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Proposed statement on standards for attestation engagements: an examination of an entity's internal control over financial reporting that is integrated with an audit of its financial statements; Exposure draft (American Institute of Certified Public Accountants), 2008, June 12

American Institute of Certified Public Accountants. Auditing Standards Board

<u>EXPOSURE DRAFT</u>

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements

(Supersedes AT Section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*)

June 12, 2008

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

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

June 12, 2008

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of a proposed Statement on Standards for Attestation Engagements (SSAE) entitled *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*.

The proposed SSAE would establish standards and provide guidance to practitioners reporting on the design and operating effectiveness of an entity's internal control over financial reporting (*examination of internal control*) that is integrated with an audit of the entity's financial statements (*integrated audit*). The proposed SSAE would supersede AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1).

A summary of the significant provisions of the proposed SSAE accompanies this letter.

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

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

Sincerely,

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Chair, Auditing Standards Board	*Vice President, Professional Standards and Services*

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Summary

Why Issued

This proposed Statement on Standards for Attestation Engagements (SSAE) is being issued to converge the standards practitioners use for reporting on a nonissuer's internal control over financial reporting (internal control) with the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control That is Integrated with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"). Consistent with the Auditing Standards Board's (ASB) efforts to avoid creating unnecessary differences between AICPA and PCAOB standards, the proposed SSAE diverges from PCAOB Auditing Standard No. 5 primarily in the terminology used for nonissuers. This proposed SSAE would supersede extant AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1).

Regulators of financial institutions, insurance companies, and governmental entities have expressed support for convergence of the standard for reporting on a nonissuer's internal control with PCAOB Auditing Standard No. 5 and believe that the revised standard will enhance the practitioner's ability to identify and evaluate deficiencies in internal control and to report on internal control. The ASB believes that the proposed attestation standard will strengthen the quality of examinations of internal control.

What the Proposed SSAE Does

The proposed SSAE

- revises the scope of AT section 501 to make it applicable only to examinations of the design and operating effectiveness of an entity's internal control over financial reporting (*examination of internal control*) that is integrated with an audit of the entity's financial statements (*integrated audit*). AT section 501 would no longer be applicable to examinations of

    — the design and operating effectiveness of an entity's internal control if the financial statements are not also being audited.

    — only the suitability of the design of an entity's internal control. (Such engagements may be developed and performed under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1). Although this SSAE would no longer be applicable to these engagements, it may be useful in planning and performing such engagements.)

- converges AT section 501 with PCAOB Auditing Standard No. 5 with modifications to reflect the terminology used for nonissuers.

- defines specified terms used in the proposed SSAE.

- revises the definitions of the terms *significant deficiency* and *material weakness* so that they conform with the definitions in PCAOB Auditing Standard No. 5. It also conforms the definition of *significant deficiency* with the definition in the exposure draft of the proposed International Standard on Auditing 265, *Communicating Deficiencies in Internal Control*.

- provides guidance on using the work of, or receiving direct assistance from, internal auditors, entity personnel, and third parties working under the direction of management or those charged with governance in an examination of internal control.

- discusses how the practitioner identifies significant accounts and disclosures and their relevant assertions.

- describes how the practitioner determines the likely sources of potential misstatements within a given significant account or disclosure.
- introduces the concept of a top-down approach for identifying the most important controls to test.
- incorporates the auditor's fraud risk assessment into the practitioner’s planning process for the examination of internal control and provides guidance on the types of controls used to identify and prevent material financial statement misstatements resulting from fraud.
- presents factors that affect the procedures a practitioner performs when updating the results of testing from an interim date to the entity’s period-end.
- discusses how knowledge obtained during past examinations of the entity’s internal control affects the nature, timing, and extent of the procedures the practitioner performs.
- addresses the following special topics:
  - — Determining the locations or business units at which to perform tests of controls when an entity has multiple locations
  - — How an entity’s use of a service organization affects the practitioner’s examination of internal control
  - — The use of a benchmarking strategy for entirely automated application controls
  - — Integrating in the examination of internal control the results of any additional tests of controls performed to express an opinion on the financial statements
- provides an illustrative written communication from the practitioner to management and those charged with governance of any significant deficiencies and material weaknesses identified during the integrated audit.
- includes an illustrative definition paragraph that may be used when an insured depository institution that is a bank (that is not subject to Section 404 of the Sarbanes-Oxley Act of 2002) elects to report on controls at the bank holding company level for Federal Deposit Insurance Corporation Improvement Act purposes.

How the Proposed SSAE Affects Existing Standards

This proposed SSAE would supersede AT section 501.

Proposed Statement on Standards for Attestation Engagements, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*

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Applicability

1. This Statement on Standards for Attestation Engagements (SSAE) establishes requirements and provides guidance that applies when a practitioner[1] is engaged to perform an examination of the design and operating effectiveness of an entity's internal control over financial reporting (*examination of internal control*)[2] that is integrated with an audit of financial statements (*integrated audit*).

2. Ordinarily, the auditor will be engaged to examine the effectiveness of the entity's internal control over financial reporting (hereinafter referred to as *internal control*) as of the end of the entity's fiscal year; however, management may select a different date. If the auditor is engaged to examine the effectiveness of an entity's internal control at a date different from the end of the entity's fiscal year, the examination should nevertheless be integrated with a financial statement audit. (See paragraphs 18–19.)

3. An auditor may be engaged to examine the effectiveness of an entity's internal control during a period of time. In that circumstance, the guidance in this SSAE would be modified accordingly.

4. This SSAE does not provide guidance for the following:

   a. Engagements to examine the suitability of design of an entity's internal control. Such engagements may be developed and performed under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1).[3]

   b. Engagements to examine controls over the effectiveness and efficiency of operations. Such engagements may be developed and performed under AT section 101.

   c. Engagements to examine controls over compliance with laws and regulations. See AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1).

   d. Engagements to report on the processing of transactions by a service organization for use by other auditors. See AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).

   e. Engagements to perform agreed-upon procedures on controls. See AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1).

5. The auditor may be requested to perform certain nonattest services related to the entity's internal control in addition to the examination of internal control. The auditor should determine whether to perform such nonattest services after considering relevant ethical requirements.

6. An auditor should not accept an engagement to review an entity's internal control or a written assertion thereon.

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[1] In this Statement on Standards for Attestation Engagements (SSAE), the *practitioner* is referred to as the *auditor* because the examination of internal control is integrated with an audit of financial statements and an examination provides the same level of assurance as an audit.

[2] In this SSAE, the phrase *examination of internal control* means an engagement to report directly on internal control or on management's assertion thereon. The performance guidance in this SSAE applies equally to either reporting alternative.

[3] Although this SSAE does not apply when an auditor is engaged to examine the suitability of design of an entity's internal control, it may be useful in planning and performing such engagements.

Definitions and Underlying Concepts

7. For purposes of this SSAE, the terms listed below are defined as follows:

Control objective. The aim or purpose of specified controls. Control objectives ordinarily address the risks that the controls are intended to mitigate. In the context of internal control, a control objective generally relates to a relevant assertion for a significant account or disclosure and addresses the risk that the controls in a specific area will not provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented, or detected and corrected on a timely basis.

