



**International Federation of Accountants**

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

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

# Agenda Item 2

**Committee:** IAASB

**Meeting Location:** New York

**Meeting Date:** October 25–27, 2006

## **Material Weaknesses in Internal Control**

### **Objectives of Agenda Item**

1. To discuss the comments received from CAG representatives at the September 2006 CAG meeting regarding the development of enhanced guidance on material weaknesses in internal control, and to obtain the views of the IAASB on the way forward.

### **Task Force Composition**

2. The members of the task force are as follows:
  - Philip Ashton (Chair, IAASB Technical Advisor and former IAASB Member)
  - Dr Mohammed Bahjatt (INTOSAI Representative)
  - Phil Cowperthwaite (IAASB Member)
  - Bodo Richardt (IAASB Member)
  - Makoto Shinohara (IAASB Member)
  - George Tucker (IAASB Technical Advisor)

### **Background**

3. At the October 2005 meeting, the IAASB approved a project proposal to develop guidance to clarify the meaning of the term “material weakness in internal control” in relation to financial reporting. A key consideration emphasized in the project proposal was that the project would not seek to extend the auditor’s responsibilities beyond those currently set out in the ISAs. At the July 2006 meeting, the IAASB considered a first issues paper prepared by the task force. Among the issues discussed, the IAASB considered a number of possible approaches to defining a material weakness. It also discussed the level at which identified control weaknesses<sup>1</sup> should be required to be reported, particularly in light of the experience of the AICPA’s Auditing Standard Board in developing standards and guidance on material weaknesses.

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<sup>1</sup> For the purposes of this paper, a control weakness denotes a generic control issue.

**Activities since Last IAASB Discussions**

4. The task force held a brief meeting in September 2006 shortly after the CAG meeting to discuss the input received from CAG, and to agree broadly the further issues on which to seek the IAASB's views prior to the preparation of a first draft of the revised guidance.

**Issues for IAASB's Consideration****A. CONTROL WEAKNESSES TO BE REPORTED****A1. *Should the Auditor be Required to Report More than Just Material Weaknesses?***

5. At the July meeting, the IAASB generally agreed that it would not be in the public interest for the ISAs to limit the requirement to report only the most serious control issues, and asked the task force to consider an approach that would allow auditors to report control weaknesses at an "intermediate" level of seriousness.<sup>2</sup> This is primarily because the ISAs establish only a *private* reporting requirement to management and those charged with governance. There was general consensus that it would be undesirable if the ISAs were to require the reporting of only the most serious control weaknesses, as this might result in the less serious issues not being reported at all. It was recognized that under audits performed in accordance with ISAs ("ISA audits"), auditors currently tend to report more control weaknesses than just those that are at the most serious level. Accordingly, it was agreed that it would not be advisable to change a practice that continues to enable auditors to serve audited entities well.
6. There was significant support from the CAG representatives for auditors to report more than just material weaknesses. In particular, the CAG working group for this project supported distinguishing a broader range of control weaknesses from material weaknesses. The working group was, however, unclear as to whether the auditor should define precise criteria by which to establish the threshold for this broader range, or whether the auditor should base the decision as to whether to communicate reportable conditions other than material weaknesses entirely on professional judgment. In either case, it expressed the view that the auditor should be required to report all identified reportable conditions to those charged with governance.
7. Two CAG representatives, however, disagreed. They argued that the auditor should be required to report only material weaknesses, with the reporting of other identified reportable conditions left open. They felt that establishing a requirement for the auditor to report all identified reportable conditions would imply a responsibility to *search for* reportable conditions. In addition, they argued that ISAs should not require the reporting of all reportable conditions because the auditor may well not identify all that exist, particularly given that an ISA audit does not include a full audit of internal control. Such an expectation gap would not be in the public interest.

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<sup>2</sup> These intermediate-level control weaknesses were known as "reportable conditions" in an earlier version of the AICPA's Auditing Standard Board's SAS 60, "Communication of Internal Control Related Matters Noted in an Audit." They are presently known as "significant deficiencies" in the U.S. PCAOB's Auditing Standard 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." For the purposes of this discussion, the term "reportable conditions" will be used.

