

AU Section 325

Communicating Internal Control Related Matters Identified in an Audit

(Supersedes SAS No. 112.)

Source: SAS No. 115.

Effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

Applicability

.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 or disclaims an opinion on financial statements. In particular, this section

- 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.

.02 This section is not applicable if the auditor is engaged to examine the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of the entity's financial statements 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*.

Introduction

.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 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

¹ The term *those charged with governance* is defined in paragraph .03 of section 380, *The Auditor's Communication With Those Charged With Governance*, 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."

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 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.

.04 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 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 risks, 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

.05 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.

.06 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.

.07 A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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 section 623, *Special Reports*, as amended.

³ Hereinafter in this section, the term *internal control* means internal control over financial reporting.

⁴ Section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*, contains a detailed discussion of internal control and identifies the following five inter-related 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 section, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable* as those terms are defined in the Financial Accounting Standards Board *Accounting Standards Codification* glossary. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

Evaluating Deficiencies Identified as Part of the Audit

.08 The auditor should evaluate the severity of each deficiency in internal control⁶ identified during 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

- 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.

.09 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 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.

.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 may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

.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

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

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 When performing substantive procedures or tests of the operating effectiveness of controls, the auditor may obtain evidence that a control does not operate effectively; for example, by identifying a misstatement that was not prevented, or detected and corrected by the control. Management may inform the auditor, or the auditor may otherwise become aware, of the existence of compensating controls that, if effective, may limit the severity of the deficiency and prevent it from being a significant deficiency or a material weakness. In these circumstances, although the auditor is not required to consider the effects of compensating controls for purposes of this section, the auditor may consider the effects of compensating controls related to a deficiency in operation provided the auditor has tested the compensating controls for operating effectiveness as part of the financial statement audit. Compensating controls can limit the severity of the deficiency, but do not eliminate the deficiency.

.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 error or fraud;
- 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.

Communication—Form, Content, and Timing

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

⁷ See paragraph .23 of section 339, *Audit Documentation*, for additional guidance related to 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 a written communication in accordance with paragraphs .17–.18, even if such significant deficiencies or material weaknesses were remediated during the audit.

.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 the risk associated with the deficiencies 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.

If other matters are communicated orally, the auditor should document the communication.

.22 The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should

- include a statement that indicates the purpose of the auditor's consideration of internal control 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 a statement that indicates that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
- include the definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
- 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 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.

.24 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 to submit to governmental authorities. Exhibit A includes an illustrative communication when the auditor has not identified any material weaknesses and decides, or has been requested, to advise management and those charged with governance that no material weaknesses were identified.

.25 The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

.26 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 during 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

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

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Exhibit A

Illustrative Written Communications

1. The following is an illustrative written communication encompassing the requirements in paragraph .22 of this section:

In planning and performing our audit of the financial statements of ABC Company (the "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 the 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 and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. 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 consider the following deficiencies in the Company's internal control to be material weaknesses:]*

[Describe the material weaknesses that were identified.]

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

[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.

2. The following is an illustrative written communication indicating that no material weaknesses were identified during the audit.

In planning and performing our audit of the financial statements of ABC Company (the "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 the 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 deficiencies, 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 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 is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Exhibit B

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

Paragraph .15 of this section 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 non-negligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.
