ICCT09

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Internal Control Communications

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Interactive Self-study CPE

Companion to PPC's Guide to Internal Control Communications

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

INTRODUCTION

Companion to PPC's Guide to Internal Control Communications consists of one interactive self-study CPE course. This is a companion course to *PPC's Guide to Internal Control Communications* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **August 31, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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The course is divided into lessons. Each lesson addresses an aspect of internal control deficiencies. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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COMPANION TO PPC'S GUIDE TO INTERNAL CONTROL COMMUNICATIONS

COURSE 1

Identifying, Evaluating, and Communicating Internal Control Deficiencies (ICCTG091)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses internal control deficiencies that an auditor may discover over the course of an engagement and steps that can be taken to deal with such deficiencies based on the guidance in SAS No. 115. Lesson 1 focuses on identifying and evaluating internal control deficiencies. Lesson 2 discusses communicating internal control deficiencies.
PUBLICATION/REVISION DATE:	June 2009
RECOMMENDED FOR:	Users of *PPC's Guide to Internal Control Communications*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of auditing
CPE CREDIT:	5 QAS Hours, 5 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Auditing
EXPIRATION DATE:	Postmark by **August 31, 2010**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Identifying and Evaluating Internal Control Deficiencies

Completion of this lesson will enable you to:

- Differentiate between internal control deficiencies due to flawed design or operation.
- Utilize appropriate methods and information to evaluate and aggregate control deficiencies.
- Assess practice issues related to internal control deficiencies.

Lesson 2—Communicating Internal Control Deficiencies Identified during the Audit

Completion of this lesson will enable you to:

- Generate communications regarding internal control deficiencies.
- Assess issues related to the communication of internal control deficiencies.

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Lesson 1: Identifying and Evaluating Internal Control Deficiencies

INTRODUCTION

SAS No. 115 (AU 325), *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies they have identified during the audit. Although SAS No. 115 does not require an auditor to perform procedures to identify deficiencies in internal control, it notes that auditors may become aware of control deficiencies while performing a host of required procedures during the audit.

For those control deficiencies the auditor identifies, SAS No. 115 requires the auditor to evaluate them to determine whether, individually or in combination, they are *significant deficiencies* or *material weaknesses*. To do this, the SAS further requires auditors to evaluate control deficiencies both *individually* and in the *aggregate* by significant account balance, disclosure, and component of internal control. This is because 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 they are individually insignificant.

This lesson provides guidance on understanding what constitutes a control deficiency, as well as guidance on how auditors might identify control deficiencies during the audit and how they should evaluate them in accordance with SAS No. 115. Lesson 2 discusses the auditors' communication requirements.

Learning Objectives:

Completion of this lesson will enable you to:

- Differentiate between internal control deficiencies due to flawed design or operation.
- Utilize appropriate methods and information to evaluate and aggregate control deficiencies.
- Assess practice issues related to internal control deficiencies.

OBTAINING AN UNDERSTANDING OF CONTROL DEFICIENCIES

SAS No. 109 (AU 314), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires auditors to obtain a sufficient understanding of the five components of internal control to assess risk and to design the nature, timing, and extent of further audit procedures. To obtain that understanding, the SAS requires auditors to perform risk assessment procedures to (a) evaluate the design of controls that are relevant to the audit and (b) determine if they have been implemented.

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 and correct, misstatements on a timely basis. A control deficiency may be either a deficiency in design or a deficiency in operation. Because of the more extensive requirements in SAS No. 109 to look at the design and implementation of internal controls, there will be more focus on internal controls during audit engagements.

Deficiencies in Design

A *deficiency in design* exists when (a) a control necessary to meet a control objective is missing or (b) an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.

Deficiencies in Operation

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 it effectively. The auditor is required to obtain an understanding of internal control but is not required to always test controls or to test controls for every class of transactions, account balance, disclosure, or assertion. However, many of the procedures commonly used in the risk assessment process to gain an understanding of internal control (such as inquiry, observation and inspection, and walkthroughs) may provide not only an understanding of the control (that is, an understanding of whether the control is properly designed and implemented) but also may provide evidence about the control's effectiveness.

The results of any tests of operating effectiveness, including any exceptions to prescribed control procedures identified by any tests, may indicate exceptions to prescribed policies or procedures. If an exception to a prescribed control procedure has been identified, a determination should be made of the following:

- The effect of the exception on the nature and extent of additional testing that may be necessary.
- The effect of the exception on the operating effectiveness of the control that was tested if the auditor intends to rely on the control.
- Whether the exception represents a deficiency in operating effectiveness.

The auditor evaluates exceptions to determine whether they represent control deficiencies as further discussed in the following paragraph.

Control Testing Exceptions. The auditor should use professional judgment when evaluating whether a control testing exception is a control deficiency. Both quantitative and qualitative factors should be considered, including the following:

- The cause of the exception.
- Whether the exception is systematic and recurring.
- The potential implications of the exception with respect to the effectiveness of other controls, such as IT general controls.
- The frequency with which the control operates.
- Whether the exception is known to have resulted in a financial statement misstatement.

Not all exceptions are necessarily control deficiencies. However, to conclude that an identified exception is not a control deficiency, it is necessary to obtain additional evidence beyond that initially planned and beyond inquiry that supports the conclusion. In other words, it is necessary to do more testing. For example, if a sampling test identifies one control exception and tests of additional items identify another exception, the conclusion would be that the control was not operating effectively.

Examples of Control Deficiencies

As discussed previously, a control deficiency may be either a deficiency in design or a deficiency in operation. Exhibit 1-1 lists examples, which come from Appendix B to SAS No. 115, of both types of control deficiencies. While the Appendix in SAS No. 115 distinguishes between deficiencies in the design of controls and deficiencies in the operation of controls, there is no requirement in SAS No. 115 to indicate in the communication to management and those charged with governance which are deficiencies in design or deficiencies in operation. The examples in this exhibit may be control deficiencies, significant deficiencies, or material weaknesses. SAS No. 115 provides additional guidance about control deficiencies that indicate material weaknesses may exist.

Exhibit 1-1

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 preparing the audited financial statements.
- Inadequate design of a control over a significant account or process.
- Inadequate documentation of the internal control components.
- Insufficient control consciousness within the entity (for example, the entity's tone at the top and the control environment).
- Segregation of duties that are absent or inadequate within a significant account or process.
- Controls that are absent or inadequate over the safeguarding of assets (if those controls 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 information that is complete and accurate consistent with the entity's financial reporting objectives and current needs.
- Employees or management lack the qualifications and training necessary to fulfill their assigned functions (for example, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording transactions or preparing the financial statements).
- Inadequate design of monitoring controls that are used to assess the design and operating effectiveness of internal control over time.
- An absent internal process for reporting internal control deficiencies to management in a timely manner.

Failures in the Operation of Controls

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control requiring dual authorization for significant disbursements).
- Failure of the entity's information and communication component of internal control to provide output that is complete and accurate because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain consolidating information from remote locations that is timely and accurate).
- Failure of controls designed to safeguard the entity's assets from loss, damage, or misappropriation. [This circumstance may need careful consideration when it is evaluated as a significant deficiency or material weakness. Material weaknesses relating to controls over the safeguarding of assets only exist if controls to prevent or detect a material misstatement of the financial statements are ineffective. For example, assume that a company uses security devices to safeguard its inventory (preventive control) and also performs timely periodic physical inventory counts (detective control). Although a physical inventory count does not safeguard inventory from theft or loss, it prevents a material misstatement of the financial statements if the inventory is performed effectively and timely. Therefore, because the definitions of material weakness and significant deficiency relate to the 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 (in this case, the physical inventory) prevents a misstatement of the financial statements.]

- Failure to reconcile significant accounts (for example, the entity does not reconcile accounts receivable subsidiary ledgers 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, expenses are consistently understated at the direction of management.
- Misrepresentation by the client to the auditor.
- Management override of controls.
- Failure of an application control that was caused by a deficiency in the design or the 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.

* * *

THE IDENTIFICATION OF CONTROL DEFICIENCIES

Identifying Deficiencies during the Course of the Audit

As previously discussed, SAS No. 115 does not require auditors to perform specific procedures to search for control deficiencies. Rather, it requires auditors to communicate to management and others any control deficiencies they become aware of during the audit. Some practitioners refer to that as a *trip across* requirement (i.e., if the auditor trips across a deficiency while performing audit procedures, he or she should evaluate the deficiency to see if it should be communicated). SAS No. 115 (AU 325.04) notes that, during the course of an audit, any of the following might cause the auditor to become aware of a control deficiency:

- Obtaining an understanding of the entity's internal control (including evaluating the design and implementation of controls).
- Assessing the risks of material misstatement of the audited financial statements, whether those risks would be caused by error or fraud.
- Communicating with management or others (including any internal auditors, governmental authorities, etc.).
- Performing further audit procedures to respond to any assessed risks, as discussed in the following paragraph.

Identifying Deficiencies When Performing Further Audit Procedures

Internal control deficiencies might be found when performing the following further audit procedures:

- Evaluating the results from any tests of controls performed in the audit of the financial statements.
- Reviewing any internal reports on controls.
- Encountering negative results of substantive procedures performed in the audit of the financial statements, including:
    - Risk evaluations made in selecting and applying substantive procedures, especially those related to fraud.

- •• Findings related to illegal acts and related-party transactions.
- •• Indications of management bias in making accounting estimates and selecting accounting principles.
- •• Misstatements detected by substantive procedures.

Whatever their source, identified control deficiencies should be accumulated so they can be evaluated to determine whether they are significant deficiencies or material weaknesses.

Evaluating the Severity of Deficiencies

Not all control deficiencies are considered either significant deficiencies or material weaknesses. If an identified control deficiency is not a significant deficiency or material weakness, SAS No. 115 does not require it to be communicated to management and those charged with governance. SAS No. 115 requires an auditor to evaluate (considering both quantitative and qualitative factors) the severity of identified control deficiencies to determine whether they are, individually or in combination with other control deficiencies, significant deficiencies or material weaknesses. Severity is evaluated by determining:

- 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.

Footnote 5 of SAS No. 115 clarifies that the meaning of *reasonably possible* is the same as the definition of that term in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (FASB ASC 450). Accordingly, it means that the likelihood that a material misstatement will not be prevented or detected and corrected in a timely manner is *more than remote but less than likely*. Evaluating the severity of control deficiencies is discussed in further detail later in this lesson.

Awareness of Deficiencies Varies with Each Audit

It is important to understand that an auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed during the audit. For example, one way an auditor might become aware of control deficiencies is when obtaining an understanding of internal control as required by SAS No. 109. That SAS requires an auditor to obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. To obtain that understanding, the SAS requires the auditor to perform risk assessment procedures to (a) evaluate the design of controls that are relevant to the audit and (b) determine if they have been implemented. While obtaining the understanding and performing those procedures, the auditor might become aware of internal control deficiencies.

Another way an auditor might become aware of control deficiencies is by performing tests of controls during an audit. The results of such tests may indicate control exceptions, which the auditor would then evaluate to determine whether they are control deficiencies.

While obtaining an understanding of internal control is required in all audits, performing tests of controls is not. Therefore, all auditors will not perform test of controls during their audits. Accordingly, the auditor who performs tests of controls might have a different awareness of control deficiencies than an auditor who did not perform tests of controls during the audit.

THE PPC PROCESS FOR EVALUATING THE SEVERITY OF CONTROL DEFICIENCIES

Under SAS No. 115, most auditors will begin by considering whether an identified deficiency should be considered a material weakness. If not, they will consider its severity to determine whether it should be communicated to management and others as a significant deficiency. A version of this process is as follows:

- Determine whether the identified deficiency is a material weakness by considering whether (a) there is at least a *reasonable possibility* that a misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis, and (b) whether such a misstatement could be *material*. If both (a) and (b) are met, consider whether there are compensating controls that mitigate the severity of the identified deficiency. (If so, those controls should be tested as discussed later in this lesson.)

- For an identified deficiency not considered a material weakness, consider whether the deficiency is important enough to merit attention by those charged with governance. If so, the following should be considered before concluding that it is a significant deficiency:

  - Are there compensating controls that mitigate the severity of the identified deficiency? (If so, those controls should be tested as discussed later in this lesson.)

  - Are there qualitative factors that cause the auditor to believe the potential effect of the identified deficiency is greater than originally evaluated? (Qualitative factors are discussed later in this lesson.)

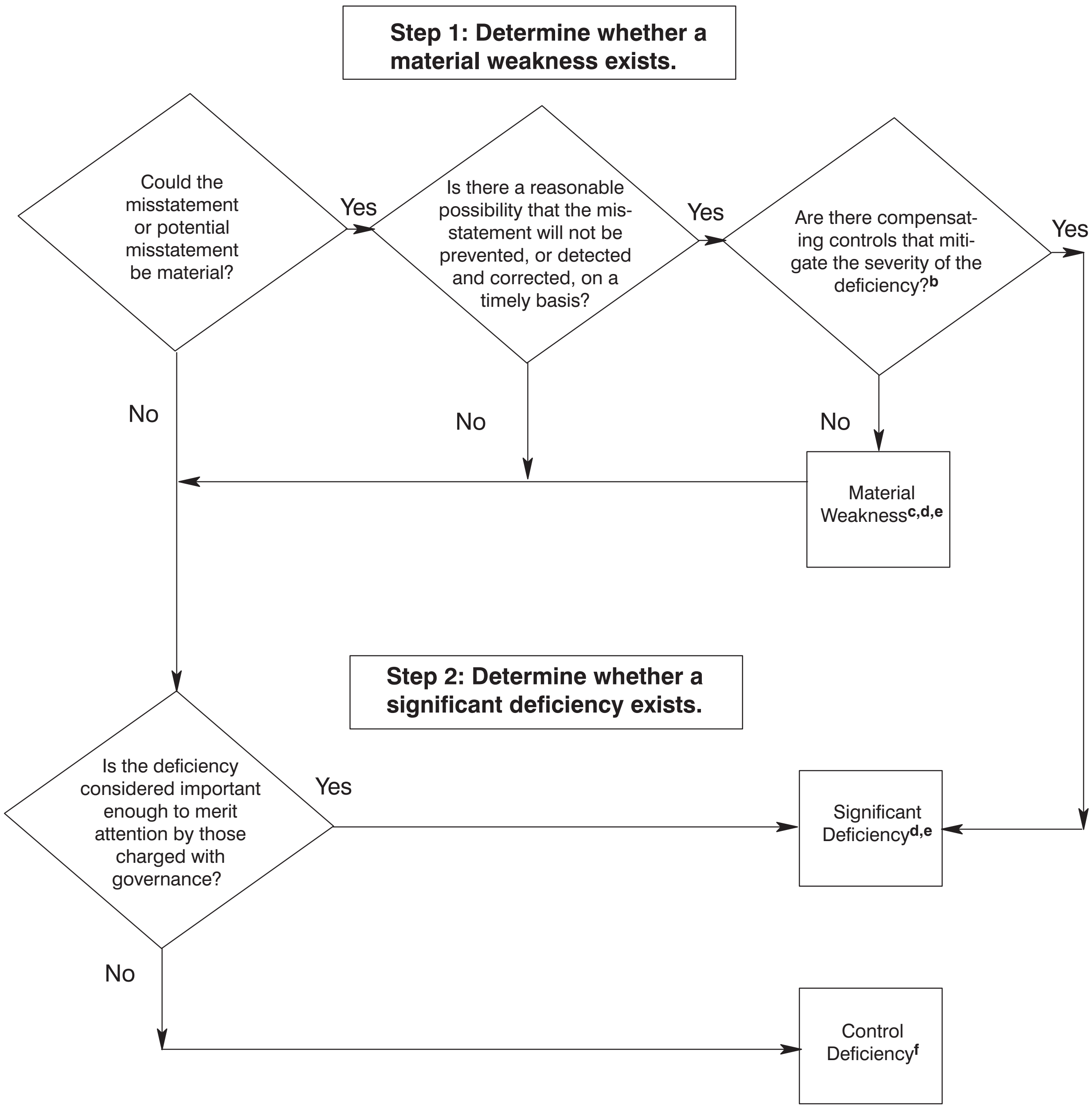
  - Would prudent officials with knowledge of the same facts and circumstances agree with your conclusion? (The views of a prudent official are discussed later in this lesson.)

Process Flowchart

The flowchart in Exhibit 1-2 describes PPC's process for evaluating the severity of individual control deficiencies identified during the audit. Once the auditor has evaluated the severity of each individual control deficiency, SAS No. 115 requires the auditor to aggregate deficiencies (including those believed to be individually insignificant) to determine whether they rise to the level of a significant deficiency or a material weakness. Auditors should summarize and evaluate whether control deficiencies, both individually or in combination, are significant deficiencies or material weaknesses. Evaluating and aggregating control deficiencies are discussed later in this lesson.

Exhibit 1-2

Process for Evaluating the Severity of Identified Control Deficiencies[a]



Notes:

[a] This flowchart describes PPC's process for evaluating the severity of each individual control deficiency identified during the financial statement audit. However, SAS No. 115 also requires the auditor to evaluate control deficiencies in the aggregate by significant account balance, disclosure, and component of internal control. This is because 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 they are individually insignificant. Auditors should summarize and evaluate whether control deficiencies, both individually and in combination, are significant deficiencies or material weaknesses.

b Compensating controls may be considered for possible mitigating effects when they achieve the same control objectives as the deficient control. In that case, however, the auditor should test the operating effectiveness of the compensating control as part of the financial statement audit. While compensating controls may limit the severity of a control deficiency, they may not eliminate the deficiency. Compensating controls are discussed in further detail later in this lesson.

c Generally, SAS No. 115 (AU 325.15) lists indicators of material weaknesses in internal control. Generally, an auditor who identifies control deficiencies that fall into the categories described in AU 325.15 should consider them to be material weaknesses unless the auditor has identified and tested compensating controls that reduce the severity of the misstatement or potential misstatement. If the auditor concludes the deficiency should not be considered a material weakness, the auditor should determine whether the deficiency is a significant deficiency as described in Step 2 of the flowchart.

d When evaluating the severity of a misstatement or potential misstatement, the auditor should consider qualitative factors as well as quantitative factors. Guidance on the auditor's consideration of qualitative factors is provided later in this lesson.

e SAS No. 115 (AU 325.17) requires auditors to conclude "whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion" as the auditor. Considering the views of a prudent official test is discussed in further detail later in this lesson.

f SAS No. 115 requires auditors to communicate only significant deficiencies and material weaknesses they become aware of during the audit. Although there is no requirement to communicate other control deficiencies (sometimes called management letter comments), many auditors make such communications as a service to the client. If the auditor decides to communicate these control deficiencies, SAS No. 115 states that the communication can be made orally, when it is not made in writing; however, the auditor should document it.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What are auditors required to do by SAS No. 115?

   a. Perform procedures during the audit to identify control deficiencies.

   b. Evaluate and communicate identified control deficiencies.

2. A *deficiency in operation* exists under what circumstances?

   a. A control needed to meet a control objective is missing or has not been properly designed.

   b. A control does not allow management or employees to prevent misstatements on a timely basis.

   c. The failure to obtain a daily summary of accounting transactions from remote locations.

   d. Any time a control testing exception exists and is discovered during the audit.

3. Lucy, a CPA, is hired to audit the WillCo Company. While performing auditing procedures, she discovers circumstances that might be considered control deficiencies, significant deficiencies, or material weaknesses. Which of the deficiencies Lucy discovered would be considered a deficiency in the design of controls?

   a. Lucy found one deviation in a sampling test of the operating effectiveness of a control for which she expected none.

   b. The company's control that requires dual authorization for significant disbursements has failed in several instances.

   c. At the direction of company management, expenses are consistently understated.

   d. The company does not have an internal process in place for reporting internal control deficiencies to management.

4. Which of the following is a further audit procedure that, when performed, might bring internal control deficiencies to light?

   a. Reviewing existing internal reports on controls.

   b. Obtaining an understanding of the client's internal control.

   c. Assessing the risks of material misstatement in the client's audited financial statements.

   d. Communicating with the client's management or others, such as internal auditors.

5. According to SAS No. 115, must all control deficiencies be communicated to management and those charged with governance?

   a. Yes.

   b. No.

6. Which of the following tasks is both required in all audits and might alert auditors to control deficiencies?

   a. Obtaining an understanding of the entity's internal control.

   b. Performing tests of controls as part of the audit.

7. Based on PPC's process for evaluating the severity of control deficiencies, what should be considered before concluding that a control deficiency that has already been evaluated and not considered a material weakness is a significant deficiency?

   a. Any compensating controls, any qualitative factors, and the prudent official test.

   b. Whether there is a reasonable possibility that misstatement will occur.

