

PROJECT PROPOSAL
MATERIAL WEAKNESSES IN INTERNAL CONTROL

1. Subject

Development of additional standards and guidance in the form of a new ISA regarding:

- (a) The meaning of control deficiencies¹ and material weaknesses in internal control;
- (b) The auditor's evaluation of control deficiencies and material weaknesses in internal control noted during an ISA audit;
- (c) The auditor's reporting on such matters to management and those charged with governance; and
- (d) The auditor's consideration of statements made by management or those charged with governance in, or accompanying, the financial statements regarding internal control, for consistency with the auditor's knowledge.

2. Project Rationale and Objectives

(a) Issue Identification

After the spate of recent corporate scandals in the United States and Europe, several regulatory authorities in major jurisdictions around the world have taken, or are in the process of taking, action to introduce more rigorous reporting requirements on listed companies in relation to their internal control and risk management systems. A key consequence of these regulatory initiatives has been to cause the national standard setters in some of these jurisdictions to revise or develop standards for auditors to address the new internal control regulatory requirements.

Specifically, in the United States, the PCAOB has, in response to the Sarbanes-Oxley Act, already issued a major auditing standard (Auditing Standard 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*) to address the audit of internal control over financial reporting. The AICPA's Auditing Standards Board has, in turn, established an internal control task force to revise and re-expose SAS 60, *Communication of Internal Control Related Matters Noted in an Audit*, to reflect certain definitions and related guidance set out in the PCAOB's Auditing Standard 2 and which are relevant to non-listed entities. In Canada, the CICA is in the process of finalizing standards and guidance for auditors to report on the effectiveness of an entity's internal control over financial reporting, in response to new internal control reporting requirements to be introduced by the Canadian Securities Administrators.

¹ The term "control deficiency" is currently used to a limited extent in the ISA literature (specifically, in paragraph 100 of ISA 240 and in the 4th bullet from last in Appendix 1 of ISA 240). Its use appears to be more in the way of standard English usage than with an intention of conveying any specific meaning regarding internal control.

In Europe, the UK APB has issued a number of briefing papers on the subject of providing assurance on the effectiveness of internal control, and on the requirements of auditors in relation to the Combined Code on corporate governance. Similarly, internal control and risk management have long been on the German agenda, and the IDW has issued its own auditing standard addressing the audit of risk recognition systems. Furthermore, the EC has been finalizing new regulatory requirements for listed entities in relation to their internal control and risk management systems. In particular, the proposed 8th Company Law Directive may require audit committees of listed entities to monitor the effectiveness of internal control and risk management systems. Additionally, proposed amendments to the 4th and 7th Directives will require listed entities to provide corporate governance statements in or with their annual reports (or on their websites, with appropriate links pointing to them from their annual reports) that describe the entities' internal control and risk management systems.

Set against this background of regulatory and standards developments around the world regarding internal control, it appears an appropriate time for the IAASB to consider revising its current standards and guidance in ISAs addressing the auditor's evaluation of, and reporting on, internal-control-related matters. Specifically, there is presently limited guidance in ISAs 315 and 330 on addressing material weaknesses in internal control noted in an audit. In addition, the existing guidance tends to be of a general nature, and the only professional requirements are in ISAs 315 and 240 in relation to communication:

ISA 315.120: The auditor should make those charged with governance or² management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal control which have come to the auditor's attention.

ISA 240.99: The auditor should make those charged with governance and management aware, as soon as practicable, and at the appropriate level of responsibility, of material weaknesses in the design or implementation of internal control to prevent and detect fraud which may have come to the auditor's attention.

Compared with some of the more recent national standards and guidance that have been, or are expected to be, issued (though often in response to specific regulatory requirements), ISAs give relatively little guidance insofar as they address (a) the auditor's evaluation of, and reporting on, material weaknesses in internal control noted during the audit, and (b) the auditor's role regarding corporate governance statements and other statements published by management or those charged with governance regarding internal control. It would

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As a side issue, with regard to the apparent inconsistency between ISA 315.120 and ISA 240.99, the project will also consider whether the requirement to communicate material weaknesses should be in relation to both those charged with governance *and* management, or either one.

therefore seem logical for the IAASB to consider updating and strengthening its standards and guidance in these areas.