8. One CAG representative emphasized the importance of open and clear communication about all identified control weaknesses between the auditor and those charged with governance, noting that it would be a matter of concern if an issue came to light that should have been reported but was not. Along the same lines, another CAG representative expressed the view that identified control weaknesses should not be categorized based on the level of importance. Instead, when in doubt, the auditor should report the control weakness to those charged with governance.
9. The task force remains of the view that, for the public interest reasons stated above, the auditor should be required to report those reportable conditions of which the auditor becomes aware when performing the audit. This would be consistent with the views expressed at the CAG meeting that it is important to maintain open and clear communication with those charged with governance regarding internal control issues that the auditor has noted, and that if in doubt, the preferred approach would be for the auditor to report the matter rather than not.
10. The task force does not agree that a requirement to communicate reportable conditions would imply a responsibility for the auditor to search for them, as the same could be said of a requirement to report material weaknesses. In relation to reporting control weaknesses, the reporting requirement in an ISA audit only pertains to control matters that have *come to the auditor's attention*. Accordingly, a requirement to communicate reportable conditions under the ISAs would not imply a requirement for the auditor to perform procedures to obtain a complete list of such matters. In this respect, the task force's view is that the use of the adjective "all" when referring to the reporting of reportable conditions has the potential for creating misunderstanding as to the scope and extent of the auditor's work. The task force believes that it will be possible to avoid the use of such wording when revising the relevant requirement.
11. Finally, the task force believes that establishing a requirement for the auditor to identify material weaknesses would not lead to an extension of the scope of the auditor's work, as in practice, auditors would form a judgment during the course of their work as to which weaknesses are more serious than others. The task force recognizes that management and those charged with governance would value an indication from the auditor as to which of the matters the auditor has reported require more immediate attention. The task force remains of the view that this approach would retain a light-touch approach to the reporting of material weaknesses without imposing a significant additional burden of work on the auditor.

**Matters for IAASB Consideration**

- Q1. Does the IAASB agree that the auditor should be *required* to report more than just material weaknesses of which the auditor becomes aware during the audit?
- Q2. Does the IAASB agree that there should also be a requirement for the auditor to report material weaknesses, but that guidance should be provided that would indicate that the identification of those weaknesses which the auditor shall report is a matter of the auditor's judgment?

**A2. How Precisely Should the Threshold for a Reportable Condition be Defined?**

12. CAG representatives generally agreed that there should not be a requirement for the auditor to report inconsequential control weaknesses (i.e. those that are trivial). They also agreed on the role of professional judgment in determining which control weaknesses are matters that should be reported. Some, however, supported the provision of specific guidance on the application of that judgment to enable the auditor to make a clear determination as to when a control weakness should be treated as a reportable condition, i.e. when does a control weakness cross the line to become a reportable condition?
13. The task force's view is that it is important to allow for an element of flexibility in the process of determining whether a control weakness is a reportable condition, simply because that determination is so judgmental. In particular, it will be difficult in many cases for the auditor to avoid facing a significant level of uncertainty regarding the likelihood that an identified control weakness will lead to a misstatement, and the potential magnitude of that misstatement. Further, in the absence of a public reporting requirement to give reasonable assurance on internal control, there is a lesser need for the auditor to be precise about the classification of control weaknesses, but a greater need to *inform* management and those charged with governance of control matters that would merit their attention. This view was supported by other CAG representatives.
14. Accordingly, the task force recommends a flexible approach to the definition of a reportable condition that would retain an emphasis on the application of professional judgment, as opposed to an approach that would specify precise criteria to enable the auditor to make a determination as to when a control weakness crosses the line to become a reportable condition. This has the benefit of establishing a relatively simple approach that auditors of both large and small entities would be able to apply without significant further work effort over and above what is required under the current ISA regime.
15. Notwithstanding the above, the task force does agree with comments made by some CAG representatives that it would be helpful to provide general guidance to illustrate some of the circumstances in which the auditor would communicate reportable conditions.