8. Jacob, a CPA, is hired to audit MegaCo. During the course of his audit, Jacob discovers a control deficiency. He uses the PPC process illustrated in the flowchart at Exhibit 2-2 to determine the severity of the control deficiency. Jacob determines that if misstatement resulted from this deficiency, it would be material; however, he believes that it is very likely that any misstatement will be prevented, or detected and corrected, in a timely manner. Finally, Jacob concludes that the deficiency is important enough to merit the attention of those charged with governance. What type of deficiency did Jacob discover?

   a. A material weakness.

   b. A significant deficiency.

   c. A control deficiency.

   d. A management letter comment.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What are auditors required to do by SAS No. 115? **(Page 3)**

   a. Perform procedures during the audit to identify control deficiencies. [This answer is incorrect. Although SAS No. 115 does not require an auditor to perform procedures to identify deficiencies in internal control, it notes that auditors may become aware of control deficiencies while performing a host of required procedures during the audit.]

   b. Evaluate and communicate identified control deficiencies. [This answer is correct. For those control deficiencies the auditor identifies, SAS No. 115 requires the auditor to evaluate them to determine whether, individually or in combination, they are significant deficiencies or material weaknesses. It also establishes requirements for auditors to communicate certain control deficiencies they have identified during the audit.]

2. A *deficiency in operation* exists under what circumstances? **(Page 3)**

   a. A control needed to meet a control objective is missing or has not been properly designed. [This answer is incorrect. A *deficiency in design* exists when (a) a control necessary to meet a control objective is missing or (b) an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.]

   b. A control does not allow management or employees to prevent misstatements on a timely basis. [This answer is incorrect. These are the circumstances of a *control deficiency*. A control deficiency may be either a deficiency in design or a deficiency in operation, depending on the circumstances.]

   c. The failure to obtain a daily summary of accounting transactions from remote locations. [This answer is correct. A deficiency in operation exists when a properly designed control does not operate as designed resulting in output that is incomplete.]

   d. Any time a control testing exception exists and is discovered during the audit. [This answer is incorrect. The auditor should use professional judgment when evaluating whether a control testing exception is a control deficiency. Not all exceptions are necessarily control deficiencies.]

3. Lucy, a CPA, is hired to audit the WillCo Company. While performing auditing procedures, she discovers circumstances that might be considered control deficiencies, significant deficiencies, or material weaknesses. Which of the deficiencies Lucy discovered would be considered a deficiency in the design of controls? **(Page 5)**

   a. Lucy found one deviation in a sampling test of the operating effectiveness of a control for which she expected none. [This answer is incorrect. Finding an observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control is a failure in the operation of controls. Under these circumstances, finding 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.]

   b. The company's control that requires dual authorization for significant disbursements has failed in several instances. [This answer is incorrect. Failure in the operation of effectively designed controls over a significant account or process is a failure in the operation of controls.]

   c. At the direction of company management, expenses are consistently understated. [This answer is incorrect. Undue bias or lack of objectivity by those responsible for accounting decisions, such as the instance described in this answer choice, is a failure in the operation of controls.]

   d. The company does not have an internal process in place for reporting internal control deficiencies to management. [This answer is correct. One example of a deficiency in the design of controls would

be an absent internal process for reporting internal control deficiencies to management in a timely manner. Another example would be inadequate design of internal control over preparing the audited financial statements.]

4. Which of the following is a further audit procedure that, when performed, might bring internal control deficiencies to light? **(Page 6)**

   a. **Reviewing existing internal reports on controls. [This answer is correct. This is a further audit procedures during the performance of which internal control deficiencies might be found. Another example of such a further audit procedure is evaluating the results from any tests of controls performed in the audit of the financial statements.]**

   b. Obtaining an understanding of the client's internal control. [This answer is incorrect. SAS No. 115 notes that, during the course of the audit, obtaining an understanding of the entity's internal control (including evaluating the design and implementation of controls) may cause the auditor to become aware of a control deficiency. However, this is not a further audit procedure.]

   c. Assessing the risks of material misstatement in the client's audited financial statements. [This answer is incorrect. Assessing the risks of material misstatement of the audited financial statements, whether those risks would be caused by error or fraud, is not a further audit procedure. However, it is possible that while assessing the risks of material misstatement, the auditor may become aware of a control deficiency.]

   d. Communicating with the client's management or others, such as internal auditors. [This answer is incorrect. This type of communication is not a further audit procedure. However, according to SAS No. 115, when communicating with management or others (including any internal auditors, governmental authorities, etc.), the auditor may become aware of a control deficiency.]

5. According to SAS No. 115, must all control deficiencies be communicated to management and those charged with governance? **(Page 7)**

   a. Yes. [This answer is incorrect. If an identified control deficiency is not a significant deficiency or material weakness, SAS No. 115 does not require it to be communicated to management and those charged with governance.]

   b. No. [This answer is correct. Not all control deficiencies are considered either significant deficiencies or material weaknesses. Communication is not required if the deficiency is not considered severe enough to meet the definition of either significant deficiency or material weakness. However, SAS No. 115 does require the auditor to evaluate the severity of deficiencies.]

6. Which of the following tasks is both required in all audits and might alert auditors to control deficiencies? **(Page 7)**

   a. **Obtaining an understanding of the entity's internal control. [This answer is correct. One way an auditor might become aware of control deficiencies is when obtaining an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures, as required by SAS No. 109. Obtaining an understanding of internal control is required in all audits.]**

   b. Performing tests of controls as part of the audit. [This answer is incorrect. An auditor might become aware of control deficiencies by performing tests of controls during an audit. The results of such tests may indicate control exceptions, which the auditor would then evaluate to determine whether they are control deficiencies. Performing tests of controls is not required for all audits. Accordingly, the auditor who performs tests of controls might have a different awareness of control deficiencies than an auditor who did not perform tests of controls during the audit.]

7. Based on PPC's process for evaluating the severity of control deficiencies, what should be considered before concluding that a control deficiency that has already been evaluated and not considered a material weakness is a significant deficiency? **(Page 7)**

a. **Any compensating controls, any qualitative factors, and the prudent official test. [This answer is correct. If an identified deficiency is not considered a material weakness, the auditor must consider whether it is important enough to merit attention by those charged with governance. If so, three things should be considered before concluding that it is a significant deficiency: (1) if there are compensating controls that mitigate the severity of the identified deficiency, (2) if there are qualitative factors that cause the auditor to believe the potential effect of the identified deficiency is greater than originally evaluated, and (3) if prudent officials with knowledge of the same facts and circumstances would agree with the auditor's conclusion.]**

b. Whether there is a reasonable possibility that misstatement will occur. [This answer is incorrect. When determining whether a deficiency is a material weakness, one consideration is whether there is at least a reasonable possibility that a misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.]

8. Jacob, a CPA, is hired to audit MegaCo. During the course of his audit, Jacob discovers a control deficiency. He uses the PPC process illustrated in the flowchart at Page 9 to determine the severity of the control deficiency. Jacob determines that if misstatement resulted from this deficiency, it would be material; however, he believes that it is very likely that any misstatement will be prevented, or detected and corrected, in a timely manner. Finally, Jacob concludes that the deficiency is important enough to merit the attention of those charged with governance. What type of deficiency did Jacob discover? **(Page 9)**

   a. A material weakness. [This answer is incorrect. According to the PPC process, to be considered a material weakness (which is the most severe classification of deficiency), the misstatement (or potential misstatement) must be material; there must be a reasonable possibility that the misstatement will not be prevented, or detected and corrected, on a timely basis; and there cannot be any compensating controls that mitigate the severity of the deficiency.]

   b. **A significant deficiency. [This answer is correct. Based on the information Jacob uncovered in the scenario above, according to the PPC process, this deficiency would be considered a significant weakness. Under SAS No. 115, significant deficiencies and material weaknesses should be communicated to those charged with governance; however, before making that communication, Jacob should also consider any relevant qualitative and quantitative factors, as well as if a prudent official would come to the same conclusion.]**

   c. A control deficiency. [This answer is incorrect. To be considered a control deficiency, the least severe type of deficiency, Jacob would have needed to discover that the potential for misstatement was not material and that the deficiency was not important enough to merit attention by those charged with governance.]

   d. A management letter comment. [This answer is incorrect. *Management letter comments* is a term that is sometimes used instead of *control deficiencies*. Based on the PPC process outlined in this course, the deficiency that Jacob discovered is not a management level comment. If it were, Jacob could communicate it as a service to the client, but he would not be required to under SAS No. 115.]

EVALUATING ANY CONTROL DEFICIENCIES THAT WERE IDENTIFIED

Although SAS No. 115 does not require an auditor to search for control deficiencies to communicate, the auditor should evaluate identified control deficiencies to determine if they are significant deficiencies or material weaknesses. SAS No. 115 requires auditors to evaluate control deficiencies both individually and in the aggregate by significant account balance, disclosure, and component of internal control. This is because 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 they are individually insignificant.

Determining whether a control deficiency rises to the level of a significant deficiency or a material weakness is subjective and often may be a difficult judgment call. There are many gray areas requiring professional judgment. Identified control deficiencies will vary with each audit, and the severity of deficiencies will depend on many entity-specific factors. It is a best practice for auditors not to draw a hard line on what constitutes a significant deficiency or a material weakness. Instead, auditors should evaluate the facts and circumstances specific to each situation.

Defining Material Weaknesses under SAS No. 115

SAS No. 115 (AU 325.08) defines a material weakness as "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." A *reasonable possibility* exists when the likelihood of the event is either *reasonably possible* or *probable* as those terms are used in Statement of Financial Accounting Standards Board (SFAS) No. 5, *Accounting for Contingencies* (FASB ASC 450).

Indicators of Material Weaknesses. SAS No. 115 (AU 325.15) provides the following list of conditions that are indicators of material weakness:

- 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 indicating that the misstatement would not have been detected by the entity's internal control.
- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

Identifying one of the deficiencies from that list, however, does not automatically result in its classification as a material weakness. For instance, there may be compensating controls that the auditor has identified and tested during the audit that would lead the auditor to conclude that the identified condition should be considered a significant deficiency rather than a material weakness. In that case, the auditor should document the tests performed as well as how the compensating control mitigates the severity of the control deficiency.

Defining Significant Deficiencies under SAS No. 115

SAS No. 115 (AU 325.07) defines a significant deficiency as 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." Note that this definition does not provide objective criteria for evaluating the probability and magnitude of deficiencies that should be considered significant deficiencies. This is generally consistent with the Auditing Standard Board's intent to encourage auditors to use professional judgment when determining what constitutes a significant deficiency, thus allowing auditors more flexibility when considering which matters to communicate to management and those charged with governance.

While SAS No. 115 provides a list of deficiencies that are indicators of material weaknesses, it does not provide a list of deficiencies that should be considered significant deficiencies. However, the *AICPA Risk Alert: Communicat-*

ing Internal Control Related Matters in an Audit—Understanding SAS No. 115, includes in paragraph 42 the following examples of deficiencies that might indicate the existence of significant deficiencies in internal control:

- Antifraud programs and controls.
- Controls over nonroutine and nonsystematic transactions.
- Controls over selecting and applying accounting principles that are in conformity with GAAP (including having sufficient expertise in the selection and application of GAAP).
- Controls over the financial reporting process at the end of a period, including controls over procedures the entity uses to (a) enter transaction totals into the general ledger; (b) initiate, authorize, record, and process journal entries into the general ledger; and (c) record adjustments that are recurring or nonrecurring to the financial statements.

While this listing might be helpful to auditors when considering the severity of identified deficiencies, auditors should not automatically classify deficiencies from the listing as significant deficiencies. In other words, auditors should evaluate the severity of such deficiencies in accordance with PPC's process as outlined previously.

Evaluating the Severity of Control Deficiencies

When an auditor identifies a control deficiency, he or she should evaluate the severity of the identified deficiencies. To do that, the auditor considers both the *probability of occurrence* and the *magnitude* of potential misstatements in the financial statements. (Note that the auditor considers the potential for misstatement, not whether an actual misstatement has occurred. The absence of an actual misstatement does not indicate that control deficiencies are not significant deficiencies or material weaknesses. Furthermore, if a misstatement has occurred, the auditor should consider the possibility of a further misstatement in the financial statements.)

The table in Exhibit 1-3 summarizes the thresholds for determining whether a control deficiency is a significant deficiency or a material weakness:

Exhibit 1-3

Thresholds for Determining Whether a Control Deficiency Is a Material Weakness or a Significant Deficiency

Probability of Occurrence of Actual or Potential Misstatement	**Magnitude of Actual or Potential Misstatement**	
	Material	**Less Than Material**
Probable	Material Weakness	Significant Deficiency or Control Deficiency
Reasonably Possible	Material Weakness	Significant Deficiency or Control Deficiency

* * *

This lesson goes on to discuss the probability of occurrence of a potential misstatement, and then discusses the magnitude of a potential misstatement in greater detail.

Determining Whether There is a Material Weakness. As outlined previously in PPC's process, most auditors will generally begin by considering whether an identified deficiency should be considered a material weakness.

Specifically, auditors should consider whether the identified deficiency is a material weakness by considering whether:

a. there is at least a *reasonable possibility* that a misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis, and

b. whether such a misstatement could be material.

If both (a) and (b) are met, the auditors will consider whether there are compensating controls that mitigate the severity of the identified deficiency. (Compensating controls the auditor tests and evaluates as part of the audit may be considered when evaluating the severity of an identified deficiency.) If both (a) and (b) are not met, the auditors will consider whether the identified deficiency should be considered a significant deficiency.

<u>Probability of Occurrence of a Misstatement.</u> The first threshold in Exhibit 1-3 relates to the probability of the occurrence of a misstatement or potential misstatement. According to SAS No. 115, a deficiency may be a material weakness if there is a *reasonable possibility* that a misstatement might occur and not be prevented, or detected and corrected by the related control. SAS No. 115 (AU 325.06) states that a *reasonable possibility* exists when the likelihood of the event occurring is either *reasonably possible* or *probable* as those terms are used in Statement of Financial Accounting Standards Board (SFAS) No. 5, *Accounting for Contingencies* (FASB ASC 450). Paragraph 3 of SFAS No. 5 further defines those terms as follows:

- *Probable.* The future event or events are likely to occur.

- *Reasonably Possible.* The chance of the future event or events occurring is more than remote but less than likely.

SAS No. 115 (AU 325.12) clarifies that the auditor may evaluate the probability of the occurrence of a financial statement misstatement without necessarily quantifying it as a specific percentage or range.

When evaluating the probability of the occurrence of a misstatement, SAS No. 115 (AU 325.11) notes that the auditor might consider factors such as:

- The nature of the accounts, classes of transactions, disclosures, and assertions involved (for example, suspense accounts or transactions with related parties may present more risk).

- Susceptibility of the related assets or liabilities to loss or fraud.

- The complexity, subjectivity, and extent of judgment needed to determine the amount involved.

- The relationship and interaction of the control with other controls.

- Interaction of the control deficiency with other control deficiencies.

- Possible future consequences resulting from the deficiency.

If, in the auditor's professional judgment, the probability that a misstatement could occur is less than reasonably possible, the auditor can conclude that the control deficiency does not rise to the level of a material weakness, regardless of the magnitude of the potential misstatement. Because the first threshold is not met (i.e., there is not at least a *reasonable possibility* that a potential misstatement could occur and go undetected), the magnitude of the potential misstatement is irrelevant.

If, however, the auditor believes that it is at least *reasonably possible* that a misstatement could occur because of a control deficiency, the auditor should next evaluate the magnitude of the deficiency to determine whether it should be classified as a material weakness.

<u>Magnitude of Misstatement or Potential Misstatement.</u> The second threshold in Exhibit 1-3 relates to the *magnitude* of a misstatement or potential misstatement. *Magnitude* refers to the extent of the misstatement or potential

misstatement. Clearly, it will be easier for the auditor to evaluate the severity of an identified control deficiency when an *actual* misstatement has occurred because the amount of the misstatement is known. (In that instance, however, the auditor should still consider whether the control deficiency could result in additional misstatements.) In most cases, however, the auditor will be evaluating the severity of a *potential* misstatement.

Determining the magnitude of a potential misstatement may well be the most difficult aspect of implementing SAS No. 115. SAS No. 115 provides little guidance on evaluating the magnitude of a potential misstatement, other than stating that the following factors, among others, affect the magnitude of a misstatement that might result from an identified deficiency:

- The financial statement amounts or transaction totals exposed to the deficiency.
- The volume of activity (in the current period or expected in future periods) in the account balance or transaction class exposed to the deficiency.

Generally, the most an account balance or transaction class could be *overstated* is the recorded amount. Potential *understatement*, however, is not limited to the recorded amount. For instance, if there is a control deficiency related to segregation of duties over accounts receivable, and the recorded amount is $250,000, that is the most accounts receivable could be overstated. However, accounts receivable potentially could be understated by any amount because an unlimited amount of receivables could have been misappropriated due to the segregation of duties deficiency.

SAS No. 115 does not provide any additional insight for considering the magnitude of a potential misstatement. However, SAS No. 107 (AU 312.4) provides the following guidance on materiality in the context of an audit:

> The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. The perceived needs of users are recognized in the discussion of materiality in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. Accordingly, when evaluating the magnitude of a potential misstatement under SAS No. 115, the auditor should consider the effects of the potential misstatement on those elements of the financial statements that, in the auditor's judgment, are most likely to be important to financial statement users.

After the auditor has determined the magnitude of the misstatement or potential misstatement from a *quantitative* standpoint, the auditor should then consider *qualitative* factors to see whether they increase the severity of the potential misstatement and, thus, the severity of the identified control deficiency. Qualitative factors are discussed later in this lesson.

Auditors performing only an audit of financial statements should remember that conclusions about the magnitude of a potential misstatement as discussed in SAS No. 115 affect only whether or not an identified deficiency is communicated to management and those charged with governance. Unlike judgments about materiality, which can affect whether a client's financial statements are fairly presented (and, thus, the auditor's opinion on those statements), the auditor's conclusions about the magnitude of a potential misstatement affects only whether the auditor communicates an identified deficiency and how it is communicated (as a significant deficiency or a material weakness).

Considerations for auditors performing an audit of an entity's financial statements and an audit of its internal control over financial reporting (that is, an integrated audit) may be different. For example, concluding that an identified deficiency is a material weakness prohibits the auditor from expressing an unqualified opinion on internal control over financial reporting. Auditors engaged to perform integrated audits should refer to *PPC's Guide to Nontraditional Engagements.*

After considering the potential for misstatement and the magnitude of the misstatement, the auditor may believe an identified deficiency should be considered a material weakness. Before reaching a conclusion on severity, however, he or she should consider whether there are compensating controls that might mitigate the severity of the deficiency. (Compensating controls the auditor tests and evaluates as part of the audit may be considered when evaluating the severity of an identified deficiency.) In addition, the auditor should consider the views of a prudent official as discussed later in this lesson.

Determining Whether There Is a Significant Deficiency. For those identified control deficiencies that are not considered material weaknesses, the auditor should exercise professional judgment and determine whether they should be communicated to management and those charged with governance as significant deficiencies. As previously discussed, SAS No. 115 defines significant deficiencies as "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." By excluding more objective criteria (that is, criteria dealing with the probability of occurrence and magnitude of misstatement) from the SAS No. 115 definition of a significant deficiency, the Auditing Standards Board encourages auditors to use professional judgment when determining whether to classify an identified deficiency as significant and, accordingly, communicate it to management and those charged with governance.

Establishing Firm Policies. It is possible that the absence of more objective criteria (such as criteria for determining magnitude for purposes of classifying an identified deficiency as a material weakness or a significant deficiency) in SAS No. 115 may cause some firms to provide such guidance in their firm policies. Firms may choose to do that for two reasons: First, such guidance would make it easier for less experienced auditors to take the first stab at classifying an identified deficiency. Second, such guidance would encourage a more consistent approach to the classification of deficiencies throughout a firm.

Examples of objective criteria that might be included in firm policies include:

- A statement that a deficiency that is *unlikely* to cause a misstatement of the financial statements (that is, one in which the probability of occurrence is *remote*) should not be considered a significant deficiency for communication under SAS No. 115, regardless of its materiality. (The firm might wish to communicate such items in a management letter.)

- A statement setting forth a specific percentage of the client's financial statement planning materiality for purposes of classifying a potential misstatement as *material* under SAS No. 115.

- A statement specifying percentages of the client's financial statement planning materiality to assist staff in making initial classifications of identified deficiencies as either material weaknesses, significant deficiencies, or control deficiencies.

Generally, firm policies clearly state the objective of any such criteria is only to enable an auditor to make a first stab at the classification of identified deficiencies, while the final classification should take into account the auditor's consideration of the qualitative factors, the views of a prudent official, and the existence of compensating controls tested as part of the financial statement audit. Finally, the policies should clarify that there is no substitute for the exercise of professional judgment when evaluating the severity of identified deficiencies under SAS No. 115.

Qualitative Considerations

When determining whether a misstatement or potential misstatement is more than inconsequential, the auditor's overall judgment may be influenced by qualitative as well as quantitative considerations. The consideration of qualitative factors may cause the auditor to conclude that the severity of a control deficiency is increased.

