

## Checkpoint Contents

Accounting, Audit & Corporate Finance Library

Editorial Materials

Audit and Attest

Management Letter Comments: Operations and Controls

Chapter 1 Communication of Management Comments

100 Introduction

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## 100 Introduction

### Background

100.1 Historically, many auditors viewed providing the client with comments to improve internal controls or operations as an additional opportunity for client service and as a way to demonstrate their knowledge of, and interest in, the client's business, operations, and needs. Clients expected their auditors to be business advisors and, as such, expected the auditors to keep them informed about matters that could benefit their business. Many clients who viewed the audit or the auditor's report as a fairly standardized product appreciated the insightful and innovative comments provided in management letters.

100.2 Management letters often contained comments that the auditors believed to be of potential benefit to the client, such as recommendations for operational or administrative efficiency or for improvements in internal control. They also included comments about matters that management may have asked the auditors to communicate. In any event, management letters included comments that the auditors concluded were less severe than either *material weakness* or *significant deficiencies*, which auditing standards required them to communicate in writing to management and those charged with governance. So, while management letters were not required, many auditors issued them in connection with their financial statement audits.

### Required Communications of *Other Internal Control Deficiencies*

100.3 As discussed beginning at paragraph 101.1, the Auditing Standards Board issued AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit* in October 2011. In addition to retaining the requirement that auditors communicate, in writing, material weaknesses and significant deficiencies identified during the audit to management and those charged with governance, AU-C 265 establishes requirements for auditors to communicate *other deficiencies in internal control*. Specifically, AU-C 265.12b requires auditors to communicate *other deficiencies in internal control* when such deficiencies (a) have not been communicated to management by other parties and (b) are of sufficient importance to merit management's attention, in the auditor's professional judgment. AU-C 265 does not require auditors to make such communications in writing; however, when the communications are made orally, AU-C 265 requires auditors to document the communications in their workpapers.

100.4 If auditors choose to make the communications in writing, they may include the communications in a separate section of the internal control communication required by AU-C 265 (that is, the written communication of material weaknesses and significant deficiencies identified during the audit)<sup>1</sup> or in a management letter.

Therefore, while AU-C 265 does not require a management letter to be issued in connection with a financial statement audit, many auditors may find that issuing one is the best way of ensuring that they comply with this requirement of AU-C 265.

### **Purpose of this Guide**

100.5 Regardless of the manner in which auditors choose to communicate *other deficiencies in internal control* in accordance with AU-C 265, this *Guide* has been designed to help auditors develop useful and relevant comments about such *other internal control deficiencies*. In addition, it also provides guidance on developing comments about other matters auditors might wish to communicate to management. Throughout this *Guide*, the authors refer to all of these comments as *management comments* or *management letter comments*.

100.6 This *Guide* contains hundreds of illustrative comments about conditions related to operations and controls typically encountered during audits of small commercial businesses. Most of the comments have been developed from actual practice. Comments on controls relate to matters such as segregation of duties, corporate governance reviews and approvals, reconciliations of detail records to summary ledgers and physical counts, physical security of assets, information technology (IT) controls, internal audit, and other matters to help prevent or detect financial statement misstatements or fraud. Comments on operations relate to matters such as cash management; credit and collection policies and procedures; control of production schedules, capacity, and defects; employee performance, benefits, and safety; Internet use and website management; and other matters to improve the efficiency and effectiveness of operations.

100.7 While it is possible the comments on internal controls presented in this *Guide* may rise to the level of material weaknesses or significant deficiencies and thus require communication under AU-C 265, this determination depends on the specific facts and circumstances of the engagement and auditor judgment. The purpose of this *Guide* is to provide sample management letter comments that may also be communicated under AU-C 265.

100.8 In addition, the comments presented in this *Guide* are not intended to include all potential comments, nor are the comments intended to be relevant to all audits. The comments are presented as examples of matters that auditors should be alert for during an audit, but that does not imply that the comments should be used as a checklist or that the auditors are required to search for weaknesses or suggestions for improvement.

### **100.9 Relation of This Guide to PPC's Expense Reduction Guide**

This *Guide* includes certain operational comments related to expense reduction, such as negotiation of discounts and more favorable terms with vendors, control of travel and entertainment expenses, etc. However, expense reduction is not the primary focus of this *Guide*. *PPC's Guide to Management Letter Comments—Expense Reduction Recommendations* focuses on expense reduction opportunities and presents recommendations for one-time or recurring savings by eliminating expense items, partially reducing the need for them, or reducing the price or charge for a good or service. The expense areas covered are travel, insurance, utilities, office supplies, repairs and maintenance, workers' compensation, leases, shipping, postage, and legal costs.

### **100.10 How This Guide Is Organized**

The comments in this *Guide* are organized in a way that will allow the auditor to quickly identify comments relevant to the client's particular conditions. Chapters 2-18 present management letter comments in the following categories, which generally parallel the audit areas in a typical commercial audit:

- Chapter 2—Cash.
  
- Chapter 3—Receivables.
  
- Chapter 4—Sales.
  
- Chapter 5—Inventory.
  
- Chapter 6—Cost of sales.
  
- Chapter 7—Property.
  
- Chapter 8—Investments.
  
- Chapter 9—Prepays and other assets.
  
- Chapter 10—Notes payable and other long-term debt.
  
- Chapter 11—Accounts payable.
  
- Chapter 12—Accruals and expenses.
  
- Chapter 13—Payroll and personnel.

- Chapter 14—Other income/expenses and taxes.
  
- Chapter 15—Equity.
  
- Chapter 16—General company administrative.
  
- Chapter 17—General accounting.
  
- Chapter 18—Other.

100.11 Within each chapter, comments related to various subsections of the main category are grouped together. For example, Chapter 2, on cash, includes sections on cash management, cash security, cash receipts and disbursements, etc.; Chapter 16, on general company administrative, includes sections on accounting department staffing, company communication, insurance, Internet and websites, etc.; and Chapter 17, on general accounting, includes sections on budgets, performance and similar measures, etc.

#### 100.12 **How This *Guide* Can Be Used**

The organization described in the preceding paragraphs allows this *Guide* to be used in the following ways:

- To identify sources for potential comments.
  
- As a source for illustrative comments.
  
- As a source for how to word comments.

100.13 This organization is convenient because as each area is being audited, the auditors can scan the comments for that area and consider whether any are relevant to conditions encountered during the audit work. (Note, however, that the listings are memory joggers rather than checklists or internal control questionnaires, and the authors do not intend to imply that the listings or comments must be reviewed partially or entirely in any audit.)

100.14 Although this *Guide* organizes management comments by audit area for ease in selecting items for a management letter, the comments selected usually will not be presented in this order in the letter. Typically, some other order of presentation will be more relevant, such as order of significance (for example, potential cost reduction), functional area (for example, budgeting, IT, personnel), location, etc. Organization of comments in the management letter is discussed further starting at paragraph 103.24.

