

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

Communicating Internal Control Related Matters Identified in an Audit

**(Amends AU Section 325, *Communicating Internal Control
Related Matters Identified in an Audit*)**

June 12, 2008

**Prepared by the AICPA Auditing Standards Board for comment from persons interested in
auditing and reporting issues.**

**Comments should be sent via the Internet to Sharon Macey at
smacey@aicpa.org and should be received by August 12, 2008.**

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June 12, 2008

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of a proposed Statement on Auditing Standards (SAS) entitled *Communicating Internal Control Related Matters Identified in an Audit*.

The proposed SAS would conform the definitions in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in the proposed Statement on Standards for Attestation Engagements (SSAE), *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*. That proposed SSAE is being exposed for comment concurrently with this exposure draft.

Comments or suggestions on any aspect of this exposure draft would be appreciated. To facilitate the ASB's consideration of responses, comments should refer to specific paragraphs and should include supporting reasons for each suggestion or comment.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA, after September 12, 2008, for one year. Comments should be sent via the Internet to Sharon Macey, Audit and Attest Standards, at smacey@aicpa.org and should be received no later than August 12, 2008.

Sincerely,

Harold L. Monk, Jr.

Charles E. Landes



Chair, Auditing Standards Board

Vice President, Professional Standards and Services

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(2007–2008)**

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Internal Control Task Force

Task Force Members

Keith O. Newton, *Chair*, assisted by
Maria C. Manasses
Douglas F. Prawitt
Darrel R. Schubert
Michael T. Umscheid
Arthur M. Winstead, Jr.

Task Force Observers

Marcia Buchanan, U.S. Government
Accountability Office
Harrison Greene, Federal Deposit
Insurance Corporation
Patricia Hildebrand, Office of Thrift
Supervision
Arthur Lindo, Federal Reserve Board

AICPA Staff

Charles E. Landes
Vice President
Professional Standards and Services

Judith Sherinsky
Technical Manager
Audit and Attest Standards

Summary

Why Issued and What the Proposed Statement on Auditing Standards Does

This proposed Statement on Auditing Standards (SAS) is being issued to conform the definitions in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in the proposed Statement on Standards for Attestation Engagements (SSAE), *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*. That proposed SSAE is being exposed for comment concurrently with this exposure draft. In addition to eliminating differences within the AICPA's Audit and Attest Standards, the amendment also would align these definitions with those used by the Public Company Accounting Oversight Board and the definitions in an exposure draft of a proposed International Standard on Auditing 265, *Communicating Deficiencies in Internal Control*, currently being exposed for comment by the International Auditing and Assurance Standards Board.

Requests for Comments on Specific Topics

Although the exposure process is intended to solicit comments or suggestions on any aspect of this proposed SAS, the ASB would appreciate comments on the following matters.

Definition of Significant Deficiency

The definition of the term *significant deficiency* in extant AU section 325 includes "the likelihood and magnitude of the misstatement that could occur" as criteria for evaluating the severity of a control deficiency. The definition of that term in paragraph 7 of the proposed SAS no longer includes these criteria. The ASB believes that removing these criteria from the definition of significant deficiency will encourage auditors to consider qualitative factors and exercise greater professional judgment in determining what is and is not a significant deficiency, thus enabling auditors to inform management and those charged with governance about matters that better approximate their concerns about internal control. It is not the ASB's intention to "lower the bar" in terms of what is a significant deficiency, as paragraph 8 makes it clear that the auditor still needs to evaluate magnitude and likelihood when evaluating the severity of any identified deficiency in internal control.

Question 1. Are these changes helpful in evaluating significant deficiencies? If not, how should the definition be amended?

Compensating Controls

Paragraph .54 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), states that obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Extant AU section 325, however, allows the auditor to consider the effectiveness of a compensating control as a basis for determining whether it mitigates the severity of a control deficiency only if the auditor has tested the operating effectiveness of the compensating control, even if the deficiency was identified while evaluating the design of the entity's controls and determining whether they were implemented.