The qualitative factors an auditor considers are similar to those discussed in SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*. SAS No. 107 (AU 312.59) states that "as a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements." Examples of quantitatively insignificant misstatements or potential misstatements that might cause an auditor to increase the severity of the identified control deficiency that caused it include a misstatement that:

- While immaterial to the entity's net income for the current period, is material to the overall trend of earnings (for example, a misstatement that reverses a downward trend of earnings or changes a loss into income).
- Results in events or circumstances that materially affect the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if it could lead to a material contingent liability, or a material loss of revenue. (This is the example given in AU 312.) In addition, some misstatements, although not individually significant, may be pervasive to the financial statements (that is, misstatements that affect numerous financial statement amounts, subtotals, or totals).
- Affects materiality thresholds related to statutory or regulatory requirements. Deficiencies in disclosures of related-party transactions or those required by statute or regulatory authority might be considered severe even though similar amounts for more routine items might be considered immaterial.
- Affects management's compensation (for example, a misstatement that indicates an earnings target has been met, which triggers a bonus).
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions.
- Has an affect on the entity's compliance with loan covenants, other contractual agreements, or regulatory provisions (for example, a misstatement that would reveal a default under a debt covenant).
- Affects an entity's investment in a joint venture, when the joint venture partners are users of the financial statements under audit.
- Is the result of fraud or suspected fraud. (In this case, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, as described in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, even if the effect of the misstatement is not material to the financial statements.)
- Affects professional fees if the auditor is concerned that there is an inadequate understanding of the client's litigation exposure and the identity of all attorneys engaged during the period.
- Affects material disclosures related to a small account balance. (For example, a joint venture investment might be small at the balance-sheet date, but a subsequent events note might indicate a subsequent major investment in that joint venture project that holds the key to the client's future success.)

In summary, the auditor needs to draw on the knowledge and understanding of the client to identify all of the qualitative factors that might influence the auditor's judgment about the magnitude of a misstatement or potential misstatement and, thus, judgments about the severity of an identified control deficiency. Finally, it is important for the auditor to recognize that qualitative considerations are used only to determine whether the judged severity of a control deficiency should be increased—not to justify a decrease in its severity.

Compensating Controls

When internal control deficiencies have been identified, SAS No. 115 (AU 325.14) states the auditor may consider (but is not required to consider) whether there are effective *compensating controls* that could prevent the identified deficiency from being considered a material weakness or a significant deficiency. A compensating control is one that results in the prevention (by preventive controls) or detection (by detective controls) of a misstatement. For instance, the auditor might identify a misstatement that was not prevented, or detected and corrected by a control that was not operating effectively. While performing substantive procedures or tests of the operating effectiveness of the control, the auditor might become aware of the existence of other controls that, if effective, could limit the severity of the deficiency and prevent it from being a material weakness (or a significant deficiency). These other controls are compensating controls.

SAS No. 115 (AU 325.14) requires the auditor to test the operating effectiveness of a compensating control only when the auditor believes the control might mitigate the severity of an identified deficiency. If the auditor tests the compensating control and finds that it is effective, the auditor should consider the extent to which it mitigates the identified deficiency. For instance, a control deficiency an auditor initially considered a material weakness might be mitigated to a significant deficiency by an effective compensating control; then again, an effective compensating control might mitigate it to a control deficiency. For a compensating control to effectively mitigate a deficiency that would otherwise be a material weakness, the compensating control should operate at a level of precision that would prevent, or detect and correct, a material misstatement. The consideration of a compensating control should include an evaluation of its existence and effectiveness (i.e., the auditor would need to test the effectiveness of the compensating control to the extent that he or she believes is necessary). Regardless of the extent to which the compensating control mitigates the control deficiency, a compensating control can only mitigate—not eliminate—the control deficiency.

On the other hand, *redundant controls* can eliminate a control deficiency. Unlike compensating controls, redundant controls are controls that duplicate other controls and achieve the same objectives. Therefore, if a client has a control that is not properly designed and operating, but a redundant control achieves the same objective as the deficient control, the auditor can test the design and operating effectiveness of that control and, if found to be effective, conclude that there is no control deficiency.

The AICPA Audit Risk Alert, *Communicating Internal Control Related Matters Noted in an Audit—Understanding SAS No. 115*, contains a number of case studies that address compensating controls and how they might affect an auditor's evaluation of the severity of identified control deficiencies. Exhibits 1-4 through 1-6, which are based on those case studies, present examples of how compensating controls may affect the auditor's conclusions about the severity of identified control deficiencies.

Exhibit 1-4

Consideration of the Mitigating Effects of Compensating Controls—Lack of Segregation of Duties over Cash Disbursements

Background: The client, a small nonprofit organization, has only one person in charge of the accounting and reporting functions. This results in a lack of segregation of duties over cash disbursements, which is a deficiency in internal control.

Example 1

Compensating Control: A board member signs all checks, reviewing invoices that support the disbursement before signing. The signed checks are returned to the client to be mailed. The bank sends the bank statement directly to the board member, who reviews the bank statement and returned checks for appropriate signatures and/or alterations. The bank statement is then given to the client for reconciliation.

Severity of Identified Deficiency, after Consideration of Compensating Control: After testing the board member's review of supporting documentation and checks, the auditor determines that the compensating control (that is, the board member's review) is effective in preventing or detecting an unauthorized disbursement. Therefore, the auditor believes that it is less than reasonably possible for a misstatement (of any amount) to occur and go undetected in the financial statements. Therefore, the auditor concludes that the identified deficiency is a control deficiency.

Example 2

Compensating Control: A board member signs all checks, reviewing invoices that support the disbursement before signing. The signed checks are returned to the client to be mailed. The bank statement and returned checks are sent directly to the client for reconciliation.

Severity of Identified Deficiency, after Consideration of Compensating Control: Although the board member reviews supporting documentation before signing checks, he does not review returned checks for subsequent alteration. Thus, the auditor does not believe the compensating control (that is, the board member's review) is effective in preventing or detecting unauthorized disbursements, some of which may be material. Thus, the auditor believes that the *probability* of a *material misstatement* occurring without being detected is *at least reasonably possible*. Therefore, the auditor concludes that the deficiency is a material weakness.

Example 3

Compensating Control: A board member signs all checks, reviewing invoices that support the disbursement before signing. Signed checks are returned to the client to be mailed. The bank sends the bank statement directly to the board member, who reviews the bank statement and returned checks over $1,000 for appropriate signatures and/ or alterations. The bank statement is then given to the client for reconciliation.

Severity of Identified Deficiency, after Consideration of Compensating Control: Although the board member reviews supporting documentation before signing checks, he only reviews returned checks over $1,000 for subsequent alteration. While the auditor believes the compensating control (that is, the board member's review) is effective in preventing or detecting *material* unauthorized disbursements, the auditor does not believe it is effective in detecting less material misstatements. Thus, the auditor concludes that the deficiency is a significant deficiency (that is, it is important enough to merit attention by those charged with governance).

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Exhibit 1-5

Consideration of the Mitigating Effects of Compensating Controls—Inventory Related Deficiencies

Background: The client is a large car dealership with a lack of effective controls over tracking inventory quantities of dealership parts. However, a quarterly physical inventory taken at the end of the quarter revealed that the parts manager was selling dealership parts, not recording the sales, and keeping the receipts. Although the amount of the writedown needed to reflect actual inventory was not material to the financial statements, management became aware of the fraud when the parts manager confessed under questioning.

Compensating Control: The client relies on the quarterly physical inventory to detect any potential misstatement of dealership parts.

Severity of Identified Deficiency, after Consideration of Compensating Control: While detective controls are seldom as effective as preventive controls (the client suffered a loss as a result of the weak preventive controls), the physical inventory was effective at detecting the loss, thus ensuring that the financial statements were not misstated. Therefore, the auditor concluded that the probability of a material misstatement was less than reasonably possible; therefore, the auditor concluded it was not a material weakness. Furthermore, according to the AICPA risk alert, because of the compensating controls, the auditor concluded that the item was also not a significant deficiency. AU 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to inform the appropriate level of management when he or she has found evidence that fraud exists. Therefore, this deficiency should be communicated anyway, irrespective of the decision the auditor makes about the internal control deficiency classification. Furthermore, the auditor may wish to communicate this deficiency (and any other instances of fraud) in the SAS No. 115 communication. Although the fraud did not result in a material misstatement of the financial statements, the fraud is evidence of a deficiency in internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition.

* * *

Exhibit 1-6

Consideration of the Mitigating Effects of Compensating Controls—Controls over Sales Contracts

Example 1

Background: The client uses a standard sales contract for most transactions. As permitted by company policy, sales personnel frequently modify terms of the company's standard sales contract. They also sometimes modify the shipping terms, which could require a delay in the timing of revenue recognition. In fact, there have been times in which revenue was improperly recorded in advance of shipment. While no individual sales contract is material to the company, the sales personnel's ability to modify the terms of the standard sales contract is a deficiency in internal control.

Compensating Controls: Accounting personnel review contract changes for significant or unusual modifications, but they do not review changes to shipping terms. Each month management also reviews gross margin and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period.

Severity of Identified Deficiency, after Consideration of Compensating Control: After testing the operating effectiveness of the compensating control, the auditor believes the compensating controls that operate monthly and at the end of accounting periods should reduce the probability of a misstatement occurring and going undetected to less than reasonably probable. Furthermore, the auditor believes that any misstatements that occur would be limited to revenue recognition errors related to shipping terms and not to broader revenue recognition matters; thus, the magnitude of misstatements would be less than material. Accordingly, the auditor concludes the deficiency is not a material weakness. However, because the company's compensating controls are only designed to detect material misstatements, the auditor concludes that the deficiency is important enough to merit the attention of management and thus a significant deficiency.

Example 2

Background: The client uses a standard sales contract for most transactions. However, sales personnel frequently modify the terms of the company's standard sales contract. Individual sales contracts frequently are material to the company, and gross margin for each transaction may vary significantly. The sales personnel's ability to modify the standard sales contract is a deficiency in internal control. In fact, there have been times in which revenue was improperly recorded in advance of shipment, and in some cases the misstatements have been material.

Compensating Controls: Each month management reviews gross margin and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period.

Severity of Identified Deficiency, after Consideration of Compensating Control: The magnitude of a financial statement misstatement resulting from this deficiency in internal control would reasonably be expected to be material because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which makes compensating controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the auditor believes that the probability of a material misstatement occurring is at least reasonably possible. In addition, because sales contracts are material, the auditor believes misstatements that might occur could be material to the client. Therefore, the auditor concludes that the deficiency is a material weakness.

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Prudent Official Test

SAS No. 115 (AU 325.16) requires auditors to consider whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's conclusion that an identified deficiency is not a material weakness. In other words, would a prudent official, knowing what the auditor knows about the facts and circumstances, other controls tested, and the probability and magnitude of potential misstatement, agree with the auditor's conclusion that a deficiency is not a material weakness? Stated more simply, would a prudent official with knowledge of the same facts and circumstances agree with the auditor's classification of the severity of the control deficiency?

SAS No. 115 does not define the term *prudent official*. But the AICPA Audit Risk Alert, *Communicating Internal Control Related Matters Noted in an Audit—Understanding SAS No. 115*, provides the following guidance in paragraph 24:

> . . . the concept is that an auditor should "stand back" and take another objective look at the severity of the deficiency as would a regulator or someone from an oversight agency.

The AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit*, provides more insight on the prudent official test. It explains in paragraph 7.55 that the SEC developed the concept of a prudent official "for setting a hypothetical target for determining reasonable assurance and reasonable detail." From a practical standpoint, the AICPA Audit Guide recommends that auditors take a "step back" and consider whether an "experienced business person" with knowledge of the same facts and circumstances would agree with how the auditor classified a control deficiency. It also states that some auditors might wish to consider how comfortable they would be with their classification of a control deficiency if it were printed on the front page of a prominent business publication. Although originally developed as a neutral concept, the AICPA Audit Guide acknowledges that the prudent official test might prompt auditors to make a more conservative classification of the severity of the control deficiency than if the concept were not used.

Generally, the auditor's consideration of whether a "prudent official" would agree with the auditor's classification of a control deficiency depends, at least to some extent, on the nature of the client's business and the needs of the users of the financial statements. In a regulated environment, evaluating the severity of the deficiency through the eyes of a regulator ordinarily would be the most practical approach. For instance, an auditor of a financial institution should generally evaluate the severity of control deficiencies by considering the views of a more cautious regulator. In some instances, that might lead the auditor to a more conservative classification of a control deficiency than the auditor would make for a client that operates in a nonregulatory environment. However, an auditor of a small manufacturing company, which is not concerned with regulatory issues, might consider instead whether an experienced business person or another practitioner would agree with the auditor's classification of the control deficiency, given the same facts and circumstances.

The AICPA Risk Alert, *Communicating Internal Control Related Matters Noted in an Audit—Understanding SAS No. 115*, contains a case study that discusses how an auditor might consider the views of a prudent official when determining the severity of an identified control deficiency. In the case study, the auditor's client is a small not-for-profit organization that receives most of its donations by checks from corporate donors. However, some donations are made in cash. While obtaining the understanding of internal control, the auditor determines that controls over cash receipts are inadequate. While cash donations are not material to the financial statements, the auditor identifies the lack of adequate controls as a fraud risk and performs additional auditing procedures relative to cash receipts. Through inquiry, the auditor learns that someone may be stealing cash. Therefore, the auditor notifies management, performs certain audit tests, and discovers evidence that an employee is pocketing cash and not recording the cash donations.

The probability that a fraud could occur and go undetected is high. In fact, the fraud has already occurred. Because total cash sales are immaterial to the financial statements, however, the magnitude of the misstatement (and any potential misstatements) would reasonably be expected to be less than material. Therefore, the auditor initially concludes that the deficiency is not a material weakness. However, because it involves fraud, the auditor believes it is significant enough to merit the attention of those charged with governance and decides to report it as a significant deficiency. Then, the auditor considers the views of a prudent official. In this case, the auditor considers how a regulator, a donor, and others in the nonprofit community are likely to view the deficiency, in light of the facts and circumstances: the client is a not-for-profit organization, cash is a sensitive area, and fraud is involved. The auditor believes they probably would view the absence of controls over cash receipts as a material weakness. Therefore, the auditor concludes that the lack of adequate controls over cash receipts is a material weakness.

Finally, it is important to understand that the prudent official test is used only to gauge whether the judged severity of a control deficiency should be increased—not to justify a decrease in the severity.

AGGREGATING ANY CONTROL DEFICIENCIES THAT WERE IDENTIFIED

SAS No. 115 requires auditors to evaluate control deficiencies both individually and in the aggregate by significant account balance, disclosure, relevant assertion, and component of internal control. This is because multiple control deficiencies that affect the same financial statement account balance or disclosure, relevant assertion, or component of internal control collectively may constitute a significant deficiency or material weakness, even though they are individually less significant.

For example, assume an auditor identified a number of deficiencies related to the lack of adequate reviews and approvals within the company. While each of the control deficiencies related to different account balances, they all related to a specific component of internal control—monitoring. Thus, even though the auditor considered each individual deficiency only a control deficiency, the requirement in SAS No. 115 to aggregate control deficiencies by internal control component caused the auditor to consider them significant enough to merit the attention of those charged with governance and thus a significant deficiency.

In another example, assume an auditor identified the following deficiencies:

- Several accounts receivable transactions (that were not material, either individually or in the aggregate) were not properly recorded in the subsidiary ledger.

- Account balances affected by the improperly recorded accounts receivable transactions were not reconciled on a timely basis.

- The company has inadequate segregation of duties over IT access controls related to the accounts receivable and billing function.

The auditor considered each of the deficiencies individually as only significant deficiencies. However, he noted that all of the deficiencies affected accounts receivable. Therefore, the SAS No. 115 requirement to aggregate control deficiencies relating to the same account caused the auditor to consider them in the aggregate. The auditor concluded that the probably of a *material misstatement* occurring in accounts receivable without being prevented, detected, or corrected by the related controls was *at least reasonably possible*. Thus, the auditor concluded that, when aggregated, the deficiencies constituted a material weakness.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Sarah, a CPA, discovers a control deficiency during the course of an audit engagement. She determines that this deficiency is insignificant and should not be classified as a material weakness or a significant deficiency. Is Sarah required to communicate this deficiency?

   a. Yes.

   b. No.

   c. It is a matter of professional judgment.

10. According to SAS No. 115, which of the following conditions indicates the existence of a material weakness?

    a. Antifraud controls and programs.

    b. Restatement of financial statements to correct material misstatement.

    c. Controls over nonsystematic and nonroutine transactions.

    d. Controls over applying and selecting accounting principles in conformity with GAAP.

11. According to the *AICPA Risk Alert: Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115*, existence of which of the following might indicate the existence of significant deficiencies in internal control?

    a. Identification of fraud by senior management.

    b. Material misstatement of the financial statements identified by the auditor.

    c. Ineffective oversight of the entity's internal control and financial reporting.

    d. Controls over the entity's financial reporting process at the end of a period.

12. Julie, a CPA, identified a control deficiency during the course of her audit engagement. She determined that the probability of occurrence of actual or potential misstatement is reasonably possible. Then she determined that the magnitude of actual or potential misstatement is less than material. Based on these thresholds, how should Julie classify this deficiency?

    a. As a material weakness.

    b. As a significant deficiency or a control deficiency.

13. When evaluating the probability of a misstatement occurring, an auditor might consider all of the following factors, **except**:

    a. The nature of the classes of transactions, accounts, assertions, and disclosures involved.

    b. How susceptible the related assets and liabilities are to fraud or loss.

    c. The control's relationship and interaction with other controls.

    d. A list of consequences suffered when this misstatement occurred in the past.

14. Which of the following statements best describes evaluating the magnitude of misstatement?

    a. Usually, an auditor will be evaluating the severity of an actual misstatement.

    b. The term *magnitude* refers to the extent of the misstatement or the potential misstatement.

    c. Determining the magnitude of a potential misstatement is not difficult if the guidance in SAS No. 115 is used.

    d. The most an account balance or transaction can be understated is the recorded amount.

15. If an auditor is engaged to perform only an audit of an entity's financial statements, what does the auditor's conclusions about the magnitude of a potential misstatement affect?

    a. Whether an identified deficiency should be communicated to management or those charged with governance.

    b. Whether the financial statements have been fairly presented and the auditor's opinion on the statements.

    c. Whether the auditor is prohibited from expressing an unqualified opinion on internal control over financial reporting.

16. In which of the following scenarios would quantitatively insignificant misstatements (or potential misstatements) possibly cause the auditor to increase the severity of the control deficiency that caused it?

    a. Mary discovers a misstatement in her client's financial statements that reflects its current downward trend of earnings.

    b. Louis discovers a misstatement that affects only one of his client's many financial statement amounts.

    c. Kris discovers a misstatement in her client's financial statements that reveals a default under a debt covenant.

    d. Jean discovers a misstatement that affects her client's investment in a joint venture, but the partners do not use the entity's financial statements.

17. What does SAS No. 115 require auditors to do regarding compensating controls related to identified control deficiencies?

    a. Consider if compensating controls exist that could limit the severity of the deficiency.

    b. Test the operating effectiveness of compensating controls under certain circumstances.

    c. Determine if compensating controls are preventative or detective.

    d. Compare the compensating controls to the case studies provided by SAS No. 115.

18. Helping Hands, a small nonprofit organization, hires Brenda, a CPA, to perform their audit. During the course of her audit, Brenda discovers that Helping Hands, due to its small staff, has only one person in charge of accounting and the related reporting functions. This lack of segregation of duties over cash disbursements is a deficiency in internal control. Which of the following compensating controls would most likely allow Brenda to classify this deficiency as a control deficiency instead of a material weakness or significant deficiency?

    a. One of Helping Hands' board members signs all checks after reviewing invoices supporting the disbursement. Signed checks are returned to Helping Hands to be mailed. The bank statement and returned checks are sent directly to Helping Hands for reconciliation.

    b. One of Helping Hands' board members signs all checks after reviewing invoices supporting the disbursement. Signed checks are returned to Helping Hands to be mailed. The bank statement is sent directly to the board member, who reviews it and returned checks over $1,000 for appropriate signatures and/or alterations before the bank statement is sent to Helping Hands for reconciliation.

    c. One of Helping Hands' board members signs all checks after reviewing invoices supporting the disbursement. Signed checks are returned to Helping Hands to be mailed. The bank statement is sent directly to the board member, who reviews it and returned checks for appropriate signatures and/or alterations before the bank statement is sent to Helping Hands for reconciliation.

19. Bear Shelves uses standard sales contracts for most transactions, but the sales personnel can modify the terms of the standard contract, including shipping terms, which can require a delay in revenue recognition. This ability is a deficiency in internal control. However, the company's auditor discovers compensating controls in place. Accounting personnel review contract changes for unusual or significant modifications, though, not for shipping term changes. Management reviews gross margin every month and investigates unusual or significant relationships. Management also reviews inventory levels at the end of each accounting period to make sure they are reasonable. Under these circumstances, the auditor should classify the internal control deficiency at what severity level?

    a. Material weakness.

    b. Significant deficiency.

    c. Control deficiency.

20. The assessment as to whether a prudent official would agree with the severity classification of a control deficiency generally depends on what (at least to some extent)?

    a. The needs of financial statement users and the nature of the client's business.

    b. The regulators who oversee the client.

    c. Inquiries made of experienced business people in the client's industry.

    d. Opinions gathered from the client's management.

