

Material Weaknesses in Internal Control—Issues Paper**A. BACKGROUND**

At its October 2005 meeting, the IAASB discussed the project proposal to develop guidance to clarify the meaning of the term “material weakness in internal control” in relation to financial reporting. The IAASB recognized that the existing definition of material weakness within the ISAs was rather general. The IAASB thus agreed that it would be appropriate to develop guidance to better explain the meaning of the term. This would improve the consistency with which auditors treat identified weaknesses in controls as material (with consequent reporting implications). The project proposal emphasized that the project would not seek to extend the auditor’s responsibilities beyond those currently set out in ISAs, and would seek to avoid unnecessary complexity in view of the applicability of ISAs to audits of unlisted as well as listed entities. The IAASB further agreed that the output of the project should be amplification and further clarification of the relevant standards and guidance in the existing ISAs, rather than the development of a new ISA.

The IAASB CAG subsequently discussed the project proposal at its November 2005 meeting. CAG representatives generally supported the project and the proposal to incorporate the enhanced definition within the existing ISAs. The European Commission (EC) representative noted that the EC was very interested in the project. In addition, another CAG representative asked that particular attention be given to potential translation issues when developing the revised guidance, particularly regarding terms such as “significant deficiency” and “material weakness.”

The task force met briefly at the December 2005 IAASB meeting to agree preliminary steps to be taken, including the need to research what is being, or has been, done on the subject around the world. The task force subsequently met for two days at the end of March 2006 to review and discuss a number of approaches to definitions or descriptions of “material weakness” and related terms around the world,¹ and to deliberate the issues to be addressed.

Section B below provides an overview of current ISA requirements addressing material weaknesses in internal control. It emphasizes the importance of distinguishing between requirements that apply in an ISA audit and those that apply in an integrated audit.² Section C presents significant issues for the IAASB’s consideration. Section D provides an indication of the proposed way forward in developing the revised guidance.

¹ See Appendix 1.

² An integrated audit comprises an audit of internal control over financial reporting performed in conjunction with an audit of financial statements. The U.S. Public Company Accounting Oversight Board (PCAOB) has issued Auditing Standard 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,” to address integrated audits of internal control over financial reporting for entities listed in the U.S.

B. THE ISA AUDIT VS THE INTEGRATED AUDIT

The extant ISA 315, “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” and the Glossary define the term “material weakness” as follows:

A material weakness in internal control is one that could have a material effect on the financial statements.

This definition pre-dates the audit risk standards. The only requirements pertaining to material weaknesses that ISAs establish are those set out in ISA 315 and ISA 240, “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements,” in relation to communication:

- ISA 315, paragraph 120:

The auditor should make those charged with governance or 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, paragraph 99³:

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.

A key element of these two requirements is that they only address material weaknesses *that have come to the auditor’s attention*. There is thus no requirement for the auditor to actively search for material weaknesses. In addition, the communication requirement applies to any material weakness that the auditor has noted regardless of whether the entity has compensating controls in place, i.e. the auditor is not required to seek out other controls and test them to determine whether they effectively compensate for known weaknesses. The requirements that ISAs 315 and 240 currently impose on the auditor are therefore of a passive nature, involving simply material weaknesses of which the auditor becomes aware during the audit.

In an integrated audit, by contrast, the auditor has a mandate to specifically audit the entity’s internal control over financial reporting⁴ to provide an opinion on its effectiveness. This implies a much wider and deeper scope of work, requiring the auditor to plan and perform specific audit procedures to obtain reasonable assurance that no material weaknesses exist in the entity’s internal control. The integrated audit involves, for example, the auditor obtaining an understanding of control activities encompassing a broader range of accounts and disclosures than what would normally be obtained in an ISA audit. Further, in the context of an identified material weakness, there is an obligation on the auditor to consider the existence of

³ Paragraph 99 of ISA 240 has been deleted in the proposed redrafted ISA 240 under the Clarity project to eliminate duplication.

⁴ The scope of this project is internal control over financial reporting, which is abbreviated “internal control” for the remainder of this paper

compensating controls and to test them to determine whether they effectively compensate for the identified weakness.

The different contexts of the ISA audit and the integrated audit should be borne in mind when considering the following significant issues.

C. SIGNIFICANT ISSUES

1) Factors to Consider in Identifying Material Weaknesses

As explained above, the auditor's responsibilities regarding material weaknesses in an ISA audit are much more limited than those in an integrated audit. The task force was therefore of the view that it would be unnecessary to develop detailed guidance on criteria that might be appropriate to identify and evaluate material weaknesses. The task force felt, however, that it would be helpful to provide enhanced guidance on factors or circumstances that the auditor might consider in identifying material weaknesses during the course of the audit. Such guidance, along with an enhanced definition of a material weakness, would help raise the auditor's awareness of some of the circumstances that might be indicative of material weaknesses. This would, in turn, make it easier for the auditor to recognize such weaknesses should these come to the auditor's attention. In this regard, while the role professional judgment should not be over-emphasized, the task force felt that its importance should be particularly recognized in the context of determining whether control issues that come to the auditor's notice represent material weaknesses in the circumstances.

