

AU Section 325

Communicating Internal Control Related Matters Identified in an Audit

(Supersedes SAS No. 60.)

Source: SAS No. 112.

Effective for audits of financial statements for periods ending on or after December 15, 2006.

Introduction

.01 This section establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. It is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). In particular, this section:

- Defines the terms *significant deficiency* and *material weakness*.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements.
- Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

.02 The term *those charged with governance* is defined in footnote 5 of section 339, *Audit Documentation*, as "the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process." In most entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors (for example, an audit or legislative oversight committee), a committee of management (for example, a finance, budget, or governmental agency executive committee), partners, equivalent persons, or some combination of these parties. In some smaller entities, management and those charged with governance may be the same people, for example, the owner in an owner-managed entity or a sole trustee.

.03 Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting. In this section, the term *financial reporting* relates to the preparation of reliable financial statements that are fairly presented in conformity with generally accepted

432 The Standards of Field Work

accounting principles.¹ The design and formality of an entity's internal control will vary depending on the entity's size, the industry in which it operates, its culture, and management's philosophy.

.04 In an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control^{2,3} or to express an opinion on the effectiveness of the entity's internal control.⁴ However, during the course of an audit, the auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risk, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

Definitions

.05 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. Control deficiencies may involve one or more of the five interrelated components of internal control.

.06 A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood⁵

¹ Reference to generally accepted accounting principles includes, where applicable, a comprehensive basis of accounting other than generally accepted accounting principles, as that term is defined in paragraph .04 of section 623, *Special Reports*.

² Hereinafter in this section, the term *internal control* means internal control over financial reporting.

³ Section 319, *Consideration of Internal Control in a Financial Statement Audit*, contains a detailed discussion of internal control and the following five interrelated components of internal control: (a) the control environment, (b) risk assessment, (c) control activities, (d) information and communication, and (e) monitoring.

⁴ The auditor's responsibility for communicating matters related to an entity's internal control identified in an audit of financial statements is not the same as the practitioner's responsibility for reporting on the effectiveness of an entity's internal control in an attestation engagement performed under AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*.

⁵ The term *remote likelihood* as used in the definitions of the terms *significant deficiency* and *material weakness* has the same meaning as the term *remote* as used in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Paragraph 3 of FASB Statement No. 5 states:

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This section uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

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

Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

AU §325.04

that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

.07 The phrase "more than inconsequential" as used in the definition of significant deficiency describes the magnitude of potential misstatement that could occur as a result of a significant deficiency and serves as a threshold for evaluating whether a control deficiency or combination of control deficiencies is a significant deficiency. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

.08 In determining whether a potential misstatement would be more than inconsequential, the auditor should consider qualitative and quantitative factors. Inconsequential in this context is not the same concept as the threshold amount the auditor establishes in an audit of financial statements below which known and likely misstatements need not be accumulated. For example, for the purposes of evaluating control deficiencies, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered inconsequential, before considering qualitative factors. However, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered more than inconsequential as a result of qualitative factors.⁶

Evaluating Control Deficiencies Identified as Part of the Audit

.09 The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatement does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses.

.10 When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of misstatement.

.11 The following are examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect a misstatement:

- The nature of the financial statement accounts, disclosures, and assertions involved. For example, suspense accounts and related party transactions involve greater risk.
- The susceptibility of the related assets or liabilities to loss or fraud.

⁶ Interpretation No. 4, "Considering the Qualitative Characteristics of Misstatements" (section 9312.15-.17), of section 312, *Audit Risk and Materiality in Conducting an Audit*, identifies qualitative factors an auditor may consider in determining whether a misstatement is material.

434 The Standards of Field Work

- The subjectivity and complexity of the amount involved, and the extent of judgment needed to determine that amount.
- The cause and frequency of any known or detected exceptions related to the operating effectiveness of a control.
- The interaction or relationship of the control with other controls.
- The interaction of the control deficiency with other control deficiencies.
- The possible future consequences of the deficiency.

.12 Several factors affect the magnitude of a misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency.
- The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods.

The maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount. However, because of the potential for unrecorded amounts, the recorded amount is not a limitation on the amount of potential understatement.

.13 Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Therefore, the auditor should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control, to determine whether they collectively result in a significant deficiency or material weakness.

.14 In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or material weakness, the auditor also should evaluate the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements, that would result in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

.15 The auditor's evaluation of the possible mitigating effects of compensating controls can be illustrated by the following example, in which an owner-managed entity does not segregate duties within the accounts payable function. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding \$1,000. The auditor could evaluate the effect of this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency in the accounts payable function (the lack of segregation of duties).