100.15 Once the auditor has selected comments, the auditor need only modify and expand the comments as appropriate to tailor them to the specific client circumstances observed. For instance, generic references to “the Company” should be changed to the client’s company name when appropriate, and terminology, names of departments, positions, systems, records, etc., should be changed to the client’s particular nomenclature. Also, specific facts, examples of the condition encountered, data and other information (such as copies of client forms, documents, organization charts, etc.) relevant to the situation should be included in the comments to illustrate, explain, or quantify the problem or support the recommendation being made.

100.16 The remainder of this chapter discusses the following matters:

- Section 101 defines *other internal control deficiencies* identified during the audit and discusses the requirement in AU-C 265 that auditors communicate such matters to management in certain circumstances. Because the auditor’s evaluation of the severity of identified deficiencies may affect which matters are communicated and how they are communicated, PPC’s evaluation process is also described in this section.
  
- Section 102 discusses other matters an auditor may wish to communicate to management in connection with the financial statement audit.
  
- Section 103 discusses the content of management comments, including considering the level of detail to include, the type of information to include, and the wording of the management comments. This section also discusses the AICPA’s ethics guidance and how it may affect an auditor’s offer of assistance to management.
  
- Section 104 discusses the ways in which management comments can be communicated to management, including orally or in writing. For situations in which management comments are communicated in writing, this section discusses including the comments in a management letter or in the auditor’s internal control communication of material weaknesses and significant deficiencies. The section also includes illustrative transmittal letters and internal control communications that include management comments.

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<sup>1</sup> *PPC’s Guide to Internal Control Communications* provides guidance on auditor’s communications of material weaknesses and significant deficiencies identified in an audit. The *Guide* may be ordered by calling your

Thomson Reuters representative at (800) 431-9025 or from the PPC website at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).

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101 Other Internal Control Deficiencies

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## 101 Other Internal Control Deficiencies

### The ASB's Clarity Project

101.1 In response to growing concerns about the complexity of auditing standards and to converge U.S. GAAS with International Standards on Auditing (ISAs), the Auditing Standards Board has been working on the Clarity Project to revise all existing standards and to design a format under which all new standards will be issued. In October 2011, the AICPA issued, among other standards, SAS No.122, *Statements on Auditing Standards: Clarification and Recodification*. This represents a completely new set of auditing standards revised in format, structure, style, and content from the existing standards. It supersedes all existing SASs through SAS No. 121, with a few exceptions.<sup>2</sup>

### 101.2 Form and Structure of the Clarified Standards

The clarified standards were developed using formatting techniques, such as bulleted lists, that make them easier to read and understand. In addition, each clarified standard is divided into the following topics:

- a. *Introduction*. Includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material.
  
- b. *Objectives*. Establishes objectives that allow the auditor to understand what he or she should achieve under the standards. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and to evaluate whether sufficient appropriate audit evidence has been obtained.
  
- c. *Definitions*. Provides key definitions that are relevant to the standard.

d. *Requirements*. States the requirements that the auditor is to follow to achieve the objectives unless the standard is not relevant or the requirement is conditional and the condition does not exist.

e. *Application and Other Explanatory Material*. Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are included in this section.

101.3 A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the ASB. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

#### 101.4 **New AU-C Section Organization**

Within the AICPA Professional Standards, the clarified standards use “AU-C” section numbers instead of “AU” section numbers. “AU-C” is being used temporarily to avoid confusion with references to existing “AU” sections, which are still effective through 2013. The “AU-C” identifier will revert to “AU” in 2014, when the clarified standards are fully effective for all engagements. The organization of the new AU-C sections (which aligns with the organization of the ISAs) is as follows:

- Preface.
  
- Glossary.
  
- AU-C Section 200-299: General Principles and Responsibilities.
  
- AU-C Section 300-499: Risk Assessment and Response to Assessed Risks.
  
- AU-C Section 500-599: Audit Evidence.

- AU-C Section 600-699: Using the Work of Others.
- AU-C Section 700-799: Audit Conclusions and Reporting.
- AU-C Section 800-899: Special Considerations.
- AU-C Section 900-999: Special Considerations in the United States
- Exhibits and Appendixes.

101.5 An exhibit to SAS No. 122 contains a complete two-part cross-reference of AU-C and AU section numbers. One part of the cross-reference shows which existing AU sections are encompassed by each new AU -C section. The other part of the cross-reference shows, for each existing AU section, where the corresponding guidance can be found in the new AU-C sections.

#### 101.6 **Use of the Terms *Must* and *Should***

The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows according to AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, and (AU-C 200.25):

- *Unconditional Requirements.* Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.
- *Presumptively Mandatory Requirements.* An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances discussed in AU-C 200.26. Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

101.7 The auditor must document the justification for any necessary departure from a presumptively mandatory requirement of GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement. Throughout this *Guide*, the authors use the terms *must* and *should* in accordance with AU-C 200.25. The authors also use the term *is required* interchangeably with *should*.

#### 101.8 **Effective Date**

With a few exceptions, the clarified standards are effective for audits of financial statements for periods ending on or after December 15, 2012. An auditor may implement aspects of SAS Nos. 122 early as long as the auditor continues to comply with existing standards.

### **AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit***

#### **101.9 Objectives and Requirements**

Issued as part of SAS No. 122, AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, provides requirements for auditors regarding certain internal control communications they are required to make in connection with their financial statement audits. When effective (that is, for audits of financial statements for periods ending on or after December 15, 2012), it will supersede the requirements of extant SAS No. 115. The objective of the auditor when communicating internal control related matters is to appropriately communicate to management and those charged with governance identified deficiencies in internal control that are, in the auditor's professional judgment, of sufficient importance to merit their respective attentions. Exhibit 1-2 summarizes the requirements that should be followed to achieve that objective.

#### **Exhibit 1-1**

#### **Requirements for Communicating Internal Control Related Matters Identified in an Audit**

<b>Requirements</b>	<b>Clarified AU-C Reference</b>
<b>Determination of Whether Deficiencies in Internal Control Have Been Identified</b>	
The auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.	AU-C 265.08
<b>Evaluating Identified Deficiencies in Internal Control</b>	
If the auditor has identified one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses.	AU-C 265.09
If the auditor determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.	AU-C 265.10
<b>Communication of Deficiencies in Internal Control</b>	
The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit.	AU-C 265.11
The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis: <ul style="list-style-type: none"> <li>• In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.</li> <li>• In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's</li> </ul>	AU-C 265.12

