



International Federation of Accountants

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## Agenda Item

# G

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** London

**Meeting Date:** September 20-21, 2007

## Communicating Reportable Deficiencies in Internal Control

### Objectives of Agenda Item

1. The objectives of this agenda item are:
  - (a) To report the task force's responses to significant comments received from Representatives at the March 2007 CAG meeting;
  - (b) To report on the main outcome of the April 2007 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, "Communicating Deficiencies in Internal Control Noted in an Audit."
2. **Agenda Item G.1, the first-read draft of the proposed ISA, is provided as a CAG Reference Paper. It has not yet been reviewed and commented upon by the IAASB.**

### Main Outcome of April 2007 IAASB Discussions

3. At the April 2007 IAASB meeting, the IAASB's discussions centered on the key issue of how to define the term "material weakness" in the ISAs. The IAASB concluded that the way forward would depend on which of the following three options should be chosen:

#### Option 1

Establish a definition similar to the definition set out in the PCAOB's Auditing Standard 5.<sup>1</sup> The primary benefit of this approach would be the harmonization of the definition of "material weakness" internationally. The PCAOB definition, however, is intended to represent a "high hurdle" so that under this approach, weaknesses that are less serious might not get reported. Accordingly, under this approach, a lower threshold (that could be called "reportable weaknesses") would have to be developed to enable auditors to continue the current practice of reporting important (but not necessarily "material") weaknesses to management. However, the existence of these two categories of weaknesses could result in

<sup>1</sup> The PCAOB's Auditing Standard 5 defines a **material weakness** as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, 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 on a timely basis."

It further indicates that "there is a **reasonable possibility** of an event when the likelihood of the event is either 'reasonably possible' or 'probable,' as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*."

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increased auditor work effort, and it was noted that this could be of concern to many practitioners, particularly auditors of smaller entities.

##### Option 2

Adopt a lighter approach to the relevant definitions. Under this option, “material weaknesses” would be defined as those weaknesses the auditor would deem to be sufficiently serious to justify reporting to *those charged with governance*, and “reportable weaknesses” those other weaknesses that the auditor would conclude should be reported to *management* but not necessarily to those charged with governance. This approach would still require an evaluation but it would be more judgmental. However, it could result in a different definition of material weakness from the PCAOB’s.

##### Option 3

Adjust the requirement in the ISAs for the auditor to communicate material weaknesses to a requirement for the auditor to communicate “reportable weaknesses.” This would acknowledge the fact that the term “material weakness” has existed in the ISAs for many years and, as a result, auditors have been interpreting it quite broadly as representing a category of control issues that they may find helpful to bring to the attention of management and those charged with governance. Under this approach, the ISAs would note that some jurisdictions may define the term “material weakness” for their own purposes (often legal or regulatory in nature) and, if so, auditors would have to evaluate control deficiencies in accordance with these definitions. This option would effectively mean that the term “material weakness” would not need to be defined in the ISAs. However, it would leave individual jurisdictions with the flexibility to define the term for their own purposes.

4. Given that the term “material weakness” is also used in the European Union’s (EU’s) Statutory Audit Directive but is undefined,<sup>2</sup> the IAASB agreed that the views of the European Commission (EC) should be sought on this issue as, if ISAs were to be adopted in the EU, it would be desirable for any definition of material weakness established in the ISAs to be acceptable to the EC for the purposes of the Statutory Audit Directive. Accordingly, the IAASB Chairman wrote to the EC on behalf of the IAASB with a summary of the April 2007 IAASB discussions, requesting the EC’s views as to an appropriate approach to the definition of material weakness. A formal EC response is pending at this time.

#### **Task Force Deliberations and Recommendations**

##### **A. ORIENTATION AND OBJECTIVE OF THE PROPOSED ISA**

5. The original aim of this project was to clarify the meaning of the term “material weakness” (as that term is defined in the old ISA 315, *Understanding the Entity and its Environment, and Assessing the Risks of Material Misstatement*), and the auditor’s responsibilities to

<sup>2</sup> Article 41(4) of the EU’s Statutory Audit Directive requires that “the statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.”

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evaluate material weaknesses as established in ISA 315. Accordingly, the task force's initial presumption was that the clarified requirements and guidance on material weaknesses would be contained in a companion ISA to ISA 315.

6. Based on the discussions at meetings of the IAASB and IAASB CAG on this project so far and the task force's further deliberations, the task force believes that it would be more appropriate to orientate the ISA towards a communication objective. The emphasis on the communication aspect would appropriately reflect the outcome that the auditor should achieve in the public interest, i.e. bringing to the notice of management and those charged with governance those control deficiencies the auditor has noted that are of sufficient importance to merit their timely attention. Accordingly, the task force proposes an objective for the ISA that reflects this desired communication outcome **(Refer Agenda Item G1, paragraph 5)**, and recommends that the proposed ISA be placed in the communication series (i.e. as a companion ISA to ISA 260, "Communication with Those Charged with Governance").