Paragraph A38 of the exposure draft of ISA 330 (Redrafted) already provides some limited guidance on factors or circumstances the auditor may consider. Specifically, it states that "a material misstatement detected by the auditor's procedures ordinarily indicates the existence of a material weakness in internal control." The task force thought that this particular guidance could be enhanced to state more emphatically that a material misstatement identified by the auditor that was not detected by the entity's internal control would be a strong indicator of a material weakness. Such guidance could be further supplemented with guidance on other relevant factors or circumstances that might be considered strong indicators of material weaknesses, such as:

- Restatements of previously issued financial statements due to error or fraud.
- Ineffective oversight by those charged with governance.
- Ineffective risk assessment component of internal control for a complex entity.
- Evidence of management fraud.

Matter for IAASB's Consideration

Q1. Does the IAASB agree that it would be helpful to provide enhanced guidance on factors or circumstances the auditor might consider in identifying material weaknesses?

2) Elements for an Enhanced Definition of Material Weakness

The task force debated the possible ways in which the definition of "material weakness" could be enhanced. It considered the following definitional elements.

a) Definition of a Control Deficiency

There is currently no definition of a control weakness or a control deficiency in the ISAs. Although the term “material weakness” is long established in ISAs, the task force felt that the word “weakness” itself is rather broad and general. Thus, a general term such as “control weakness” may not convey clearly that there is a deficiency in a control or a set of controls. The task force agreed that the term “material weakness” should continue to be used in ISAs to denote a serious control issue that should be appropriately communicated, given that its use is entrenched in practice. It believed, however, that the specific term “control deficiency”⁵ should be defined to indicate a generic control problem, the nature and severity of which the auditor should evaluate to determine whether it constitutes a material weakness. This specific term would provide a clearer link to a problem in the control the effect of which is to cause the control not to achieve its objective relating to the prevention or detection of material misstatements in the financial statements. It would also enable the auditor to better distinguish between a control problem that is serious from one that is not, thus enabling the auditor to filter out only material weaknesses for reporting purposes. Further, there would be merit in defining control deficiency to eliminate any possibility of confusion with material weakness.

The task force noted a common understanding among a number of national standard setters regarding the essential meaning of a control deficiency as reflected in their respective definitions, i.e. it is a deficiency in the *design* or *effective operation* of a control, regardless of whether the control is preventive or detective in nature. Most of these definitions have been long-standing and, therefore, the meaning of a control deficiency has become well accepted among practitioners in these jurisdictions. The task force agreed that it would be logical for the auditor to focus on identifying a problem in the design or operation of a control, as a control that has not been properly designed or which does not operate as designed would not meet its intended objective. Accordingly, the task force’s view was that the generic term “control deficiency” should be defined in terms of a problem in the design or operation of a control which could result in the control not achieving its objective relating to the prevention or detection of misstatements in the financial statements.

The task force further considered the potential for translation difficulties in the use of terminology, including terms such as control deficiency and material weakness. The task force was of the view that it would be difficult to anticipate all potential translation issues in relation to specific terminology. Accordingly, there should be an attempt to minimize them by developing guidance that clearly explains the different meanings ascribed to different terms.

Matter for IAASB’s Consideration

Q2. Does the IAASB agree that it would be appropriate to define the generic term “control deficiency” in terms of a problem in the design or operation of a control that could result in the control not achieving its objective relating to the prevention or detection of misstatements in the financial statements?

⁵ The term “control deficiency” is already used in the ISA literature (paragraph 100 of extant ISA 240), although in the context of common English usage, but it is undefined.

b) Consideration of the Effects of a Material Weakness on the Current Period Financial Statements

As the auditor may come across material weaknesses during the course of the audit, the task force agreed that the definition of “material weakness” should be related only to consideration of potential material misstatements in the financial statements being audited and not future financial statements. The task force generally believed that the auditor should only be concerned with material weaknesses affecting the current period financial statements as these fall within the scope of the audit. In addition, the determination of the materiality of the potential effects of a control deficiency can only be made in relation to the materiality criteria established for the current audit because the auditor has no information on future financial statements. Accordingly, the task force proposes to clarify the definition of material weakness to indicate that the materiality of the effects should be evaluated by reference to the financial statements *being audited*.

The task force further noted that this clarification would be helpful in highlighting that, although the auditor may identify control deficiencies on a preliminary basis during an interim review of financial statements, the final determination of the existence of material weaknesses should only be made by reference to the full financial statements being audited and not interim financial statements being *reviewed*. This is because the measurement of the effects of identified control deficiencies should only be made by reference to the full period benchmarks and not interim benchmarks.