Deficiency. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A deficiency in design exists when (*a*) a control necessary to meet the control objective is missing or (*b*) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Detective control. A control that has the objective of detecting and correcting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

Financial statements and related disclosures. An entity's financial statements and notes to the financial statements as presented in accordance with the applicable financial reporting framework.[4] References to financial statements and related disclosures do not extend to the preparation of other financial information presented outside an entity's basic financial statements and notes.

Internal control over financial reporting.[5] A process effected by those charged with governance,[6] management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with the applicable financial reporting framework and includes those policies and procedures that[7]

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[4] The applicable financial reporting framework is the accounting framework used for preparing and presenting the financial statements, such as generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA), as described in AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1).

[5] For insured depository institutions (IDIs) subject to the internal control reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), internal control includes controls over the preparation of the IDI's financial statements and related disclosures in accordance with GAAP and with the instructions to the *Consolidated Financial Statements for Bank Holding Companies*. Internal control also includes controls over the preparation of the IDI's financial statements and related schedules in accordance with GAAP or controls over the preparation of schedules equivalent to the basic financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (call report instructions) or with the Office of Thrift Supervision Instructions for Thrift Financial Reports (TFR instructions).

[6] The term *those charged with governance* is defined in paragraph .03 of AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), as "… the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards."

[7] The auditor's procedures performed as part of the integrated audit are not part of an entity's internal control.

i. pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity;

ii. provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the applicable financial reporting framework, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and

iii. provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Internal control has inherent limitations. Internal control is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control 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 and corrected on a timely basis by internal control. However, these inherent limitations are known aspects of the financial reporting process.

Management's assertion. Management's conclusion about the effectiveness of the entity's internal control that is included in management's report on internal control.

Material weakness. A deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility[8] that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Preventive control. A control that has the objective of preventing errors or fraud that could result in a misstatement of the financial statements.

Relevant assertion. A financial statement assertion[9] that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.

Significant account or disclosure. An account balance or disclosure that has a reasonable possibility that it could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account balance or disclosure is a significant account or disclosure is made without regard to the effect of controls.

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

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[8] In this SSAE, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

[9] The financial statement assertions are described in AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). The auditor may use the financial statement assertions as they are described in AU section 326 or express them differently, provided aspects described in AU section 326 have been covered and the auditor has selected and tested controls over the identified risks in each significant account and disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

8. Effective internal control provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements. If one or more material weaknesses exist, the entity's internal control cannot be considered effective.

9. The auditor's objective in an examination of internal control is to form an opinion on the effectiveness of the entity's internal control. Because an entity's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor should plan and perform the examination to obtain sufficient appropriate evidence to obtain reasonable assurance[10] about whether material weaknesses exist as of the date specified in management's assertion. A material weakness in internal control may exist even when financial statements are not materially misstated. The auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.

10. An auditor engaged to examine an entity's internal control should comply with the general, fieldwork, and reporting standards in AT section 101, and the specific performance and reporting requirements set forth in this SSAE. In this SSAE, the subject matter is the effectiveness of internal control and the responsible party usually is management of the entity. Accordingly, the term *management* is used in this SSAE to refer to the responsible party.

11. The auditor should use the same suitable and available control criteria[11] to perform his or her examination of internal control as management uses for its evaluation of the effectiveness of the entity's internal control.

12. An auditor may perform an examination of internal control only if the following conditions are met:

    a. Management accepts responsibility for the effectiveness of the entity's internal control

    b. Management evaluates the effectiveness of the entity's internal control using suitable and available criteria

    c. Management supports its assertion about the effectiveness of the entity's internal control with sufficient appropriate evidence (see discussion beginning at paragraph 14)

    d. Management provides its assertion about the effectiveness of the entity's internal control in a report that accompanies the auditor's report (see paragraph 96)

13. Management's refusal to furnish a written assertion should cause the auditor to withdraw from the engagement. However, if law or regulation does not allow the auditor to withdraw from the

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[10] The high, but not absolute, level of assurance that is intended to be obtained by the auditor is expressed in the auditor's report as obtaining reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects as of the date specified in management's assertion. See paragraph .54 of AT section 101, *Attest Engagements*, and AU section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1), for further discussion of the concept of reasonable assurance.

[11] According to paragraph .23 of AT section 101 "[t]he third general attestation standard is—*The auditor must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.*" The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) report *Internal Control—Integrated Framework* provides suitable and available criteria against which management may evaluate and report on the effectiveness of the entity's internal control. *Internal Control—Integrated Framework* describes an entity's internal control as consisting of five components: control environment, risk assessment, control activities, information and communication, and monitoring. See AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), for a discussion of these components. If management selects another framework, see paragraphs .23–.34 of AT section 101 for guidance on evaluating the suitability and availability of criteria.

engagement and management refuses to furnish a written assertion, the auditor should disclaim an opinion on internal control.[12]

Evidence Supporting Management's Assertion

14. Management is responsible for documenting the controls and the control objectives that they were designed to achieve. Such documentation serves as a basis for management's assertion. Documentation of the design of controls, including changes to those controls, is evidence that controls upon which management's assertion is based are

    - identified.
    - capable of being communicated to those responsible for their performance.
    - capable of being monitored and evaluated by the entity.

15. Management's documentation may take various forms, for example, entity policy manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, or completed questionnaires. No one particular form of documentation is prescribed, and the extent of documentation may vary depending upon the size and complexity of the entity and the entity's monitoring activities.

16. Management's monitoring activities may also provide evidence of the design and operating effectiveness of internal control in support of management's assertion. Monitoring is an assessment by appropriate personnel of the design and operation of controls on a suitably timely basis and the taking of necessary actions. Monitoring can be done through ongoing activities or separate evaluations. The greater the degree and effectiveness of ongoing monitoring, the less need for separate evaluations. Usually, some combination of ongoing monitoring and separate evaluations will ensure that internal control maintains its effectiveness over time.

17. Monitoring includes the following activities performed by appropriate personnel, on a timely basis:

    - Determining whether controls are designed and operating effectively by periodically testing and assessing them
    - Identifying and reporting deficiencies to appropriate individuals within the organization

Integrating the Examination With the Financial Statement Audit

18. The examination of internal control should be integrated with an audit of financial statements. Although the objectives of the engagements are not the same, the integrated audit is planned and performed, and tests of controls are designed, to achieve the objectives of both engagements

    - to obtain sufficient appropriate evidence to support the auditor's opinion on internal control as of the period-end; and

[12] See paragraphs 118–122 when disclaiming an opinion, including the requirement for the auditor's report to include a description of any material weaknesses identified.

- to obtain sufficient appropriate evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

19. In an integrated audit, the date specified in management’s assertion (the as-of date of the examination) should correspond to the balance sheet date (or period ending date) of the period covered by the financial statements.

20. Obtaining sufficient appropriate evidence to support the operating effectiveness of controls for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of substantive procedures that otherwise would have been necessary to opine on the financial statements. (Integration is described further beginning at paragraph 160.)

21. In some circumstances, particularly in some audits of smaller, less complex entities, the auditor might choose not to test the operating effectiveness of controls for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the entity's internal control is effective as of year-end. The auditor should consider the results of the financial statement auditing procedures in determining his or her risk assessments and the testing necessary to conclude on the operating effectiveness of a control.