**Matters for IAASB Consideration**

- Q3. Does the IAASB agree that it would be appropriate to retain a relatively flexible definition of reportable conditions, such as control issues (other than trivial matters) that, in the auditor's view, merit the attention of management and those charged with governance?
- Q4. Does the IAASB agree that it would be helpful to provide general guidance on some circumstances in which the auditor may communicate reportable conditions?

**A3. How Precisely Should the Term “Material Weakness” be Defined?**

16. The original mandate for this project was to clarify the existing definition of material weakness<sup>3</sup> in the ISAs. Given the recognition that it is more important for the auditor to communicate a broader range of control weaknesses for purposes of the ISAs, the question arose at the July IAASB meeting as to whether there is a need for the auditor to separately identify and report material weaknesses, and thus whether the term “material weakness” needs to be defined for these purposes.
17. The IAASB generally agreed that not defining the term in the ISAs would leave a void that would be filled by regulators, national standard setters and others who would find a need to define the term for their various purposes. This would be an undesirable situation in a world seeking convergence over the longer term. In addition, the term has long been established in the ISAs and is familiar to practitioners around the world. Accordingly, the general consensus was that a public interest need exists for an international definition to remain available that stakeholders could refer to and use as appropriate.
18. This view received significant support from the CAG representatives. One CAG representative, however, noted that establishing material weaknesses as a category of control weaknesses (indicating a need for the auditor to evaluate the significance of every identified control weakness to determine whether it should be classified as a material weakness) might be seen as giving rise to a substantial increase in auditor work effort. It was also argued that a failure to alert those charged with governance that a particular control weakness is a material weakness could expose the auditor to a charge of negligence after the fact.
19. Although the CAG working group supported defining material weaknesses in the ISAs, it raised the further issue that, even with an ISA definition, difficulties could still arise if that definition were to differ from those established in other national auditing standards, particularly those promulgated by the U.S. PCAOB. The working group was concerned that this could create problems for preparers, auditors and users around the world. The IAASB touched upon this issue at the July meeting, specifically in relation to the definition in the PCAOB’s Auditing Standard 2,<sup>4</sup> although it did not reach a conclusion. In this regard, a CAG representative questioned whether the issue is not so much one of definition but rather how a single definition is applied in the different audit scopes (level of assurance and work effort).
20. The task force remains of the view that material weaknesses should continue to be defined in the ISAs, albeit in a revised form, for the public interest reasons mentioned above. Although it has not yet concluded on what that revised definition might appropriately be, it is of the opinion that a definition characterized by specific defined thresholds (such as along the lines of the current definition in the PCAOB’s Auditing Standard 2) is neither appropriate nor

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<sup>3</sup> A “material weakness” is presently defined in the ISAs as “one that could have a material effect on the financial statements.”

<sup>4</sup> The PCAOB’s Auditing Standard 2 defines a material weakness as follows:

“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 annual or interim financial statements will not be prevented or detected.” (The PCAOB announced in May 2006 that it would revise this definition).

practicable because the ISAs do not require a full audit of internal control. Accordingly, the level of assurance that the auditor gives, implicitly or explicitly, on internal control in an ISA audit is less than that which is possible under a full audit of internal control. Furthermore, an external reporting requirement would necessitate a greater degree of precision in the definition to support a more comprehensive evaluation framework.

21. Accordingly, the task force's preliminary recommendation is for the revised ISA definition to allow for a greater degree of judgment in the evaluation process, focusing on whether the control weakness could *clearly* result, directly or indirectly, in a material misstatement of the financial statements. The task force acknowledges that this would represent a structurally different definition from the one the PCAOB has adopted, although the principal component would remain the same, i.e. the weakness could result in a material misstatement of the financial statements that is not prevented or detected. The task force is of the view that the difference in definition will emphasize the difference between the scope of an ISA audit and the scope of an audit that includes an audit of internal control. Indeed, because of the different audit scopes and reporting obligations, the task force is not at this stage persuaded that the co-existence of differing ISA and PCAOB definitions will cause significant issues with preparers, auditors and users in practice.
22. With regard to the other concerns expressed by the CAG representatives (paragraph 18 above), the task force does not believe that defining the term "material weakness" in the ISAs will imply a need for the auditor to perform significant additional work to classify identified control weaknesses as material weaknesses. The task force also does not believe that defining the term in the ISAs would create liability issues for practitioners because ISAs do not establish any public reporting requirement for material weaknesses. Further, an identified control weakness would be reported to those charged with governance under the proposed requirement for the auditor to communicate reportable conditions, regardless of whether the control weakness is in fact a material weakness.