Matter for IAASB’s Consideration

Q3. Does the IAASB agree that the definition of material weakness should be explicitly related to consideration of the potential effects on the full financial statements being audited for the current period?

c) Likelihood (or Probability) vs. Risk of Material Misstatement

Although ISA 315 defines a material weakness as one that could have a material effect on the financial statements, it does not describe the auditor’s evaluation of the weakness in terms of an assessment of likelihood or risk of adverse effect. The “could” factor in the existing definition sets no threshold, which might imply that even a control deficiency that has a negligible (but greater than zero) chance of resulting in a material misstatement could be considered a material weakness. The task force concluded that it would not be in the public interest to require the auditor to communicate control deficiencies that would be unlikely to lead to (or would have only a slight risk of leading to) material misstatements. Accordingly, the task force felt that the definition of material weakness would be enhanced if it articulated the auditor’s consideration of the likelihood or risk of material misstatement to determine whether a control deficiency or set of control deficiencies constitutes a material weakness.

There seems to be two schools of thought regarding how the potential outcome of a material weakness could be characterized:

- i) The likelihood (or probability) of a material misstatement occurring (the approach used by some national standard setters); and
- ii) The risk of material misstatement not being reduced to an acceptably low level (the approach used by other national standard setters).

It could be argued that the two approaches essentially achieve the same objective of informing about the *potential* for a material misstatement – they only do so by different means. In other words, the first approach considers *how likely* the potential adverse consequence of an identified material weakness would occur, whereas the second approach considers *how exposed to risk* the financial statements are to a material misstatement because of the material weakness.

The task force considered the approach taken by a national standard setter in defining a material weakness as one that results in *more than a remote likelihood* that a material misstatement would not be prevented or detected. The task force felt overall that this approach would tend to over-complicate the guidance that would be necessary to explain the applicable threshold, especially as the assessment of likelihood implies a judgment call as to the possible occurrence of future events. In particular, the task force considered the possibility of establishing the likelihood threshold in such terms as “more than remote,” “reasonably possible,” and “probable,” but felt that these would be contentious. In addition, these terms are inherently subjective, making it difficult to develop guidance that would achieve consistent application. The alternative would be to develop a quantitative probabilistic threshold in terms of a percentage, but the task force did not support this approach as it could lead to mechanistic evaluations of control deficiencies.

In view of this, the task force favored a risk-based approach to determine whether a control deficiency or set of control deficiencies should be classified as a material weakness. The benefit of this approach is that it uses terminology with which auditors are already familiar, and allows for the proper exercise of judgment in the assessment of risk. It would avoid the potential complication of explaining the meaning of likelihood in forward-looking terms. Further, the risk-based approach would be consistent with the objective of effective internal control, which is to provide the entity with reasonable assurance about achieving its financial reporting goals, i.e. a relatively low risk that material misstatements will not be prevented or detected on a timely basis.

Matter for IAASB’s Consideration

Q4. Does the IAASB agree that it would be appropriate to use a risk-based approach to explain the meaning of material weakness?

d) Magnitude of Potential Outcome and Significant Deficiencies

The task force noted that in their varying definitions or approaches to describing a material weakness, national standard setters generally acknowledge the need for the auditor to evaluate the *magnitude* of the potential financial effects of a control deficiency in determining its severity. They also agree in principle that a material weakness is one that could result in a material misstatement of the financial statements. Accordingly, the task force concluded that a material

weakness should continue to be defined in terms of the potential *material* misstatement of the financial statements.

Material weaknesses, however, form only a subset of control deficiencies that might broadly exist at any given time within the entity. While material weaknesses should always be communicated, the task force recognized that a further subset could exist comprising *significant* control deficiencies that are not material weaknesses. These deficiencies would be sufficiently significant that the auditor might wish to report them to management and those charged with governance; however, the magnitude of their potential effects would not qualify them as material weaknesses that should always be communicated.

The task force thought that the determination of whether control deficiencies (individually or in combination) are significant deficiencies but not material weaknesses should be a matter of the auditor's judgment. ISAs should, however, not go so far as to formally establish significant deficiencies as a separate category of control deficiencies, as doing so would necessitate a definition of the term "significant deficiency," complete with thresholds. Given the auditor's limited responsibilities towards material weaknesses in an ISA audit, the task force's view was that this would be inappropriate and could lead to over-complication of the ISAs. Accordingly, the task force agreed that only general guidance should be provided to the effect that the auditor might judge some control deficiencies to be more significant than others but not so significant as to be deemed material weaknesses. In these circumstances, the auditor might judge it appropriate to also communicate those significant deficiencies to management and those charged with governance. Supporting guidance on factors to consider in evaluating significance in this context might then be appropriately added.