Planning the Examination

22. The auditor should plan the examination of internal control. Evaluating whether the following matters are important to the entity’s financial statements and internal control and, if so, how they may affect the auditor's procedures, may assist the auditor in planning the examination:

    - Knowledge of the entity’s internal control obtained during other engagements performed by the auditor
    - Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
    - Matters relating to the entity's business, including its organization, operating characteristics, and capital structure
    - The extent of recent changes, if any, in the entity, its operations, or its internal control
    - The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses
    - Deficiencies previously communicated to those charged with governance or management
    - Legal or regulatory matters of which the entity is aware
    - The type and extent of available evidence related to the effectiveness of the entity's internal control
    - Preliminary judgments about the effectiveness of internal control
    - Public information about the entity relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the entity's internal control

- Knowledge about risks related to the entity evaluated as part of the auditor's client acceptance and retention evaluation

- The relative complexity of the entity's operations

23. Many smaller entities have less complex operations. Additionally, some larger, complex entities may have less complex units or processes. Factors that might indicate less complex operations include fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

24. Risk assessment underlies the entire examination process described by this SSAE, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary to conclude on the effectiveness of a given control.

25. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the entity's internal control and the amount of attention that would be devoted to that area. In addition, the risk that an entity's internal control will fail to prevent, or detect and correct a misstatement caused by fraud usually is higher than the risk of failure to prevent, or detect and correct a misstatement caused by error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

26. The complexity of the organization, business unit, or process may also affect the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Examination

27. The size and complexity of the entity, its business processes, and business units, may affect the way in which the entity achieves many of its control objectives. The size and complexity of the entity also might affect the risks of material misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to examinations of all entities. Accordingly, a smaller, less complex entity, or even a larger, less complex entity might achieve its control objectives differently than a more complex entity.

Addressing the Risk of Fraud

28. When planning and performing the examination of internal control, the auditor should incorporate the results of the fraud risk assessment performed in the financial statement audit. As part of identifying and testing entity-level controls, as discussed beginning at paragraph 37, and selecting other controls to test, as discussed beginning at paragraph 54, the auditor should evaluate whether the entity's controls sufficiently address identified risks of material misstatement

due to fraud[13] and controls intended to address the risk of management override of other controls. Controls that might address these risks include

- controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- controls over journal entries and adjustments made in the period-end financial reporting process;
- controls over related party transactions;
- controls related to significant management estimates; and
- controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

29. If the auditor identifies deficiencies in controls designed to prevent, or detect and correct misstatements caused by fraud during the examination of internal control, he or she should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), paragraphs .44–.45.

Using the Work of Others

30. AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), applies in an integrated audit. For purposes of the examination of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, entity personnel (in addition to internal auditors), and third parties working under the direction of management or those charged with governance that provide evidence about the effectiveness of internal control. In an integrated audit, the auditor also may use this work to obtain evidence supporting the assessment of control risk for purposes of the financial statement audit.

31. The auditor should obtain an understanding of the work of others sufficient to identify those activities related to the effectiveness of internal control that are relevant to planning the examination of internal control. The extent of the procedures necessary to obtain this understanding will vary, depending on the nature of those activities.

32. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09–.11 of AU section 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

33. For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding, knowledge, and skills that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the

[13] See paragraphs .19–.42 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), regarding identifying risks that may result in material misstatement due to fraud.

person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

34. If the auditor determines that the persons whose work the auditor plans to use are sufficiently competent and objective, the auditor should consider how such work may affect the examination of internal control. The extent to which the auditor may use the work of others depends, in part, on the risk associated with the control being tested (see paragraph 62). As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases. The effect of the work of others on the auditor's work also depends on the relationship between the risk associated with a control and the competence and objectivity of those who performed the work. As the risk associated with a control decreases, the necessary level of competence and objectivity decreases as well. In higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

Materiality

35. In planning and performing the examination of internal control, the auditor should use the same materiality used in planning and performing the audit of the entity's financial statements.[14]

Using a Top-Down Approach

36. The auditor should use a top-down approach[15] to the examination of internal control to select the controls to test. A top-down approach would begin at the financial statement level and with the auditor's understanding of the overall risks to internal control. The auditor would then focus on entity-level controls and work down to significant accounts and disclosures and their relevant assertions. This approach would direct the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor would then verify his or her understanding of the risks in the entity's processes and select for testing those controls that sufficiently address the assessed risk of material misstatement to each relevant assertion.

Identifying Entity-Level Controls

37. Entity-level controls include

- controls related to the control environment;
- controls over management override;[16]

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[14] See AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), which provides additional explanation of materiality.

[15] The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the examination procedures.

[16] Controls over management override are important to effective internal control for all entities, and may be particularly important at smaller, less complex entities because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller, less complex entities, the controls that address the risk of management override might be different from those at a larger entity. For example, a

- the entity's risk assessment process;
- centralized processing and controls, including shared service environments;
- controls to monitor results of operations;
- controls to monitor other controls, including activities of the internal audit function, those charged with governance, and self-assessment programs;
- controls over the period-end financial reporting process; and
- programs and controls that address significant business control and risk management practices.

38. Entity-level controls vary in nature and precision:

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be prevented, or detected and corrected on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.
- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that material misstatements to a relevant assertion will be prevented, or detected and corrected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.
- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent, or detect and correct on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of material misstatement, the auditor need not test additional controls relating to that risk.

39. The auditor should test those entity-level controls that are important to his or her conclusion about whether the entity has effective internal control. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that he or she otherwise would have performed on other controls.

Control Environment

40. Because of its importance to effective internal control, the auditor should evaluate the control environment at the entity. When evaluating the control environment, the auditor should apply paragraphs .67–.75 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, (AICPA, *Professional Standards*, vol. 1). As part of evaluating the control environment, the auditor should assess

- whether management's philosophy and operating style promote effective internal control;

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smaller, less complex entity might rely on more detailed oversight by those charged with governance that focuses on the risk of management override.

- whether sound integrity and ethical values, particularly of top management, are developed and understood; and

- whether those charged with governance understand and exercise oversight responsibility over financial reporting and internal control.

Period-End Financial Reporting Process

41. Because of its importance to financial reporting and to the integrated audit, the auditor should evaluate the period-end financial reporting process.[17] The period-end financial reporting process includes the following:

    - Procedures used to enter transaction totals into the general ledger

    - Procedures related to the selection and application of accounting policies

    - Procedures used to initiate, authorize, record, and process journal entries in the general ledger

    - Procedures used to record recurring and nonrecurring adjustments to the financial statements

    - Procedures for preparing financial statements and related disclosures

42. As part of evaluating the period-end financial reporting process, the auditor should assess

    - the inputs, procedures performed, and outputs of the processes the entity uses to produce its financial statements;

    - the extent of IT involvement in the period-end financial reporting process;

    - who participates from management;

    - the locations involved in the period-end financial reporting process;

    - the types of adjusting and consolidating entries; and

    - the nature and extent of the oversight of the process by management and those charged with governance.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

43. The auditor should identify significant accounts and disclosures and their relevant assertions. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include

    - size and composition of the account;

[17] Because the annual period-end financial reporting process normally occurs after the as-of date of management's assertion, those controls usually cannot be tested until after the as-of date.