The ASB has concluded that the requirement to test the operating effectiveness of compensating controls in order to categorize a control deficiency for the purpose of communicating to management and those charged with governance goes beyond the auditor's obligation to obtain an understanding of the entity and its environment, including its internal control. Paragraph 14 of the proposed SAS reflects this view and indicates that (1) the auditor is not required to consider the effects of compensating controls for the

purpose of communicating significant deficiencies or material weaknesses, and (2) if the auditor decides to consider the effects of compensating controls for this purpose he or she should

- evaluate the design of the compensating controls to determine whether such controls are capable of preventing the deficiency from rising to the level of a significant deficiency or a material weakness, and
- determine whether the compensating controls were implemented.

The ASB concluded that the proposed SAS need not provide guidance to the auditor whose strategy entails testing the operating effectiveness of controls because AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), is very clear that an auditor may not rely on a control nor reduce control risk without testing controls.

Question 2. If the auditor identifies an improperly designed control, and is not testing the operating effectiveness of controls as part of the financial statement audit, is it sufficient for the auditor to evaluate the design of a compensating control, determine whether it has been implemented, and use that information as a basis for (1) considering the mitigating effects of the compensating control on the deficiency and (2) categorizing the deficiency for the purpose of communicating to management and those charged with governance?

How the Proposed SAS Affects Existing Standards

This proposed SAS would amend AU section 325.

Proposed Statement on Auditing Standards, *Communicating Internal Control Related Matters Identified in an Audit*

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Applicability

1. This Statement on Auditing Standards (SAS) 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 or disclaims an opinion on financial statements. In particular, this SAS
 - defines the terms *deficiency in internal control*, *significant deficiency*, and *material weakness*.
 - provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements.
 - requires the auditor to communicate, in writing, to management and those charged with governance,¹ significant deficiencies and material weaknesses identified in an audit.
2. This SAS is not applicable if the auditor is engaged to report on the effectiveness of an entity's internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*. (A revision of AT section 501 is being exposed for comment concurrently with this exposure draft.)

Introduction

3. 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 the 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 SAS, the term financial reporting relates to the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles (GAAP).² 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.
4. In an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control^{3, 4} or to express an opinion on the effectiveness of the entity's

¹ The term *those charged with governance* is defined in paragraph .03 of AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), 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 process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards."

² 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 AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), as amended.

³ Hereinafter in this Statement on Auditing Standards (SAS), the term *internal control* means internal control over financial reporting.

internal control. However, during the course of an audit, the auditor may become aware of deficiencies in internal control while obtaining an understanding of the entity and its environment, including its 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 deficiencies in internal control varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

Definitions

5. A deficiency in internal control 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 and correct misstatements on a timely basis.

A deficiency in *design* exists when

- a control necessary to meet the control objective is missing; or
- an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

A deficiency in *operation* exists when

- a properly designed control does not operate as designed; or
- the person performing the control does not possess the necessary authority or competence to perform the control effectively.

6. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility⁵ that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.
7. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that, in the auditor's professional judgment, is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Evaluating Deficiencies Identified as Part of the Audit

8. The auditor should evaluate the severity of each deficiency in internal control⁶ identified as part of the audit to determine whether the deficiency, individually or in combination, is a significant deficiency or a material weakness. The severity of a deficiency depends on

⁴ AU section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), contains a detailed discussion of internal control and identifies the following five interrelated components of internal control: (a) the control environment, (b) the entity's risk assessment, (c) information and communication systems, (d) control activities, and (e) monitoring .

⁵ In this SAS, a reasonable possibility exists 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*.

⁶ Hereinafter in this SAS, the term *deficiency in internal control* is referred to as a *deficiency* or *deficiencies*.

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and
- whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure.

The severity of a deficiency does not depend on whether a misstatement actually occurred.