#### **Matters for IAASB Consideration**

- Q5. Does the IAASB agree that there is sufficient justification for having an ISA definition of material weakness that is different from the PCAOB definition?
- Q6. What are the IAASB's views regarding how a material weakness should be defined in the ISAs? In particular:
  - (a) Would it be sufficient to define a material weakness broadly in terms of whether it could clearly result, directly or indirectly, in a material misstatement of the financial statements that is not prevented or detected?
  - (b) Should the definition include reference to the limited scope of work performed on internal control, the absence of assurance given thereon, and the fact that the material weaknesses reported are only matters that have come to the auditor's attention?

**B. TERMINOLOGY TO BE USED*****B1. What Term Should be Used to Denote Control Weaknesses at the Intermediate Level?***

23. In addition to the term “material weakness,” the task force believes that two further terms need to be defined:
- a) A generic control issue, the nature and significance of which the auditor should evaluate to determine whether it should be reported; and
  - b) A significant control issue in the nature of a reportable condition.
24. In relation to the first item, the task force believes that a generic control issue could be referred to as either a “control weakness” or a “control deficiency.” A number of national auditing standard setters have chosen the latter and defined it in terms of a deficiency in the design or effective operation of a 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. The task force is mindful of the need to minimize the extent of differences with established definitions elsewhere, unless there are good reasons for having such differences. Accordingly, the task force suggests that the term “control deficiency” be adopted together with the aforementioned definition, which the task force believes captures the meaning intended reasonably well.
25. With regard to significant control issues that are in the nature of reportable conditions, a number of CAG representatives advised against calling these “significant deficiencies,” as this term is difficult to translate in a number of languages. In addition, the adjective “significant” itself is used to qualify other terms in different contexts in the ISAs and these terms have generally not been defined. More importantly, given the task force’s suggested approach to defining reportable conditions (see paragraphs 13-14 above), the task force believes it is necessary to use a term that is different from the significant deficiencies that the PCAOB has defined in its standards.
26. The task force has not reached a conclusion on the appropriate term to use to refer to reportable conditions. The following options could be considered:
- a) Reportable conditions;
  - b) Reportable deficiencies;
  - c) Reportable weaknesses; or
  - d) Control matters to be reported (or reportable control matters);
27. The first of these options had a specific definition<sup>5</sup> in the previous version of the AICPA’s Auditing Standards Board’s SAS 60. This standard was subsequently revised in February 2006

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<sup>5</sup> The previous SAS 60 defined “reportable conditions” as 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. Such deficiencies may involve aspects of the five internal control components of (a) the control environment, (b) risk assessment, (c) control activities, (d) information and communication, and (e) monitoring.

and the term was deleted. The task force believes the definition it is proposing differs from the definition of reportable conditions in the earlier SAS 60 and, accordingly, recommends that this term not be used to minimize confusion. The task force seeks the IAASB's guidance on the other suggestions.

**Matters for IAASB Consideration**

- Q7. Does the IAASB agree that it would be appropriate to adopt the term "control deficiency" as other national standard setters have defined it?
- Q8. What would be the most appropriate term to use to refer to a control matter that the auditor should report to management and those charged with governance?

**C. WAY FORWARD**

28. As briefly considered at the July IAASB meeting, the task force supports the idea that a separate ISA, including sections for an objective, requirements and application material, be developed from this project as a companion document to ISA 315. This ISA could be numbered 316. This will ensure that all the relevant requirements and application material pertaining to material weaknesses can be located in one readily accessible place. It will also facilitate the development of the material as the project moves forward, and minimize the extent of changes to ISA 315 (the final version of which the IAASB just approved in September) and other relevant ISAs.

**Matter for IAASB Consideration**

- Q9. Does the IAASB agree that it would be appropriate to develop a new ISA 316 to contain all the revised material?