Matter for IAASB's Consideration

Q5. Does the IAASB agree that the identification of significant deficiencies should be left to the auditor's judgment and that only general guidance in evaluating significance in this regard should be provided?

e) Combination of Control Deficiencies

The existing definition of material weakness is silent on whether identified control deficiencies should be considered in combination, where relevant, to determine whether they amount to a material weakness. As ISA 315 acknowledges, controls may work individually or in combination to effectively prevent, or detect and correct, material misstatements.

The task force noted that national standard setters generally recognize the need to evaluate control deficiencies not only individually but also in combination to determine whether they could give rise to a material weakness. Thus, control issues that appear immaterial when considered in isolation could well indicate a material weakness when linked. In an ISA audit, however, the auditor is not responsible for identifying all control deficiencies relating to a specific element, account or item in the financial statements to determine whether, in combination, these deficiencies constitute a material weakness. Nevertheless, with regard to

those control deficiencies that have come to the auditor's attention, the task force felt that it would be logical for the auditor to also consider them in combination (where their effects can be combined) to determine whether they constitute a material weakness.

However, one reservation that the task force had in proposing that control deficiencies be combined where applicable was that it could create an expectation gap with the financial statement users, i.e. users could expect the auditor to have identified all control deficiencies that might exist within the entity.

Matters for IAASB's Consideration

Q6. Does the IAASB agree that the definition of material weakness should be clarified to indicate that identified control deficiencies should be evaluated individually and, where applicable, in combination to determine whether they result in a material weakness?

Q7. If so:

- (i) Would there be a need to provide guidance on how the auditor should combine control deficiencies, e.g. by control objective, financial statement assertion, account balance, or internal control component?
- (ii) Would the potential expectation gap discussed above be an acceptable price?

3) Communication Issues

As the existing requirement regarding material weaknesses deals with communication, the task force was of the view that the following issues relating to communications should also be considered in this project.

a) Material Weaknesses not Remediated on Cost-Benefit Grounds

Management may be aware of material weaknesses that it has not remediated on cost-benefit grounds, i.e. it considers the associated risks acceptable. ISAs are currently silent regarding whether the auditor should communicate to those charged with governance material weaknesses of which management is already aware but which it has decided not to remediate on cost-benefit grounds.

It might appear unreasonable for the auditor to report material weaknesses if it would be more costly to remediate them relative to the potential benefits. It could, however, be argued from the public interest perspective that the auditor should communicate material weaknesses regardless of the cost of remediating them because these are serious control issues of which all relevant parties should be aware. This would be consistent with the general requirement in the proposed revised ISA 260, "The Auditor's Communication with Those Charged with Governance," for the auditor to communicate to those charged with governance all significant matters related to the audit that may be relevant to their oversight responsibilities. In addition, if the auditor were to ignore these material weaknesses for communication purposes, the auditor could be viewed as having made the cost-benefit decision on management's behalf. Accordingly, the task force agreed that it would be appropriate to clarify that the general requirement for the auditor to

communicate material weaknesses applies regardless of the cost and benefit of remediating them (and indeed any other considerations).

Matter for IAASB's Consideration

Q8. Does the IAASB agree that it would be appropriate to clarify that the auditor should communicate to those charged with governance material weaknesses that management has chosen not to remediate based on cost-benefit or other considerations?

b) Communication of the Actual or Potential Effects of Material Weaknesses

The ISA 315 requirement for the auditor to communicate material weaknesses to management and those charged with governance appears to imply that only the nature of these matters need be reported. The task force considered whether this requirement should include communication of the actual or potential effects of the material weaknesses. The task force noted that in situations where the auditor has identified *actual* material misstatements arising from material weaknesses before the completion of the audit, the auditor would be able to quantify their magnitude. Although the basic requirement to communicate identified material misstatements to those charged with governance is established in the proposed revised ISA 260, the task force agreed that guidance on communication of material weaknesses should clarify that such communication should provide an indication of any actual material misstatements that have resulted from the material weaknesses.

Where the auditor did not identify actual misstatements arising from material weaknesses during the audit, however, quantification of the potential effects of the weaknesses would inherently be a forward-looking exercise for which a high degree of precision and certainty would not be achievable. Accordingly, the task force agreed that in such circumstances the auditor's communication of material weaknesses should only indicate that specific elements, accounts or items in the financial statements *could* be materially misstated as a result of the identified material weaknesses. Providing only a general indication in this way would avoid the auditor having to justify the auditor's basis for evaluating the potential effects of the weaknesses.