- susceptibility to misstatement due to errors or fraud;
- volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- nature of the account, class of transactions, or disclosure;
- accounting and reporting complexities associated with the account, class of transactions, or disclosure;
- exposure to losses in the account;
- possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- existence of related party transactions in the account; and
- changes from the prior period in the account, class of transactions, or disclosure characteristics.

44. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

45. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the examination of internal control as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same in an integrated audit.[18]

46. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

47. When an entity has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the consolidated financial statements.

Understanding Likely Sources of Misstatement

48. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives:

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded
- Identify the points within the entity's processes at which a misstatement, including a misstatement due to fraud, could arise that, individually or in combination with other

[18] The risk assessment procedures performed in connection with a financial statement audit are described in AU section 314.

misstatements, would be material (for example, points at which information is initiated, transferred, or otherwise modified)

- Identify the controls that management has implemented to address these potential misstatements

- Identify the controls that management has implemented over the prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could result in a material misstatement of the financial statements

49. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 48 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU section 322.

50. The auditor also should understand how IT affects the entity's flow of transactions. The auditor should apply paragraphs .57–.63 of AU section 314, which discuss the effect of IT on internal control and the risks to assess.

51. The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify likely sources of misstatement and the controls to test, as well as to assess, risk and allocate audit effort.

Performing Walkthroughs

52. Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 48. A walkthrough involves following a transaction from origination through the entity's processes, including information systems, until it is reflected in the entity's financial records, using the same documents and IT that entity personnel use. Walkthrough procedures may include a combination of inquiry, observation, inspection of relevant documentation, recalculation, and control reperformance.

53. A walkthrough includes questioning the entity's personnel about their understanding of what is required by the entity's prescribed procedures and controls at the points at which important processing procedures occur. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough may provide an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

54. The auditor should test those controls that are important to the auditor's conclusion about whether the entity's controls sufficiently address the assessed risk of material misstatement to each relevant assertion.

55. There might be more than one control that addresses the assessed risk of material misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of material misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

56. The decision concerning whether a control would be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of material

misstatement to a given relevant assertion rather than on how the control is labeled (for example, entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control).

Testing Controls

Evaluating Design Effectiveness

57. The auditor should evaluate the design effectiveness of controls by determining whether the entity's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the entity's control objectives, and can effectively prevent, or detect and correct misstatements caused by errors or fraud that could result in material misstatements in the financial statements.

58. A smaller, less complex entity might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex entity might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the entity to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

59. Procedures performed to evaluate design effectiveness may include a mix of inquiry of appropriate personnel, observation of the entity's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

60. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.[19]

61. Procedures performed to test operating effectiveness may include a mix of inquiry of appropriate personnel, observation of the entity's operations, inspection of relevant documentation, recalculation, and reperformance of the control.

Relationship of Risk to the Evidence to be Obtained

62. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness exists. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

63. Although the auditor should obtain evidence about the effectiveness of controls for each relevant assertion, he or she is not responsible for obtaining sufficient appropriate evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to

[19] In some situations, particularly in smaller, less complex entities, an entity might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for an entity's financial reporting and associated controls, the auditor may take into account the combined competence of entity personnel and other parties that assist with functions related to financial reporting.

express an opinion on the entity's internal control overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

64. Factors that affect the risk associated with a control may include

- the nature and materiality of misstatements that the control is intended to prevent, or detect and correct;
- the inherent risk associated with the related account(s) and assertion(s);
- whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- whether the account has a history of errors;
- the effectiveness of entity-level controls, especially controls that monitor other controls;
- the nature of the control and the frequency with which it operates;
- the degree to which the control relies on the effectiveness of other controls (for example, the control environment or IT general controls);
- the competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- whether the control relies on performance by an individual or is automated (that is, an automated control would generally be expected to be lower risk if relevant IT general controls are effective);[20] and
- the complexity of the control and the significance of the judgments that would be made in connection with its operation.[21]

65. When the auditor identifies control deviations, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

66. Because effective internal control cannot, and does not, provide absolute assurance of achieving the entity's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

67. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control,

[20] A smaller, less complex entity or business unit with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of IT controls might focus on the application controls built into the prepackaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

[21] Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

different combinations of the nature, timing, and extent of testing may provide sufficient appropriate evidence in relation to the risk associated with the control.

68. Walkthroughs may include a combination of inquiry of appropriate personnel, observation of the entity's operations, inspection of relevant documentation, recalculation, and reperformance of the control and might provide sufficient appropriate evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough, and the results of those procedures.

Nature of Tests of Controls

69. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and reperformance of a control. Inquiry alone, however, does not provide sufficient appropriate evidence to support a conclusion about the effectiveness of a control.

70. The nature of the tests of effectiveness that will provide sufficient appropriate evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

71. A smaller, less complex entity or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or reperformance of certain controls, might provide sufficient appropriate evidence about whether the control is effective.

Timing and Extent of Tests of Controls

72. Testing controls over a longer period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assertion provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient appropriate evidence of operating effectiveness.

73. Prior to the date specified in management's assertion, management might implement changes to the entity's controls to make them more effective or efficient or to address deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment in the financial statement audit, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (Integration is discussed beginning at paragraph 160.)

74. The more extensively a control is tested, the greater the evidence obtained from that test.

Rollforward Procedures

75. When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should

determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

76. The additional evidence that is necessary to update the results of testing from an interim date to the entity's period-end depends on the following factors:[22]

- The specific control tested prior to the as-of date, including the risks associated with the control, the nature of the control, and the results of those tests
- The sufficiency of the evidence of operating effectiveness obtained at an interim date
- The length of the remaining period
- The possibility that there have been any significant changes in internal control subsequent to the interim date

Special Considerations for Subsequent Years' Examinations

77. In subsequent years' examinations, the auditor should incorporate knowledge obtained during past examinations he or she performed of the entity's internal control into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 62–76.

78. Factors that affect the risk associated with a control in subsequent years' examinations include those in paragraph 64 and the following:

- The nature, timing, and extent of procedures performed in previous examinations
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous examination

79. After taking into account the risk factors identified in paragraphs 64 and 78, the additional information available in subsequent years' examinations might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

80. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' examinations. Benchmarking is described further beginning at paragraph 154.

81. In addition, the auditor should vary the nature, timing, and extent of testing of controls from period to period to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

[22] In some circumstances, such as when evaluation of these factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

82. The auditor should evaluate the severity of each deficiency to determine whether the deficiency, individually or in combination, is a material weakness as of the date of management's assertion.

83. The severity of a deficiency depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and

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

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

85. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency

- The volume of activity (in the current period or expected in future periods) in the account balance or class of transactions exposed to the deficiency

86. In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated is generally the recorded amount, whereas understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

87. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved

- The susceptibility of the related asset or liability to loss or fraud

- The subjectivity, complexity, or extent of judgment required to determine the amount involved

- The interaction or relationship of the control with other controls

- The interaction among the deficiencies

- The possible future consequences of the deficiency

88. The evaluation of whether a deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

89. Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control increase the likelihood of material misstatement and may, in combination, constitute a material weakness, even though such deficiencies individually may be less severe. Therefore, the auditor should determine whether deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

90. Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control may also collectively result in a significant deficiency.