Requirements	Clarified AU-C Reference
professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.	
The communications should be made no later than 60 days following the report release date.	AU-C 265.13
<p>The auditor should include in the written communication of significant deficiencies and material weaknesses:</p> <ul style="list-style-type: none"> <li>• The definition of the term <i>material weakness</i> and, when relevant, the definition of the term <i>significant deficiency</i>.</li> <li>• A description of the significant deficiencies and material weaknesses and an explanation of their potential effects.</li> <li>• Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor should include in the communication the following elements that explain that: <ul style="list-style-type: none"> <li>•• The purpose of the audit was for the auditor to express an opinion on the financial statements.</li> <li>•• The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control.</li> <li>•• The auditor is not expressing an opinion on the effectiveness of internal control.</li> <li>•• The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.</li> </ul> </li> <li>• In accordance with AU-C 905, <i>Alert That Restricts the Use of an Auditor's Report</i>, a restriction regarding the use of the communication to management, those charged with governance, others within the organization, and any governmental authority to which the auditor is required to report.</li> </ul>	AU-C 265.14
When the auditor issues a written communication stating that no material weaknesses were identified during the audit, the communication should include the matters in AU-C 265.14a and c-d.	AU-C 265.15
The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.	AU-C 265.16
For audits of group financial statements, the group engagement team should communicate to group management and those charged with governance material weaknesses in internal control that are relevant to the group (either identified by the group engagement team or brought to its attention by a component auditor during the audit)	AU-C 600.45

#### 101.10 Implementation in this Guide

While the changes to AU-C 265 are extensive, the authors believe that it will not create many substantive changes in practice. However, AU-C 265 makes explicit some requirements that were implicit in SAS No. 115.

As previously discussed, it also adds requirements to (1) communicate to management deficiencies other than significant deficiencies and material weaknesses that are important enough to warrant management's attention and (2) explain the potential effects of significant deficiencies and material weaknesses in the auditor's internal control communication. Because these new requirements go beyond those required by extant SAS No. 115, auditors may implement these aspects of AU-C 265 before its effective date. Therefore, the discussions throughout this *Guide*, references to authoritative literature, and practice aids have been updated for the requirements of AU-C 265. As a result, auditors may use this edition of the *Guide* both before and after the effective date of the clarified standards. The remainder of this section provides an overview of the requirements of AU-C 265 since they may affect which matters are communicated to management and how they are communicated; *PPC's Guide to Internal Control Communications* provides a more in-depth discussion of AU-C 265. The *Guide* may be ordered from Thomson Reuters by calling (800) 431-9025 or online at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).

#### 101.11 Overview

AU-C 265 establishes requirements for auditors to communicate certain control deficiencies they have identified during the audit. Although AU-C 265 does not require an auditor to perform procedures to identify deficiencies in internal control, it notes that auditors may become aware of control deficiencies while performing a host of required procedures during the audit.

101.12 For those control deficiencies the auditor identifies, AU-C 265 requires the auditor to evaluate them to determine whether, individually or in combination, they are *significant deficiencies* or *material weaknesses*. The standard further requires auditors to evaluate control deficiencies both *individually* and in combination with other deficiencies affecting the same account balance or disclosure, financial statement assertion, and component of internal control. This is because multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

#### 101.13 Understanding Control Deficiencies

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A control deficiency may be either a deficiency in design or a deficiency in operation.

#### 101.14 Deficiencies in Design.

AU-C 265.07 states that a *deficiency in design* exists when (a) a control necessary to meet a control objective is missing or (b) an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met. The authors believe a design deficiency includes inadequate documentation of the design of controls and the lack of an internal process to report discovered deficiencies to management on a timely basis.

#### 101.15 Deficiencies in Operation.

According to AU-C 265.07, 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 it effectively. The auditor is required to obtain an understanding of internal control but is not required to always test controls or to test controls for every class of transactions, account balance, disclosure, or assertion. However, many of the procedures commonly performed during risk assessment to gain an understanding of internal control (such as inquiry, observation and inspection, and walkthroughs) may provide not only an understanding of the control (that is, an understanding of whether the control is properly designed and implemented) but also may provide evidence about the control's operating effectiveness.

101.16 An auditor may become aware of control deficiencies while performing a variety of audit procedures as discussed beginning at paragraph 101.23. For example, a test of controls may detect deviations from prescribed procedures. Deviations might be caused by factors such as changes in personnel, human error, or significant fluctuations in the volume of transactions. The auditor does not draw an immediate conclusion about the operating effectiveness of a control (and, thus, the existence of an identified deficiency) when a deviation is detected. Instead, the auditor determines whether the entity has another strong control, or a combination of effectively operating controls, that achieve the same control objective as the weak or ineffectively operating control that gave rise to the deviation. In that case, the auditor might conclude that there is no identified deficiency.

#### 101.17 **Discussions with Management**

Before concluding on the existence of an identified deficiency, the auditor discusses the relevant facts and circumstances related to the potential deficiency with the appropriate level of management. In most cases, that includes management personnel who are familiar with the internal control area affected and who have the authority to take remedial actions. In certain circumstances, however, it might not be appropriate for the auditor to discuss the findings directly with management. For example, certain findings might cause the auditor to believe that (a) there is evidence of fraud or intentional noncompliance with laws and regulations by management or (b) management is unable to oversee the preparation of adequate financial statements, which may raise doubts about management's competence. In those circumstances, it generally would not be appropriate for the auditor to communicate such deficiencies directly to management.<sup>3</sup>

101.18 When discussing the facts and circumstances surrounding the auditor's findings with management, the auditor may obtain information that is relevant to his determination, including:

- The actual or suspected cause of the deficiency.
  
- Exceptions or deviations arising from the deficiency (for example, a misstatement that was not prevented by the relevant IT controls).
  
- A preliminary indication of management's response to the auditor's findings.

101.19 This information also may prove helpful to the auditor when evaluating the severity of identified deficiencies and communicating relevant information about identified control deficiencies to management and

those charged with governance. Finally, such a discussion provides the auditor with an opportunity to alert management, on a timely basis, to the existence of previously unknown deficiencies. (The “Control Deficiency Comment and Management Point Development Worksheet” at Appendix 1A may be used to document relevant information relating to identified control deficiencies.)

#### 101.20 Considerations for Smaller, Less Complex Entities

When determining whether an identified deficiency exists in a smaller entity, an auditor considers the unique characteristics of such entities. In smaller entities, the formality with which controls operate will vary. In addition, controls performed by managements of smaller entities may negate the need for certain types of control activities. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for the small entity to perform more detailed control activities.

101.21 In addition, a smaller entity often has fewer employees, which may limit the extent to which segregation of duties is practicable. However, in that same entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. On the other hand, such increased management oversight also may increase the risk of management override of controls. Those considerations may affect the auditor's conclusions about whether an identified deficiency exists in a smaller less complex entity.

#### 101.22 Examples of Control Deficiencies

As discussed in paragraph 101.13, a control deficiency may be either a deficiency in design or a deficiency in operation. Exhibit 1-2 lists examples, which come from AU-C 265.A37, of both types of control deficiencies.