The development of such additional standards and guidance would be particularly important in light of the provisions on internal control and risk management contained in the EC's proposed 8th Directive, and its proposed amendments to the 4th and 7th Directives. This project would also appear to be a natural stepping stone to the development of a more extensive standard addressing an audit of internal control over financial reporting at a later stage, should the IAASB consider it appropriate to undertake such a project in the future based on market demand.

(b) Objectives to be Achieved

- To improve the consistency with which auditors interpret the meanings of the terms “control deficiency” and “material weakness.”
- To strengthen standards and guidance regarding auditors’ evaluation of the significance of identified control deficiencies.
- To improve the consistency of auditors’ reporting of control deficiencies and material weaknesses in internal control noted during the audit to management and those charged with governance.
- To clarify the nature and extent of the auditor’s responsibility in relation to statements made by management or those charged with governance regarding internal control.

3. Outline of the Project

(a) Project Scope

This project will revise, expand and strengthen the standards and guidance in ISA 315 addressing the auditor’s evaluation of, and reporting on, control deficiencies and material weaknesses in internal control noted during an ISA audit.

The project will consider recent developments in standards in a number of major jurisdictions, and what is the most appropriate approach for international purposes.

At this stage, the project will not address an audit of internal control over financial reporting (whether involving the auditor reporting directly on the effectiveness of internal control, or on management’s assertion regarding the effectiveness of internal control). The project will also not seek to change the nature of an ISA audit, or to expand the auditor’s responsibilities in relation to testing internal control beyond what is presently established in ISAs. Additionally, the scope will specifically exclude audits not dealing with financial reporting, such as compliance audits.

(b) List the Major Problems and Key Issues that Should be Addressed

CLARIFYING THE MEANING OF A “CONTROL DEFICIENCY” AND A “MATERIAL WEAKNESS IN INTERNAL CONTROL”

To explain the meaning of a material weakness in internal control, standard setters in the United States have recently developed a structured approach. This approach, reflected in the AICPA's Auditing Standards Board's re-exposure draft of SAS 60 and in the PCAOB's Auditing Standard 2, establishes a hierarchy that differentiates among three levels of control deficiencies, namely a *control deficiency*, a *significant control deficiency*, and a *material weakness*.³ A primary objective of the SAS and the PCAOB's standard in introducing this hierarchy seems to be to distinguish among three degrees of severity for identified control deficiencies:

- (i) Not significant;
- (ii) Sufficiently significant that there is more than a remote likelihood⁴ that a misstatement could be more than inconsequential; and
- (iii) So significant that there is more than a remote likelihood that a misstatement could be material.

³ The proposed revised SAS 60 adopts the following definitions, substantially derived from those established in the PCAOB's Auditing Standard 2:

- 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 on a timely basis.
 - 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 is not always 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 qualifications to perform the control effectively.
- A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.
- A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

⁴ The term "remote likelihood," as used in the definitions of *significant deficiency* and *material weakness* in the proposed revised SAS 60 and the PCAOB's Auditing Standard 2, has the same meaning as the term "remote" as used in paragraph 3 of the U.S. Financial Accounting Standards Board's Statement No. 5, *Accounting for Contingencies*:

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:

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

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

Although this hierarchy appears to be more complex and detailed than what is currently established in ISAs, it appears to better facilitate the evaluation of control deficiencies, as it conveys the fact that not all of these necessarily result in material weaknesses. By setting apart material weaknesses as being clearly exceptional occurrences, a consequence of the hierarchy seems to be to enable all relevant parties in the reporting and oversight processes (auditors, management, those charged with governance and regulators) to focus attention and resources on the most important control issues. In enabling the auditor to classify an identified control deficiency according to its severity, the U.S. approach would seem to help enhance the quality of auditor performance, as it would require the auditor to give greater thought to the evaluation of the significance and potential effects of the identified deficiency.