21. John, a CPA, is hired to audit Concentric Circles, Inc. During the course of his audit, John identifies several internal control deficiencies related to the lack of adequate approvals and reviews within the company. Each is related to a different account balance. John determines that none of the deficiencies is very severe and ranks each as deficiencies a control deficiency. Is John required to communicate these deficiencies to those charged with governance?

    a. Yes.

    b. No.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Sarah, a CPA, discovers a control deficiency during the course of an audit engagement. She determines that this deficiency is insignificant and should not be classified as a material weakness or a significant deficiency. Is Sarah required to communicate this deficiency? **(Page 16)**

   a. Yes. [This answer is incorrect. SAS No. 115 only requires auditors to communicate significant deficiencies and material weaknesses, so Sarah is not required to communicate this deficiency as described above. However, there are other factors that Sarah must consider before making her final decision.]

   b. No. [This answer is incorrect. Generally, Sarah would not be required by SAS No. 115 to communicate an insignificant deficiency; however, before making her final decision, Sarah must take other factors into account.]

   c. **It is a matter of professional judgment. [This answer is correct. Based on the guidance in SAS No. 115, after discovering this deficiency, Sarah must evaluate it both individually and in the aggregate by significant account balance, disclosure, and component of internal control. This is because 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 they are individually insignificant. Determining whether a control deficiency rises to the level of a significant deficiency or a material weakness is subjective and often may be a judgment call.]**

10. According to SAS No. 115, which of the following conditions indicates the existence of a material weakness? **(Page 16)**

   a. Antifraud controls and programs. [This answer is incorrect. Antifraud programs and controls might indicate the existence of significant deficiencies in internal control based on the list provided by the *AICPA Risk Alert: Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115*.]

   b. **Restatement of financial statements to correct material misstatement. [This answer is correct. Material weakness is indicated if there is restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.]**

   c. Controls over nonsystematic and nonroutine transactions. [This answer is incorrect. Such controls are a possible indicator of significant deficiencies, not material weaknesses.]

   d. Controls over applying and selecting accounting principles in conformity with GAAP. [This answer is incorrect. Controls over selecting and applying accounting principles that are in conformity with GAAP (including having sufficient expertise in the selection and application of GAAP) might indicate the existence of a significant deficiency, not a material weakness.]

11. According to the *AICPA Risk Alert: Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115*, existence of which of the following might indicate the existence of significant deficiencies in internal control? **(Page 16)**

   a. Identification of fraud by senior management. [This answer is incorrect. According to SAS No. 115, identification of fraud, whether or not material, on the part of senior management is an indicator of material weakness.]

   b. Material misstatement of the financial statements identified by the auditor. [This answer is incorrect. Identification by the auditor of a material misstatement of the financial statements under audit in circumstances indicating that the misstatement would not have been detected by the entity's internal control is a possible indicator of a material weakness, not a significant deficiency.]

c. Ineffective oversight of the entity's internal control and financial reporting. [This answer is incorrect. One indicator of a material weakness, not a significant deficiency, is ineffective oversight of the entity's financial reporting and internal control by those charged with governance.]

d. **Controls over the entity's financial reporting process at the end of a period. [This answer is correct. Controls over the financial reporting process at the end of a period, including controls over procedures the entity uses to (1) enter transaction totals into the general ledger; (2) initiate, authorize, record, and process journal entries into the general ledger; and (3) record adjustments that are recurring or nonrecurring to the financial statements might indicate a significant deficiency.]**

12. Julie, a CPA, identified a control deficiency during the course of her audit engagement. She determined that the probability of occurrence of actual or potential misstatement is reasonably possible. Then she determined that the magnitude of actual or potential misstatement is less than material. Based on these thresholds, how should Julie classify this deficiency? **(Page 17)**

    a. As a material weakness. [This answer is incorrect. A deficiency could be classified as a material weakness whether the probability of occurrence of actual or potential misstatement is considered probable or reasonably possible. However, it would have to be considered a material weakness if its magnitude of actual or potential misstatement was material.]

    b. **As a significant deficiency or a control deficiency. [This answer is correct. Based on the threshold table found at Exhibit 1-3, as long as the magnitude of the deficiency is determined less than material, it is appropriate for Julie to classify the deficiency as either a significant deficiency or a control deficiency.]**

13. When evaluating the probability of a misstatement occurring, an auditor might consider all of the following factors, **except**: **(Page 18)**

    a. The nature of the classes of transactions, accounts, assertions, and disclosures involved. [This answer is incorrect. According to SAS No. 115, one factor an auditor might consider in this evaluation is the nature of the accounts, classes of transactions, disclosures, and assertions involved (for example, suspense accounts or transactions with related parties may present more risk).]

    b. How susceptible the related assets and liabilities are to fraud or loss. [This answer is incorrect. This is a factor that SAS No. 115 notes might be considered during this evaluation. Another example of such a factor is the complexity, subjectivity, and extent of judgment needed to determined the amount involved.]

    c. The control's relationship and interaction with other controls. [This answer is incorrect. The relationship and interaction of the control with other controls is one factor the auditor might consider. Another factor for the auditor to consider is the interaction of the control deficiency with other control deficiencies.]

    d. **A list of consequences suffered when this misstatement occurred in the past. [This answer is correct. According to SAS No. 115, one factor the auditor might consider in this situation is possible future consequences resulting from the deficiency.]**

14. Which of the following statements best describes evaluating the magnitude of misstatement? **(Page 18)**

    a. Usually, an auditor will be evaluating the severity of an actual misstatement. [This answer is incorrect. Clearly, it will be easier for the auditor to evaluate the severity of an identified control deficiency when an *actual* misstatement has occurred because the amount of the misstatement is known. In most cases, however, the auditor will be evaluating the severity of a *potential* misstatement.]

    b. **The term *magnitude* refers to the extent of the misstatement or the potential misstatement. [This answer is correct. The second threshold for evaluating the severity of a control deficiency relates to the magnitude of a misstatement or potential misstatement. *Magnitude* refers to the extent of the misstatement or potential misstatement.]**

c. Determining the magnitude of a potential misstatement is not difficult if the guidance in SAS No. 115 is used. [This answer is incorrect. Determining the magnitude of a potential misstatement may well be the most difficult aspect of implementing SAS No. 115. SAS No. 115 provides little guidance on evaluating the magnitude of potential misstatement.]

d. The most an account balance or transaction can be understated is the recorded amount. [This answer is incorrect. Generally, the most an account balance can be *overstated* is the recorded amount. Potential *understatement*, however, is not limited to the recorded amount.]

15. If an auditor is engaged to perform only an audit of an entity's financial statements, what does the auditor's conclusions about the magnitude of a potential misstatement affect? **(Page 19)**

    a. **Whether an identified deficiency should be communicated to management or those charged with governance. [This answer is correct. Auditors performing only an audit of financial statements should remember that conclusions about the magnitude of a potential misstatement as discussed in SAS No. 115 affect only whether or not an identified deficiency is communicated to management and those charged with governance. The auditor's conclusions about the magnitude of a potential misstatement affect only whether the auditor communicates an identified deficiency and how it is communicated (as a significant deficiency or a material weakness).]**

    b. Whether the financial statements have been fairly presented and the auditor's opinion on the statements. [This answer is incorrect. Judgments about materiality can affect whether a client's financial statements are fairly presented (and, thus, the auditor's opinion on those statements).]

    c. Whether the auditor is prohibited from expressing an unqualified opinion on internal control over financial reporting. [This answer is incorrect. Considerations for auditors performing an audit of an entity's financial statements and an audit of its internal control over financial reporting (that is, an integrated audit) may be different than those for auditors performing only an audit of the financial statements. For example, concluding that an identified deficiency is a material weakness prohibits the auditor from expressing an unqualified opinion on internal control over financial reporting.]

16. In which of the following scenarios would quantitatively insignificant misstatements (or potential misstatements) possibly cause the auditor to increase the severity of the control deficiency that caused it? **(Page 20)**

    a. Mary discovers a misstatement in her client's financial statements that reflects its current downward trend of earnings. [This answer is incorrect. Mary would need to consider increasing the severity of the deficiency if the misstatement, while immaterial to the entity's net income for the current period, was material to the overall trend of earnings (for example, if the misstatement in this scenario reversed a downward trend of earnings or changed a loss into income).]

    b. Louis discovers a misstatement that affects only one of his client's many financial statement amounts. [This answer is incorrect. Louis would need to consider increasing the severity of the deficiency if the misstatement, though individually insignificant, was pervasive to the financial statements (that is, affected numerous financial statement amounts, subtotals, or totals).]

    c. **Kris discovers a misstatement in her client's financial statements that reveals a default under a debt covenant. [This answer is correct. Kris should increase the severity of the identified control deficiency under these circumstances, because the misstatement has an affect on the entity's compliance with loan covenants, other contractual agreements, or regulatory provisions.]**

    d. Jean discovers a misstatement that affects her client's investment in a joint venture, but the partners do not use the entity's financial statements. [This answer is incorrect. Jean would need to consider increasing the severity of the deficiency if the misstatement affected the entity's investment in a joint venture, when the joint venture partners were also users of the financial statements under audit.]

17. What does SAS No. 115 require auditors to do regarding compensating controls related to identified control deficiencies? **(Page 22)**

    a. Consider if compensating controls exist that could limit the severity of the deficiency. [This answer is incorrect. When internal control deficiencies have been identified, SAS No. 115 states the auditor may consider (but is not required to consider) whether there are effective compensating controls that could prevent the identified deficiency from being considered a material weakness or a significant deficiency.]

    b. **Test the operating effectiveness of compensating controls under certain circumstances. [This answer is correct. SAS No. 115 requires the auditor to test the operating effectiveness of a compensating control only when the auditor believes the control might mitigate the severity of an identified deficiency.]**

    c. Determine if compensating controls are preventative or detective. [This answer is incorrect. A compensating control is one that results in the prevention (by preventive controls) or detection (by detective controls) of a misstatement. However, SAS No. 115 does not require an auditor to determine if compensating controls are preventative or detective.]

    d. Compare the compensating controls to the case studies provided by SAS No. 115. [This answer is incorrect. SAS No. 115 does not provide case studies, nor does it require auditors to make such a comparison. However, case studies that address compensating controls are available in the AICPA Audit Risk Alert, *Communicating Internal Control Related Matters Noted in an Audit—Understanding SAS No. 115*.]

18. Helping Hands, a small nonprofit organization, hires Brenda, a CPA, to perform their audit. During the course of her audit, Brenda discovers that Helping Hands, due to its small staff, has only one person in charge of accounting and the related reporting functions. This lack of segregation of duties over cash disbursements is a deficiency in internal control. Which of the following compensating controls would most likely allow Brenda to classify this deficiency as a control deficiency instead of a material weakness or significant deficiency? **(Page 22)**

    a. One of Helping Hands' board members signs all checks after reviewing invoices supporting the disbursement. Signed checks are returned to Helping Hands to be mailed. The bank statement and returned checks are sent directly to Helping Hands for reconciliation. [This answer is incorrect. This compensating control would not be effective in preventing or detecting unauthorized disbursements, some of which may be material. Therefore, Brenda should conclude that the *probability* of a *material misstatement* occurring without being detected is *at least reasonably possible*, so she should classify this deficiency as a material weakness.]

    b. One of Helping Hands' board members signs all checks after reviewing invoices supporting the disbursement. Signed checks are returned to Helping Hands to be mailed. The bank statement is sent directly to the board member, who reviews it and returned checks over $1,000 for appropriate signatures and/or alterations before the bank statement is sent to Helping Hands for reconciliation. [This answer is incorrect. Because the board member only reviews checks over $1,000, Brenda can conclude that the control is effective at preventing or detecting *material* unauthorized disbursements, but not less material misstatements. Thus, Brenda classifies the deficiency as a significant deficiency.]

    c. **One of Helping Hands' board members signs all checks after reviewing invoices supporting the disbursement. Signed checks are returned to Helping Hands to be mailed. The bank statement is sent directly to the board member, who reviews it and returned checks for appropriate signatures and/or alterations before the bank statement is sent to Helping Hands for reconciliation. [This answer is correct. This compensating control could be believed effective in preventing or detecting an unauthorized disbursement. Therefore, Brenda could conclude that it is less than reasonably possible for a misstatement (of any amount) to occur and go undetected in the financial statements. Thus, Brenda could classify the identified deficiency as a control deficiency.]**

19. Bear Shelves uses standard sales contracts for most transactions, but the sales personnel can modify the terms of the standard contract, including shipping terms, which can require a delay in revenue recognition. This ability is a deficiency in internal control. However, the company's auditor discovers compensating controls in place. Accounting personnel review contract changes for unusual or significant modifications, though, not for shipping term changes. Management reviews gross margin every month and investigates unusual or significant relationships. Management also reviews inventory levels at the end of each accounting period to make sure they are reasonable. Under these circumstances, the auditor should classify the internal control deficiency at what severity level? **(Page 24)**

   a. Material weakness. [This answer is incorrect. Material weakness would be the appropriate classification if the compensating control was as follows: each month management reviews gross margin and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period.]

   b. **Significant deficiency. [This answer is correct. The compensating controls in this scenario would allow the auditor not to classify the deficiency as a material weakness; however, the compensating controls are only designed to detect material misstatements. Therefore, the deficiency is important enough to merit the attention of management and, thus, is a significant deficiency.]**

   c. Control deficiency. [This answer is incorrect. Despite the compensating control, the auditor in this scenario should not classify the deficiency as a control deficiency. It needs a higher severity rating.]

20. The assessment as to whether a prudent official would agree with the severity classification of a control deficiency generally depends on what (at least to some extent)? **(Page 25)**

   a. **The needs of financial statement users and the nature of the client's business. [This answer is correct. From a practical standpoint, the auditor's consideration of whether a "prudent official" would agree with the auditor's classification of a control deficiency depends, at least to some extent, on the nature of the client's business and the needs of the users of the financial statements.]**

   b. The regulators who oversee the client. [This answer is incorrect. The AICPA Audit Risk Alert, *Communicating Internal Control Related Matters Noted in an Audit—Understanding SAS No. 115*, says, "…the concept is that an auditor should 'stand back' and take another objective look at the severity of the deficiency as would a regulator or someone from an oversight agency." However, auditors do not have to depend on actual regulators to make this determination.]

   c. Inquiries made of experienced business people in the client's industry. [This answer is incorrect. From a practical standpoint, the AICPA Audit Guide recommends that auditors take a "step back" and consider whether an "experienced business person" with knowledge of the same facts and circumstances would agree with how the auditor classified a control deficiency. However, the auditor does not have to make inquiries of actual business people in the client's industry to perform this test.]

   d. Opinions gathered from the client's management. [This answer is incorrect. The concept behind the prudent official test is that the auditor is looking at the severity classification from an objective point of view, not from the point of view of someone associated with the client.]

21. John, a CPA, is hired to audit Concentric Circles, Inc. During the course of his audit, John identifies several internal control deficiencies related to the lack of adequate approvals and reviews within the company. Each is related to a different account balance. John determines that none of the deficiencies is very severe and ranks each as deficiencies a control deficiency. Is John required to communicate these deficiencies to those charged with governance? **(Page 26)**

   a. **Yes. [This answer is correct. Though each of these deficiencies is related to a different account balance, they all relate to a specific component of internal control—monitoring. Therefore, even though John considered each deficiency only a control deficiency, the requirement in SAS No. 115 to aggregate control deficiencies by internal control component should cause John to consider them significant enough to merit the attention of those charged with governance, which makes them a significant deficiency.]**

b. No. [This answer is incorrect. Though individually, a control deficiency does not require John to communicate the issue with those charged with governance, when he aggregates them, as required by SAS No. 115, the severity is enough that it merits the attention of those charged with governance, making them significant deficiencies.]

PRACTICE ISSUES RELATED TO SAS NO. 115

The AICPA staff has indicated that some auditors may be misunderstanding important concepts underlying SAS No. 115. Therefore, the following issues are discussed:

- If the auditor prepares the financial statements, does the auditor automatically have to communicate a material weakness?
- Would a client's lack of expertise in financial accounting and reporting automatically cause the auditor to communicate a material weakness?
- What is the relationship between SAS No. 115 and the AICPA's ethics rules relating to nonattest services (Interpretation 101-3)?
- Would a client's lack of segregation of duties automatically cause the auditor to communicate a material weakness?
- If an auditor identifies a material misstatement during the course of the audit, does the auditor always have to evaluate the severity of the control deficiency that allowed the misstatement to occur?
- Should a control deficiency that allows fraud to occur always be considered a material weakness?

The first two questions are interrelated since the preparation of financial statements often hinges on the client's expertise in financial accounting and reporting. The discussion beginning in the next paragraph addresses those questions. The interrelationship between SAS No. 115 and the AICPA's ethics rules, segregation of duties problems, material misstatements identified during the course of the audit, and evaluating the severity of a control deficiency that allows fraud to occur are discussed later in this lesson.

Can the Auditor Prepare the Financial Statements?

Some practitioners believe that the auditor's preparation of a company's financial statements automatically results in a control deficiency that should be considered a material weakness. A question that frequently arises is whether auditors can prepare the client's financial statements without having to communicate a material weakness. The intent of SAS No. 115 is not to prevent auditors from preparing (or assisting with the preparation of) the client's financial statements. Instead, the issue to be considered when determining whether a significant deficiency or material weakness exists is whether the client is capable of preparing the financial statements and has the skills and competencies necessary to prevent, or detect and correct, a material misstatement. A system of internal control over financial reporting does not consist solely of controls over the proper recording of transactions in the general ledger. Rather, it includes controls over financial statement preparation, including footnote disclosures. A control deficiency exists when the client does not have controls over preparation of the financial statements that would prevent, or detect and correct, a misstatement in the financial statements.

If the client is not capable of preparing the financial statements and lacks the skills and competencies to prevent, or detect and correct, a misstatement, the client has a control deficiency that is probably a material weakness. The auditor can still prepare the financial statements, but the material weakness should be communicated to management and those charged with governance. The fact that the auditor prepares the financial statements may give the client confidence that those statements are materially correct, but it does not eliminate the control deficiency.

Stated another way, an auditor cannot be considered part of the client's internal control. Thus, controls over the financial statement preparation function that exist in the auditor's firm cannot be considered. Only controls that the client has in place can be considered in determining whether there is a control deficiency and its severity. (However, a CPA firm other than the auditor's firm can be part of the client's internal control, and those controls could be considered.)

It is important for the client to recognize that even if the auditor prepares the financial statements and the related notes, the client remains responsible for them. It is a best practice for the auditor to clearly communicate to management and those charged with governance that the financial statements are the responsibility of management. Further, management and those charged with governance need to be made aware of the possible consequences of not correcting control deficiencies.

Another way of looking at this issue is to consider whether the client has sufficient knowledge to identify a material misstatement in auditor-prepared financial statements. If the auditor gave the financial statements to a client knowing that they contained material errors, would the client have controls in place that would detect those misstatements? For example, would the client recognize a misstatement in the tax accrual, identify an error in the classification of long-term debt on the balance sheet, or notice that an important disclosure has been omitted from the notes to the financial statements? If the answer to questions such as these is "no," the client lacks the skills and competencies to prevent, or detect and correct, a misstatement and, therefore, has a control deficiency that is probably a material weakness.

Relationship between SAS No. 115 and AICPA Ethics Rules. It is important to distinguish between the auditor's responsibilities under the AICPA Ethics Rules and SAS No. 115. Ethics Rule 101 requires independence in the performance of an audit. According to Ethics Interpretation 101-3, *Performance of Nonattest Services*, before auditors perform nonattest services, they should determine that the requirements of Interpretation 101-3 have been met. Interpretation 101-3 is discussed further in *PPC's Guide to Audits of Nonpublic Companies*.

The determination of auditor independence is totally separate from the evaluation of whether there is a control deficiency. Even though the auditor can prepare financial statements and maintain independence under the ethics rules, there could be a control deficiency. It is important to note that there are two levels of understanding of accounting and financial reporting required by SAS No. 115 and Interpretation 101-3. Under SAS No. 115, the issue to be considered is whether the client is capable of performing accounting functions and preparing the financial statements and has the skills and competencies necessary to prevent, or detect and correct, a misstatement. Under Interpretation 101-3, the auditor may assist the client in performing accounting functions and preparing the financial statements if they meet certain criteria. Among those criteria, Interpretation 101-3 requires clients to designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee nonattest services. Possessing suitable skill, knowledge, or experience to oversee a service requires a lower level of technical knowledge than the competence criteria described in SAS No. 115.

Under Ethics Interpretation 101-3, establishing and maintaining (or functioning as) the client's internal controls would impair the auditor's independence. However, proposing journal entries or preparing the client's financial statements would not automatically impair independence. As a practical matter, small businesses typically view proposing journal entries and preparing financial statements as part of the audit and, based on implementation guidance published by the AICPA Professional Ethics Executive Committee (PEEC), it seems clear that PEEC did not intend for Interpretation 101-3 to require viewing those services as separate from the audit. Thus, proposing journal entries and preparing financial statements in connection with an audit would not impair independence.