### Exhibit 1-2

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

##### *Deficiencies in the Design of Controls*

- Inadequate design of internal controls over the preparation of financial statements.
  
- Inadequate design of a control over a significant account or process.
  
- Inadequate documentation of the internal control components.
  
- Insufficient control consciousness within the organization, e.g., the tone at the top and the control environment.

- Absent or inadequate segregation of duties within a significant account or process.
  
- Absent or inadequate controls over the safeguarding of assets (if those controls would be necessary for effective internal control over financial reporting).
  
- Inadequate design of IT general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
  
- Employees or management lack the qualifications and training to fulfill their assigned functions (for example, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording transactions or preparing the financial statements).
  
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of internal control over time.
  
- The absence of an internal process to report internal control deficiencies to management on a timely basis.
  
- An indication that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance or other evidence that certain aspects of the control environment are ineffective.
  
- Failure of management to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified or other evidence that the entity's risk assessment process is ineffective.
  
- Absence of controls over a significant identified risk or other evidence of an ineffective response to significant risks that have been identified.

- Absence of a risk assessment process when such a process would ordinarily be expected to have been established.

#### *Failures in the Operation of Controls*

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control requiring dual authorization for significant disbursements).

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations).

- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. [This circumstance may need careful consideration when it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs timely periodic physical inventory counts (detective control). Although a physical inventory count does not safeguard inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, because the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (in this case, the physical inventory) prevents a misstatement of the financial statements. A material weakness relating to controls over the safeguarding of assets would exist only if the entity does not have effective controls (considering both safeguarding and other controls) to prevent, or detect and correct, a material misstatement of the financial statements.]

- Failure to reconcile significant accounts (for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner).

- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, expenses are consistently understated at the direction of management.

- Misrepresentation by the client to the auditor (an indicator of fraud).

- Management override of controls.

- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
  
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

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### 101.23 Identifying Deficiencies during the Course of the Audit

AU-C 265.08 states that the auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. AU-C 265 does not require auditors to perform specific procedures to search for control deficiencies; rather, it requires auditors to communicate to management and others any control deficiencies they become aware of based on the audit procedures performed. Some practitioners refer to that as a *trip across* requirement (i.e., if the auditor trips across a deficiency while performing audit procedures, he or she should evaluate the deficiency to see if it should be communicated). An auditor may become aware of control deficiencies while performing a variety of audit procedures, including the following:

- Obtaining an understanding of the entity's internal control (including evaluating the design and implementation of controls).
  
- Performing risk assessment procedures.
  
- Performing tests of the operating effectiveness of controls (that is, tests of controls).

101.24 Internal control deficiencies might also be found when performing further audit procedures such as evaluating the results from any tests of controls performed in the audit of the financial statements or reviewing any internal reports on controls. It is important to understand that an auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed during the audit.

101.25 Regardless of how the auditors identify control deficiencies throughout the audit, AU-C 265 requires them to evaluate the severity of the deficiencies, both individually and in combination with other deficiencies affecting the same account balance or disclosure, financial statement assertion, or component of internal

control, to determine whether they are *material weaknesses* or *significant deficiencies*. In that case, AU-C 265.12 requires that those matters be communicated in writing to management and those charged with governance. Identified deficiencies that are not deemed to be either material weaknesses or significant deficiencies may be *other internal control deficiencies*. When those matters have not been communicated to management by other parties and are, in the auditor's professional judgment, of sufficient importance to merit management's attention, AU-C 265.12b requires the auditor to also communicate them to management.

#### 101.26 PPC's Process for Evaluating The Severity of Identified Deficiencies

In summary, when evaluating the severity of an identified control deficiency under AU-C 265, the authors believe most auditors will begin by considering whether an identified deficiency is considered a material weakness. If not, they will consider its severity to determine whether to communicate it to management and others as a significant deficiency. Specifically, the authors believe the process will be as follows:

- For an identified deficiency, determine whether it is a material weakness by considering whether (a) the magnitude of the potential misstatement could result in a material misstatement to the financial statements and (b) it is at least reasonably possible that the misstatement would not be prevented, or detected and corrected, on a timely basis by the entity's internal controls. Determining whether a material weakness exists is discussed beginning at paragraph 101.35.
- For an identified deficiency not considered a material weakness, consider whether the deficiency is important enough to merit attention by management and those charged with governance as a significant deficiency.<sup>4</sup> Determining whether a significant deficiency exists is discussed beginning at paragraph 101.43.
- Combine individual deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control and evaluate whether they are considered either a significant deficiency or a material weakness. (Combining individual deficiencies is discussed beginning at paragraph 101.44.)

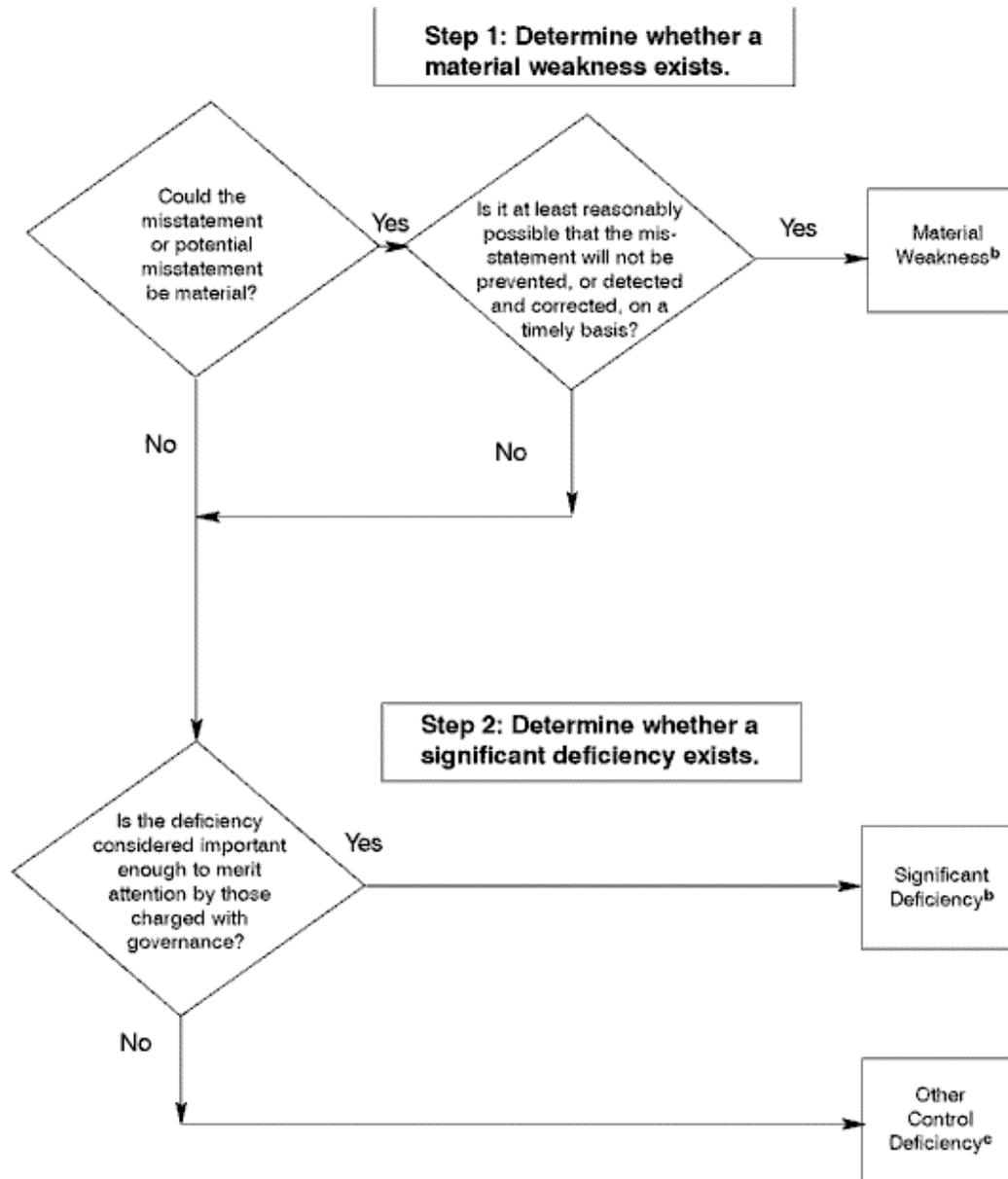
101.27 Finally, for other deficiencies in internal control not communicated as either material weaknesses or significant deficiencies, the auditor needs to consider whether to communicate them to management in accordance with the requirement in AU-C 265.12(b). (Communicating other deficiencies in internal control is discussed in section 104.)

