some of the deficiencies being reported need not, in fact, have been reported; and
 - (e) The communication is intended solely for the purposes of management, those charged with governance and, where appropriate, relevant other parties, and may not be suitable for other purposes. (Ref: Para. A18-A20)

Application and Other Explanatory Material

Confirmation of the Auditor's Understanding of Deficiencies Noted (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 deficiencies in internal control of which they may not have been previously aware. Circumstances in which

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

it may be appropriate for the auditor to confirm the facts and circumstances of the auditor's findings with those charged with governance include situations where the deficiencies in internal control concern management directly, such as difficulties in the preparation of adequate financial statements that raise doubt about management's competence, or evidence of fraud on management's part.

- A2. In confirming the facts and circumstances of the auditor's findings with management or those charged with governance, the auditor may obtain other relevant information for further consideration, such as:
- The understanding that management or those charged with governance have of the actual or suspected causes of the deficiencies.
 - Exceptions arising from the deficiencies that management or those charged with governance may have noted during the period.
 - A preliminary indication from management or those charged with governance of their response to the findings.
- A3. Management or those charged with governance may also bring to the auditor's attention the existence of controls not previously known to the auditor that they believe would prevent or detect the potential misstatements not addressed by the deficient controls. The existence of these other controls does not eliminate the fact that the auditor has noted deficiencies in certain controls. Although the auditor is not required to search for or obtain evidence regarding the design and operating effectiveness of these other controls, the auditor is not precluded from doing so in concluding whether to communicate the deficiencies noted.

[ISSUE B3]

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

- A4. 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 an IT subsystem may consist of a combination of automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the relevant account balances. A deficiency in internal control on its own may not be sufficiently important to constitute a reportable deficiency. However, combining the deficiency with other deficiencies affecting the same financial statement assertions may result in their potential effects becoming sufficiently important that the deficiencies would, in the auditor's professional judgment, constitute reportable deficiencies.
- A5. The importance of a deficiency or combination of deficiencies in internal control depends upon whether a misstatement could occur and the materiality of the misstatement, and not on whether a misstatement has actually occurred. Reportable deficiencies may therefore exist even though the auditor has not identified misstatements during the audit. **[ISSUE C]**
- A6. Whether a misstatement could occur is a matter of the auditor's professional judgment in the circumstances. This involves a consideration of the risks and uncertainties arising from the

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

deficiencies to the extent that such deficiencies affect the particular underlying financial statement assertions. Examples of factors that affect whether deficiencies could give rise to misstatements in the financial statements include:

- The nature of the financial statement accounts, disclosures and assertions (for example, related party disclosures ordinarily involve greater risk than other disclosures).
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as those involving fair values.
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The relationship of the control with other controls, such as monitoring controls.
- The interaction of the deficiency in internal control with other deficiencies in internal control.

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

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

A8. In concluding whether a deficiency or combination of deficiencies in internal control could give rise to a misstatement in the financial statements, the auditor may consider the mitigating effects of other controls that would prevent or detect the potential misstatements not addressed by the deficient controls if the auditor has obtained evidence regarding the operating effectiveness of such controls as part of the financial statement audit.

A9. Deficiencies in the following areas are ordinarily of sufficient importance to be reportable:

- Controls over the selection and application of appropriate accounting policies.
- 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).

A10. Indicators of reportable deficiencies include, for example:

- Ineffective oversight of the financial reporting process by those charged with governance, especially in an environment of limited segregation of duties.

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
- Material misstatements detected by the auditor's procedures that were not identified by the entity's internal control.
- Identification of fraud, whether or not material, involving management that was not identified by the entity's internal control.

