



International Federation of Accountants

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Agenda Item

8

Committee: IAASB

Meeting Location: Madrid

Meeting Date: September 24–28, 2007

Communicating Reportable Deficiencies in Internal Control

Objectives of Agenda Item

1. To review a first-read draft of the proposed ISA XXX, *Communicating Deficiencies in Internal Control Noted in an Audit*.

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)
 - Makoto Shinohara (IAASB Member)
 - George Tucker (former IAASB Technical Advisor)

Background

3. The original purpose of this project was to develop a revised definition of “material weaknesses” in internal control as this term is used in the ISAs, and to clarify the auditor’s responsibilities to evaluate and communicate such matters to management and those charged with governance. As this project has evolved and new issues have arisen during debate at a number of meetings of the IAASB and the IAASB Consultative Advisory Group (CAG), there has been a shift to a current focus on developing a clear definition of the threshold at which control deficiencies should be communicated to management and those charged with governance, and the level of detail at which such matters should be communicated.
4. This project is being undertaken in the context of the following regulatory and standard-setting developments:
 - (a) The requirement under the European Union’s (EU’s) Statutory Audit Directive for auditors to report identified material weaknesses to audit committees; and
 - (b) The U.S. Public Company Accounting Oversight Board’s (PCAOB’s) newly released Auditing Standard 5, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements*.

Activities since Last IAASB Discussions

5. The task force met in July 2007 to consider the significant comments received at the April 2007 meetings of the IAASB and the IAASB CAG. In developing the wording of the proposed ISA, the task force considered the definitions of material weakness and related terms in the PCAOB's Auditing Standard 5. The task force held a conference call in August 2007 to finalize the wording of the proposed ISA now being presented to the IAASB.

Main Outcome of April 2007 IAASB Discussions

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

Option 1

Establish a definition similar to the definition set out in the PCAOB's Auditing Standard 5.¹ The primary benefit of this approach would be the harmonization of the definition of "material weakness" internationally. The PCAOB definition, however, is intended to represent a "high hurdle" so that under this approach, weaknesses that are less serious might not get reported. Accordingly, under this approach, a lower threshold (that could be called "reportable weaknesses") would have to be developed to enable auditors to continue the current practice of reporting important (but not necessarily "material") weaknesses to management. However, the existence of these two categories of weaknesses could result in increased auditor work effort, and it was noted that this could be of concern to many practitioners, particularly auditors of smaller entities.

Option 2

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

Option 3

Adjust the requirement in the ISAs for the auditor to communicate material weaknesses to a requirement for the auditor to communicate "reportable weaknesses." This would acknowledge the fact that the term "material weakness" has existed in the ISAs for many years and, as a result, auditors have been interpreting it quite broadly as representing a category of control

¹ The PCAOB's Auditing Standard 5 defines a **material weakness** as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

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

issues that they may find helpful to bring to the attention of management and those charged with governance. Under this approach, the ISAs would note that some jurisdictions may define the term “material weakness” for their own purposes (often legal or regulatory in nature) and, if so, auditors would have to evaluate control deficiencies in accordance with these definitions. This option would effectively mean that the term “material weakness” would not need to be defined in the ISAs. However, it would leave individual jurisdictions with the flexibility to define the term for their own purposes.

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

Task Force Deliberations and Recommendations

A. APPROACH TO THE DEFINITION OF MATERIAL WEAKNESS

8. Notwithstanding any views the EC might have on the issue, the task force believes that Option 3 should be chosen. In the task force’s view, the most important public interest consideration for the wide range of audits covered by the ISAs is to ensure that the auditor communicates the relevant control deficiencies the auditor has noted during the audit to those parties within the entity who can competently attend to them on a timely basis. Thus, the primary consideration is knowing *what* to communicate and *to whom* to communicate it, rather than the relative importance of the control deficiencies communicated.