91. A compensating control can limit the severity of a deficiency and prevent it from rising to a significant deficiency or a material weakness. Although compensating controls can mitigate the effects of a deficiency, they do not eliminate the deficiency. The auditor should evaluate the effect of compensating controls when determining whether a deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent, or detect and correct a material misstatement.

Indicators of Material Weaknesses

92. Indicators of material weaknesses in internal control include

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

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

Wrapping-Up

Forming an Opinion

94. The auditor should form an opinion on the effectiveness of internal control by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified deficiencies.

95. As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control and evaluate deficiencies identified in those reports.

96. After forming an opinion on the effectiveness of the entity's internal control, the auditor should evaluate management's report to determine whether it appropriately contains the following:

- A statement regarding management's responsibility for internal control
- A description of the subject matter of the examination (for example, controls over the preparation of the entity's financial statements in accordance with generally accepted accounting principles [GAAP])

- An identification of the criteria against which internal control is measured (for example, criteria established in the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control—Integrated Framework*)

- Management's assertion about the effectiveness of internal control

- A description of the material weaknesses, if any

- The date as of which management's assertion is made

97. If the auditor determines that any required element of management's report is incomplete or improperly presented, the auditor should request management to revise its report. If management does not revise its report, the auditor should follow paragraph 118. If management refuses to furnish a report, the auditor should follow paragraph 13.

Obtaining Written Representations

98. In an examination of internal control, the auditor should obtain written representations from management

    a. acknowledging management's responsibility for establishing and maintaining effective internal control;

    b. stating that management has performed an evaluation of the effectiveness of the entity's internal control and specifying the control criteria;

    c. stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assertion;

    d. stating management's assertion about the effectiveness of the entity's internal control based on the control criteria as of a specified date;

    e. stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control;

    f. describing any fraud resulting in a material misstatement to the entity's financial statements and any other fraud that does not result in a material misstatement to the entity's financial statements, but involves senior management or management or other employees who have a significant role in the entity's internal control;

    g. stating whether deficiencies identified and communicated to those charged with governance during previous engagements pursuant to paragraph 101 have been resolved, and specifically identifying any that have not; and

    h. stating whether there were, subsequent to the date being reported on, any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

99. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the examination.[23] The auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, such as those obtained in the audit of the entity's financial statements.

100. The auditor should apply AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), as it relates to matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

Communicating Certain Matters

101. Deficiencies identified during the integrated audit that upon evaluation are considered significant deficiencies or material weaknesses should be communicated, in writing, to management and those charged with governance as a part of each integrated audit, including significant deficiencies and material weaknesses that were previously communicated to management and those charged with governance and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated in writing by referring to the previously issued written communication and the date of that communication.

102. If the auditor concludes that the oversight of the entity's financial reporting and internal control by the audit committee (or similar subgroups with different names) is ineffective, the auditor should communicate that conclusion, in writing, to the board of directors or other similar governing body if one exists.

103. The written communications referred to in paragraphs 101–102 should be made by the report release date,[24] which is the date the auditor grants the entity permission to use the auditor's report. For a governmental entity, the auditor is not required to make the written communications by the report release date, if such written communications would be publicly available prior to management's report on internal control, the entity's financial statements, and the auditor's report thereon. In that circumstance, the written communications should be made as soon as practicable, but no later than 60 days following the report release date.

104. Because of the importance of timely communication, the auditor may choose to communicate significant matters during the course of the integrated audit. If the communication is made during the integrated audit, the form of interim communication would be affected by the relative significance of the identified deficiencies and the urgency for corrective follow-up action. Such early communication is not required to be in writing. However, regardless of how the early communication is delivered, the auditor should communicate all significant deficiencies and material weaknesses in writing to management and those charged with governance in accordance with paragraphs 101–103, even if the significant deficiencies or material weaknesses were remediated during the examination.

105. The auditor also should communicate to management, in writing, all deficiencies (those deficiencies that are not material weaknesses or significant deficiencies) identified during the integrated audit on a timely basis, but no later than 60 days following the report release date, and inform those charged with governance when such a communication was made. The auditor is not required to communicate deficiencies (those deficiencies that are not material weaknesses or

[23] See paragraph 118 when the scope of the engagement has been restricted.

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

significant deficiencies) that were included in previous written communications, whether those communications were made by the auditor, internal auditors, or others within the organization.

106. The auditor is not required to perform procedures that are sufficient to identify all deficiencies; rather, the auditor communicates deficiencies of which he or she is aware.

107. Because the integrated audit does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were identified during the integrated audit.

Reporting on Internal Control

108. The auditor's report on the examination of internal control should include the following elements:[25]

a. A title that includes the word independent

b. A statement that management is responsible for maintaining effective internal control and for evaluating the effectiveness of internal control

c. An identification of management's assertion on internal control that accompanies the auditor's report, including a reference to management's report

d. A statement that the auditor's responsibility is to express an opinion on the entity's internal control (or on management's assertion)[26] based on his or her examination[27]

e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants

f. A statement that such standards require that the auditor plan and perform the examination to obtain reasonable assurance about whether effective internal control was maintained in all material respects

g. A statement that an examination includes obtaining an understanding of internal control, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considers necessary in the circumstances

h. A statement that the auditor believes the examination provides a reasonable basis for his or her opinion

i. A definition of internal control (the auditor should use the same description of the entity's internal control as management uses in its report)

j. A paragraph stating that, because of inherent limitations, internal control may not prevent, or detect and correct misstatements and that projections of any evaluation of effectiveness to

[25] Report modifications are discussed further beginning at paragraph 116.

[26] The auditor may report directly on the entity's internal control or on management's written assertion, except as described in paragraph 112.

[27] Because the examination of internal control is integrated with the audit of the financial statements and an examination provides the same level of assurance as an audit, the auditor may refer to the examination of internal control as an audit in his or her report or other communications.

future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate

k. The auditor's opinion on whether the entity maintained, in all material respects, effective internal control as of the specified date, based on the control criteria; or, the auditor's opinion on whether management's assertion about the effectiveness of the entity's internal control as of the specified date is fairly stated, in all material respects, based on the control criteria

l. The manual or printed signature of the auditor's firm

m. The date of the report

Separate or Combined Reports

109. The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and an opinion on internal control) or separate reports on the entity's financial statements and on internal control.

110. If the auditor issues a separate report on internal control, he or she should add the following paragraph to the auditor's report on the financial statements:

> We also have examined [*or audited*][28] in accordance with attestation standards established by the American Institute of Certified Public Accountants, [*company name*]'s internal control over financial reporting as of December 31, 20X8, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

The auditor also should add the following paragraph to the report on internal control:

> We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of [*company name*] and our report dated [*date of report, which should be the same as the date of the report on internal control*] expressed [*include nature of opinion*].

Report Date

111. The auditor should date the report no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion. Because the examination of internal control is integrated with the audit of the financial statements, the reports should be dated the same.

Adverse Opinions

112. Paragraphs 82–93 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses as of the date specified in management's assertion, the auditor should express an adverse opinion on the entity's internal control, unless there is a restriction on the scope of the engagement.[29] In such circumstances,

[28] See footnote 27.