A11. Law or regulation in some jurisdictions may establish an additional requirement for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) specific types of deficiencies in internal control that the auditor has noted during the audit, and may define terms such as "material weakness" for this purpose. **[ISSUE B2]**

Communication of Reportable Deficiencies (Ref: Para. 9-10)

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

A13. The level of detail at which to communicate reportable deficiencies to those charged with governance is a matter of the auditor's professional judgment in the circumstances. For example, in some circumstances, the auditor may find it appropriate (or may be requested) to communicate to those charged with governance the same reportable deficiencies at the same level of detail that the auditor has communicated to management. In other circumstances, the auditor may consider it appropriate to communicate in detail to those charged with governance only those reportable deficiencies that the auditor judges to be the most important ones, and include a summary of the other reportable deficiencies communicated to management. Factors that the auditor may consider in determining the appropriate level of detail at which to communicate reportable deficiencies to those charged with governance include, for example:

- The nature and size of the entity.
- The entity's governance structure.
- The nature and volume of reportable deficiencies noted.
- The nature of the oversight responsibilities of those charged with governance.
- Whether there has been a specific agreement with those charged with governance as to the nature and extent of the communication on reportable deficiencies.
- Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control. **[ISSUE B2]**

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

- A14. The auditor may find it appropriate to also communicate other control-related matters that do not give rise to potential misstatements in the financial statements if the auditor judges such matters to be of sufficient importance to merit the attention of management or, where appropriate, those charged with governance. An example of such a matter is the use of a superseded price list by the entity's computerized sales system, resulting in the entity under-billing its customers for its products or services.
- A15. As [proposed] ISA 260 (Revised and Redrafted) indicates, it may often be appropriate to communicate reportable deficiencies that have come to the auditor's attention to management and those charged with governance as soon as practicable if they are able to implement timely corrective action. Although such communication may be made orally during the audit, the requirement to communicate the reportable deficiencies in writing reflects the importance of the matters being communicated and assists management and those charged with governance, respectively, in fulfilling their responsibilities for the preparation of adequate financial statements and for the oversight of the financial statement preparation process.
- A16. Management may already be aware of the existence of the reportable deficiencies that have come to the auditor's attention during the audit and may have intentionally chosen not to correct them because of cost or other considerations. The responsibility for evaluating the costs and benefits of correcting the reportable deficiencies the auditor has noted rests with management. Accordingly, the requirement for the auditor to communicate reportable deficiencies to management and those charged with governance applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether such deficiencies should be corrected.
- A17. The fact that the auditor communicated a reportable deficiency to management and those charged with governance in the previous audit, or that they already knew about it through other means (such as from work done by internal auditors), does not eliminate the need for the auditor to repeat the communication if corrective action has not yet been taken in the current period. If the auditor has previously communicated the matter to management and those charged with governance, the current year communication may include the same description of the reportable deficiency as the auditor previously communicated, or it may be summarized, with a specific reference to the previous communication. The auditor may inquire of management or those charged with governance to understand why the reportable deficiency has not yet been corrected. A failure to act, in the absence of rational explanations from management or those charged with governance, may in itself be a reportable deficiency.
- A18. Laws or regulations may establish requirements for the auditor or management to furnish a copy of the auditor's written communication of reportable deficiencies to appropriate regulatory authorities, such as those in the financial services industry. Where this is the case, the auditor's written communication may include a specific reference to such regulatory authorities.
- A19. The auditor may be expected, or may have agreed with the entity, to submit a written communication on reportable deficiencies to those charged with governance at the

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2007)

Agenda Item G.1

Material Weaknesses – September 2007 IAASB Agenda Item 8-A

completion of each audit, regardless of whether the auditor has noted any such deficiencies. For example, the entity may operate in a regulated industry where the regulator requires the entity to submit a copy of the auditor's communication on reportable deficiencies to those charged with governance after each audit. In such a case, if the auditor has not become aware of any reportable deficiencies during the audit, it may be necessary for the auditor to provide a written communication to those charged with governance stating that no reportable deficiencies were noted during the audit. Because of the risk that such type of communication could be misinterpreted as giving a degree of assurance on internal control, the auditor may consider it appropriate to include a disclaimer in the communication to the effect that the auditor has not performed procedures to obtain reasonable assurance, and is not providing any assurance, on the effectiveness of internal control.

Considerations Specific to Public Sector Entities

A20. Public sector auditors may have additional responsibilities to communicate deficiencies in internal control noted during the audit in ways, at a level of detail and to parties not envisaged in this ISA. For example, reportable deficiencies may have to be communicated to the legislature or other governing body. Legislation may also mandate that public sector auditors report deficiencies in internal control, the potential effects of which would otherwise be regarded as clearly trivial. Further, legislation may require public sector auditors to report on broader internal control-related matters than the reportable deficiencies required by this ISA.