By contrast, ISA 315 does not employ this type of hierarchy but instead adopts a single high-level definition of a material weakness in internal control, i.e. one that could have a material effect on the financial statements.⁵ In addition, ISAs have not tended to use the term “control deficiencies”; the only reference within the text of the ISAs is in paragraph 100 of ISA 240⁶ where its use is a common sense one.

Consequently, the project will consider:

- Whether the U.S. approach described above would be appropriate for international purposes (including unlisted as well as listed entities), or whether another model or models would be more appropriate; and
- Notwithstanding the final conceptual approach adopted:
 - Whether to refine the concept of material weakness in internal control in terms of significance and likelihood of misstatements in the financial statements;
 - Whether to clarify and illustrate the meaning of “control deficiencies” (including consideration whether it is necessary to define and use this term) and “material weaknesses” to enable auditors to classify them more consistently; and
 - Whether to provide enhanced guidance on criteria for the evaluation of the significance or severity of identified control deficiencies (for example, based on their nature, likelihood of misstatements, and magnitude of potential misstatements).

REPORTING CONSIDERATIONS

As indicated above, ISA 315 establishes a high-level requirement for the auditor to make those charged with governance or management aware of material weaknesses in internal

⁵ Within this definition, the meaning of “material effect” appears ambiguous as it is not directly linked to the likelihood of misstatements in the financial statements.

⁶ ISA 240.100 states: “If the auditor identifies a risk of material misstatement of the financial statements due to fraud, which management has either not controlled, or for which the relevant control is inadequate, or if in the auditor's judgment there is a material weakness in management's risk assessment process, the auditor includes such internal control deficiencies in the communication of audit matters of governance interest (see ISA 260).”

control identified during the audit. Although general guidance on communication with those charged with governance is provided in ISA 260, there is no specific guidance on the form (orally or in writing) and content of the reports (e.g. purpose, types of matters reported, and limitations) regarding control deficiencies and material weaknesses noted during the audit to assist auditors in fulfilling their communication responsibilities to management or those charged with governance. Accordingly, the project will consider developing appropriate guidance on the form and content of such reports. Consideration should also be given to whether it would be helpful to provide illustrative reports for different types of situations, and whether it would be appropriate to introduce more specific guidance regarding the timing of such communication.

CONSIDERATION OF STATEMENTS MADE BY MANAGEMENT OR THOSE CHARGED WITH GOVERNANCE REGARDING INTERNAL CONTROL

Consideration needs to be given to the nature and extent of the auditor's responsibilities in relation to statements made by management or those charged with governance regarding the effectiveness of internal control over financial reporting (or other related matters), pursuant to the new regulatory requirements on internal control and risk management that have arisen, or will arise, around the world. In most cases, these statements by management or those charged with governance are required to be provided as part of the entities' annual reports containing the audited financial statements. The question therefore arises as to:

- (a) Whether the auditor should have a responsibility⁷ to read such statements for consistency with his knowledge, if not otherwise required by law or regulation; and
- (b) Whether such responsibility should be an extension of the auditor's responsibility under ISA 720 to read other information in documents containing audited financial statements for consistency with the financial statements.

In particular, in the event that the auditor has identified material weaknesses in internal control, consideration should be given to whether this would place any constraints on what the auditor would regard as being consistent with his knowledge when reading such statements. Should the auditor have a responsibility to read such internal control statements, consideration should be given to whether guidance (beyond what is already in ISA 720) should be provided to assist the auditor in identifying inconsistencies and in addressing them.

4. Describe the Implications for any Specific Persons or Groups

- The EC, given the provisions on internal control and risk management contained in the proposed 8th Directive and amendments to the 4th and 7th Directives.
- The Basel Committee on Banking Supervision, due to the Committee's strong interest in internal-control-related matters in the banking sector.