Matter for IAASB's Consideration

Q9. Does the IAASB agree that guidance on the requirement to communicate material weaknesses should clarify that, where *actual* material misstatements have been identified that can be clearly linked to material weaknesses, the auditor should disclose these misstatements when reporting the weaknesses, but should otherwise only provide a general indication that specific elements, accounts or items in the financial statements could be materially misstated?

c) Communication of Material Weaknesses Already Reported by Others

The communication requirement in ISA 315 does not appear to take into account that material weaknesses that come to the auditor's attention may have been previously communicated to

management and those charged with governance. The task force noted, in particular, that the auditor may become aware of the existence of material weaknesses through the work of others (such as internal audit), who may already have communicated them to management and those charged with governance. The task force considered whether the auditor should repeat this communication even though the auditor may be aware that the relevant matters have already been brought to the attention of management and those charged with governance.

Given that the auditor has a different objective than others who may also have identified the same control issues, the task force was of the view that the auditor should communicate identified material weaknesses without regard to whether management and those charged with governance have prior knowledge of them. In addition, others who may have reported the control issues to management and those charged with governance may not have identified them as material weaknesses as defined in the ISAs, or may have reported them under different contexts. Accordingly, the task force believes some clarification to the guidance may be appropriate to address this consideration.

Matter for IAASB's Consideration

Q10. Does the IAASB agree that it would be appropriate to clarify the auditor's responsibility to communicate material weaknesses even though the same matters may already have been reported on by others?

d) Communication of Material Weaknesses Remediated by the Completion of the Audit

The task force considered whether the requirement to communicate material weaknesses should encompass a material weakness that existed during the period under audit but which the entity remediated by the end of the audit. The auditor may become aware of such a material weakness through discussion with sources within the entity (such as its accounting or internal audit personnel), or simply because the auditor reported it during the previous audit. The task force agreed that the communication of material weaknesses need not include those that have been remediated because such weaknesses should no longer exist.

Matter for IAASB's Consideration

Q11. Does the IAASB agree that some clarification could be provided that the requirement to communicate material weaknesses does not include those that have been remediated?

4) Other Issues

a) Form and Content of Communication

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 auditor's communication (e.g. purpose, types of matters reported, and illustrative reports) regarding material weaknesses noted during the audit. The proposed revised ISA 260 only requires that the auditor communicate in writing with those charged with governance regarding

significant findings from the audit if the auditor judges that oral communication would be inadequate. The task force felt that findings of material weaknesses are sufficiently serious that they should be formally communicated to those charged with governance in writing (this would not preclude the auditor from initially bringing them to the attention of those charged with governance orally for practical purposes). Accordingly, the task force agreed that the basic communication requirement in ISA 315 should be clarified to that effect.

With regard to developing guidance on the content of the auditor's communication, the task force felt that this would be outside the scope of this project, as it would likely involve the need to establish new requirements to standardize such content. The task force agreed that the development of specific guidance on content, if considered necessary, should be more appropriately addressed within the scope of the ISA 260 project.

Matters for IAASB's Consideration

Q12. Does the IAASB agree that communication of material weaknesses to those charged with governance should be in writing?

Q13. Does the IAASB agree that the development of further guidance on the content of the auditor's communication would be outside the scope of this project?

b) Consideration of Statements Made by Management or Those Charged with Governance Regarding Internal Control

A number of new regulatory requirements⁶ have recently emerged around the world calling for management or those charged with governance to provide written statements on risk management or internal control ("internal control statements") as part of their companies' annual reports containing the audited financial statements. The task force considered whether the auditor should have a responsibility to read such statements for consistency with the auditor's knowledge. In particular, in the event that the auditor has identified material weaknesses, the task force discussed whether this would place any constraints on what the auditor would regard as being consistent with the auditor's knowledge when reading such statements.

The task force considered whether a responsibility to consider internal control statements would fall under the general requirement in ISA 720, "Other Information in Documents Containing Audited Financial Statements," for the auditor to read other information in documents containing audited financial statements to identify material inconsistencies with the financial statements. The task force noted that ISA 720 explains that a "material misstatement of fact" in other information exists when such information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented. ISA 720 further states that while reading the other information for this purpose, the auditor may *become aware* of an apparent material misstatement of fact, which the auditor should discuss with management.

⁶ For example, requirements under the UK Combined Code and the European Commission's revised 4th and 7th Directives.

Under this guidance, the task force concluded that inaccurate internal control statements would represent material misstatements of fact. In addition, although there is no explicit requirement in ISA 720 for the auditor to search for material misstatements of fact, the auditor would be required to discuss with management inaccurate internal control statements if they come to the auditor's attention. Accordingly, the task force agreed that it would be helpful to clarify the guidance in ISA 720 by illustrating material misstatements of fact in terms of inaccurate internal control statements.

Matter for IAASB's Consideration

Q14. Does the IAASB agree that a conforming change to guidance in ISA 720 could be made to clarify that material misstatements of fact include inaccurate internal control statements?