9. Factors that affect the magnitude of a misstatement that might result from a deficiency or deficiencies 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 current period or expected in future periods) in the account balance or class of transactions exposed to the deficiency
10. In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.
11. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:
 - The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved
 - The susceptibility of the related asset or liability to loss or fraud
 - The subjectivity, complexity, or extent of judgment required to determine the amount involved
 - The interaction or relationship of the control with other controls
 - The interaction among the deficiencies
 - The possible future consequences of the deficiency
12. The evaluation of whether a deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.
13. Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control increase the likelihood of material misstatement and may, in combination, constitute a significant deficiency or a material weakness, even though such deficiencies individually may be less severe. Therefore, the auditor should determine whether deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a significant deficiency or a material weakness.
14. A compensating control can limit the severity of a deficiency and prevent it from rising to a significant deficiency or a material weakness. Although compensating controls can mitigate the effects of a deficiency, they do not eliminate the deficiency. The auditor is not required to consider the effects of compensating controls for the purpose of communicating significant deficiencies or material weaknesses. However, when the auditor decides to consider the effects of compensating

controls for the purpose of communicating significant deficiencies or material weaknesses, he or she should

- evaluate the design of the compensating controls to determine whether they are capable of preventing the deficiency from rising to a significant deficiency or a material weakness; and
- perform procedures to determine whether the compensating controls are implemented.

15. Indicators of material weaknesses in internal control include

- identification of fraud, whether or not material, on the part of senior management;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control; and
- ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

16. If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. If not, the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Communication—Form, Content, and Timing

17. Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this SAS should 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.

18. The written communication referred to in paragraph 17 is best made by the report release date,⁷ 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.

19. For some matters, early communication to management or those charged with governance may be important because of their relative significance and the urgency for corrective follow-up action. Accordingly, the auditor may decide to communicate certain matters during the audit. These matters need not be communicated in writing during the audit, but significant deficiencies and material weaknesses should ultimately be included in the written communication in accordance with paragraphs 17–18, even if the significant deficiencies or material weaknesses were remediated during the audit.

⁷ See paragraph .23 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), for additional guidance related to the report release date.

20. 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 exists regardless of management's decisions.
21. Nothing precludes the auditor from communicating to management and those charged with governance other matters related to an entity's internal control. For example, the auditor may communicate
- matters the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls.
 - deficiencies (that are not significant deficiencies or material weaknesses) upon the request of management or those charged with governance. If such deficiencies are communicated orally, the auditor should document the communication.
22. The written communication regarding significant deficiencies and material weaknesses identified during an audit of financial statements should
- include a statement that indicates 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.
 - include a statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
 - include the definition of the terms significant deficiency and material weakness, where relevant.
 - identify the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
 - include a statement that indicates 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.
23. The following is an illustrative written communication encompassing the requirements in paragraph 22:

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.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to 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 material weaknesses [*and other deficiencies that we consider to be significant deficiencies*].

A deficiency in internal control 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 and correct misstatements on a timely basis. [*A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We believe that the following deficiencies constitute material weaknesses.*]

[*Describe the material weaknesses that were identified.*]

[*A significant deficiency is a deficiency, or a combination of deficiencies, in internal control, that, in the auditor's professional judgment, is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies to be significant deficiencies in internal control.*]

[*Describe the significant deficiencies 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.

24. The auditor 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.
25. Management or those charged with governance may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements for the entity to submit to governmental authorities. The following is an illustrative written communication that may be used when the auditor has not identified any material weaknesses and has been requested to communicate to management and those charged with governance that no material weaknesses were identified.

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.

A deficiency in internal control 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be 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 third 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*]. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that, in the auditor's professional judgment, is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

26. The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.
27. 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 may 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 was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Effective Date

28. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

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

Paragraph 15 of this Statement on Auditing Standards identifies indicators of material weaknesses in internal control. The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses:

Deficiencies in the Design of Controls

- Inadequate design of controls over the preparation of the financial statements being audited.
- Inadequate design of controls 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 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 (GAAP), the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP 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.
- 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 and correct 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 entity 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.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor 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.