The Government Accountability Office's *Government Auditing Standards* (the Yellow Book) is more restrictive with respect to providing nonattest services that impair the independence of auditors of entities that are subject to the Yellow Book. See *PPC's Guide to Single Audit*s for further guidance if the entity is subject to those standards.

Examples Where Auditor Assists with Financial Statements. Determining whether a control deficiency exists and whether it is a significant deficiency or a material weakness is subjective and often may be a difficult judgment call. Exhibit 1-7 illustrates three situations in which an auditor assists with the financial statements. (These examples are adapted from the AICPA SAS No. 115 Audit Risk Alert, *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115*.) Each illustration provides guidance on the auditor's consideration of whether there is a control deficiency and, if so, the severity of the deficiency.

Exhibit 1-7

Evaluation of Whether Assistance with the Financial Statements Is a Control Deficiency, Significant Deficiency, or Material Weakness

In each of the following situations, the auditor posts client-approved adjusting entries to the trial balance and assists in drafting the financial statements from the trial balance. The auditor is not responsible for preparing or approving adjusting entries except as discussed.

Example 1—Auditor Proposes Material Adjustment

The client's accounting manager is technically competent and is able to prepare the financial statements. However, the auditor maintains the company's depreciation schedules using prepackaged software and each year provides the accounting manager with a detailed schedule of depreciation, gain/loss calculations, and year-end fixed assets. The accounting manager supervises and takes responsibility for the auditor's depreciation work. In most years, the accounting manager, using the depreciation schedules, provides the auditor with the year-end adjustment unless the adjustment had already been made to the general ledger. However, this year the accounting manager is busier than usual and asks the auditor to calculate the year-end depreciation adjustment. The adjustment is material to the financial statements.

Because the auditor proposes the adjustment, he should consider whether there is a control deficiency. The auditor should first consider the probability that a misstatement would occur and not be detected. Because an auditor cannot be part of a client's internal controls, the auditor cannot take into account the controls over the calculation that exist in his firm. Thus, only the controls the client has in place can be considered. Based only on these facts, the auditor might conclude that the client has the competency to perform the accounting function but has chosen to outsource the depreciation function this year. Therefore, since the client is reviewing and taking responsibility for the depreciation calculations, and has the skills and competencies to prevent, or detect and correct, a misstatement, then the auditor would determine that there is not a control deficiency. (If, however, the client were not able to prevent, or detect and correct, a misstatement, then the auditor would conclude that there is a control deficiency.)

Example 2—Auditor Assists in Drafting the Financial Statements

The client's controller asks the auditor to assist in drafting the financial statements, including the footnotes. Before signing the management representation letter, the controller reviewed and approved the financial statement grouping schedules and calculations of note disclosure amounts. The controller also reviewed the disclosures and determined they were complete and proper. Also, both the controller and the owner have read, revised, and approved the financial statements.

Based only on these facts, there does not appear to be a control deficiency. However, the auditor needs to consider the controller's competency and expertise and whether the client's controls are designed appropriately and operating effectively. If, in the auditor's judgment, the controller and owner have the necessary accounting expertise to prevent, or detect and correct, a potential misstatement in the financial statements or notes, this is not a control deficiency. However, if the auditor concludes that the controller and owner lack the expertise to detect a misstatement, then the lack of expertise would be considered a control deficiency that would need to be evaluated.

Example 3—Bookkeeper Lacks Sufficient Financial Expertise

The client's bookkeeper records cash receipts and disbursements and prepares adjusting entries needed to record accounts receivable and payable at year end. The bookkeeper prepares draft financial statements, including note disclosures, using a format originally provided by the auditor. During the year, the bookkeeper recorded monthly payments on a new equipment lease but did not evaluate whether the lease should be capitalized. During the audit, the auditor determined that the lease should be capitalized and that it is material. The auditor also learned that the equipment was damaged in a fire shortly before year end and insurance proceeds covered only a portion of the damages. The financial statements do not reflect the fixed asset or related liability, or the expense and liability for damages in excess of the company's insurance.

Based only on these facts, the auditor would determine that there is a control deficiency, because the company's controls did not prevent, or detect and correct, the misstatements in the financial statements. The company does not have staff with sufficient expertise to properly analyze the lease and record the fixed asset acquisition. Further, the bookkeeper did not have sufficient accounting knowledge to realize that she needed help to record the transactions. Because the auditor identified a material misstatement, the deficiency that caused it would be considered a material weakness. (If the bookkeeper had called the auditor for guidance on how to account for the transactions before recording them, the auditor's conclusion might have been different. A discussion with a client about a technical issue does not necessarily indicate a control deficiency. The client's ability to detect a potential misstatement and gain necessary competence are factors the auditor would consider in the evaluation.)

*   *   *

Lack of Segregation of Duties

Because of their limited resources, smaller businesses are generally more sensitive to the costs of implementing effective controls. Often, the quality of evidence and other documentation that is necessary to denote the existence and operation of key controls can place additional burdens on smaller entities because of a lack of segregation of duties and lower levels of accounting sophistication frequently present in such organizations. Despite these challenges, the Committee of Sponsoring Organizations (COSO) has internal control components for achieving effective internal control over financial reporting that are the same for smaller entities as for their larger counterparts. No exemption or special relief is given to a smaller entity because of its size or the challenges of achieving effective internal control. However, the approaches that a smaller entity may adopt in implementing the components and satisfying underlying principles will generally differ from those of a larger entity.

As noted in Exhibit 1-1, absent or inadequate segregation of duties within a significant account or process is an example of a deficiency in the design of controls according to SAS No. 115. As such, an auditor should evaluate the severity of the deficiency by considering the probability of occurrence of a misstatement and the magnitude of the potential misstatement in accordance with the standard. The AICPA Risk Alert, *Communicating Internal Control Related Matters Noted in an Audit—Understanding SAS No. 115*, contains a number of case studies that address the severity of a control deficiency caused by a lack of adequate segregation of duties. In fact, Exhibit 1-5 presents an example dealing with a lack of segregation of duties. In the example, the auditor considers the effect of compensating controls on the evaluation of the severity of the identified control deficiency related to a lack of segregation of duties caused by the small number of employees in the client's cash disbursement department. In the first example in that exhibit, a member of the client's board of directors performs certain oversight procedures to compensate for the lack of segregation of duties. After the auditor tested the controls and determined them to be effective, he concluded that the risk of a misstatement (of any amount) occurring and going undetected would be less than reasonably possible; thus, the auditor classified the deficiency as only a control deficiency.

In another example from the Audit Risk Alert, the client's accounting department consists of a lone bookkeeper. Because the bookkeeper has been with the company for many years, the owner frequently leaves blank, signed checks with the bookkeeper to be used "in case of emergency." The owner does not perform any oversight functions; she believes the auditors are a substitute for her lack of oversight. Therefore, she has the auditors perform quarterly interim procedures, including a review of the bank reconciliation prepared by the bookkeeper. Because there is inadequate separation of duties in the accounting department, there is a deficiency in the client's internal controls. Since there is at least a reasonable possibility that the bookkeeper could use one of the blank checks to make an unauthorized withdrawal of company funds, and that withdrawal could be material, the auditor concludes that the deficiency is a material weakness. (In this example, there are no compensating controls for the auditor to consider since the owner performs no oversight procedures, and the auditor's procedures cannot be part of the client's internal controls.)

Auditor Identifies a Material Misstatement

During the course of an audit, an auditor might identify (and propose adjustments to correct) any number of errors, some of which may be material to the entity's financial statements. The auditor's identification of a material misstatement of the financial statements in circumstances that indicate that it would not have been identified by the entity's internal control is a strong indicator of a material weakness according to SAS No. 115. Therefore, whenever the auditor identifies a material misstatement in the financial statements, he or she should evaluate whether the control deficiency that allowed the misstatement to occur represents a material weakness or a significant deficiency. Exhibit 1-8 illustrates a situation in which the auditor's evaluation of the severity of a control deficiency that allowed a material misstatement in the client's financial statements resulted in its classification as a material weakness.

Exhibit 1-8

Auditor Identifies Material Misstatements

> The client experienced significant turnover of personnel for much of the year. At year end, there was no one on staff with sufficient knowledge to correctly prepare GAAP-based financial statements. As a result, the financial statements contained numerous errors, and the auditor proposed several adjustments to the accounting records subsequent to the start of the audit. Material adjustments included the recording of prior year audit adjustments and writing off uncollectible receivables. Several other adjustments were made to correct immaterial errors.
>
> The auditor determined that the client's internal control focused primarily on achieving effective and efficient operations (i.e., performance and mission goals and safeguarding of resources). However, the controls over reliable financial reporting contained certain deficiencies. Specifically, the client had no one on staff with sufficient knowledge to prepare GAAP-based financial statements, which is a key element of financial reporting. Therefore, the auditor believes it is probable that this control deficiency will not prevent and detect misstatements, some of which may be material, from occurring (in fact, numerous material adjustments were required because of material misstatements the auditor identified in the financial statements). Thus, the auditor concluded this deficiency would be considered a material weakness.

* * *

If an auditor identifies a financial statement misstatement that is less than material, a best practice would be for the auditor to also evaluate whether the control deficiency that allowed the misstatement to occur represents a control deficiency, a significant deficiency, or a material weakness. If the auditor determines the control deficiency is, individually or when aggregated with other deficiencies, a significant deficiency or a material weakness, SAS No. 115 requires the auditor to communicate such deficiencies to the appropriate parties.

Occurrence of Fraud

When an auditor becomes aware of fraud that has occurred, the auditor is responsible for evaluating the severity of the control deficiency (ies) that allowed it to occur. Some auditors have questioned whether a control deficiency that allows fraud to occur should always be considered a material weakness. The AICPA SAS No. 115 Audit Risk Alert, *Communicating Internal Control Related Matters Noted in an Audit—Understanding SAS No. 115*, clarifies that the answer to this question is "no." Exhibit 1-5, which was adapted from the risk alert, presents an example that addresses this issue. In the example, deficiencies in the client's controls over its parts inventory allowed the parts manager to sell parts and pocket the money without recording the related sales. However, a discrepancy noted during the most recent physical inventory led management to discover the fraud. Although the actual amount to writedown the inventory account for the fraud was not material, SAS No. 115 requires the auditor to evaluate the potential for further material misstatements when considering the severity of the control deficiency.

From the example, it is clear that the client's physical inventory detected the misstatement that resulted from the fraud. Accordingly, the auditor believed there was less than a reasonable possibility that a misstatement, whether material or immaterial, of the client's financial statements would occur. Therefore, the auditor concluded that the deficiency should not be considered a material weakness. However, while the fraud did not cause the client's financial statements to be materially misstated, the fraud is evidence of a deficiency in internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition. AU 316, *Consideration of Fraud in a Financial Statement Audit*, requires auditors to bring fraud to the attention of an appropriate level of management; from a practical standpoint, most auditors would include a discussion of the control deficiency in the SAS No. 115 communication. If the fraud had been perpetrated by a member of senior management, SAS No. 115 states that, whether material or not, the fraud is an indicator of a material weakness.

In another example involving the evaluation of a deficiency permitting a fraud, after considering the views of a prudent official, the auditor concluded that the control deficiency that allowed the fraud should be considered a material weakness, even though the resulting financial statement misstatement was less than material.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. A company requests its auditor to prepare its financial statements. Who **cannot** be part of the client's internal control under these circumstances?

    a. The client.

    b. The auditor.

    c. Another CPA firm.

23. How does SAS No. 115 relate to the AICPA ethics rules?

    a. If the requirements of Interpretation 101-3 are met, the requirements of SAS No. 115 are automatically met.

    b. Determining auditor independence under Interpretation 101-3 is totally separate from determining if a control deficiency exists.

24. SmallCo's accounting department is made up of a single bookkeeper. The bookkeeper has been with the company for a long time, and the owner frequently leaves him with signed, blank checks in case of emergency and does not perform oversight functions. The bookkeeper has the auditor perform quarterly interim procedures, including a review of the bank reconciliation, as a substitute for the lack of oversight. The auditor concludes that this control deficiency is a material weakness. What is the cause of the deficiency in this scenario?

    a. The occurrence of fraud.

    b. Auditor identification of material misstatement.

    c. Lack of segregation of duties.

    d. The auditor being part of the company's internal control.

25. If a control deficiency exists that allows fraud to occur, should that deficiency always be considered a material weakness?

    a. Yes.

    b. No.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. A company requests its auditor to prepare its financial statements. Who **cannot** be part of the client's internal control under these circumstances? **(Page 36)**

    a. The client. [This answer is incorrect. It is important for the client to recognize that even if the auditor prepares the financial statements and the related notes, the client remains responsible for them.]

    b. **The auditor. [This answer is correct. To avoid a control deficiency that is probably a material weakness, the auditor cannot be considered part of the client's internal control.]**

    c. Another CPA firm. [This answer is incorrect. A CPA Firm other than the auditor's firm can be part of the client's internal control, and those controls could be considered.]

23. How does SAS No. 115 relate to the AICPA ethics rules? **(Page 37)**

    a. If the requirements of Interpretation 101-3 are met, the requirements of SAS No. 115 are automatically met. [This answer is incorrect. It is important to distinguish between the auditor's responsibilities under the AICPA Ethics Rules and SAS No. 115. The determination of auditor independence is totally separate from the evaluation of whether there is a control deficiency; therefore, meeting the guidelines of one does not mean that the guidelines of the other piece of authoritative literature are met.]

    b. **Determining auditor independence under Interpretation 101-3 is totally separate from determining if a control deficiency exists. [This answer is correct. Even though the auditor can prepare financial statements and maintain independence under the ethics rules, there could be a control deficiency. Under SAS No. 115, the issue to be considered is whether the client is capable of performing accounting functions and preparing the financial statements and has the skills and competencies necessary to prevent, or detect and correct, a misstatement. Under Interpretation 101-3, the auditor may assist the client in performing accounting functions and preparing the financial statements if they meet certain criteria.]**

24. SmallCo's accounting department is made up of a single bookkeeper. The bookkeeper has been with the company for a long time, and the owner frequently leaves him with signed, blank checks in case of emergency and does not perform oversight functions. The bookkeeper has the auditor perform quarterly interim procedures, including a review of the bank reconciliation, as a substitute for the lack of oversight. The auditor concludes that this control deficiency is a material weakness. What is the cause of the deficiency in this scenario? **(Page 39)**

    a. The occurrence of fraud. [This answer is incorrect. In the scenario described above, the auditor has not yet discovered the existence of fraud.]

    b. Auditor identification of material misstatement. [This answer is incorrect. The auditor would have to identify a material misstatement in the financial statements before determining that the deficiency exists for this to be an example of auditor identification of material misstatement.]

    c. **Lack of segregation of duties. [This answer is correct. This scenario describes the lack of segregation of duties in a small business. Because there is inadequate separation of duties in the accounting department, there is a deficiency in the client's internal controls. There is at least a reasonable possibility that the bookkeeper could use one of the blank checks to make an unauthorized withdrawal of company funds, and that withdrawal could be material, which justifies the conclusion of this deficiency as a material weakness.]**

    d. The auditor being part of the company's internal control. [This answer is incorrect. The concern of a deficiency arising from the auditor being part of a company's internal control has to do with the auditor preparing the company's financial statements, which is not what is described in the above scenario.]

25. If a control deficiency exists that allows fraud to occur, should that deficiency always be considered a material weakness? **(Page 40)**

    a. Yes. [This answer is incorrect. When an auditor becomes aware of fraud that has occurred, the auditor is responsible for evaluating the severity of the control deficiency(ies) that allowed it to occur. However, AU 316, *Consideration of Fraud in a Financial Statement Audit*, requires auditors to bring fraud to the attention of an appropriate level of management; from a practical standpoint, most auditors would include a discussion of the control deficiency in the SAS No. 115 communication.]

    b. **No. [This answer is correct. Some auditors have questioned whether a control deficiency that allows fraud to occur should always be considered a material weakness. The AICPA SAS No. 115 Audit Risk Alert, *Communicating Internal control Related Matterse Noted in an Audit—Understanding SAS No. 115*, clarifies that the answer to this question is "no."]**

EXAMINATION FOR CPE CREDIT

Lesson 1 (ICCTG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. What piece of authoritative literature requires auditors to obtain a sufficient understanding of internal control?

   a. SAS No. 107.

   b. SAS No. 109.

   c. SAS No. 115.

   d. Interpretation 101-3.

2. Under what circumstances does a *control deficiency* exist?

   a. The auditor does not have a sufficient understanding of the five components of internal control.

   b. The client does not have a sufficient understanding of the five components of internal control.

   c. The auditor does not perform risk assessment procedures on controls relevant to the audit.

   d. A control's design or operation does not allow the client to prevent, or detect and correct, misstatements.

3. List all of the following factors that should be considered when an auditor evaluates a control testing exception to see if it is a control deficiency?

   i. The exception's cause.

   ii. Possible implications of the exception in relation to the effectiveness of other controls.

   iii. How frequently the control operates.

   iv. If the exception has resulted in any known misstatements to the financial statements.

   v. If the exception is systematic and recurring.

   vi. If the exception is a deficiency in design.

   vii. If the exception is a deficiency in operation.

   a. iv., vi., and vii.

   b. i., ii., iii., and v.

   c. i., ii., iii., iv., and v.

   d. i., ii., iii., iv., v., vi., and vii.

4. Jack, a CPA, is hired to audit Smiles, Inc. While performing auditing procedures, Jack discovers circumstances that might be considered control deficiencies, significant deficiencies, or material weaknesses. Which of the deficiencies Jack discovered would be considered a failure in the operation of controls?

   a. The company does not reconcile its accounts receivable subsidiary ledgers to the general ledger account accurately.

   b. The company does not have proper segregation of duties in regards to its most significant account, Pediatric Pros.

   c. The tone at the top of the company and its control environment do not promote an internal control consciousness.

   d. Leo, the member of management responsible for preparing the company's financial statements, lacks knowledge of how to apply GAAP.

5. Assume the same details as in the question above. During the course of his audit, Jack also discovers that Smiles, Inc. has inadequate documentation of the components of internal control. What type of deficiency is this?

   a. A deficiency in operation.

   b. A deficiency in design.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

6. When evaluating the severity of a control deficiency, how likely must it be that the entity's controls will fail to prevent, or detect and correct, the misstatement of a disclosure or account balance?

   a. It must be very likely that the control will fail.

   b. It must be reasonably possible that the control will fail.

   c. It must be at least remotely possible that the control will fail.

   d. Do not select this answer choice.

7. Dawn, a CPA, discovers a control deficiency while performing an audit. She uses the PPC process to determine the severity of the control deficiency. Dawn determines that the deficiency would not be considered material, and that it would not be considered important enough to merit the attention of those charged with governance. According to the PPC process, what type of deficiency has Dawn discovered and would it require communication under SAS No. 115?

   a. A material weakness; communication is required.

   b. A significant deficiency; communication is not required.

   c. A control deficiency; communication is required.

   d. A control deficiency; communication is not required.

8. The process for evaluating the severity of identified control deficiencies consists of two steps. All of the following are decisions the auditor makes in the first step **except** which one?

   a. Could the misstatement or potential misstatement be material?

   b. Is there a reasonable possibility that the misstatement will not be prevented, or detected and corrected on a timely basis?

   c. Is the deficiency important enough to merit attention by those charged with governance?

   d. Are there compensating controls that mitigate the severity of the deficiency?

9. What term is SAS No. 115 referring to when it describes "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"?

    a. A management letter comment.

    b. A control deficiency.

    c. A significant deficiency.

    d. A material weakness.

10. What are auditors encouraged to rely on when determining if a deficiency qualifies as a significant deficiency?

    a. A list of indicators provided by SAS No. 115.

    b. A list of indicators provided by the *AICPA Risk Alert: Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115*.

    c. The auditor's own professional judgment.

    d. The PPC process for evaluating the severity of a deficiency.

11. Which of the following statements best describes an auditor's evaluation of the severity of control deficiencies?

    a. Probability of occurrence and magnitude of potential misstatements are considered during this evaluation.

    b. Only misstatements that have actually occurred must be considered when making this evaluation.

    c. If a misstatement has not occurred, a deficiency cannot be termed a significant deficiency or a material weakness.

    d. The possibility of further misstatement in the financial statements is not a factor in this evaluation.

12. David, a CPA, identified a control deficiency during the course of his audit engagement. He determined that the probability of occurrence of actual or potential misstatement is probable. Then he determined that the magnitude of actual or potential misstatement is material. Based on these thresholds, how should David classify this deficiency?

    a. As a material weakness.

    b. As a significant deficiency or a control deficiency.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

13. How does SFAS No. 5, *Accounting for Contingencies*, define *reasonably possible*?

    a. Future events are likely to occur.

    b. The chance of future events occurring is less than likely but more than remote.

    c. The chance of future events occurring is likely based on a specific percentage or range.

    d. Future events are only remotely likely to occur.