D. WAY FORWARD

Taking the above discussion of the issues into account, the task force suggests on a preliminary basis that guidance be developed or revised as indicated below. In addition, the task force has reviewed references to material weaknesses and related terms in extant ISAs, ISREs, and recent exposure drafts and draft revised ISAs, and has provided an indication of possible conforming changes in Appendix 2.

Issue	Nature of Guidance	Location
The meaning of material weaknesses		
The need for a revised definition of material weakness	Enhanced definition of material weakness tied to the financial statements being audited, supported by a definition of a control deficiency	ISA 315
Guidance on factors or circumstances to consider in identifying material weaknesses	Illustrative guidance on factors or circumstances that might be strong indicators of material weaknesses	ISA 315; Guidance in para A38 of ISA 330 (Redrafted) clarified and moved to ISA 315
Identification of control deficiencies that are more significant than other control deficiencies but that are not material weaknesses	Guidance on the identification of control deficiencies that are more significant than other control deficiencies but that are not material weaknesses Guidance on the communication of such significant deficiencies to management and those charged with governance, based on the auditor's judgment	ISA 315
The role of compensating controls	Clarification of the auditor's responsibility to evaluate and test compensating controls in the presence of identified control deficiencies	ISA 315

Issue	Nature of Guidance	Location
Combination of control deficiencies	Guidance on combination of control deficiencies based on parameters such as account balance or financial statement assertion	ISA 315
Communication issues		
Material weaknesses not remediated for cost-benefit or other reasons	Clarification of whether the communication requirement encompasses circumstances where management has decided not to remediate material weaknesses even though management is aware of them	ISA 315
Communication of actual or potential effects of material weaknesses	Clarification of whether the auditor should communicate any specific actual or potential effects of material weaknesses	ISA 315
Communication of material weaknesses already reported by others	Clarification of the auditor's responsibility to communicate material weaknesses already communicated by others	ISA 315
Communication of material weaknesses remediated by the end of the audit	Clarification of the auditor's responsibility to communicate material weaknesses already remediated by the end of the audit	ISA 315
Other issues		
Form of communication of material weaknesses	Clarification that the communication should formally be in writing	ISA 315
Consideration of the existence of inconsistencies in internal control statements made by management or those charged with governance	Conforming amendment to ISA 720 to illustrate material misstatements of fact in terms of inaccurate internal control statements	ISA 720

Appendix 1

Approaches to Defining or Describing Material Weaknesses and Related Terms Around the World

The following lists a number of approaches to definitions or descriptions of material weaknesses and related terms around the world.

1) Prior AICPA Standard

The AICPA's Auditing Standards Board recently revised its standard on communication of internal control-related matters noted in an audit (AU 325). The revised standard establishes definitions that are consistent with those in the PCAOB's Auditing Standard 2. AU 325, before its revision, provided the following definitions:

- “Reportable conditions” are matters coming to the auditor’s attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
- A “material weakness” in internal control is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

2) Australian Standard

Australia’s auditing standard AUS 810⁷ deals with special purpose reports on the effectiveness of control procedures. It is set in the context of special purpose engagements (audit, review or agreed-upon procedures) to report on internal control, and provides the following definition:

- “Control weakness” means a deficiency in the design of control procedures or a deficiency in operation of a control procedure that could potentially result in risks relevant to the area of activity not being reduced to an acceptable level. Relevant risks are those that threaten achievement of the objectives relevant to the area of activity being examined.

3) Basel Committee on Banking Supervision

In its September 1998 document, “Framework for Internal Control Systems in Banking Organizations,” the Basel Committee outlined 13 principles for use by banking supervisory authorities when evaluating banks’ internal control systems. Although this framework does not specify any definitions, it provides the following relevant guidance:

⁷ AUS 810 has not received legislative backing in Australia but remains applicable to professional accountants in that jurisdiction.

- Internal control deficiencies, or ineffectively controlled risks, should be reported to the appropriate person(s) as soon as they are identified, with serious matters reported to senior management and the board of directors.
- Control issues that appear to be immaterial when individual control processes are looked at in isolation, may well point to trends that could, when linked, become a significant control deficiency if not addressed in a timely manner.

4) German Standard on Audit of the “Risk Early Recognition System”

German auditing standards are essentially aligned with ISAs but Germany does have a specific auditing standard dealing with the audit of the “Risk Early Recognition System” that a listed entity is required by law to design and implement to (a) provide it with early warning of risks that may endanger the entity as a going concern, and (b) enable the entity to manage those risks.

The German Standard does not provide any specific definitions, but it explains the concept of “risk analysis” in the following terms, in the context of ensuring that the entity can continue as a going concern:

- Risk analysis includes the assessment of the probability of occurrence and of the quantitative effects of recognized risks, and also assessment of risks of lesser significance, which when considered in isolation, may – through their interaction or cumulatively over time – risk endangering the going concern basis.