[29] See paragraph 118 when the scope of the engagement has been restricted.

the auditor is prohibited from expressing an opinion on management's assertion and should report directly on the effectiveness of internal control.

113. When expressing an adverse opinion on internal control because of one or more material weaknesses, the auditor's report should include

- the definition of a material weakness.
- a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's assertion.

114. If one or more material weaknesses have not been included in management's report accompanying the auditor's report, the auditor's report should be modified to state that one or more material weaknesses have been identified but not included in management's report. Additionally, the auditor's report should include a description of each material weakness not included in management's report, which should provide the users of the report with specific information about the nature of each material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate in writing to those charged with governance that one or more material weaknesses were not disclosed or identified as a material weakness in management's report. If one or more material weaknesses have been included in management's report but the auditor concludes that the disclosure of such material weaknesses is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe each material weakness.

115. The auditor should determine the effect an adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the material weaknesses.[30]

Report Modifications

116. The auditor should modify his or her report if any of the following conditions exist:

a. Elements of management's report are incomplete or improperly presented

b. There is a restriction on the scope of the engagement

c. The auditor decides to refer to the report of another auditor as the basis, in part, for the auditor's own report

d. There is other information contained in management's report

Elements of Management's Report are Incomplete or Improperly Presented

117. If the auditor determines that any required element of management's report (see paragraph 96) is incomplete or improperly presented and management does not revise its report, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about one or more

[30] If the auditor issues a separate report on internal control in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraph 110. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

material weaknesses is not fairly presented in all material respects, the auditor should follow paragraph 114.

Scope Limitations

118. The auditor can express an opinion on the entity's internal control only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion.

119. When disclaiming an opinion because of a scope limitation, the auditor should state that he or she does not express an opinion on the effectiveness of internal control and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an examination of internal control (paragraph 108[d] and [f–i]); to do so might overshadow the disclaimer.

120. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that one or more material weaknesses exist, the auditor's report also should include

- the definition of a material weakness.

- a description of any material weaknesses identified in the entity's internal control. This description should provide the users of the report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraph 113. The auditor should also apply the requirements in paragraph 115.

121. The auditor may issue a report disclaiming an opinion on internal control as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.[31] The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient appropriate evidence to express an opinion.

122. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination, the auditor should communicate, in writing, to management and those charged with governance that the examination of internal control cannot be satisfactorily completed.

Opinions Based, In Part, on the Report of Another Auditor

123. When another auditor has examined the internal control of one or more subsidiaries, divisions, branches, or components of the entity, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the auditor's decision of whether to serve as the principal auditor of the financial statements. The auditor

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[31] In this case, in following paragraph 111 regarding dating the report, the report date is the date that the auditor has obtained sufficient appropriate evidence to support the representations in the report.

should apply paragraphs .02–.03 of AU section 543 in deciding whether he or she may serve as the principal auditor of the examination of internal control.

124. When serving as the principal auditor of internal control, the auditor should decide whether to make reference in his or her report on internal control to the examination of internal control performed by the other auditor. In these circumstances, the decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on an entity's financial statements as described in AU section 543.

125. The decision about whether to make reference to another auditor in the report on the examination of internal control might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control might not make a similar reference because management's assertion ordinarily would not extend to controls at the equity method investee.[32]

126. When the principal auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the entity's internal control, the principal auditor should refer to the report of the other auditor when describing the scope of the examination and when expressing the opinion.

Management's Report Contains Additional Information

127. Management's report accompanying the auditor's report may contain information in addition to the elements described in paragraph 96 that are subject to the auditor's evaluation.[33] If management's report could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

128. The auditor may use the following sample language as the last paragraph of the auditor's report to disclaim an opinion on such additional information:

> We do not express an opinion or any other form of assurance on [*describe additional information, such as management's cost-benefit statement*].

129. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should apply the guidance in paragraphs .92–.94 of AT section 101 and take appropriate action. If the auditor concludes that a material misstatement of fact remains, the auditor should notify management and those charged with governance, in writing, of the auditor's views concerning the information. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), may also require the auditor to take additional action.

Subsequent Events

130. Changes in internal control or other factors that might significantly affect internal control might occur subsequent to the date as of which internal control is being examined but before the date of

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[32] See paragraph 141 for further discussion of the evaluation of the controls for an equity method investment.

[33] An entity may publish various documents that contain information in addition to management's report and the auditor's report on internal control. Paragraphs .91–.94 of AT section 101 provide guidance to the auditor in these circumstances. If management makes the types of disclosures described in paragraph 127 outside its report and includes them elsewhere within a document that includes the auditor's report, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in paragraph 129, if the auditor believes that the additional information contains a material misstatement of fact.

the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 98.

131. To obtain additional information about changes in internal control or other factors that might significantly affect the effectiveness of the entity's internal control, the auditor should inquire about and examine, for this subsequent period, the following:

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period

- Independent auditor reports (if other than the auditor's) of deficiencies

- Regulatory agency reports on the entity's internal control

- Information about the effectiveness of the entity's internal control obtained through other engagements

132. The auditor might inquire about and examine other documents for the subsequent period. Paragraphs .01–.09 of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), establish requirements and provide guidance on subsequent events for a financial statement audit that also may be helpful to the auditor performing an examination of internal control.

133. If, subsequent to the date as of which internal control is being examined but before the date of the auditor's report, the auditor obtains knowledge about a material weakness that existed as of the date specified in management's assertion, the auditor should report directly on internal control and issue an adverse opinion, as required by paragraph 112. The auditor should also follow paragraph 117 if management's assertion states that internal control is effective. If the auditor is unable to determine the effect of the matter on the effectiveness of the entity's internal control as of the date specified in management's assertion, the auditor should disclaim an opinion. As described in paragraph 127, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the entity, if any.

134. The auditor may obtain knowledge about conditions that did not exist at the date specified in management's assertion but arose subsequent to that date and before the release of the auditor's report. If a subsequent event of this type has a material effect on the entity's internal control, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report.

135. The auditor has no responsibility to keep informed of events subsequent to the date of his or her report; however, after the release of the report on internal control, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The evaluation of such subsequent information is similar to the evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

Special Topics

Entities With Multiple Locations

136. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of attention devoted to the location or business unit with the degree of risk. The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the entity's consolidated financial statements.

137. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the entity's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient appropriate evidence.

138. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform examination procedures.

139. In applying the requirement in paragraph 81 regarding special considerations for subsequent years' examinations, the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

Special Situations

140. The scope of the examination should include entities that are acquired on or before the date of management's assertion and operations that are accounted for as discontinued operations on the date of management's assertion that are reported in accordance with the applicable financial reporting framework in the entity's financial statements.

141. For equity method investments, the scope of the examination should include controls over the reporting in accordance with the applicable financial reporting framework, in the entity's financial statements, of the entity's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The examination ordinarily would not extend to controls at the equity method investee.

142. In situations in which a regulator allows management to limit its assertion by excluding certain entities, the auditor may limit the examination in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assertion and the auditor's examination of internal control. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the regulator's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should communicate the matter to the appropriate level of management. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform those charged with governance of the matter as soon as practicable. If management and those charged with governance do not respond appropriately, the auditor should modify his or her report on the examination of internal control to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

143. AU section 324 applies to the audit of financial statements of an entity that obtains services from another organization that are part of the entity's information and communication systems. The auditor may apply the relevant concepts described in AU section 324 to the examination of internal control.