#### 101.28 Process Flowchart

The flowchart in Exhibit 1-3 describes PPC's process for evaluating the severity of individual control deficiencies identified during the audit.

#### Exhibit 1-3

#### Process for Evaluating the Severity of Identified Control Deficiencies<sup>a</sup>



**Notes:**

<sup>a</sup> This flowchart describes PPC's process for evaluating the severity of each individual control deficiency identified during the financial statement audit. However, AU-C 265 also requires the auditor to evaluate whether deficiencies are considered to be material weaknesses or significant deficiencies when combined with other deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control. This is because multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

<sup>b</sup> AU-C 265 requires auditors to communicate significant deficiencies and material weaknesses they become

aware of during the audit in writing to management and those charged with governance.

◦ AU-C 265.12 states that the auditor also should communicate to management in writing or orally, *other deficiencies in internal control* identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit *management's* attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

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### 101.29 Defining Material Weaknesses

AU-C 265.07 defines a material weakness as “a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.”

### 101.30 Indicators of Material Weaknesses.

AU-C 265.A11 provides the following list of conditions that are indicators of material weakness:

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

101.31 While AU-C 265 identifies the factors described in the preceding paragraph only as *indicators of material weaknesses*, the authors believe auditors generally would consider such deficiencies material weaknesses. For that reason, many auditors begin the evaluation process by determining whether any of the deficiencies identified during the audit are indicators of a material weakness.

### 101.32 Defining Significant Deficiencies

AU-C 265.07 defines a significant deficiency as a “deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.” Note that this definition does not provide objective criteria for evaluating the probability and

magnitude of deficiencies that should be considered significant deficiencies. The authors believe this is consistent with the Auditing Standard Board's intent to encourage auditors to use professional judgment when determining what constitutes a significant deficiency, thus allowing auditors more flexibility when considering which matters to communicate to management and those charged with governance.

101.33 While AU-C 265 provides a list of deficiencies that are indicators of material weaknesses (see paragraph 101.30), it does not provide a list of deficiencies that should be considered significant deficiencies. However, the *AICPA Risk Alert: Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (the AICPA Risk Alert), includes in paragraph 42 the following examples of deficiencies that might indicate the existence of significant deficiencies in internal control:

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

101.34 While the AICPA Audit Risk Alert applies specifically to the requirements of SAS No. 115, which will be superseded by AU-C 265 for audits of periods ending on or after December 15, 2012, the authors believe this listing will continue to be helpful to auditors when considering the severity of identified deficiencies. However, the authors caution auditors against automatically classifying deficiencies from the listing as significant deficiencies. In other words, they recommend that auditors evaluate the severity of such deficiencies in accordance with PPC's process.

#### 101.35 **Determining Whether There Is a Material Weakness**

As outlined in PPC's process described in paragraph 101.26, the authors believe most auditors will begin by considering whether an identified deficiency should be considered a material weakness. The authors believe most auditors will begin that evaluation process by determining whether any of the deficiencies identified during the audit are indicators of a material weakness as discussed beginning at paragraph 101.30. If not, auditors will consider whether the identified deficiency is a material weakness by considering:

- a. the *magnitude* of the potential misstatement resulting from the deficiency or deficiencies (see the discussion beginning at paragraph 101.37); and

b. 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. A reasonable possibility exists when the chance of the future event or events occurring is more than remote (see the discussion beginning at paragraph 101.42).

101.36 The table in Exhibit 1-4 summarizes the thresholds for determining whether a control deficiency is a significant deficiency or a material weakness:

**Exhibit 1-4**

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

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

101.37 Factors Affecting the Magnitude of a Potential Misstatement.

While AU-C 265 discusses evaluating the magnitude of a potential misstatement, it is really dealing with whether an identified deficiency could result in a misstatement that is material to the financial statements. Determining what is material to the financial statements is one of the most difficult parts of applying AU-C 265.

101.38 If a factual misstatement has occurred, it obviously is easier for the auditor to evaluate the severity of an identified control deficiency since the amount of the misstatement is known. In that instance, however, it is still necessary to evaluate whether the control deficiency could result in additional misstatements. In many cases, though, the auditor will be evaluating only a potential misstatement. According to AU-C 265.A6, factors that affect the magnitude of a misstatement that might result from a deficiency, or deficiencies, in internal control, include, but are not limited to, the following:

- The financial statement amounts or transaction totals exposed to the deficiency.

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

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

101.40 Other than the indicators of material misstatements discussed in paragraph 101.30, AU-C 265 does not provide any additional insight for determining the magnitude of a potential misstatement. However, Statement of Financial Accounting Concepts (SFAC) No. 8, *Conceptual Framework for Financial Reporting—Chapter 1, “The Objective of General Purpose Financial Reporting,” and Chapter 3, “Qualitative Characteristics of Useful Financial Information,”* recognizes that *qualitative*, as well as *quantitative* factors, can influence an auditor's materiality judgments. *PPC's Guide to Internal Control Communications* provides guidance on the qualitative factors auditors might consider when making such judgments.