⁷ Such a responsibility might perhaps derive from Section 110 of the revised IFAC Code of Ethics, which requires a professional accountant not to be associated with misleading financial information.

- Other regulators that have introduced, or are contemplating introducing, requirements relating to reporting on internal-control-related matters.
- National standard setters, due to the potential effect that new or revised international standards and guidance on material weaknesses in internal control may have on corresponding national standards.
- The IAASB task force charged with revising ISA 402, *Audit Considerations Relating to Entities Using Service Organizations*, as any new or revised guidance on material weaknesses in internal control will be of relevance to engagements to report on service organizations' internal control.
- INTOSAI, due to the importance of internal control and risk management in the public sector.

5. Development Process, Project Timetable and Project Output

(a) Project timetable

It is proposed that an issues paper be presented to the IAASB for discussion sometime in 2006. The exact timing of this and subsequent stages of the project should be finalized after the IAASB's discussions on the timetable for the Clarity project at the September 2005 meeting.

(b) Project output

A new ISA that will contain all the relevant requirements and guidance addressing the meaning of control deficiencies and material weaknesses in internal control, and the auditor's responsibilities in relation to the identification, evaluation of, and reporting on, internal-control-related matters noted during the audit.

Conforming amendments may be necessary in other ISAs that contain some guidance on material weaknesses in internal control, for example, ISAs 240, 260, 315 and 330. Consideration should be given to moving the overarching requirement to communicate material weaknesses in internal control that is in ISA 315 to the proposed new ISA.

Conforming amendments to ISA 720 may also be necessary to address the nature and extent of the auditor's responsibilities when reading, for consistency purposes, statements regarding internal control and other related matters made by management or those charged with governance. A revision of other aspects of ISA 720 is not advocated at this time.

6. Resources Required

It is suggested that the task force be made up of five members, with a majority drawn from the IAASB. One member should be drawn from the U.S. and have expertise in engagements to report on internal control or in dealing with internal control frameworks such as COSO/CoCo/COBIT. To keep track of developments currently occurring in the EU, the task force should also include members (possibly drawn from external sources) having close contact with the Committee of European Securities Regulators (CESR), and having good knowledge of the development of the revised 4th, 7th and 8th EC Directives.

Given the importance of internal control in the public sector, it is also suggested that INTOSAI be invited to nominate a representative to the task force. It is understood that INTOSAI's input will be limited to the scope of this project, i.e. audits of financial statements, and will exclude matters relating to public sector compliance audits.

In addition, one IAASB staff member will provide support to the task force.

The task force should consult the following groups at appropriate stages during the project:

- IAASB CAG, for regulatory and other relevant input
- IFAC's SMP Permanent Task Force, for SMP perspectives
- National standard setters, for input from national perspectives and considerations of potential effects of introducing the new guidance at national level

7. List Important Sources of Information that Address the Matter being Proposed

- AICPA Auditing Standards Board's re-exposure draft of proposed revised Statement on Auditing Standards No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, and accompanying guidance, *A Framework for Assessing Control Deficiencies* (issued in September 2005 with a 60-day comment period)
- Proposed AICPA Auditing Standards Board's re-exposure draft of revised Attestation Standard 501, *Reporting on an Entity's Internal Control over Financial Reporting*
- AICPA Financial Reporting Alert, *Internal Control Reporting – Implementing Sarbanes-Oxley Act Section 404* (2004)
- AICPA Audit Guide, *Audits of Service Organizations: Applying SAS No. 70* (Updated May 2005)
- U.S. PCAOB Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (March 2004)
- U.S. PCAOB Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (May 2005)
- U.S. PCAOB Proposed Auditing Standard, *Reporting on the Elimination of a Material Weakness* (March 2005)
- U.S. SEC Staff Statement on Management's Report on Internal Control over Financial Reporting (May 2005)
- CICA ballot draft of new auditing section *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (April 2005)
- IDW Auditing Standard AuS 340, *The Audit of the Risk Early Recognition System* (September 2000)
- UK APB Audit Briefing Paper, *Providing Assurance on the Effectiveness of Internal Control* (July 2001)