144. Paragraph .03 of AU section 324 describes the situation in which a service organization's services are part of an entity's information and communication systems. If the service organization's services are part of an entity's information and communication systems, as described therein, then they are part of the information and communication component of the entity's internal control. When the service organization's services are part of the entity's internal control, the auditor should consider the activities of the service organization when determining the evidence required to support his or her opinion.

145. The auditor should perform the procedures in paragraphs .07–.16 of AU section 324 with respect to the activities performed by the service organization. These procedures include

    a. obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization; and

    b. obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.

146. Evidence that the controls that are relevant to the auditor's opinion on internal control are operating effectively may be obtained by following the procedures described in paragraph .12 of AU section 324. These procedures include one or more of the following:

    a. Obtaining a service auditor's report[34] on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls. If the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU section 324, the auditor should evaluate whether the agreed-upon procedures report provides sufficient appropriate evidence in the same manner described in paragraph 147.

    b. Performing tests of the user organization's controls over the activities of the service organization (for example, testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

    c. Performing tests of controls at the service organization.

147. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient appropriate evidence to

[34] The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" as described in paragraph .24[b] of AU section 324, *Service Organizations* [AICPA, *Professional Standards*, vol. 1]). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" as described in paragraph .24[a] of AU section 324) does not provide evidence of operating effectiveness.

support his or her opinion on internal control. In evaluating whether such a service auditor's report provides sufficient appropriate evidence, the auditor should assess the following factors:[35]

- The time period covered by the tests of controls and its relation to the as-of date of management's assertion

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the entity's controls

- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls

148. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the entity applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the entity is applying the necessary procedures.

149. In determining whether the service auditor's report provides sufficient appropriate evidence to support the auditor's opinion on internal control, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10(a) of AU section 543.

150. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assertion, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the entity's internal control. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

151. As risk increases, the need for the auditor to obtain additional evidence increases. Accordingly, the auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors:

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assertion

- The significance of the activities of the service organization

- Whether there are errors that have been identified in the service organization's processing

[35] These factors are similar to factors the auditor would consider in determining whether the report provides sufficient appropriate evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in paragraph .16 of AU section 324.

- The nature and significance of any changes in the service organization's controls identified by management or the auditor

152. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include

    - evaluating procedures performed by management and the results of those procedures.
    - contacting the service organization, through the user organization, to obtain specific information.
    - requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
    - visiting the service organization and performing such procedures.

153. The auditor should not refer to the service auditor's report when expressing an opinion on internal control.

Benchmarking of Automated Controls

154. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a benchmarking strategy.

155. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (that is, last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including the strength of the entity's program change controls.

156. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

157. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are

    - the extent to which the application control can be matched to a defined program within an application.
    - the extent to which the application is stable (that is, there are few changes from period to period).
    - the availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

158. Benchmarking automated application controls can be especially effective for entities using purchased software when the possibility of program changes is remote (for example, when the vendor does not allow access or modification to the source code).

159. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors:

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls, and computer operations.

- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.

- The nature and timing of other related tests.

- The consequences of errors associated with the application control that was benchmarked.

- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

Integration with the Financial Statement Audit

Tests of Controls in an Examination of Internal Control

160. The objective of the tests of controls in an examination of internal control is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the entity's internal control. The auditor's opinion relates to the effectiveness of the entity's internal control as of a point in time and taken as a whole.

161. To express an opinion on internal control as of a point in time, the auditor should obtain evidence that internal control has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the entity's financial statements. To express an opinion on internal control taken as a whole, the auditor should obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

162. When concluding on the effectiveness of internal control for purposes of expressing an opinion on internal control, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

Tests of Controls in an Audit of Financial Statements

163. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. Tests of controls are performed when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures

alone do not provide sufficient appropriate audit evidence at the relevant assertion level.[36] Tests of controls are designed to obtain sufficient appropriate audit evidence that the controls are operating effectively throughout the period of reliance.[37] However, the auditor is not required to test controls for all relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

164. When concluding on the effectiveness of controls for the purpose of the financial statement audit, the auditor also should evaluate the results of any additional tests of controls performed by the auditor to achieve the objective related to expressing an opinion on the entity's internal control, as discussed in paragraph 161. Consideration of these results may cause the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified deficiencies.

Effect of Tests of Controls on Substantive Procedures

165. If, during the examination of internal control, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

166. Regardless of the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.[38] Performing procedures to express an opinion on internal control does not diminish this requirement.

Effect of Substantive Procedures on Conclusions About the Operating Effectiveness of Controls

167. In an examination of internal control, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control. This evaluation should include, at a minimum,

- the risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- findings with respect to illegal acts and related party transactions.
- indications of management bias in making accounting estimates and in selecting accounting principles.
- misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

168. To obtain evidence about whether a selected control is effective, the control should be tested directly; the operating effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by

[36] See paragraph .23 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1).

[37] See paragraph .46 of AU section 318.

[38] See paragraphs .09 and .51 of AU section 318.

substantive procedures, however, may affect the auditor's risk assessments in determining the testing necessary to conclude on the operating effectiveness of a control.

Effective Date

169. This SSAE is effective for integrated audits for dates or periods ending on or after December 15, 2008. Earlier implementation is permitted.

170.

Appendix A—Illustrative Reports

1. The following illustrate the report elements described in this Statement on Standards for Attestation Engagements (SSAE). These illustrative reports refer to an examination; however, the auditor may refer to the examination of internal control as an audit.[1]

2. Report modifications are discussed beginning at paragraph 116 of this SSAE.

Example 1: Unqualified Opinion on Internal Control

3. The following is an illustrative report expressing an unqualified opinion directly on internal control.

Independent Auditor's Report

[*Introductory paragraph*]
We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[2] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

[*Scope paragraph*]
We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An examination includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. An examination also includes performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Definition paragraph*]
An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance

[1] Because the examination of internal control is integrated with the audit of the financial statements and an examination provides the same level of assurance as an audit, the auditor may refer to the examination of internal control as an audit in his or her report or other communications.

[2] For example, the following may be used to identify the criteria: "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]
Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]
In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

[*Audit of financial statements paragraph*]
We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

Example 2: Unqualified Opinion on Management's Assertion

4. The following is an illustrative report expressing an unqualified opinion on management's assertion.

Independent Auditor's Report

[*Introductory paragraph*]
We have examined management's assertion, included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 20XX based on [*identify criteria*].[3] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on management's assertion based on our examination.

[*Scope paragraph*]
We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An examination includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. An examination also includes performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[3] See footnote 2 of this appendix.

[*Definition paragraph*]
An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]
Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]
In our opinion, management's assertion that W Company maintained effective internal control over financial reporting as of December 31, 20XX is fairly stated, in all material respects, based on [*identify criteria*].

[*Audit of financial statements paragraph*]
We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

5. The following is an illustrative report expressing an adverse opinion on internal control. In this example, the opinion on the financial statements is not affected by the adverse opinion on internal control.