14. During the course of an audit engagement, Sam, the auditor, discovers a control deficiency. Based on Sam's professional judgment, he concludes that the likelihood of misstatement occurring because of this deficiency is less than reasonably possible. How should Sam proceed?

    a. Determine the magnitude of the potential misstatement in order to decide if the deficiency is a material weakness.

    b. Conclude that the deficiency is not a material weakness, regardless of the potential misstatement's magnitude.

    c. Perform tests and audit procedures on the deficiency to quantify it, which will support his professional judgment.

    d. Consider any relevant compensating controls that will rule out the possibility of the deficiency being a material misstatement.

15. When determining the magnitude of misstatement, which of the following should an auditor consider first?

    a. Qualitative factors.

    b. Quantitative factors.

    c. Do not select this answer choice.

    d. Do not select this answer choice

16. All of the following are examples of objective criteria that might be included in a firm policy established for determining the magnitude of a control deficiency **except** which one?

    a. A deficiency that is unlikely to cause a misstatement of the financial statements should be communicated in a management letter.

    b. For purposes of classifying a potential misstatement as material under SAS No. 115, a specific percentage of the client's financial statement is set forth in the firm policy.

    c. The final classification of the control deficiency will not include the auditor's consideration of the qualitative factors, the views of prudent officials and compensating controls shall be ignored.

    d. For purposes of classifying a potential misstatement as material weaknesses, significant deficiencies or control deficiencies, a specific percentage of the client's financial statement is set forth in the firm policy.

17. List all of the following qualitative factors related to an insignificant misstatement that might cause an auditor to increase the severity of a control deficiency that he or she has identified.

    i. Events or circumstances resulting from the misstatement materially affect the financial statements.

    ii. Management's compensation is affected by the misstatement.

    iii. The misstatement results from fraud (or suspected fraud).

    iv. Materiality thresholds related to regulatory or statutory requirements are affected by the misstatement.

    v. A change in earnings or other trends is masked by the misstatement.

    vi. The misstatement affects material disclosures that are related to a small account balance.

    a. i., v., and vi.

    b. ii., iii., and iv.

    c. iii., iv., v., and vi.

    d. i., ii., iii., iv., v., and vi.

18. Auditors can use qualitative considerations to identify what aspect of control deficiencies?

    a. Whether severity of a deficiency should be increased.

    b. Whether decreasing the deficiency's severity is justified.

    c. Whether the deficiency's severity should be either increased or decreased.

    d. Do not select this answer choice.

19. What type of control can eliminate a control deficiency?

    a. A preventive control.

    b. A detective control.

    c. A redundant control.

    d. A compensating control.

20. Which of the following statements best describes the prudent official test?

    a. SAS No. 115 defines a prudent official as someone objective, such as a regulator or a representative from an oversight agency.

    b. SAS No. 115 requires auditors to consider if prudent officials would agree with their conclusion that a deficiency is not a material weakness.

    c. The concept was developed to be neutral, but the AICPA audit guide warns that the test may influence auditors to make more liberal classifications of severity.

    d. The prudent official test can be used to justify a decrease in the judged severity of an identified control deficiency.

21. While performing audit procedures, Tim, the auditor, identifies several internal control deficiencies that he judges individually as significant deficiencies. They are as follows:

    > Several accounts receivable transactions were not properly recorded in the subsidiary ledger. They were not material, either individually or in the aggregate.
    >
    > The account balances that were affected by the improperly recorded transactions listed above were not reconciled on a timely basis.
    >
    > Tim's client does not have adequate segregation of duties over the IT access controls related to the accounts receivable and billing function.

    When considered in the aggregate, how should Tim rank the severity of these deficiencies?

    a. As control deficiencies.

    b. As significant deficiencies.

    c. As material weaknesses.

    d. Based on the circumstances in this scenario, Tim should not aggregate the deficiencies.

22. Which of the following issues would most likely indicate a significant deficiency or material weakness?

    a. The auditor prepared the client's financial statements.

    b. The client's controls over preparation of financial statements are inadequate.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

23. In which of the following scenarios would the auditor conclude that a control deficiency exists?

    a. Joe, the client's accounting manager, is technically competent and can prepare the financial statements. Jill, the auditor, uses prepackaged software to maintain the client's depreciation schedules and provides Joe with necessary schedules and information. Usually, Joe uses the information to provide Jill with the year-end adjustment, but this year Joe asks Jill to do the calculation. Jill's calculation results in an adjustment to the financial statements. The adjustment is material to the financial statements.

    b. Mary, the client's controller, requests that Moe, the auditor, assist in drafting the financial statements, including footnotes. Mary reviews and approves all financial statement grouping schedules and calculations of note disclosure amounts before signing the management representation letter. She also reviewed the disclosures. Mary and Milo, the owner, have read, revised, and reviewed the financial statements. Mary and Milo have the necessary experience to prevent, or detect and correct, potential misstatements in the financial statements and the notes.

    c. Grady, the client's bookkeeper, records cash disbursements and receipts and prepares adjusting journal entries needed to record accounts payable and receivable at year end. He prepares a draft of the financial statements, including note disclosures, using a format originally provided by Gigi, the auditor. This year, Grady recorded monthly payments on a new equipment lease, but did not evaluate if it should be capitalized. During the audit, Gigi discovers that the lease is material and should be capitalized. She also discovers that the equipment was damaged before year-end and insurance proceeds did not fully cover the damages, which is not reflected in the financial statements.

    d. Do not select this answer choice.

24. Because smaller businesses have more limited resources, does SAS No. 115 provide any special relief or exemptions when determining if their lack of segregation of duties creates a control deficiency?

    a. Yes.

    b. No.

    c. Yes, but only if the small business meets certain qualifications.

    d. No, but a small business can apply to the Committee of Sponsoring Organizations (COSO) for relief.

25. Jan is the auditor for Cherry Wood, Inc. (CWI). Over the year, CWI had significant turnover of personnel, and by year-end, no one on staff had the knowledge to correctly prepare GAAP-based financial statements. During the course of her audit, Jan found numerous errors and proposed several adjustments, including writing off uncollectible receivables. What is this an example of?

    a. The client having a lack of segregation of duties.

    b. The auditor identifying an occurrence of fraud.

    c. The auditor being part of the client's internal control.

    d. The auditor identifying material misstatements.

Lesson 2: Communicating Internal Control Deficiencies Identified during the Audit

INTRODUCTION

SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*, requires auditors to communicate *significant deficiencies* and *material weaknesses* in internal control identified during an audit to management and those charged with governance. The SAS indicates that it is preferable for auditors to make the required communication by the *report release date*. However, the auditor should make the communication no later than 60 days following that date. SAS No. 115 also requires auditors to continue to communicate significant deficiencies and material weaknesses communicated in prior years as long as they continue to exist.

Finally, the SAS requires that auditors make these communications to management and those charged with governance in *writing*. It contains guidance on the elements required to be included in the written communication and provides illustrative language that auditors may use in their communications.

This lesson discusses each element of the required SAS No. 115 communication in further detail.

Learning Objectives:

Completion of this lesson will enable you to:
- Generate communications regarding internal control deficiencies.
- Assess issues related to the communication of internal control deficiencies.

DECIDING WHERE TO DIRECT THE COMMUNICATION

SAS No. 115 requires auditors to communicate to *management and those charged with governance* certain conditions relating to an entity's internal control that have been identified during the audit. *Those charged with governance* is defined in SAS No. 114, *The Auditor's Communication with Those Charged with Governance* (AU 380.03), and includes the person or persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process.

SAS No. 115 notes that governance is a collective responsibility that may be carried out by a board of directors or a committee of the board, a management committee such as a finance or budget committee, or by partners, equivalent persons, or some combination thereof. For entities with a board of directors, this term encompasses the term *board of directors* or *audit committees* expressed elsewhere in generally accepted auditing standards (for example, in SAS No. 103, *Audit Documentation*, at AU 339.15, footnote 5). In some smaller entities, *management and those charged with governance* may be the same person, for example, the owner in an owner-managed entity. For some entities, auditor judgment may be required to determine the person or persons charged with governance.

COMMUNICATION TIMING

SAS No. 115 notes the auditor generally should make the required communications by the *report release date*. The *report release date* is defined in SAS No. 103 (AU 339.23) as "the date that the auditor grants the entity permission to use the auditor's report in connection with the financial statements." In many cases, that will be the date that the auditor delivers the audit report to the client. In any event, the auditor should make the communications no later than 60 days following the report release date. That corresponds with the requirement in SAS No. 103 to have the final audit file assembled and completed within 60 days of the report release date. SAS No. 103 refers to the date that the audit file should be completed as the *documentation completion date*.

SAS No. 115 also notes, however, that there might be times when the auditor identifies a control deficiency that should be communicated earlier in the audit. In this case, the standard indicates that the form of the auditor's communication would be affected by the severity of the identified deficiency and the need for swift corrective action. Such early communication may be made orally; however, it should ultimately be communicated in writing.

SAS No. 115 (AU 325.19) clarifies that the auditor should communicate in writing all significant deficiencies and material weaknesses identified during the audit, even those that were remediated during the audit. Assume, for instance, that an auditor identified certain significant deficiencies while performing audit procedures at an interim date. Because of the nature of such items, the auditor orally communicated them to management at the end of the interim procedures, and management remediated the deficiencies before year end. Would the auditor have to include such deficiencies in his or her written communication at year end? Yes, SAS No. 115 clarifies that the auditor is still required to include such significant deficiencies in the written communication at year end. That is because of the need to inform users about the possibility that a misstatement may have occurred while the significant deficiency existed, even though it has been corrected by year end. Of course, if management is preparing a written response to the auditor's communication, they may wish to include in the auditor's communication a statement that the significant deficiency has been remediated by year end.

THE COMMUNICATION OF SIGNIFICANT DEFICIENCIES

Required Elements of the Auditor's Communication

SAS No. 115 requires the auditor's written communication to include the following items:

- 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.
- A statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
- 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.
- The definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
- An identification of matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- 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.

Impact When Audit of Financial Statements Includes a Scope Restriction. The communication of significant deficiencies includes a reference to an audit of financial statements. Although not explicitly required by SAS No. 115, if the auditor's report on the financial statements was qualified because of a scope restriction, it is a best practice for the restriction and its effect on the consideration of internal control to be indicated in the communication of significant deficiencies.

Illustrative Communication When *Only* Significant Deficiencies Identified

The following is an example of a written SAS No. 115 communication in which the auditor identified *only* significant deficiencies during the audit. This letter is illustrative in nature; as long as the auditor includes all of the required elements described previously, he or she is not required to use the exact language contained in this letter.

> To Management and the Board of Directors of ABC Company[a]
>
> In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20X1, 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.[b] Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.[c]

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 such deficiencies have been identified.[d] However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.[e]

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.[f] We did not identify any deficiencies in internal control that we consider to be material weaknesses.[g]

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.[h] We consider the following deficiencies in ABC Company's internal control to be significant deficiencies:

[Describe the significant deficiencies identified during the audit.] [i, j]

This communication is intended solely for the information and use of management, [Identify the body or individuals 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.[k]

Firm's signature

City, State
February 14, 20X2[l]

Notes:

[a] The communication is addressed to management and those charged with governance. In most entities, governance is the collective responsibility of a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager when there are no other owners, or a sole trustee. In an owner-managed entity and other small entities, management and those charged with governance may be the same people.

[b] This is the required statement 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 internal control over financial reporting. If the auditor's report on the financial statements was qualified because of a scope restriction, the restriction and its effect on the evaluation of internal control should generally be described in this communication.

[c] This is the required statement that the auditor is not expressing an opinion on the effectiveness of internal control.

[d] This is the required statement that indicates that the auditor's consideration of internal control is not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

[e] This sentence has been added to modify the required statement in "d" by alerting the reader to the fact that significant deficiencies have been identified and are being included in the communication.

[f] This sentence defines a material weakness as required by SAS No. 115.

[g] This sentences clarifies for the reader that no material weaknesses have been identified during the audit; thus, none are being communicated. While auditors are not required to communicate that none of the identified deficiencies were considered material weaknesses, many auditors choose to make this communication.

[h] Because it is relevant to this communication (that is, because the auditor identified and is communicating significant deficiencies), this sentence includes the definition of a significant deficiency.

[i] Significant deficiencies that previously were communicated and have not yet been remediated must be repeated in the current year's communication.

[j] SAS No. 115 does not preclude the auditor from also communicating 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, or matters that the entity has requested the auditor to communicate, such as control deficiencies that are not significant deficiencies or material weaknesses. Under SAS No. 115, such matters may be communicated orally, in this letter, or in a separate communication. If the other matters are communicated orally, the auditor should document such communications. If the less serious deficiencies are communicated in this letter, SAS No. 115 requires the communication to explicitly identify the comments that are considered to be significant deficiencies and material weaknesses (i.e., distinguish the comments that are considered significant deficiencies and material weaknesses from those that are not). If the less serious deficiencies are included in a separate communication, such as a management letter, although not required, some auditors choose to make reference to the other communication in this letter. In that case, a sentence such as the following could be added as the next to the last paragraph of this letter:

> In addition, we noted other matters involving internal control and its operation that we have communicated to management of ABC Company in a separate letter dated February 14, 20X2.

[k] This paragraph restricts the communication to management and those charged with governance. The communication also may refer to a governmental authority if that authority requires the company to furnish it a copy of the communication. In that case, this paragraph might be worded as follows:

> 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 [specify regulatory agency] and is not intended to be and should not be used by anyone other than these specified parties.

[l] Generally, the communication should be dated the same as the auditor's report on the financial statements, but should be dated no later than 60 days following the report release date.

Material Weaknesses Identified

If material weaknesses in internal control also have been identified, SAS No. 115 requires the auditor to distinguish them from the significant deficiencies. The requirements for a communication that includes material weaknesses as well as significant deficiencies are discussed later in this lesson.

OTHER MATTERS FOR POSSIBLE COMMUNICATION

Inherent Limitations of Internal Control

SAS No. 115 (AU 325.23) states that auditors may add a statement indicating the inherent limitations of internal control, including the possibility of management override of controls, to their communication. However, SAS No. 115 does not provide sample language that can be used. A sentence similar to the following could be added as the second sentence of the second paragraph of the communication illustrated previously:

> In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls.

Some auditors may choose to add a more extensive discussion of the inherent limitations of internal control. In that case, they may add language such as the following in place of the sentence discussed in the previous paragraph.

> Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk. Nevertheless, we identified certain deficiencies in internal control that we consider to be significant deficiencies, as discussed below. Auditors who decide to use this language would omit the last sentence of the second paragraph in the communication illustrated previously.
>
> This language is based on the guidance in Paragraph A5 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With An Audit of Financial Statements*. Although such guidance applies only to public companies, auditors who wish to include a more extensive discussion of the inherent limitations of internal control in their SAS No. 115 communications could use such language in their communications.

Nature and Extent of the Consideration of Internal Control

SAS No. 115 (AU 325.23) states that auditors may wish to mention the specific extent and nature of their consideration of internal control during the audit. For example, if the auditors' consideration of internal control included procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented, but not procedures to test the operating effectiveness of controls, the auditors may wish to mention that in their communication of significant deficiencies to emphasize that their engagement was not directed to discovering significant deficiencies in internal control. In that case, they might insert the following sentence between the first and second sentences in the first paragraph of the letter illustrated previously:

> Our consideration of internal control included procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they had been implemented, but it did not include procedures to test the operating effectiveness of controls. In addition, our consideration was not directed to discovering significant deficiencies in internal control.

If the auditor's consideration of internal control included procedures to evaluate both the design and operating effectiveness of controls, the auditor might add instead the following language. In that case, the auditor could replace the second paragraph of the letter illustrated with this one:

> 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 part of our audit, we performed procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they had been implemented. We also performed procedures to test the operating effectiveness of certain controls. Based on those and other procedures performed during the audit, we identified certain deficiencies in internal control that we consider to be significant deficiencies, as described below.

Using the Work of Other Auditors

Although not discussed in SAS No. 115, if the principal auditor's report on the financial statements makes reference to the report of other auditors, it is a best practice for the principal auditor's communication of significant deficiencies and material weaknesses noted during the audit to also refer to the other auditors. The SAS No. 115 communication may be modified in a manner similar to that described in SAS No. 58 for an auditor's report containing an opinion based, in part, on the report of other auditors. Accordingly, the principal auditor's communication may be worded as follows:

> We have audited the financial statements of ABC Company and subsidiaries (the Company) for the year ended December 31, 20X1, and have issued our report thereon dated February 14, 20X2. Our opinion on the consolidated financial statements and this communication, insofar as they relate to XYZ Company, a consolidated subsidiary, are based solely on the report of other auditors. In planning and performing our audit of the consolidated financial statements of ABC Company as of and for the year ended <u>[Date]</u>, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting . . .

Inadequate Separation of Duties

As discussed in Lesson 1, effective internal controls often are harder for smaller businesses to maintain because of the lack of separation of duties and lower levels of accounting sophistication often present in such organizations. Despite these challenges, COSO requires smaller entities to maintain the same internal control components for achieving effective internal control over financial reporting as their larger counterparts. In other words, there is no exemption or special relief given to a smaller entity because of its size or the challenges present when achieving effective internal control.

Many smaller entities suffer from absent or inadequate separation of duties within a significant account or process. Because such a condition often prevents an entity from providing reasonable assurance that all transactions are appropriately reflected in the financial statements, the lack of adequate segregation of duties often is considered at least a significant deficiency (if not a material weakness) by the auditor. Accordingly, the auditor should communicate it to management and those charged with governance. In that case, language similar to the following could be added to SAS No. 115 communications:

> A fundamental concept in a good system of internal control is the separation of duties. The basic premise is that no one employee should have access to both physical assets and the related accounting records or to all phases of a transaction. If the separation of duties is inadequate, there is a resulting danger that intentional fraud or unintentional errors could occur and not be detected. Although the size of the entity's accounting staff might make complete adherence to this concept more difficult, we believe certain steps could be taken to segregate incompatible duties, as discussed in the following.
>
> <u>[Describe the recommendations to the client.]</u>

Lack of Controls over the Financial Reporting Process

As discussed in Lesson 1, a system of internal control over financial reporting does not consist solely of controls over the proper recording of transactions in the general ledger. Rather, it includes controls over financial statement preparation, including footnote disclosures. A control deficiency exists when the client does not have controls over preparation of the financial statements that would prevent, detect, or correct a misstatement in the financial statements.

If the client is not capable of preparing the financial statements and lacks the skills and competencies to prevent, detect, and correct a misstatement, the client may request that the auditor assist with the preparation of the financial statements. Although the auditor can assist with their preparation, the client's lack of controls over the financial reporting process usually is considered a significant deficiency or a material weakness in internal control. In that case, the auditors may wish to include language such as the following in their SAS No. 115 communication:

> Management is responsible for establishing and maintaining internal controls, including monitoring, and for the fair presentation in the financial statements of financial position, results of operations, and cash flows, including the notes to financial statements, in conformity with U.S. generally accepted accounting principles [or specify another comprehensive basis of accounting] .
>
> At times, management may choose to outsource certain accounting functions due to cost or training considerations. Such accounting functions and service providers must be governed by the control policies and procedures of the entity. Management is as responsible for outsourced functions performed by a service provider as it would be for such functions performed internally. Specifically, management is responsible for management decisions and functions; for designating an individual with suitable skill, knowledge, or experience to oversee any outsourced services; and for evaluating the adequacy and results of those services and accepting responsibility for them.
>
> As part of the audit, management requested us to prepare a draft of your financial statements, including the related notes to financial statements. Management reviewed, approved, and accepted responsibility for those financial statements prior to their issuance; however, management did not perform a detailed review of the financial statements.
>
> The absence of controls over the preparation of the financial statements is considered a material weakness because there is a reasonable possibility that a material misstatement of the financial statements could occur and not be prevented, or detected and corrected, by the entity's internal control.
>
> Sometimes, the auditor may consider the lack of controls over the preparation of the financial statements only a significant deficiency. In that case, the auditor could add language such as the following as the last paragraph of this report:
>
>> While the absence of this control procedure is considered less severe than a material weakness, we believe it is important enough to merit your attention. Thus, it is considered a significant deficiency.

Existence of Significant Deficiencies or Material Weaknesses Already Known to Management

Sometimes, management may already be aware of a significant deficiency or a material weakness in the entity's internal control but, because of cost benefit or other considerations, management might have made a conscious decision to accept the degree of risk associated with the deficiency. In smaller entities, that is often the case with deficiencies related to inadequate separation of duties or inadequate controls over the preparation of the financial statements, as discussed previously. In that case, the auditors may consider adding language such as the following to their SAS No. 115 communication:

> 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 and the related benefits. We are responsible for communicating significant deficiencies and material weaknesses in accordance with professional standards, regardless of management's decisions.

COMMUNICATION OF MATERIAL WEAKNESSES

SAS No. 115 (AU 325.06) defines a material weakness as "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." As previously discussed, SAS No. 115 requires the auditor to communicate material weaknesses identified during the audit to management and those charged with governance.