101.41 Finally, the authors encourage auditors to remember that the magnitude of a potential misstatement discussed in AU-C 265 affects only whether a deficiency is communicated to management and those charged with governance. Unlike judgments about materiality, which can affect whether a client's financial statements are fairly presented (and, thus, the auditor's opinion on those statements), the auditor's judgment about the magnitude of a potential misstatement affects only whether the auditor is required to communicate the identified deficiency to the client. Therefore, when in doubt about the severity of a control deficiency, the authors recommend the auditor communicate it to the client.

#### 101.42 Factors Affecting Whether There is a Reasonable Possibility of a Misstatement<sup>5</sup>.

AU-C 265A-5 states that a *reasonable possibility* exists when the chance of the future event or events occurring is more than remote. AU-C 265.A8 lists a number of risk factors that may affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in internal control will result in a misstatement of an account balance or disclosure. Those factors include, but are not limited to, the following:

- The nature of the accounts, classes of transactions, disclosures, and assertions involved (for example, suspense accounts or transactions with related parties may present more risk).
- Susceptibility of the related assets or liabilities to loss or fraud.
- The complexity, subjectivity, or extent of judgment needed to determine the amount involved.

- The relationship and interaction of the control with other controls.
  
- Interaction of the control deficiency with other control deficiencies.
  
- Possible future consequences resulting from the deficiency.
  
- The importance of the controls to the financial reporting process—for example, whether the deficiency involves general monitoring controls (such as oversight of management) or controls over:
  - The prevention and detection of fraud
  
  - The selection and application of significant accounting policies
  
  - Significant transactions with related parties
  
  - Significant transactions outside the entity's normal course of business
  
  - The period-end financial reporting process (such as controls over nonrecurring journal entries)

#### 101.43 **Determining Whether There Is a Significant Deficiency**

For those identified control deficiencies that are not considered material weaknesses, the auditor should exercise professional judgment and determine whether they should be communicated to management and those charged with governance as significant deficiencies. As previously discussed, AU-C 265.07 defines significant deficiencies as “a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.” By excluding more objective criteria (that is, criteria dealing with the probability of occurrence and magnitude of misstatement) from the standard's definition of a significant deficiency, the Auditing Standards Board encourages auditors to use professional judgment when determining whether to classify an identified deficiency as significant and, accordingly, communicate it to management and those charged with governance.

#### 101.44 Combining Control Deficiencies

As previously discussed, in addition to evaluating the severity of individual control deficiencies identified during the audit, AU-C 265.09 states that the auditor should evaluate whether deficiencies are considered to be material weaknesses or significant deficiencies when combined with other deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control. *PPC's Guide to Internal Control Communications* provides a more in-depth discussion of the combining identified deficiencies as part of the evaluation process. It also provides guidance on making the required communication of material weaknesses and significant deficiencies in accordance with AU-C 265. The *Guide* may be ordered from Thomson Reuters by calling (800) 431-9025 or online at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com). Section 103 of this *Guide* discusses developing comments related to identified deficiencies. The "Control Deficiency Comment and Management Comment Development Worksheet" at Appendix 1A can be used to document the pertinent facts and details of identified deficiencies as they are encountered during the audit.

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<sup>2</sup> *PPC's Guide to Audits of Nonpublic Companies* provides more information on the SASs that were not superseded by the issuance of SAS No. 122. The *Guide* may be ordered by calling your Thomson Reuters representative at (800) 431-9025 or from the PPC website at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).

<sup>3</sup> AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AU-C 250.21-.27), establishes requirements and provides guidance on the reporting of identified or suspected noncompliance with laws and regulations, including when those charged with governance are themselves involved in such noncompliance. AU-C 240, *Consideration of Fraud in a Financial Statement Audit* (AU-C 240.40), establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.

<sup>4</sup> When making this evaluation, consider whether a prudent official with knowledge of the same facts and circumstances would likely reach the same conclusion. *PPC's Guide to Internal Control Communications* provides guidance on considering the views of a prudent official. The *Guide* may be ordered by calling Thomson Reuters at (800) 431-9025 or online at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).

<sup>5</sup> AU-C 265.A9 also clarifies that the auditor can evaluate probability without *quantifying* its occurrence as a specific percentage or range.

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102 Other Matters

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## 102 Other Matters

102.1 In addition to other internal control deficiencies that auditors are required to communicate, the auditors may also wish to communicate other matters to management in connection with their financial statement audit.

Those matters might include the following:

- Weaknesses and inefficiencies in controls not related to financial data.
- Operational inefficiencies, such as inefficient inventory management controls, and suggestions for improvement.
- Opportunities to increase profits by using assets more effectively, such as by investment of idle cash.
- Suggestions for increasing personnel motivation or performance.
- Comments about data processing hardware or software.
- Potential tax planning ideas or savings strategies.
- New accounting pronouncements that will have an effect on the company and when they must be adopted.

- Observations and suggestions about operational or administrative efficiencies, business strategies, and other items of perceived benefit to the client.

102.2 As discussed in section 100, this *Guide* is organized to help auditors identify possible management letter comments, including comments about such other matters. The “Control Deficiency Comment and Management Comment Development Worksheet” at Appendix 1A can be used to document the pertinent facts and details of such other matters as they are encountered during the audit.

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Checkpoint Contents

Accounting, Audit & Corporate Finance Library

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Management Letter Comments: Operations and Controls

Chapter 1 Communication of Management Comments

103 Content of the Management Comments

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## 103 Content of the Management Comments

103.1 As previously discussed, AU-C 265 requires auditors to communicate certain identified deficiencies to management and those charged with governance. However, it provides little guidance on what the auditor should communicate in connection with these matters. In this section, the authors provide their views on matters an auditor should consider when developing management letter comments including matters about other internal control deficiencies and other matters that the auditors have decided to communicate to management.

### Considering the Level of Detail to Communicate

103.2 The auditor should use professional judgment when determining the level of detail at which to communicate the management comments. When making that determination, AU-C 265.A18 states that the auditor may consider the following factors:

- a. *The Nature of the Entity.* For example, the level of detail in a communication for a governmental entity may differ from that required for a communication to a nongovernmental entity.
  
- b. *The Size and Complexity of the Entity.* For example, the level of detail in a communication required for a complex entity may differ from that required for an entity that operates a simple business.
  
- c. The nature of the matters the auditor has identified.
  
- d. Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.

e. *The Entity's Governance Composition.* For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.

In any event, management comments should be responsive to the individual client situation and the auditor's actual observations, where appropriate, and the illustrative comments provided in this *Guide* should be tailored as necessary for specific circumstances. The following paragraphs give further guidance on developing management comments.

### **Considering the Type of Information to Include**

103.3 Management comments can be communicated by any combination of descriptive commentary, tabular arrangements, graphs, charts, lists, flowcharts, slides, photographs, computer screen shots, colorful graphics, and illustrations. Whatever the format, the authors believe a well-developed management comment should have the following characteristics. (It may be impractical or redundant to include every one of these elements in each management comment, and not every management comment presented in Chapters 2-18 necessarily includes every element; however, the quality of the comment may be improved if each element is considered when drafting the comment and included when appropriate in the specific circumstances.)