A1. Control Deficiencies to be Communicated

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

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

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

A reportable deficiency is a deficiency, or combination of deficiencies, in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of management and those charged with governance. (See paragraph 6(b)).³

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

11. The task force notes that this approach opens up the possibility of the EC interpreting the meaning of the term "material weakness" as used in the EU Statutory Audit Directive in a manner that would not be inconsistent with the definition of reportable deficiency proposed above.
- A2. *To Whom and to What Extent to Communicate Reportable Deficiencies*
12. With regard to whom to communicate reportable deficiencies, the task force agreed that these should be communicated to both management and those charged with governance. However, the task force felt that it would be neither practicable nor reasonable for the ISAs to constrain the auditor in precisely what to communicate to those charged with governance, and at what level of detail, because the degree of specificity would depend on the circumstances of the entity and the engagement. For example, in some circumstances, the auditor may find that it would be appropriate to communicate to those charged with governance the same reportable deficiencies at the same level of detail that the auditor has communicated to management. In other circumstances, the auditor may consider it appropriate to communicate in detail to those charged with governance only a subset of those deficiencies based on an assessment of importance, and include a summary of the other deficiencies.
13. The difficulty in mandating the specific content and extent of the communication to those charged with governance was also apparent in the IAASB CAG discussions in April 2007. Some CAG representatives argued strongly that the auditor should communicate to those charged with governance the same reportable deficiencies the auditor has communicated to management on the grounds that (i) the former might very well be interested in the matters communicated to the latter; and (ii) those charged with governance should, in any event, be given the opportunity to make their own decisions. Other CAG representatives, however, were of the firm view that some differentiation of the matters communicated would be appropriate based on the auditor's assessment of their relative importance, particularly given that in some cases the reportable deficiencies to be communicated could be voluminous.
14. In light of these arguments and for the reasons set out in paragraph 12 above, the task force took the view that it would best serve the public interest by not limiting what auditors should

³ Paragraph numbers refer to the first-read draft of the proposed ISA unless otherwise stated.

report to those charged with governance, and by allowing auditors to tailor the content and extent of their communication to the circumstances.

15. The task force therefore proposes that the auditor should be required to communicate reportable deficiencies to:
 - (a) Management; and
 - (b) *At a level of detail considered appropriate in the circumstances*, to those charged with governance. (See paragraph 9).

The task force proposes guidance in paragraph A13 as to what would be considered appropriate in the circumstances.

16. Given this proposed change to the extant requirement to communicate material weaknesses to a requirement to communicate reportable deficiencies, it would become unnecessary to define the term “material weakness” in the ISAs. Consequently, the task force proposes that this term no longer be used and that appropriate conforming changes be made to the relevant ISAs and proposed ISAs (see Agenda Item 8-B). However, to highlight the fact that there may be legal or regulatory requirements for the auditor to communicate such control matters as “material weaknesses,” the task force proposes the following guidance in paragraph A11 of the application material:

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

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

A3. Rationale for not Choosing Option 1 or Option 2

18. The majority of the task force concluded that Option 1 would not be appropriate for engagements conducted under the ISAs because of the excessive auditor work effort it would likely entail. As the IAASB noted at the April 2007 meeting, this option would require auditors to undertake careful evaluation of the severity of the control deficiencies noted based on likelihood and materiality criteria to determine whether to categorize them as material weaknesses or other reportable deficiencies. Whilst such an evaluation might be appropriate if the auditor were to be required to report publicly on material weaknesses (as under the PCAOB’s Auditing Standard 5), the task force concluded that this would be unduly burdensome in an ISA context (where there is no public reporting requirement) because of the need to perform detailed analysis of whether the relevant criteria have been met in the circumstances, and the need to document the significant professional judgments made in such evaluation. The majority of the task force believes that for Option 1, the likely increased complexity and cost for audits conducted under the ISAs (particularly audits of smaller entities) would not be in the public interest.