Required Elements

When the auditor has identified both significant deficiencies and material weaknesses during the audit, his or her communication should include the same elements as those previously listed related to significant deficiencies. However, as indicated in the following paragraph, the form of the auditor's communication will differ from the one illustrated previously.

Illustrative Communication

The following is an example of a written communication in accordance with SAS No. 115 in which the auditor identified *both* material weaknesses and significant deficiencies during the audit. Like the report illustrated previously, it is illustrative in nature. As long as the auditor includes all of the required elements, he or she is not required to use the exact language contained in this letter.

> To Management and the Board of Directors of ABC Company[a]
>
> In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20X1, 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.[b] Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.[c]
>
> 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 such deficiencies have been identified.[d] However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies and material weaknesses.[e]
>
> 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.[f] We consider the following deficiencies in the Company's internal control to be material weaknesses:
>
> [Describe the material weaknesses identified during the audit.][g, h]
>
> 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.[f] We consider the following deficiencies in the Company's internal control to be significant deficiencies:
>
> [Describe the significant deficiencies identified during the audit.][g, h]

This communication is intended solely for the information and use of management, [Identify the body or individuals 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.[i]

Firm's signature

City, State
February 14, 20X2[j]

Notes:

[a] The communication is addressed to management and those charged with governance. In most entities, governance is the collective responsibility of a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager when there are no other owners, or a sole trustee. In an owner-managed entity and other small entities, management and those charged with governance may be the same people.

[b] This is the required statement 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 internal control over financial reporting. If the auditor's report on the financial statements was qualified because of a scope restriction, it is believed that the restriction and its effect on the evaluation of internal control should generally be described in this communication.

[c] This is the required statement that the auditor is not expressing an opinion on the effectiveness of internal control.

[d] This is the required statement that indicates that the auditor's consideration of internal control is not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

[e] This sentence has been added to modify the required statement in "d" by alerting the reader that material weaknesses and significant deficiencies have been identified and are being communicated.

[f] These are the definitions of a material weakness and a significant deficiency as required by SAS No. 115.

[g] Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated should be repeated in the current year's communication.

[h] SAS No. 115 does not preclude auditors from also communicating 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, or matters that the entity has requested the auditor to communicate, such as control deficiencies that are not significant deficiencies or material weaknesses. Under SAS No. 115, such matters may be communicated orally, in this letter, or in a separate communication. If the other matters are communicated orally, the auditor should document such communications. If the less serious deficiencies are communicated in this letter, SAS No. 115 requires the communication to explicitly identify the comments that are considered to be significant deficiencies (i.e., distinguish the comments that are considered significant deficiencies from those that are not). If the less serious deficiencies are included in a separate communication, such as a management letter, although not required, some auditors choose to make reference to the other communication in this letter. For example, a sentence such as the following could be added as the next to the last paragraph of this letter:

In addition, we noted other matters involving internal control and its operation that we have communicated to management of ABC Company in a separate letter dated February 14, 20X2.

[i] This paragraph restricts the communication to management and those charged with governance. The communication also may refer to a governmental authority if that authority requires the company to furnish it a copy of the communication. In that case, this paragraph might be worded as follows:

> 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.

[j] Generally, the communication should be dated the same as the auditor's report on the financial statements, but should be dated no later than 60 days following the report release date.

RESTRICTING THE COMMUNICATION'S USE

SAS No. 115 requires that the communication on significant deficiencies and material weaknesses indicate that it is intended for internal use only (that is, use by management, those charged with governance, and others within the organization), and that it is not intended to be and should not be used by anyone other than these specified parties.

SAS No. 115 also states that when governmental regulations require the communication to be furnished to governmental authorities, the communication may refer to those authorities as well.

Sometimes, a client may request the auditor to provide a copy of the SAS No. 115 communication to a third-party user (such as a bank or nonprofit agency) that is not included in the communication as a specified party. even though the SAS No. 115 communication is restricted in its use and is not intended for distribution to nonspecified third parties. However, the Statements on Auditing Standards acknowledge that an auditor is not responsible for controlling a client's distribution of restricted-use communications or reports. Accordingly, the last paragraph in the SAS No. 115 communication should alert readers to the restriction on the use of the report by indicating that the communication is not intended to be and should not be used by anyone other than the specified parties.

COMMUNICATION OF RECURRING ITEMS

SAS No. 115 (AU 325.17) requires the auditor to repeat in the current year's communication significant deficiencies or material weaknesses that were communicated in previous years that have not yet been remediated. That is to ensure that management or those charged with governance do not incorrectly assume at some point that the control deficiencies have been mitigated since they are not repeated in subsequent communications.

Options for Indicating Comments Were Previously Communicated

When significant deficiencies or material weaknesses identified in prior-year audits are repeated, best practices call for an indication that the same comments were made in prior communications. The indication can be provided in a number of different ways, including the following:

- Such comments may be presented separately from new comments under a heading such as "Significant Deficiencies (or Material Weaknesses) Communicated in Prior Years." Prior-year comments typically are presented after new comments, although some auditors present them first if they are more significant or numerous than the new comments.

- Auditors may simply use language in their letter that indicates the comments were communicated in previous years. For example, an auditor may use language such as the following in the letter:

  In the current year, as well as the prior year, we noted that the supporting schedules for various accounts did not agree to the general ledger balance.

- The previously communicated comments might include an asterisk or other distinct notation, along with an explanation such as the following that precedes the comments:

  Comments noted with an asterisk represent control deficiencies from 20X1 that we continue to consider significant deficiencies (or material weaknesses) in internal control.

Prior significant deficiencies or material weaknesses may also be communicated by referring to the auditor's previously issued written communication and indicating the date of that communication. Rather than including the entire comment from the prior year, the auditor could provide an abbreviated description. For instance, the auditor might include language and abbreviated descriptions such as the following in the current year's communication:

> In our communication dated March 1, 20X1, we included the following deficiencies that we considered to be significant deficiencies in internal control. Please refer to that communication for a more detailed explanation of the deficiencies.
>
> - Lack of segregation of duties in the cash area.
>
> - Lack of timely reconciliations for accounts receivable.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. According to SAS No. 115, special conditions related to an entity's internal control that are identified during the audit must be communicated to whom?

    a. The entity's management and those charged with governance.

    b. Those responsible for the entity's strategic direction and accountability obligations.

    c. Partners, equivalent persons, or a combination thereof.

    d. It is solely up to the auditor's professional judgment.

27. SAS No. 115 says that, generally, the internal control communications should be made by the report release date. What is the definition of the *report release date*?

    a. The date by which the audit file is completed.

    b. The date by which the auditor delivers the audit report to the client.

    c. The date the entity has permission to use the auditor's report in connection with the financial statements.

28. SAS No. 115 requires the auditor's written communication of significant deficiencies to include which of the following statements?

    a. The auditor considered internal control in order to identify all existing internal control deficiencies.

    b. The users of the communication are not limited in any way.

    c. The auditor is not expressing any opinion on the effectiveness of the entity's internal control.

29. Kenneth, a CPA, is engaged to audit Whammy, Inc. Over the course of his audit, Kenneth identifies several significant deficiencies that must be included in the internal control communication. Based on his evaluation of the deficiencies, both individually and in the aggregate, no material weaknesses need to be communicated. Based on the guidance in SAS No. 115, is Kenneth required to communicate the fact that no material weaknesses were identified during the audit?

    a. Yes.

    b. No.

30. Assume the same details as in the question above. Whammy, Inc. requested that Kenneth communicate all control deficiencies found, including those not severe enough to qualify as significant deficiencies or material weaknesses. What does SAS No. 115 require for this type of communication?

    a. Comments that are not significant deficiencies or material weaknesses must be clearly distinguished from those that are.

    b. The communication of such deficiencies must be made orally or in a letter that is separate from the internal control communication.

    c. References to any other type of letter, such as the management letter, are prohibited from being included in this communication.

    d. Despite Whammy, Inc.'s request, Kenneth is prohibited by SAS No. 115 from communicating on the less severe control deficiencies.

31. Which of the following describes the overarching limit of internal controls?

    a. Auditors are not always engaged to evaluate both the design and effectiveness of internal controls.

    b. Internal controls may not exist if there is inadequate separation of duties.

    c. Almost any internal control is subject to management override.

    d. Management may make a decision to accept the degree of risk associated with a known control deficiency.

32. How is the internal control communication affected if management already knows about the existence of a significant deficiency or a material weakness and decided to accept the associated risk?

    a. The auditor does not have to include the accepted deficiency in the communication.

    b. The auditor may wish to add additional discussion of this decision in the communication.

33. Which of the following statements best describes the SAS No. 115 internal control communication if both significant deficiencies and material weaknesses were discovered during the audit?

    a. Material weaknesses that were communicated in the audit of a prior year that have not been remediated do not need to be included in the report for the year currently under audit.

    b. Auditors are prohibited from including information on other matters that they believe could be potentially beneficial to the entity.

    c. A statement that the auditor identified all deficiencies in internal control must be included in the communication.

    d. Though the communication is generally restricted to management and those charged with governance, it may also refer to a governmental entity.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

26. According to SAS No. 115, special conditions related to an entity's internal control that are identified during the audit must be communicated to whom? **(Page 53)**

    a. **The entity's management and those charged with governance. [This answer is correct. SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*, requires auditors to communicate to *management* and *those charged with governance* certain conditions, such as significant deficiencies and material weaknesses, relating to an entity's internal control that have been identified during the audit.]**

    b. Those responsible for the entity's strategic direction and accountability obligations. [This answer is incorrect. *Those charged with governance* is defined in SAS No. 114, *The Auditor's Communication with Those Charged with Governance*, and includes the person or persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process. However, this is not the requirement found in SAS No. 115.]

    c. Partners, equivalent persons, or a combination thereof. [This answer is incorrect. Under SAS No. 115, such persons could be considered *those charged with governance*; however, this is not the communication requirement of that SAS for internal control related matters.]

    d. It is solely up to the auditor's professional judgment. [This answer is incorrect. For some entities, auditor judgment may be required to determine to whom the communication regarding internal controls should be made. However, there are specific guidelines in SAS No. 115 that the auditor must keep in mind when directing this communication.]

27. SAS No. 115 says that, generally, the internal control communications should be made by the report release date. What is the definition of the *report release date*? **(Page 53)**

    a. The date by which the audit file is completed. [This answer is incorrect. Under SAS No. 103, this is the definition of the *documentation completion date*. That SAS requires that the final audit file be assembled and completed within 60 days of the report release date.]

    b. The date by which the auditor delivers the audit report to the client. [This answer is incorrect. In many cases, the date that the auditor delivers the audit report to the client will be the report release date, but that is not the official definition of that date.]

    c. **The date the entity has permission to use the auditor's report in connection with the financial statements. [This answer is correct. Under SAS No. 103, the *report release date* is defined as "the date that the auditor grants the entity permission to use the auditor's report in connection with the financial statements."]**

28. SAS No. 115 requires the auditor's written communication of significant deficiencies to include which of the following statements? **(Page 54)**

    a. The auditor considered internal control in order to identify all existing internal control deficiencies. [This answer is incorrect. The requirement of SAS No. 115 is for the communication to 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.]

    b. The users of the communication are not limited in any way. [This answer is incorrect. According to SAS No. 115, the communication should 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 those 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.]

c. **The auditor is not expressing any opinion on the effectiveness of the entity's internal control. [This answer is correct. One statement required in the communication by SAS No. 115 is one that indicates the auditor is not expressing any opinion on the effectiveness of internal control. Other items that are required to be included are the definition of the term material weakness; where relevant, the definition of the term significant deficiency; and the identification of matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.]**

29. Kenneth, a CPA, is engaged to audit Whammy, Inc. Over the course of his audit, Kenneth identifies several significant deficiencies that must be included in the internal control communication. Based on his evaluation of the deficiencies, both individually and in the aggregate, no material weaknesses need to be communicated. Based on the guidance in SAS No. 115, is Kenneth required to communicate the fact that no material weaknesses were identified during the audit? **(Page 54)**

a. Yes. [This answer is incorrect. The illustrative communication for when only significant deficiencies were identified includes a sentence that says, "We did not identify any deficiencies in internal control that we consider to be material weaknesses." However, inclusion of such a sentence is not required by SAS No. 115.]

b. **No. [This answer is correct. The addition of such a sentence clarifies for the reader that no material weaknesses have been identified during the audit; thus, none are being communicated. The sentence could follow the sentence that defines material weakness, which is required to be included under SAS No. 115. While auditors are not required to communicate that none of the identified deficiencies were considered material weaknesses, many auditors choose to make this communication.]**

30. Assume the same details as in the question above. Whammy, Inc. requested that Kenneth communicate all control deficiencies found, including those not severe enough to qualify as significant deficiencies or material weaknesses. What does SAS No. 115 require for this type of communication? **(Page 54)**

a. **Comments that are not significant deficiencies or material weaknesses must be clearly distinguished from those that are. [This answer is correct. If the less serious deficiencies are communicated in the management letter, SAS No. 115 requires the communication to explicitly identify the comments that are considered to be significant deficiencies and material weaknesses (i.e., distinguish the comments that are considered significant deficiencies and material weaknesses from those that are not.)]**

b. The communication of such deficiencies must be made orally or in a letter that is separate from the internal control communication. [This answer is incorrect. Under SAS No. 115, matters that the auditor believes to be potential benefit to the entity may be communicated orally, in the internal control communication letter, or in a separate communication.]

c. References to any other type of letter, such as the management letter, are prohibited from being included in this communication. [This answer is incorrect. If the less serious deficiencies are included in a separate communication, such as a management letter, although not required, some auditors choose to make reference to the other communication in the internal control communication letter.]

d. Despite Whammy, Inc.'s request, Kenneth is prohibited by SAS No. 115 from communicating on the less severe control deficiencies. [This answer is incorrect. SAS No. 115 does not preclude the auditor from also communicating 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, or matters that the entity has requested the auditor to communicate, such as control deficiencies that are not significant deficiencies or material weaknesses.]

31. Which of the following describes the overarching limit of internal controls? **(Page 57)**

    a. Auditors are not always engaged to evaluate both the design and effectiveness of internal controls. [This answer is incorrect. Although this answer choice is a true statement, it is not the overarching limit of internal controls. Auditors always evaluate the design of internal controls before issuing a report. If management wants a report on the operating effectiveness of internal controls, then the auditor must be informed of the scope of the engagement in order to include procedures to test the operating effectiveness of the internal controls.]

    b. Internal controls may not exist if there is inadequate separation of duties. [This answer is incorrect. Separation of duties is a fundamental concept in a good system of internal control, it is not the overarching limit of internal controls. Inadequate separation of duties may indicate that controls be redesigned or compensating controls be implemented.]

    c. **Almost any internal control is subject to management override. [This answer is correct. Although controls may be in place, management override of controls will limit the effectiveness of an internal control which could lead to misstatements due to error or fraud that would remain undetected.]**

    d. Management may make a decision to accept the degree of risk associated with a known control deficiency. [This answer is incorrect. Although management may make a cost benefit analysis and decide to accept the degree of risk associated with a control deficiency, this is not the overarching limit of internal controls.]

32. How is the internal control communication affected if management already knows about the existence of a significant deficiency or a material weakness and decided to accept the associated risk? **(Page 59)**

    a. The auditor does not have to include the accepted deficiency in the communication. [This answer is incorrect. Auditors are responsible for communicating significant deficiencies and material weaknesses to management, regardless of management's decisions, so the auditor cannot leave this deficiency out of the communication just because management already knows about it and accepts the risk.]

    b. **The auditor may wish to add additional discussion of this decision in the communication. [This answer is correct. Sometimes, management may already be aware of a significant deficiency or a material weakness in the entity's internal control but, because of cost benefit or other considerations, management might have made a conscious decision to accept the degree of risk associated with the deficiency. In that case, auditors may consider adding additional language to the internal control communication.]**

33. Which of the following statements best describes the SAS No. 115 internal control communication if both significant deficiencies and material weaknesses were discovered during the audit? **(Page 60)**

    a. Material weaknesses that were communicated in the audit of a prior year that have not been remediated do not need to be included in the report for the year currently under audit. [This answer is incorrect. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated should be repeated in the current year's communication.]

    b. Auditors are prohibited from including information on other matters that they believe could be potentially beneficial to the entity. [This answer is incorrect. As with the communication when only significant deficiencies are included, SAS No. 115 does not preclude auditors from also communicating matters that the auditor believes to be of potential benefit to the entity or matters the entity has requested the auditor to communicate. Under SAS No. 115, such matters may be communicated orally, in the internal control communication letter, or in a separate communication.]

    c. A statement that the auditor identified all deficiencies in internal control must be included in the communication. [This answer is incorrect. The auditor is required to include a statement indicating that the auditor's consideration of internal control is not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, this statement can be modified by a statement alerting the reader that material weaknesses and significant deficiencies have been identified and are being communicated.]

d. **Though the communication is generally restricted to management and those charged with governance, it may also refer to a governmental entity. [This answer is correct. The communication should be restricted to management and those charged with governance. However, the communication may also refer to a governmental authority if that authority requires the company to furnish it a copy of the communication.]**

MAKING A REFERENCE TO MANAGEMENT'S RESPONSE IN THE AUDITOR'S COMMUNICATION

Management's Response to the Communication

Management may prepare (or may be required by a regulator to prepare) a written response to the auditor's SAS No. 115 communication. For example, management's written response might describe corrective action taken, plans to implement new controls, or include 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.

Disclaiming an Opinion on Management's Response

If management's response is included in the same document containing the auditor's communication, the auditor should disclaim an opinion on the information by adding a paragraph such as the following as the last paragraph of the auditor's communication:

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

Attesting to the Client's Remediation of a Control Deficiency

Rather than disclaiming an opinion on management's response, there may be circumstances in which the client requests the auditor to attest to its remediation related to some (or all) of the deficiencies included in the SAS No. 115 communication. There is nothing that would prohibit a client from engaging an auditor to do that. Typically, that engagement would be performed under Statements on Standards for Attestation Engagements (SSAEs).

If the audit is being performed under Government Auditing Standards (the Yellow Book) issued by the U.S. Government Accountability Office (GAO), the auditor is required to obtain and report the views of responsible officials concerning the auditors' findings, conclusions, and recommendations. When the auditor disagrees with the comments, the reasons for disagreeing should be explained in the auditors' communication. OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, contains a similar requirement. *PPC's Guide to Single Audits* provides guidance on Yellow Book and OMB Circular A-133 requirements relating to management's responses. To order, visit **ppc.thomsonreuters.com** or call (800) 323-8724.

Auditor Disagrees with Management's Response

There may be situations in which the auditors do not agree with management's response to the SAS No. 115 communication. For example, an auditor may believe that management's response related to a specific deficiency is contradicted by information that he or she became aware of during the audit. What should an auditor do in that situation? The SAS No. 115 communication is the auditor's communication, and there is nothing in that SAS that requires the auditor to include management's response in that communication.

ISSUING THE COMMUNICATION IF THERE ARE NO SIGNIFICANT DEFICIENCIES

SAS No. 115 (AU 325.25) precludes auditors from issuing 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 (i.e., the fact that the auditors did not identify any significant deficiencies might lead readers to believe that there are none, but since the auditors do not have a responsibility to specifically identify significant deficiencies, they could have overlooked them). Therefore, in an audit engagement where no significant deficiencies or material weaknesses were identified, no SAS No. 115 communication would be provided to the client.

If there are no significant deficiencies or material weaknesses, less serious control deficiencies may still exist, and SAS No. 115 does not preclude auditors from communicating those to management. The form of communication is not subject to the requirements of SAS No. 115. Accordingly, auditors may want to include the deficiencies in a separate communication, such as a management letter. Guidance on communicating management letter comments is provided later in this lesson.

COMMUNICATING IN A SEPARATE LETTER THAT THERE WERE NO MATERIAL WEAKNESSES

AU 325.24 notes that a client may ask the auditor to issue a communication indicating that no material weaknesses were noted during the audit for submission to governmental authorities. The auditor may make that communication in one of two ways:

- *In the Same Letter That Communicates the Significant Deficiencies Identified during the Audit.* An example of a letter that may be used to communicate the significant deficiencies identified during the audit in accordance with SAS No. 115 was provided previously. That letter also indicates (in the third paragraph) that no material weaknesses were identified during the engagement. Accordingly, one way the auditor may communicate that no material weaknesses were identified during the audit is to issue such a letter to the governmental authority. In that case, the auditor should add the name of the governmental authority as a specified party in the final paragraph of the letter.

- *In a Separate Letter.* Sometimes, a client would rather furnish the governmental authority with a separate communication that states that no material weaknesses were noted during the audit. (This way, the governmental authority does not also receive the communication that identifies the significant deficiencies noted during the engagement.) If the auditor issues a separate letter, he or she should ensure that the communication does not imply that no significant deficiencies were noted during the audit.

  If the auditor has identified significant deficiencies during the audit, he or she may refer in the separate communication of no material weaknesses to the letter used to communicate the significant deficiencies to management and those charged with governance. An example of a separate communication of no material weaknesses is presented in the "Illustrative Communication" paragraph below.