- There should be a specific *description of the condition noted*, beginning perhaps with a description of the client's procedure or circumstance, followed by a description of its weakness or inefficiency, or of the opportunity for improvement. The comments might be accompanied by copies of relevant client forms or documents that illustrate the condition being commented on.
- The comment should include an *explanation of why the condition needs improvement*. A reference might be made to the control or operational objective that is involved, if appropriate. Applicable amounts or statistics might be mentioned, such as the number of months' sales in inventory and the estimated cost to carry the excessive inventory.
- There should be a brief *description of the cause of the problem* (for instance, whether the condition was caused by a lack of a procedure or by the failure of employees to follow the procedure). If practicable, the description include the auditors' explanation of the cause. However, sometimes the actual cause cannot easily be determined, and the auditors might include management's explanation or indicate that further study is necessary.
- The comment should include a brief *description of the potential effects of the problem*. The auditor may wish to include an estimate of the potential magnitude of the misstatement that might be caused by the condition, including relevant dollar amounts or percentages. Explaining the potential effects is discussed further beginning at paragraph 103.4.

- There should be a specific *description of the recommended action*. A recommendation is more useful to the client if it indicates how the recommended action might be carried out and who might perform it. Sample forms might be designed for a recommended procedure. Detailed recommendations will seem more feasible to the client, who thus will be more likely to adopt them. If the most appropriate course of action is not clear, alternative approaches might be suggested. Of course, the auditors might not be able to give much detail about some conditions that require additional study to determine what action should be taken. In such cases, the auditors should indicate the need for further study.
- The *costs and benefits* related to the comment should be discussed in as much detail as possible. A discussion of costs and benefits will demonstrate the recommendation's feasibility and allow the client to decide whether it is worth adopting. When possible, the costs and benefits should not be described in vague terms, such as "better control," or "improved accounting procedures." Instead, for example, an estimate of the time it would take to perform a procedure or the average cost of a recommended piece of computer hardware or software might be given. If possible, an estimate of related potential savings might be made, such as the estimated value of time saved by using alternative software. Provision of estimates can help the client decide priorities in adopting recommendations. Care should be taken, however, that estimates are as realistic as possible and neither overly pessimistic or optimistic. Intangible benefits that cannot be quantified should be mentioned, such as improved employee morale or more timely and accurate records resulting from computerization.

#### 103.4 Explaining the Potential Effects

As discussed at paragraph 100.3, AU-C 265.14 states the auditor should include in the written communication a description of the significant deficiencies and material weaknesses *and an explanation of their potential effects*. AU-C 265.A29 of the standard elaborates:

In explaining the potential effects of the significant deficiencies and material weaknesses, the auditor need not quantify those effects. The potential effects may be described in terms of the control objectives and types of errors the control was designed to prevent, or detect and correct, or in terms of the risk(s) of misstatement that the control was designed to address. The potential effects may be evident from the description of the significant deficiencies or material weaknesses.

103.5 It is important to understand, however, that this requirement applies only to descriptions of material weaknesses and/or significant deficiencies included in the auditors' internal control communication required by AU-C 265. The standard does *not* require the disclosure of that information as it relates to other, less severe deficiencies the auditors may communicate to management under AU-C 265.12(b). Nevertheless, some firms may consider the requirements in AU-C 265 "best practices" when developing comments about *all* internal control deficiencies identified during the audit (that is, not just comments relating to material weaknesses and

significant deficiencies identified during the audit.) If so, they may adopt firm policies requiring auditors to follow such requirements when developing all management letter comments.

103.6 In some cases, a management comment consists of ideas for improving the client's business operations and is not based on a deficiency identified during the audit. In that case, such an explanatory would obviously not apply. But when appropriate, the authors believe a well-worded management comment should include an explanation of the potential effects of the condition. For auditors who wish to comply with that requirement, the "Control Deficiency Comment and Management Point Development Worksheet" at Appendix 1A contains a space to indicate the potential effects; thus, that practice aid may be helpful when accumulating the information for inclusion in the management letter. In addition, the authors believe many of the comments included in this *Guide* already include an explanation of the potential effects of the condition. For example, consider the following control deficiency related to the parts inventory of a small manufacturer:

**Control Parts Substitutions.** In the manufacturing of a finished unit, production personnel may be substituting parts and components that are of a higher quality than is specified in the bill of materials. *This deviation from the bill of materials could result in inventory shrinkage and an unanticipated reduction in margins.* A system of controls should be established to ensure that finished units are manufactured in accordance with the bill of materials and that any approved substitutions are accounted for in the cost system.

103.7 In this comment, the auditors describe the potential effect of the identified deficiency in the second sentence (italicized above). The authors believe that description adequately provides management with information that would enable them to take appropriate remedial action on the identified control deficiency.

103.8 Other management comments may address opportunities for improvement without necessarily implying a deficiency. In fact, clients are likely to be more receptive to positive and constructive comments than negative ones. It is important that management comments not merely describe weaknesses or inefficiencies but also offer realistic ways to solve problems and indicate the potential benefit that can result.

### **Wording of Management Comments**

103.9 Since management comments are not considered material weaknesses or significant deficiencies, any descriptions of deficiencies should be carefully worded so as not to imply that they rise to the level of material weaknesses or significant deficiencies required to be communicated under AU-C 265, or to inadvertently undermine the audit opinion on the financial statements.<sup>6</sup> This point is particularly relevant when the management letter includes comments that are not resolved in future years. If audit quality is later questioned, the firm may be held liable for not communicating material weaknesses or significant deficiencies to management and those charged with governance.

103.10 Comments should be tactfully worded and not contain patronizing or accusatory language. Functions (such as "the accounts payable process"), rather than individuals (such as "the accounts payable clerk" or "Ed Jones"), should be identified, when possible, particularly when describing deficiencies.

103.11 Comments might compliment the client for strengths noted, improvements made, prior-year recommendations adopted, etc. Hyperbole and superlatives that appear to promise more than can be delivered should be avoided. For instance, words such as "best," "optimum," "assure," etc., connote an undue degree of

certainty and are better replaced by words such as “better,” “improved,” “likely,” “usually,” “apparently,” “frequently,” etc., as long as such words are not overused.

103.12 Comments should use terminology relevant to the client's specific industry, operations, and conditions. Technical jargon, “buzz” words, and accounting terminology that might be unfamiliar to the client should be avoided or explained if used. Also, it might be necessary to include an explanation of complex details or terminology that might not be understood by persons who might be expected to read the management letter (such as senior management personnel or members of the Board of Directors).