.16 In an audit in which the auditor has decided to test the operating effectiveness of controls, the auditor may encounter deviations in the operation of those controls. A control that has an observed nonnegligible deviation rate is a deficiency regardless of the reason for the deviation. For example, if the auditor

AU §325.12

Communicating Internal Control

435

designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

.17 The auditor should conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

.18 Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.
- Antifraud programs and controls.
- Controls over nonroutine and nonsystematic transactions.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

.19 Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement. (The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.)
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control. This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

AU §325.19

436

The Standards of Field Work

- Identification of fraud of any magnitude on the part of senior management. (The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud.⁷ However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial misstatements—on the part of senior management, of which he or she is aware.)
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected. See paragraph .20 for communication requirements in these circumstances.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

See the Appendix [paragraph .32] of this section for examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

Communication—Form, Content, and Timing

.20 Control deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this section must be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and have not yet been remediated. (Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated in writing by referring to the previously issued written communication and the date of that communication.)

.21 The written communication referred to in paragraph .20 is best made by the report release date, which is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements, but should be made no later than 60 days following the report release date. See section 339.23 for additional guidance related to the report release date.

.22 For some matters, early communication to management or those charged with governance may be important. Accordingly, the auditor may decide to communicate certain identified significant deficiencies and material weaknesses during the audit. If the communication is made during the audit, the form of interim communication would be affected by the relative significance of the identified control deficiencies and the urgency for corrective follow-up action. Such early communication is not required to be in writing. However, regardless of how the early communication is delivered, the auditor must communicate all significant deficiencies and material weaknesses in

⁷ Section 316, *Consideration of Fraud in a Financial Statement Audit*, provides guidance on the auditor's responsibilities for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.

Communicating Internal Control

437

writing to management and those charged with governance in accordance with paragraphs .20 and .21.

.23 The existence of significant deficiencies or material weaknesses may already be known to management and may represent a conscious decision by management or those charged with governance to accept that degree of risk because of cost or other considerations. Management is responsible for making decisions concerning costs to be incurred and related benefits. The auditor's responsibility to communicate significant deficiencies and material weaknesses in accordance with paragraph .20 exists regardless of management's decisions.

.24 Nothing precludes the auditor from communicating to management and those charged with governance other matters that the auditor:

- Believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving internal control.
- Has been requested to communicate, for example, control deficiencies that are not significant deficiencies or material weaknesses.

Such matters may be communicated either orally or in writing. If the information is communicated orally, the auditor should document the communication.

.25 The written communication regarding significant deficiencies and material weaknesses identified during an audit of financial statements should:

- State that the purpose of the audit was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control over financial reporting.
- State that the auditor is not expressing an opinion on the effectiveness of internal control.
- Include the definition of the terms *significant deficiency* and, where relevant, *material weakness*.
- Identify the matters that are considered to be significant deficiencies and, if applicable, those that are considered to be material weaknesses.
- State that the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

.26 The following is an illustrative written communication encompassing the requirements in paragraph .25.

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

AU §325.26

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies [*and other deficiencies that we consider to be material weaknesses*].

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 significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following deficiencies to be significant deficiencies in internal control:

[Describe the significant deficiencies that were identified.]

[A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiencies constitute material weaknesses.]

[Describe the material weaknesses that were identified.]

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

.27 If the auditor wishes, he or she may include additional statements in the communication regarding the general inherent limitations of internal control, including the possibility of management override of controls, or the specific nature and extent of the auditor's consideration of internal control during the audit.

.28 A client may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements for the client to submit to governmental authorities. The following is an illustrative communication that may be used when the auditor has not identified any material weaknesses and wishes, or has been requested, to advise management and those charged with governance that no material weaknesses were identified.⁸

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

⁸ If an examination of internal control under AT section 501 was performed for the same period or "as of" date as the audit of the financial statements, the issuance of a report indicating that no material weaknesses had been identified during the audit of the financial statements would not be appropriate.

Communicating Internal Control

439

Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

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 significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, *[identify the body or individuals charged with governance]*, others within the organization, and *[identify any specified governmental authorities]* and is not intended to be and should not be used by anyone other than these specified parties.

If one or more significant deficiencies have been identified, the auditor may add the following sentence to the fourth paragraph of the communication:

However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on *[date]*.

.29 The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

.30 Management may wish to, or may be required by a regulator to, prepare a written response to the auditor's communication regarding significant deficiencies or material weaknesses identified in the audit. Such management communications may include a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses, the auditor should add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph.

ABC Company's written response to the significant deficiencies *[and material weaknesses]* identified in our audit has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

AU §325.30

440

The Standards of Field Work

Effective Date

.31 This section is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

AU §325.31

.32

Appendix

Examples of Circumstances That May Be Control Deficiencies, Significant Deficiencies, or Material Weaknesses

Paragraph .18 of this section identifies areas in which control deficiencies ordinarily are at least significant deficiencies, and paragraph .19 identifies indicators that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness. The following are examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

Deficiencies in the Design of Controls

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply generally accepted accounting principles in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.

442

The Standards of Field Work

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy, for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.
- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

[The next page is 444-21.]