Because SAS No. 115 (AU 325.24) specifically allows an auditor to provide a communication of no material weaknesses to a *governmental authority*, some believe that auditors are not permitted to provide such a communication to other third-party users. Auditors should consult with their legal counsel about the potential risks involved before agreeing to furnish such a communication to other third-party users.

There are some differences in communicating material weaknesses and significant deficiencies in a financial statement only audit (under SAS No. 115) and an integrated audit (under AT 501). One of the key differences is the auditor should not issue a report indicating that no material weaknesses were identified during the integrated audit. *PPC's Guide to Nontraditional Engagements* provides additional guidance on communications in an integrated audit.

Illustrative Communication

The following is an example of a separate communication indicating that no material weaknesses were identified during the audit that an auditor may issue to a governmental authority:

> To Management and the Board of Directors of ABC Company**[a]**
>
> In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20X1, 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.**[b]** Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.**[c]**

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, 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.[d]

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 significant deficiencies, or material weaknesses and, therefore, there can be no assurance that all such deficiencies have been identified.[e] We did not identify any deficiencies in internal control that we consider to be material weaknesses.[f]

This communication is intended solely for the information and use of management, XYZ Governmental Authority, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties.[g]

Firm's Signature

City, State
February 14, 20X2[h]

Notes:

[a] The communication is addressed to management and those charged with governance. In most entities, governance is the collective responsibility of a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager when there are no other owners, or a sole trustee. In an owner-managed entity and other small entities, management and those charged with governance may be the same people.

[b] This is the required statement 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 internal control over financial reporting.

[c] This is the required statement that the auditor is not expressing an opinion on the effectiveness of internal control.

[d] This paragraph contains the definition of a material weakness as required by SAS No. 115. In this letter, this paragraph is the second instead of the third paragraph of the auditor's communication illustrated for significant deficiencies. This is consistent with the example included in Exhibit A of SAS No. 115.

[e] This paragraph includes the required statement 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. In this letter, this paragraph is the third instead of the second paragraph of the auditors communication illustrated for significant deficiencies. This is consistent with the example included in Exhibit A of SAS No. 115.

[f] This states that no material weaknesses were identified during the audit engagement, in accordance with the purpose of the communication.

[g] This paragraph restricts the communication to management and those charged with governance, as well as to the specific governmental authority that will receive a copy of the communication.

[h] Preferably, the communication should be dated the same as the auditor's report on the financial statements, but should be dated no later than 60 days following the report release date.

ISSUING MANAGEMENT LETTER COMMENTS

As previously discussed, SAS No. 115 requires auditors to communicate significant deficiencies and material weaknesses they become aware of during the audit. In addition, many auditors communicate other weaknesses, inefficiencies, or opportunities for improvement in operations that they have observed. There is no requirement to communicate these other control deficiencies (sometimes called "management points"), and authoritative literature contains little discussion and no required format for, or illustrations of, management letters. However, SAS No. 115 (AU 325.21) notes that auditors are not precluded from communicating to a client matters that the auditor "believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls," or "deficiencies that are not significant deficiencies or material weaknesses." If the auditor decides to communicate such matters, the SAS states that the communication can be made orally; when it is made orally, however, the auditor should document any such communication.

Many auditors follow the practice of issuing management letter comments as additional opportunities for client service and to demonstrate to clients their knowledge of, and interest in, the clients' business and operations. Not to be overlooked is the potential for practice development if the client engages the auditors to further study or implement the comments or suggestions. Some clients who view the audit or auditor's report as a fairly standardized product give particular attention to insightful and innovative management letters directed to the clients' specific business and operational circumstances. If auditors approach the audit alert for possible management letter comments, they should be able to offer the additional service at little additional cost.

PPC's Guide to Management Letter Comments: Operations and Controls provides auditors with illustrative letters that auditors can use when drafting a management letter for a client as well as hundreds of examples of management letter comments that might be helpful to the auditor when drafting a management letter for a client. To order, visit **ppc.thomsonreuters.com** or call (800) 323-8724.

INTERNAL CONTROL COMMUNICATIONS REQUIRED BY THE U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Audits performed in accordance with *Government Auditing Standards* (the Yellow Book) issued by the U.S. Government Accountability Office (GAO) are also required to have written reports on internal controls. The Yellow Book requires a report that discloses significant deficiencies and material weaknesses in internal controls over financial reporting based on the audit of the financial statements. The 2007 Yellow Book, however, has not been updated to reflect the SAS No. 115 definitions of significant deficiency and material weakness. Therefore, in November 2008, the GAO issued the following interim guidance on implementing SAS No. 115 in a Yellow Book audit:

- Auditors can meet the Yellow Book's internal control reporting requirements by:
  - including in their report on internal control all identified material weaknesses and significant deficiencies,
  - following the new definitions and requirements from SAS No. 115,
  - providing those definitions, and
  - describing the scope of testing performed on internal control over financial reporting.
- Auditors are reminded to comply with all other relevant Yellow Book requirements related to reporting deficiencies in internal control, such as:
  - developing findings and providing recommendations for corrective action,
  - obtaining views of responsible officials, and
  - ensuring appropriate report distribution.

The GAO cautions auditors that this issue will be fully deliberated in conjunction with the next Yellow Book update and may change at that time. The AICPA released illustrative Yellow Book reports on internal control over financial reporting and on compliance and other matters based on an audit of the financial statements performed in accordance with *Government Auditing Standards* in June 2009 (see **http://gaqc.aicpa.org/Resources/Illustrative+Auditors+Reports/**). If auditors are early implementing SAS No. 115 in Yellow Book-only engagements, those illustrative reports may be used. (The AICPA plans to include the SAS 115 Yellow Book reports in the Fall 2009 edition of the AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits*.) Although the GAO has issued interim guidance on applying SAS No. 115 in a Yellow Book audit and the AICPA has released illustrative Yellow Book reports, OMB Circular A-133 and other similar federal regulations or audit guides have not been updated to reflect new internal control definitions for reporting on internal control over compliance. The AICPA Audit Risk Alert, *Government Auditing Standards and Circular A-133 Developments—2008*, states that it would not be appropriate to use SAS No. 115 definitions for reporting on internal control over compliance until OMB Circular A-133 or other regulations or guides are amended to allow usage of new updated definitions. When this course was written, such amendments had not yet been made, and the AICPA had not yet developed illustrative reports that reflect SAS No. 115. *PPC's Guide to Single Audits* discusses this issue in more detail.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Kelly, an auditor, communicates all significant deficiencies and material weaknesses that she discovered during an audit engagement to her client's management and those charged with governance. Management prepares a written response to Kelly's communication. After reading the response, Kelly feels that it is contradicted by other information that Kelly became aware of during the course of the audit. What course of action would be the most appropriate for Kelly to take under these circumstances?

    a. Kelly should disclaim an opinion on management's response.

    b. Kelly should attest to management's remediation for the noted deficiencies.

    c. Kelly should not include management's response in her SAS No. 115 communication.

35. If an auditor finds no significant deficiencies during the audit, what is he or she prohibited from doing based on the guidance in SAS No. 115?

    a. Issuing an internal control communication that says no significant deficiencies were identified.

    b. Providing an internal control communication to the client in the form of a management letter.

    c. Communicating any less serious control deficiencies to management.

36. Which of the following actions can an auditor take in response to a client's request that the auditor issue a letter separate from the SAS No. 115 internal control communication to a governmental authority stating that no material weaknesses were found during the audit?

    a. If no significant deficiencies were found during the audit, the auditor must also make this clear in the letter sent to the governmental authority.

    b. If significant deficiencies were noted during the audit, the auditor can refer to the internal control communication in the letter to the governmental authority.

    c. Because sending a separate letter would be misleading, the auditor must send the governmental authority a copy of the internal control communication.

37. According to guidance released by the U.S. Government Accountability Office (GAO) in November 2008, auditors can meet the internal control reporting requirements of *Government Auditing Standards* (the Yellow Book) by doing which of the following?

    a. Including all identified significant deficiencies and material weaknesses in their internal control report.

    b. Developing findings and providing recommendations to the client for corrective action.

    c. Ensuring that the report is distributed appropriately.

    d. Obtaining the views of all officials who are considered responsible.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. Kelly, an auditor, communicates all significant deficiencies and material weaknesses that she discovered during an audit engagement to her client's management and those charged with governance. Management prepares a written response to Kelly's communication. After reading the response, Kelly feels that it is contradicted by other information that Kelly became aware of during the course of the audit. What course of action would be the most appropriate for Kelly to take under these circumstances? **(Page 71)**

    a. Kelly should disclaim an opinion on management's response. [This answer is incorrect. If the response is included in the same document as Kelly's communication, she could include language disclaiming an opinion on management's response. However, there is another response that may be more appropriate under these specific circumstances.]

    b. Kelly should attest to management's remediation for the noted deficiencies. [This answer is incorrect. If requested by the client, Kelly could accept an engagement to attest to its remediation related to some (or all) of the deficiencies included in the SAS No. 115 communication. There is nothing that would prohibit a client from engaging an auditor to do that. Typically, that engagement would be performed under Statements on Standards for Attestation Engagements. However, if Kelly already knows that she disagrees with management's response, this may not be the most appropriate action for her to take.]

    c. **Kelly should not include management's response in her SAS No. 115 communication. [This answer is correct. There may be situations in which auditors do not agree with management's response to the SAS No. 115 communication. The SAS No. 115 communication is the auditor's communication, and there is nothing in that SAS that requires the auditor to include management's response in that communication. Therefore, this would be an appropriate action for Kelly to take under these circumstances.]**

35. If an auditor finds no significant deficiencies during the audit, what is he or she prohibited from doing based on the guidance in SAS No. 115? **(Page 71)**

    a. **Issuing an internal control communication that says no significant deficiencies were identified. [This answer is correct. SAS No. 115 precludes auditors from issuing 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 (i.e., the fact that the auditors did not identify any significant deficiencies might lead readers to believe that there are none, but since the auditors do not have a responsibility to specifically identify significant deficiencies, they could have overlooked them).]**

    b. Providing an internal control communication to the client in the form of a management letter. [This answer is incorrect. In an audit engagement where no significant deficiencies or material weaknesses were identified, no SAS No. 115 communication would be provided to the client however, SAS No. 115 does not prohibit a management letter.]

    c. Communicating any less serious control deficiencies to management. [This answer is incorrect. If there are no significant deficiencies or material weaknesses, less serious control deficiencies may still exist, and SAS No. 115 does not preclude auditors from communicating those to management. The form of communication is not subject to SAS No. 115. Accordingly, auditors may want to include the deficiencies in a separate communication, such as a management letter.]

36. Which of the following actions can an auditor take in response to a client's request that the auditor issue a letter separate from the SAS No. 115 internal control communication to a governmental authority stating that no material weaknesses were found during the audit? **(Page 72)**

    a. If no significant deficiencies were found during the audit, the auditor must also make this clear in the letter sent to the governmental authority. [This answer is incorrect. If the auditor issues a separate letter, he or she should ensure that the communication does not imply that no significant deficiencies were noted during the audit.]

b. **If significant deficiencies were noted during the audit, the auditor can refer to the internal control communication in the letter to the governmental authority. [This answer is correct. If the auditor has identified significant deficiencies during the audit, he or she may refer in the separate communication of no material weaknesses to the letter used to communicate the significant deficiencies to management and those charged with governance.]**

c. Because sending a separate letter would be misleading, the auditor must send the governmental authority a copy of the internal control communication. [This answer is incorrect. Sending the governmental authority the internal control communication is an option available to the auditor under these circumstances; however, the auditor also has the option of sending the separate letter that the client requested.]

37. According to guidance released by the U.S. Government Accountability Office (GAO) in November 2008, auditors can meet the internal control reporting requirements of *Government Auditing Standards* (the Yellow Book) by doing which of the following? **(Page 74)**

    a. **Including all identified significant deficiencies and material weaknesses in their internal control report. [This answer is correct. Audits performed in accordance with the Yellow Book issued by the GAO are also required to have written reports on internal controls. The Yellow Book requires a report that discloses significant deficiencies and material weaknesses in internal controls over financial reporting based on the audit of the financial statements. Based on the November 2008 guidance, auditors can meet the Yellow Book's internal control reporting requirements by including in their report all identified material weaknesses and significant deficiencies.]**

    b. Developing findings and providing recommendations to the client for corrective action. [This answer is incorrect. This is a relevant Yellow Book requirement that the November 2008 guidance reminds auditors to comply with it. An example of a specific recommendation for meeting the internal control requirements would be for the auditor to follow the new definitions and requirements from SAS No. 115.]

    c. Ensuring that the report is distributed appropriately. [This answer is incorrect. The November 2008 guidance reminds auditors to comply with all other relevant Yellow Book guidance, such as this. An example of how auditors can meet the Yellow Book internal control requirements is by providing the new definitions found in SAS No. 115.]

    d. Obtaining the views of all officials who are considered responsible. [This answer is incorrect. Obtaining the views of responsible officials is a relevant Yellow Book requirement related to reporting deficiencies in internal control that the November 2008 guidance reminds auditors to comply with. An example of how auditors can meet the Yellow Book's internal control reporting requirements is by describing the scope of testing performed on internal control over financial reporting.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (ICCTG091)

Determine the best answer for each question below. Then mark your answer choice on the **Examination for CPE Credit Answer Sheet** located in the back of this workbook or by logging onto the Online Grading System.

26. List all of the following who could be considered part of *those charged with governance* in regards to issuing the internal control communication?

i. Board of directors	iv. Management
ii. The auditor	v. Employees of the entity
iii. Audit committee	vi. Partners or equivalent persons
	vii. A finance or budget committee

  a. i. and v.

  b. ii., iv., and vi.

  c. i., iii., iv., vi., and vii.

  d. i., ii., iii., iv., v., vi., and vii.

27. The report release date for Judy's audit engagement is September 30, 2009. What is the latest date that Judy can make the required internal control communication to her client?

  a. August 31, 2009.

  b. September 30, 2009.

  c. October 30, 2009.

  d. November 29, 2009

28. According to SAS No. 115, how should the auditor make the internal control communication to the client?

  a. The communication should be in writing and should include all significant deficiencies and material weaknesses identified during the audit.

  b. The communication should be in writing and should include all significant deficiencies and material weaknesses except for those remediated during the audit.

  c. The communication should made orally and should include all significant deficiencies and material weaknesses identified during the audit.

  d. The communication should be made orally throughout the audit, each time that a significant deficiency or a material weakness is discovered.

29. Does SAS No. 115 require the internal control communication to be written using specific wording?

    a. Yes, specific wording is required and matches the illustrative letters provided in this course.

    b. No, the SAS requires specific elements be included, but exact language is not required.

    c. Exact wording is required for material weaknesses, but not if significant deficiencies alone are communicated.

    d. Exact wording is required for material weaknesses, but not if significant deficiencies alone are communicated.

30. If an auditor identifies both material weaknesses and significant deficiencies during an audit, how should they be treated in the internal control communication letter?

    a. There is no difference in the way that the two types of control deficiencies should be treated.

    b. The material weaknesses must be distinguished from the significant deficiencies.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

31. Tomey and Melton CPA firm includes the following sentence in their auditor's report for the SMK Company.

    "We performed procedures to test the operating effectiveness of certain controls."

    Based on this sentence, what type of audit was Tomey and Melton engaged to perform?

    a. An audit to evaluate both the design and effectiveness of internal controls.

    b. An audit to evaluate the design of controls but not the operating effectiveness of those controls.

    c. An audit directed to discovering significant deficiencies in internal control.

    d. An audit using the work of other auditors.

32. Generally, if an auditor discovers that a small business audit client has inadequate separation of duties, should the auditor communicate this fact to management and those charged with governance?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

33. Which of the following statements best describes the internal control communication if both significant deficiencies and material weaknesses were identified during the audit?

    a. This communication would not differ from a communication written if only significant deficiencies were identified.

    b. The same elements as a communication regarding only significant deficiencies are required, but the form of the communication will differ.

    c. The exact language provided by SAS No. 115 for this type of internal control communication must be adhered to in the communication.

    d. The communication of material weaknesses must be a separate document from the communication of significant deficiencies.

34. How should the SAS No. 115 internal control communication be restricted?

    a. For internal use only.

    b. For the use of governmental agencies only.

    c. For internal use and the use of nonspecified third parties.

    d. For the use of management only.

35. If, during the current-year audit, the auditor discovers significant deficiencies or material weaknesses that were communicated in previous years and have yet to be remediated, what course of action is required by SAS No. 115?

    a. The auditor must include a reference to the prior-year communication and include the date of that communication.

    b. The auditor must present repeated comments separately from new comments in the internal control communication.

    c. The auditor must note repeated comments with an asterisk (or other distinct notation) and include appropriate explanatory language.

    d. The auditor must repeat the deficiencies in the current-year communication so it is not believed that those deficiencies have been mitigated.

36. If a client asks an auditor to issue a communication that no material weaknesses were noted during the audit to a governmental authority, how should the auditor proceed?

    a. If an internal control communication of only significant deficiencies exists, the author must issue a copy of that letter to the authority.

    b. The auditor can issue a copy of an internal control communication of only significant deficiencies or send a separate letter stating that no material weaknesses were noted.

    c. The auditor must refuse the client's request. Sending such a letter is prohibited under SAS No. 115 because auditors did not attempt to identify all deficiencies in internal control.

    d. Do not select this answer choice.

37. Which of the following statements best describes the communication of management letter comments?

    a. SAS No. 115 prohibits auditors from communicating anything other than significant deficiencies or material weaknesses.

    b. Authoritative guidance provides explicit formatting instructions for management letters to which auditors must strictly adhere.

    c. Issuing management letter comments in hopes of practice development is generally time consuming and seldom cost effective.

    d. If the auditor chooses to make this communication orally, the auditor should make sure to document the communication.

GLOSSARY

The Committee of Sponsoring Organizations (COSO): COSO is the National Commission on Fraudulent Financial Reporting and was known as the Treadway Commission for its chairman, James Treadway. The commission was sponsored by the American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors (IIA), the Financial Executives Institute (FEI), the Institute of Management Accountants (IMA), and the American Accounting Association (AAA). These five organizations comprise the Committee of Sponsoring Organizations or COSO. COSO also sponsored a major research study on internal control.

Control deficiency: A deficiency that 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 control deficiency may be either a deficiency in design or a deficiency in operation.

Deficiency in design: A deficiency that exists when (1) a control necessary to meet a control objective is missing or (2) an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.

Deficiency in operation: A deficiency that 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 it effectively.

Documentation completion date: The date that the audit file should be completed.

Internal control: COSO defines *internal control* as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.
- When an internal control system satisfies specified criteria, it can be deemed effective. Internal control consists of five components: control environment, risk assessment, control activities, information and communication, and monitoring.

Internal use only: Restricting use of a communication, such as the internal control communication, to use by management, those charged with governance, and others within the organization, which means the communication is not intended to be and should not be used by anyone other than those specified parties.

Management points: Weaknesses, inefficiencies, or opportunities for improvement in operations that auditors observed other than control deficiencies that are severe enough to be ranked significant deficiencies or material weaknesses.

Management letter: A letter written by a CPA to the audit client making recommendations for improvement to the client's enterprise. Management letter recommendations may include the following:

- Suggestions for improvement of the system of internal control.
- Suggestions for more efficient operations, accounting policies, and procedures.
- Suggestions for additional tax and management services that the CPA firm can provide.

Material weakness: 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.

Probable: The future event or events are likely to occur.

Reasonably possible: The chance of a future event or events occurring is more than remote but less than likely.

Report release date: The date that the auditor grants the entity permission to use the auditor's report in connection with the financial statements.

SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*: This SAS establishes requirements for auditors to communicate certain control deficiencies they have identified during the audit.

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

Those charged with governance: The person or persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process.

U.S. Government Accountability Office (GAO): The GAO, formerly named the General Accounting Office, is the body authorized to promulgate standards that must be followed in the audits of recipients of federal financial assistance. These standards are for the audit of governmental organizations, programs, activities, and functions. The GAO's authority derives from its position as a federal agency so charged, and it reports directly to Congress (legislative branch) and not to the executive branch of the government.

INDEX

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Internal Control Communications—Identifying, Evaluating, and Communicating Internal Control Deficiencies (ICCTG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   ICCTG091 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $75. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $214 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $270 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $319 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **August 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Internal Control Communications—Identifying, Evaluating, and Communicating Internal Control Deficiencies (ICCTG091)

Price $75

First Name: ______________________________

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⦸ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	20.	○	○	○	○	29.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	21.	○	○	○	○	30.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	22.	○	○	○	○	31.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	23.	○	○	○	○	32.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	24.	○	○	○	○	33.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	25.	○	○	○	○	34.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	26.	○	○	○	○	35.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	27.	○	○	○	○	36.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	28.	○	○	○	○	37.	○	○	○	○
10.	○	○	○	○															

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: August 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Internal Control Communications—Identifying, Evaluating, and Communicating Internal Control Deficiencies

Course Acronym: ICCTG091

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	**Low (1) . . . to . . . High (10)** 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
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Additional Comments:

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