- UK APB Bulletin 2004/3, *The Combined Code on Corporate Governance: Requirements of Auditors under the Listing Rules of the Financial Services Authority* (November 2004)
- Australian Auditing Standard AUS 810, *Special Purpose Reports on the Effectiveness of Control Procedures*
- Australian AGS 1006, *Expression of an Opinion on Internal Control*
- IAASB Project Proposal, Revision of ISA 402, *Audit Considerations Relating to Entities Using Service Organizations* (January 2005)
- Recent publications of National Standard Setters and others that are relevant
- Firms' methodologies and practices for evaluating and reporting on internal control weaknesses, and for reporting on management's statements on internal control effectiveness

Prepared by Ken Siong

Date August 18, 2005

Approved by Philip Ashton

Date September 1, 2005

(Chair on behalf of the task force)

Approved by _____

Date _____

(Chair on behalf of the board)

COMMENTS BY TECHNICAL MANAGERS

The comments of Technical Manager from each technical area are required before this Project Proposal is considered by the board, committee or permanent task force proposing to undertake the project.

Technical Manager to the Compliance Advisory Panel

It would seem that other standard-setters (PCAOB, UK APB, ASB) have or are developing pronouncements this area and it will be interesting to see to what extent the final ISA will be converged or differ from the pronouncements our member bodies are subject to.

Signed Sylvia Barrett

Date September 15, 2005

Technical Manager to the Developing Nations Permanent Task Force

This standard is of interest to the DNPTF and we would like to be kept regularly informed of progress. It is likely the DNPTF would like to have some input during the development process at a staff level.

Signed Claire Egan

Date September 23, 2005

Technical Manager to the Education Committee

The Committee wishes to be kept informed of project progress and is unlikely to have any wish for direct involvement, except for any aspects which may refer to the competence and skills required to fulfill the requirements prescribe in the standard. There will be an implication for the proposed IES currently under development, *Competence Requirements for Audit Professionals*.

Signed Claire Egan

Date September 23, 2005

Technical Manager to Ethics Committee

No specific comment.

Signed Jan Munro

Date September 28, 2005

Technical Manager to the PAIB Committee

The PAIB Committee is considering undertaking a project on internal control. The first part will be a theme booklet which will comprise interviews with a number of professional accountants in business on various practical aspects of internal control; the second, a series of case studies of

internal control models, encouraging collaborative research and facilitating liaison. We would like to be kept informed on the progress of the IAASB's project.

Signed Robin Mathieson

Date September 27, 2005

Technical Manager to the IPSASB

This subject is of great importance in the public sector. Auditors-general have frequently issued qualified opinions, or disclaimers of opinion, because the level of internal control has been so low as to cause the auditor to have concerns about the financial statements accuracy. Notable examples include the European Commission and the US Department of Defense. INTOSAI's participation in the task force should be considered essential.

Signed Matthew Bohun

Date September 21, 2005

Technical Manager to the SMP Permanent Task Force

This is an important subject for SMPs. We understand that much of the debate surrounding the revisions to SAS 60 on reporting on internal control matters centered on the issues for SME and their auditors. (a) (b) and (c) of the subject scope (page 1) are important to SMP / SME in so far as ensuring the ISA is written with small as well as large entities in mind. (d) is less important, as there is often no effective independent governance function. We would encourage the IAASB to consider appointing an SMP representative to work on the task force. We have a short list of suitable candidates were the IAASB not to find one within their ranks.

Signed Paul Thompson

Date September 22, 2005

Technical Manager to the Transnational Auditors Committee

No specific comment.

Signed Victoria Rand

Date September 28, 2005

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