5) Definitions in the PCAOB Standard

The PCAOB’s Auditing Standard 2, which deals with an audit of internal control over financial reporting performed in conjunction with an audit of financial statements, provides the following definitions:

- 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”⁸ is a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a

⁸ As part of a four-point plan to improve auditors’ implementation of the internal control reporting provisions of the Sarbanes-Oxley Act of 2002, the PCAOB announced on May 17, 2006 that it would revise Auditing Standard 2 to clarify the definitions of “significant deficiency” and “material weakness.”

misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be prevented or detected.

- A “material weakness”⁸ is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

6) UK Auditing Practices Board

In its July 2001 briefing paper, “Providing Assurance on the Effectiveness of Internal Control,” the APB discussed concepts underlying the provision of assurance on internal control. The APB did not provide any specific definitions in its paper, but it stated the following with regard to risk identification and assessment:

- Once identified, risks can be assessed in terms of their likelihood (probability), imminence (timing) and potential impact (materiality). Risk assessment is the process of prioritizing the ‘potential risks’ into those ‘applicable risks’ that need to be actively managed. [Paragraph 32]

APPENDIX 2

References to Material Weaknesses and Related Terms in ISAs, ISREs and Recent Drafts of Proposed Revised or Redrafted ISAs, with Suggested Changes

Paragraph	Reference	Suggested Change
ISA 210 (Terms of engagement)		
Appendix	<p>Example of an Engagement Letter</p> <p>You have requested that we audit the financial statements of ...</p> <p>In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we expect to provide you with a separate letter concerning any material weaknesses in the design or implementation of internal control over financial reporting that come to our attention during the audit of the financial statements....</p>	<p>Strengthen wording of engagement letter by replacing the statement “we expect to provide you with a separate letter...” with wording such as “we will communicate to you material weaknesses that have come to our attention...”</p> <p>Also, clarify that material weaknesses can also arise in the <i>operation</i> of internal control</p>
Exposure Draft of ISA 240 (Redrafted)		
A1	<p>Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in internal control. ...</p>	<p>Possible conforming change in terminology (i.e. more specific reference to control deficiencies as opposed to weaknesses)</p>
A31	<p>Consideration of Fraud Risk Factors</p> <p>Considerations Specific to Smaller Entities</p> <p>In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.</p>	<p>Possible conforming change in terminology</p>

Paragraph	Reference	Suggested Change
A63	<p>Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:</p> <ul style="list-style-type: none"> • ... • A failure by management to appropriately address identified material weaknesses in internal control, or to appropriately respond to an identified fraud. • ... 	No change
Appendix 1	<p>Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting</p> <p><i>Opportunities</i></p> <p>The nature of the industry or the entity’s operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:</p> <p>...</p> <p>Internal control components are deficient as a result of the following:</p> <ul style="list-style-type: none"> • ... • Ineffective accounting and information systems, including situations involving material weaknesses in internal control. <p><i>Attitudes/Rationalizations</i></p> <p>...</p> <ul style="list-style-type: none"> • Management failing to correct known material weaknesses in internal control on a timely basis. <p>...</p> <p>Risk Factors Arising From Misstatements Arising From Misappropriation of Assets</p> <p>...</p> <p>Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.</p> <p>...</p> <p><i>Attitudes/Rationalizations</i></p> <p>...</p>	Possible conforming changes in terminology

Paragraph	Reference	Suggested Change
	<ul style="list-style-type: none"> Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies. 	
Appendix 3	<p>Examples of Circumstances that Indicate the Possibility of Fraud</p> <p>Problematic or unusual relationships between the auditor and management, including:</p> <p>...</p> <ul style="list-style-type: none"> An unwillingness to address identified weaknesses in internal control on a timely basis <p>...</p>	Possible conforming change in terminology
Proposed Revised ISA 260 (Redrafted)		
16	<p>The auditor shall communicate with those charged with governance:</p> <p>...</p> <p>(c) Unless all of those charged with governance are involved in managing the entity:</p> <p>(i) Material weaknesses, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention;</p> <p>...</p>	No change
A45	<p>The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:</p> <ul style="list-style-type: none"> ... It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, it may often be appropriate to communicate material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention as soon as practicable. ... 	No change
A31	<p>The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with</p>	Possible conforming change in terminology if significant deficiencies identified as a separate