#### Matter for CAG's Consideration

- Q1. Do Representatives agree with the proposed objective of the ISA?

#### B. APPROACH TO THE DEFINITION OF MATERIAL WEAKNESS

7. Subject to further input from the IAASB and the IAASB CAG, the task force believes that Option 3 described in paragraph 3 above should be chosen. In the task force's view, the most important public interest consideration for the wide range of audits covered by the ISAs is to ensure that the auditor communicates the relevant control deficiencies the auditor has noted during the audit to those parties within the entity who can competently attend to them on a timely basis. Thus, the primary consideration is knowing *what* to communicate and *to whom* to communicate it, rather than the relative importance of the control deficiencies communicated.

#### B1. Control Deficiencies to be Communicated

8. The task force believes that it should be a matter of the auditor's professional judgment as to which control deficiencies to communicate, based on what the auditor would judge to be of sufficient importance in the circumstances to bring to the attention of the responsible parties within the entity. This would be consistent with current practice under the ISAs where auditors have historically applied their judgment to determine broadly the control matters that they would consider to be "material weaknesses" for reporting to management and those charged with governance (without being required to perform specific evaluations of the level of severity of such matters). This approach would also be consistent with the IAASB's consensus view that it would be in the public interest for the auditor to communicate a broader range of control deficiencies noted during the audit than would be implied by material weaknesses as defined in the PCAOB's Auditing Standard 5.

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9. Accordingly, the task force proposes that the auditor be required to communicate *reportable deficiencies*, defined broadly in judgmental terms as follows:

A *reportable deficiency* is 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. **(Refer Agenda Item G1, paragraph 6(b)).**

In this regard, the task force recommends that the term "reportable deficiencies" be used as opposed to "reportable weaknesses." This would better differentiate the terminology from the "material weaknesses" wording. The proposed term would also be more consistent with the generic term "control deficiency," which the proposed ISA defines along the same lines as the PCAOB's Auditing Standard 5, and would minimize potential translation issues.

10. The task force believes that this approach would help address the reporting issue that needs to be resolved, without prejudicing any decision the EC and others may take in the future regarding defining the term "material weakness."

#### B2. To Whom and to What Extent to Communicate Reportable Deficiencies

11. With regard to whom to communicate reportable deficiencies, the task force agreed that these should be communicated to both management and those charged with governance. However, the task force felt that it would be neither practicable nor reasonable for the ISAs to constrain the auditor in precisely what to communicate to those charged with governance, and at what level of detail, because the degree of specificity would depend on the circumstances of the entity and the engagement. For example, in some circumstances, the auditor may find that it would be appropriate 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 a *subset* of those deficiencies based on an assessment of importance, and include a summary of the other deficiencies.
12. The difficulty in mandating the specific content and extent of the communication to those charged with governance was also apparent in the Representatives' discussions at the March 2007 CAG meeting. Some Representatives (Ms. Todd McEnally, and Messrs. Lamoureux and Hallqvist) were of the view that the auditor should communicate to those charged with governance the same reportable deficiencies the auditor has communicated to management on the grounds that (i) the former might very well be interested in the matters communicated to the latter; and (ii) those charged with governance should, in any event, be given the opportunity to make their own decisions. They also noted that an approach requiring auditors to classify control deficiencies based on level of severity would create difficulties for auditors in evaluating the materiality of such control deficiencies. Other Representatives (Messrs. Morris, Krantz, Cassel, Monk and Johnson) supported an approach that would provide some differentiation of the matters communicated based on the auditor's assessment

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of the relative importance of such matters, particularly given that in some cases the reportable deficiencies to be communicated could be voluminous.

13. In light of the dichotomy of views from the Representatives, and for the reasons set out in paragraph 11 above, the task force took the view that it would best serve the public interest to not limit what auditors should report to those charged with governance, and to permit auditors to tailor the content and extent of their communication *to the circumstances*.
14. The task force therefore proposes that the auditor should be required to communicate reportable deficiencies to:
  - (a) Management; and
  - (b) *At a level of detail considered appropriate in the circumstances*, to those charged with governance. **(Refer Agenda Item G1, paragraph 9).**

The task force proposes guidance **(Refer Agenda Item G1, paragraph A13)** as to what would be considered appropriate in the circumstances.

15. Given this proposed change to the existing requirement to communicate material weaknesses to a requirement to communicate *reportable deficiencies*, it would become unnecessary to define the term “material weakness” in the ISAs. Consequently, the task force proposes that this term no longer be used and that appropriate conforming changes be made to the relevant ISAs and proposed ISAs. However, to highlight the fact that there may be legal or regulatory requirements for the auditor to communicate such control matters as “material weaknesses,” the task force proposes the following guidance **(Refer Agenda Item G1, paragraph 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.