19. One member of the task force, however, took the opposite view, believing that Option 1 would represent the best outcome because it would result in a revised definition of material weakness, as this project originally set out to develop. The member of the task force also disagreed that Option 1 would result in significant additional work effort for auditors in classifying control deficiencies as material weaknesses.
 20. The task force also concluded that Option 2 would not be appropriate because it would result in a definition of material weakness being established in the ISAs that would conflict with that set out in the PCAOB's Auditing Standard 5. The co-existence of two different definitions of the same term in IAASB and PCAOB standards could potentially generate confusion amongst practitioners and users of financial statements around the world, and lead to attempts at reconciling their meanings for varying reporting purposes. The task force believes that this outcome would also not be in the public interest.
- B. CONSIDERATION OF THE POTENTIAL FUTURE EFFECTS OF REPORTABLE DEFICIENCIES
21. Given that the importance of a control deficiency depends upon whether a misstatement *could* occur (as well as the materiality of the misstatement), and not on whether a misstatement has actually occurred, the task force considered whether it would be appropriate to provide guidance in the proposed ISA on how the auditor would evaluate the potential future effects of control deficiencies. The task force concluded that this evaluation should be best left to the auditor's judgment in the circumstances because of the difficulties in anticipating the course of future events and their potential effects. Accordingly, the guidance throughout the proposed ISA simply focuses on whether misstatements *could* occur as a result of the control deficiencies.
- C. COMPENSATING CONTROLS
22. At the April 2007 meeting, the task force suggested that the auditor may consider the mitigating effects of compensating controls if these controls are brought to the auditor's attention by management when discussing identified control deficiencies. It was noted that an emphasis on compensating controls in the proposed ISA (with attendant consideration of their operating effectiveness) would add to the complexity of the guidance for auditors and that such complexity was uncalled for in an ISA context.
 23. In light of this and given that ISAs do not specifically require auditors to identify and test the operating effectiveness of compensating controls, the task force reconsidered this suggestion and concluded that references to compensating controls in the proposed ISA should be kept to a minimum. Accordingly, the task force proposes that the guidance in the ISA simply indicate that:
 - Management or those charged with governance may bring to the auditor's attention the existence of controls not previously known to the auditor that they believe would prevent or detect the potential misstatements not addressed by the deficient controls the auditor has noted; and
 - Although the auditor is not required to search for or obtain evidence regarding the design and operating effectiveness of these other controls, the auditor is not precluded from doing

so in concluding whether to communicate the control deficiencies noted. (See paragraph A3).

D. ORIENTATION OF THE PROPOSED ISA

24. The original aim of this project was to clarify the meaning of the term “material weakness” (as that term is defined in the old ISA 315, *Understanding the Entity and its Environment, and Assessing the Risks of Material Misstatement*), and the auditor’s responsibilities to evaluate material weaknesses as established in ISA 315. Accordingly, the task force’s initial presumption was that the clarified requirements and guidance on material weaknesses would be contained in a companion ISA to ISA 315.
25. Based on the IAASB’s discussions on this project to date and the task force’s further deliberations, the task force believes that it would be more appropriate to orientate the ISA towards a communication objective. The emphasis on the communication aspect would appropriately reflect the outcome that the auditor should achieve in the public interest, i.e. bringing to the notice of management and those charged with governance those control deficiencies the auditor has noted that are of sufficient importance to merit their timely attention. Accordingly, the task force proposes an objective for the ISA that reflects this desired communication outcome (see paragraph 5), and recommends that the proposed ISA be placed in the communication series (i.e. as a companion ISA to ISA 260).

Material Presented

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| Agenda Item 8-A (Pages 2757 – 2764) | First Read of Proposed ISA XXX, <i>Communicating Deficiencies in Internal Control Noted in an Audit</i> |
| Agenda Item 8-B (Pages 2765 – 2772) | Proposed Conforming Amendments |

Action Requested

The IAASB is asked to consider the above issues and recommendations of the task force, and to provide the task force with feedback and guidance on the first draft of the proposed ISA.

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