Paragraph	Reference	Suggested Change
	governance in for overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, e.g., significant deficiencies in governance structures or processes , and significant decisions or actions by senior management that lack appropriate authorization.	category of control deficiencies
Exposure Draft of ISA 300 (Redrafted)		
Appendix	<p>Examples of Matters the Auditor may Consider in Establishing the Overall Audit Strategy</p> <p><i>Matters that Determine the Focus of the Engagement Team's Effort and Direction of the Audit ...</i></p> <ul style="list-style-type: none"> Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified weaknesses and action taken to address them. <p>...</p>	Possible conforming change in terminology
Exposure Draft of ISA 315 (Redrafted)		
4(c)	Material weakness – A weakness in internal control that could have a material effect on the financial statements.	Revised definition
26	<p>The auditor shall as soon as practicable make those charged with governance and management, at an appropriate level of responsibility, aware of material weaknesses in the design or implementation of internal control which have come to the auditor's attention. Such controls may include those to prevent, or detect and correct, error, or those to prevent and detect fraud. The auditor shall include within material weaknesses the following:</p> <ul style="list-style-type: none"> Risks of material misstatement that the auditor identifies and which the entity has either not controlled, or for which the relevant control is inadequate. A weakness in the entity's risk assessment process that the auditor identifies as material. 	Possible conforming changes in terminology and to also refer to effectiveness of operation
A33	The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A87-A90), though their purposes may overlap. Monitoring of controls is specifically concerned with the effective operation of internal control through consideration of information about the control. The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties). In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control .	Possible conforming change in terminology

Paragraph	Reference	Suggested Change
Exposure Draft of ISA 330 (Redrafted)		
A2	The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at period end. Weaknesses in the control environment , however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by conducting more audit procedures as of the period end rather than at an interim date, seeking more extensive audit evidence from substantive procedures, or increasing the number of locations to be included in the audit scope.	Possible conforming change in terminology
A38	A material misstatement detected by the auditor's procedures ordinarily indicates the existence of a material weakness in internal control .	Conforming change to indicate that material misstatements are ordinarily strong indicators of material weaknesses Consideration of transferring this guidance to ISA 315
A50	An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, <ul style="list-style-type: none"> The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a material weakness in internal control. ... 	No change
Proposed Revised ISA 540 (Close Off Draft)		
21	During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. If so, the auditor considers why the entity's risk assessment process failed to identify them and whether the process is appropriate for the circumstances. ISA 315 provides guidance when the auditor identifies a material weakness in the entity's risk assessment processes .	Possible conforming change in terminology

Paragraph	Reference	Suggested Change
Re-Exposure Draft of Proposed Revised ISA 600 (Group Audits)		
39	<p>The other auditor’s memorandum or report of work performed in accordance with paragraphs 22-24 shall contain matters relevant to the group auditor’s conclusion with regard to the group audit. In particular, it shall:</p> <p>...</p> <p>(f) Describe any identified material weaknesses in internal control over financial reporting at the component level;</p> <p>...</p>	No change
46	<p>The group auditor shall make group management aware, on a timely basis and at an appropriate level of responsibility, of:</p> <p>(a) Material weaknesses in the design or operation of group-wide controls, including controls over the preparation and presentation of the group financial statements;</p> <p>(b) Material weaknesses in internal controls at components that have been identified by the group auditor, or that have been brought to the attention of the group auditor by the other auditors, that the group auditor judges are of significance to the group.</p>	Possible conforming changes
A11	<p>In a group audit, matters such as the following may be included in the terms of engagement in addition to those required by ISA 210, “Terms of Audit Engagements:”</p> <ul style="list-style-type: none"> • ... • The fact that important communications between the other auditors, those charged with governance of the component, and component management, including communications on material weaknesses in internal control, should be made available to the group auditor. • ... 	No change
Appendix	<p>Additional Matters to be Included in the Group Auditor’s Letter of Instruction (Paragraph A33)</p> <p>Other information</p> <ul style="list-style-type: none"> • A request that the following are reported to the group auditor in a timely basis: <ul style="list-style-type: none"> ○ ... ○ Material weaknesses in controls that have come to the attention of the other auditor during the performance of the work on the financial information of the component, and information that indicates that a fraud may exist. 	No change

Paragraph	Reference	Suggested Change
ISRE 2410 (Interim Reviews)		
15	<p>The procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following:</p> <ul style="list-style-type: none"> • ... • Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control. 	Possible conforming change to clarify that the reference to material weaknesses is in relation to the preparation of the <i>annual</i> financial statements
18	<p>This understanding enables the auditor to focus the inquiries made, and the analytical and other review procedures applied in performing a review of interim financial information in accordance with this ISRE. As part of obtaining this understanding, the auditor ordinarily makes inquiries of the predecessor auditor and, where practicable, reviews the predecessor auditor's documentation for the preceding annual audit, and for any prior interim periods in the current year that have been reviewed by the predecessor auditor. In doing so, the auditor considers the nature of any corrected misstatements, and any uncorrected misstatements aggregated by the predecessor auditor, any significant risks, including the risk of management override of controls, and significant accounting and any reporting matters that may be of continuing significance, such as material weaknesses in internal control.</p>	No change

[Blank Page]