16. The task force believes that this approach would be capable of accommodating any specific legal or regulatory requirements that might exist because auditors would be able to factor such requirements into their communication process, having regard to any relevant definitions that law or regulation might have established for the specific matters to be communicated.

#### *B3. Rationale for not Choosing Option 1 or Option 2*

17. The majority of the task force concluded that Option 1 would not be appropriate for engagements conducted under the ISAs because of the excessive auditor work effort it would likely entail. As the IAASB noted at its April 2007 meeting, this option would require auditors to undertake careful evaluation of the severity of the control deficiencies noted

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based on likelihood<sup>3</sup> and materiality criteria to determine whether to categorize these as material weaknesses or other reportable deficiencies. Whilst such an evaluation might be appropriate if the auditor were to be required to report publicly on material weaknesses (as under the PCAOB's Auditing Standard 5), the task force concluded that this would be unduly burdensome in an ISA context (where there is no public reporting requirement) because of the need to perform detailed analysis of whether the relevant criteria have been met in the circumstances, and the need to document the significant professional judgments made in such evaluation. The majority of the task force believes that for Option 1, the likely increased complexity and cost for audits conducted under the ISAs (particularly audits of smaller entities) would not be in the public interest.

18. One member of the task force, however, took the opposite view, believing that Option 1 would represent the best outcome because it would result in a revised definition of material weakness, as this project originally set out to develop. The member of the task force also disagreed that Option 1 would result in significant additional work effort for auditors in classifying control deficiencies as material weaknesses.
19. The task force also concluded that Option 2 would not be appropriate because it would result in a definition of material weakness being established in the ISAs that would conflict with that set out in the PCAOB's Auditing Standard 5. The co-existence of two different definitions of the same term in IAASB and PCAOB standards could potentially generate confusion amongst practitioners and users of financial statements around the world, and lead to attempts at reconciling their meanings for varying reporting purposes. The task force believes that this outcome would also not be in the public interest. At the March 2007 CAG meeting, a Representative (Mr. Rabine) also asked the task force to give further consideration to the definition in order to avoid such a conflict in definitions around the world.

#### Matters for CAG's Consideration

- Q2. What are the Representatives' views regarding the task force's suggested approach to the definition of material weakness?
- Q3. Do Representatives agree with the task force's views regarding Options 1 and 2?

#### C. CONSIDERATION OF THE POTENTIAL FUTURE EFFECTS OF REPORTABLE DEFICIENCIES

20. Given that the importance of a control deficiency depends upon whether a misstatement *could* occur (as well as the materiality of the misstatement), and not on whether a misstatement has actually occurred, the task force considered whether it would be appropriate to provide guidance in the proposed ISA on how the auditor would evaluate the

<sup>3</sup> A Representative (Ms. Blomme) also noted at the March 2007 CAG meeting that the term "reasonable possibility" used in the PCAOB definition could be problematical because it was not consistent with the risk-based terminology used in the ISAs. The Representative also highlighted potential translation difficulties with that term.

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potential future effects of control deficiencies. The task force concluded that this evaluation should be best left to the auditor's judgment in the circumstances because of the difficulties in anticipating the course of future events and their potential effects. Accordingly, the guidance throughout the proposed ISA simply focuses on whether misstatements *could* occur as a result of the control deficiencies.

21. On a related point, at the March 2007 CAG meeting, the task force suggested that if the term "material weakness" were to be defined, the scope of that definition should be limited to the current period financial statements because materiality parameters to evaluate the severity of identified control deficiencies would need to be determined by reference to the current period financial statements. A Representative (Mr. Roussey) noted that such a definition would effectively imply that although there *could* be a material misstatement in the financial statements, the auditor would have carried out sufficient further work in the audit to ensure that there were no such misstatements in the current period financial statements. This would, however, not preclude the possibility of material misstatements arising in the future. The task force Chair noted that the fact that the auditor completed all necessary audit work at the end of the audit would not change the fact that a material weakness existed during the earlier part of the year. To reinforce this message, the proposed ISA includes guidance to that effect **(Refer Agenda Item G.1, paragraph A5).**

#### Matters for CAG's Consideration

- Q4. Do Representatives agree that the evaluation of the potential future effects of control deficiencies should be best left to the auditor's professional judgment in the circumstances?
- Q5. Do Representatives agree with the guidance in paragraph A5 of the proposed ISA?

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

- Agenda Item G.1      Proposed ISA XXX, "Communicating Deficiencies in Internal Control Noted in an Audit" – *Agenda Item 8-A of the September IAASB meeting material*