Independent Auditor's Report

[*Introductory paragraph*]
We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[4] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

[*Scope paragraph*]

[4] See footnote 2 of this appendix.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An examination includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. An examination also includes performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Definition paragraph*]
An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]
Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]
A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. The following material weakness has been identified and included in the accompanying [*title of management's report*].

[*Identify the material weakness described in management's report*.][5]

[*Opinion paragraph*]
In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

[*Audit of financial statements paragraph*]
We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company. We considered the material weakness identified above in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect our

[5] See paragraphs 112–115 of this SSAE for specific reporting requirements.

report dated [*date of report, which should be the same as the date of the report on the examination of internal control*], which expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

Example 4: Disclaimer of Opinion on Internal Control

6. The following is an illustrative report expressing a disclaimer of opinion on internal control. In this example, a material weakness was identified.

Independent Auditor's Report

[*Introductory paragraph*]
We were engaged to examine W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[6] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*].

[*Paragraph that describes the substantive reasons for the scope limitation*]

[*Definition paragraph*]
An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]
Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]
A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. If one or more material weaknesses exist, an entity's internal control over financial reporting cannot be considered effective. The following material weakness has been identified and included in the accompanying [*title of management's report*].

[6] See footnote 2 of this appendix.

[*Identify the material weakness described in management's report and include a description of the material weakness, including its nature and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the material weakness.*]

[*Opinion paragraph*]
Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves that there are no other material weaknesses in W Company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness W Company's internal control over financial reporting.

[*Audit of financial statements paragraph*]
We have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report*] expressed [*include nature of opinion*]. We considered the material weakness identified above in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect our report dated [*date of report*], which expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

Example 5: Unqualified Opinion on Internal Control Based, In Part, on the Report of Another Auditor

7. The following is an illustrative report expressing an unqualified opinion on internal control when the auditor decides to refer to the report of another auditor as the basis, in part, for the auditor's own report.

Independent Auditor's Report

[*Introductory paragraph*]
We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[7] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was examined by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

[*Scope paragraph*]

[7] See footnote 2 of this appendix.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An examination includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. An examination also includes performing such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other auditors provide a reasonable basis for our opinion.

[*Definition paragraph*]
An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]
Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]
In our opinion, based on our examination and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[8]

[*Audit of financial statements paragraph*]
We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

[8] Whether the other auditor's opinion is expressed on management's assertion or on internal control does not affect the determination of whether the principal auditor's opinion is expressed on management's assertion or on internal control.

Example 6: Combined Report Expressing an Unqualified Opinion on Internal Control and on the Financial Statements

8. The following is an illustrative combined report expressing an unqualified opinion directly on internal control and on the financial statements. This report refers to the examination of internal control as an audit.[9]

Independent Auditor's Report

[*Introductory paragraph*]
We have audited the accompanying balance sheet of W Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. We also have audited W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[10] W. Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on these financial statements and an opinion on W Company's internal control over financial reporting based on our audits.

[*Scope paragraph*]
We conducted our audit of the financial statements in accordance with auditing standards generally accepted in the United States of America and our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. An audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. An audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]
An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of

[9] See footnote 1 of this appendix.

[10] See footnote 2 of this appendix.

unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]
Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

[*Signature*]

[*Date*]

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Appendix B—Illustrative Communication of Significant Deficiencies and Material Weaknesses

1. The following is an illustrative written communication of significant deficiencies and material weaknesses.

> In connection with our audit of W Company's (the "Company") financial statements as of December 31, 20XX and for the year then ended, and our audit of the Company's internal control over financial reporting as of December 31, 20XX ("integrated audit"), the attestation standards established by the American Institute of Certified Public Accountants require that we advise you of the following internal control matters identified during our integrated audit.
>
> Our responsibility is to plan and perform our integrated audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects (that is, whether material weaknesses exist as of the date specified in management's assertion). The integrated audit is not designed to detect deficiencies that, individually or in combination, are less severe than a material weakness. However, we are responsible for communicating to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit. We are also responsible for communicating to management deficiencies that are of a lesser magnitude than a significant deficiency, unless previously communicated, and inform those charged with governance when such a communication was made.
>
> A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. [*A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented, or detected and corrected on a timely basis. We believe the following deficiencies constitute material weaknesses:*]
>
> [*Describe the material weaknesses that were identified during the integrated audit. The auditor may separately identify those material weaknesses that exist as of the date of management's assertion by referring to the auditor's report.*]
>
> [*A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that, in the auditor's professional judgment, is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies to be significant deficiencies:*]
>
> [*Describe the significant deficiencies that were identified during the integrated audit.*]
>
> 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.

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Appendix C—Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)

1. In Financial Institution Letter (FIL) 86-94, *Additional Guidance Concerning Annual Audits, Audit Committees and Reporting Requirements*, issued December 23, 1994, the Federal Deposit Insurance Corporation (FDIC) provided guidance on the meaning of the term *financial reporting* for purposes of compliance by insured depository institutions (IDIs) with Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (Section 36 of the Federal Deposit Insurance Act, 12.U.S.C. 1831m), and its implementing regulation, 12 CFR Part 363. The FDIC indicated that financial reporting, at a minimum, includes financial statements prepared in accordance with generally accepted accounting principles (GAAP) and the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report (for example, Schedules RC, RI, and RI-A in the Consolidated Reports of Condition and Income [Call Report]). Accordingly, to comply with FDICIA and Part 363, management of the IDI (or a parent holding company)[1] and the auditor should identify and test controls over the preparation of GAAP-based financial statements as well as the schedules equivalent to the basic financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report. Further, both management and the auditor should include in their report on the IDI's (or its holding company's) internal control a specific description indicating that the scope of internal control included controls over the preparation of the IDI's (or its holding company's) GAAP-based financial statements as well as the schedules equivalent to the basic financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report.

2. In accordance with paragraph 108 of this SSAE, management's assertion and the auditor's report should define internal control. The following is an illustrative definition paragraph that may be used when an IDI that is a bank (which is not subject to Section 404 of the Sarbanes-Oxley Act of 2002) elects to report on controls for FDICIA purposes at the bank holding company level:

    An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our examination were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our examination of [*Holding Company's*] internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C).[2] An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America,

[1] See Financial Institution Letter (FIL) 86-94 for further discussion of reporting at the holding company level for Federal Deposit Insurance Corporation Improvement Act purposes and the application of holding company reporting as it relates to controls over the preparation of "regulatory reports."

[2] This sentence would be modified if the insured depository institution (IDI) reports at the institution level rather than at the bank holding company level to refer to the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income or the Office of Thrift Supervision Instructions for Thrift Financial Reports instead of to the Form FR Y-9C. This sentence would also be modified if the IDI reports at a holding company level and employs another approach to reporting on controls over the preparation of regulatory reports as permitted by FIL 86-94.

and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

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Appendix D—Illustrative Management Report

1. The following is an illustrative management report containing the reporting elements described in paragraph 96 of this SSAE:

Management's Report on Internal Control Over Financial Reporting

W Company's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Management is responsible for establishing and maintaining effective internal control over financial reporting. Management assessed the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control—Integrated Framework*. Based on that assessment, management concluded that, as of December 31, 20XX, W Company's internal control over financial reporting is effective based on the criteria established in *Internal Control—Integrated Framework*.

W Company

Report signers, if applicable
Date