### 103.13 **Offers of Assistance**

The auditor might wish to include an offer to assist the client in implementing the recommendation proposed for correcting or improving the condition. Such an offer could result in a nonattest engagement. A number of the illustrative comments in this *Guide* include an offer of assistance. However, before including such an offer in a management comment, the auditor should consider whether performing the service would impair independence of the audit client. The AICPA's Ethics Interpretation 101-3, “Nonattest Services,” identifies nonattest services that would impair independence, including the following:

- Appraisal, valuation, or actuarial services, if the results of the service, individually or in the aggregate would be material to the financial statements and the service involves a “significant degree of subjectivity.”
  
- Certain forensic accounting services in matters involving the client, such as expert witness services, or other services in which the auditor serves as a trier-of-fact, special master, court-appointed expert, or arbitrator.
  
- Internal audit assistance (“outsourcing”) services if the auditor in effect manages the client's internal audit activities. (See discussion beginning at paragraph 103.14.)

Interpretation 101-3 also sets certain general requirements for remaining independent if performing nonattest services that the Interpretation identifies as not impairing independence. Interpretation 101-3 is discussed in more detail in *PPC's Guide to GAAS* and *PPC's Guide to Audits of Nonpublic Companies*. *PPC's Guide to PCAOB Audits* discusses SEC and PCAOB independence requirements specific to auditors of public companies.

### 103.14 Proposed Changes to AICPA Ethics Rules.

In May 2012, PEEC approved a number of revisions to Interpretation 101-3, including changing the title of the interpretation to “Nonattest Services,” clarifying the period in which independence is considered impaired, explaining that certain communications (as discussed in the interpretation) between the auditor and the client are a normal part of the attest engagement, revising the table of examples of nonattest services, and clarifying certain language in the interpretation. As of the date this *Guide* was sent for publishing, those revisions had not

yet been issued in the *Journal of Accountancy* but are expected to be issued by the end of July. Because the revisions are effective on August 31, 2012, the changes have been incorporated into this edition of the *Guide*.

103.15 In addition to those revisions, PEEC issued in June 2012 an exposure draft titled *Proposed Revised and New Interpretations and Proposed Deletion of Ethics Rulings* (June 2012 exposure draft). Among other things, the exposure draft includes a provision that would highlight that providing multiple nonattest services to a client could increase the significance of the threats to independence, even though, individually, the nonattest services would not impair independence. The proposal would require members to consider whether the performance of multiple (otherwise permitted) nonattest services in the aggregate would create a significant threat to independence and, if so, to determine what, if any, safeguards could be applied to eliminate or reduce the threat to an acceptable level. When no safeguards are available to eliminate or reduce the threats to an acceptable level, independence would be considered impaired.

103.16 The June 2012 exposure draft also clarifies guidance in an earlier proposal requiring members to evaluate the significance of the management participation threat created by performing separate evaluations on the effectiveness of a client's internal control system. Depending upon the nature and frequency of the separate evaluations, the member could perform services that are equivalent to ongoing monitoring procedures and, thus, a responsibility of management. The exposure draft also clarifies that separate evaluations performed to determine the effectiveness of client controls are an example of an internal audit service and should be treated the same as other internal audit services.

103.17 Finally, the June 2012 exposure draft discusses the effect of performing certain internal audit services that involve assisting the client in the performance of its internal audit activities (sometimes referred to as internal audit outsourcing) on an auditor's independence. When evaluating whether independence would be impaired with respect to an attest client when providing internal audit services, the auditor should consider the nature of the services. For example, the exposure draft states that a member may assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making without impairing independence. However, assisting the client in performing financial and operational internal audit activities would impair independence, unless the auditor takes appropriate steps to ensure that the client understands and accepts its responsibility for designing, implementing, and maintaining internal control and for directing the internal audit function, including the management thereof. Accordingly, any outsourcing of the internal audit function to the member whereby the auditor manages the internal audit activities of the client would impair independence. That is because designing, implementing, or maintaining the client's monitoring activities are management responsibilities. Because these new proposals could affect an auditor's independence, auditors should be alert for further developments in this area. Future editions of this *Guide* will update the status of this project.

#### **Example of a Well-developed and Well-worded Management Comment**

103.18 An example of a well-developed and well-worded management comment follows (Chapters 2-18 present numerous other examples of management comments):

The Company does not take advantage of cash discounts offered by suppliers for prompt payment of accounts payable.<sup>a</sup> Payment of trade liabilities during discount periods could

generate substantial savings.<sup>b</sup> One reason discounts are not fully taken advantage of is that unpaid vendor invoices are filed for payment by due date without regard to whether the vendor offers a discount for early payment.<sup>c</sup> Therefore, by the time an invoice is pulled for payment, it is too late to take advantage of any discounts offered. The effect of that situation may be substantial. For example, our review of cash disbursements for the months of July and August indicated that discounts totaling \$XX,XXX were lost during that period.<sup>d</sup> We believe that situation may be easily remedied if vendor invoices are filed by discount date rather than by due date.<sup>e</sup> If funds are short at the discount payment date, payment can still be deferred to the later date. Such a change should not involve any additional clerical time or effort, yet it could result in substantial savings. We estimate that the discounts that could have been earned in July and August would have exceeded the cost of giving up other use of the funds by approximately \$XX,XXX.<sup>f</sup>

**Notes:**

- <sup>a</sup> specific description of the condition,
- <sup>b</sup> a reason for improving the condition,
- <sup>c</sup> a description of the cause of the problem,
- <sup>d</sup> a description of the potential effect of the problem,
- <sup>e</sup> a specific recommendation for action to be taken, and
- <sup>f</sup> a discussion of the benefits that could result from implementing the recommendation.

**Inclusion of the Client's Comments in the Management Letter**

103.19 Some auditors include the client's comments about each management comment in their letters. That practice provides documentation of the auditors' discussion of the recommendation with management and allows the client to express its reservations or describe any corrective action that may be in process. However, there are disadvantages to including management's comments. For example, any recommendations that are determined to be inappropriate as a result of discussion with the client normally will be excluded from the letter. Including management's comments on the remaining comments (those that the auditors still believe are valid) may appear to cast doubt on their validity.

**Documentation of Management Comments**

103.20 There should be a symmetry between the management letter and the audit workpapers. Any comment included in the management letter should be supported by documentation of the audit procedure that disclosed the comment. Similarly, any management comment documented in the workpapers should be included in the management letter or the reason for excluding it should be documented in the workpapers. Appendix 1A presents a "Control Deficiency Comment and Management Comment Development Worksheet" that can be used during the audit to reference to the audit workpaper documenting the audit procedure that prompted the

comment, and to quickly jot down one or two sentences or key phrases related to each of the elements of a well-developed management comment described in paragraph 103.3. It also provides space for documenting the discussion with the client as well as the decision about whether to include the comment in the management letter.

103.21 The authors believe that better management comments can be developed if facts related to an observed condition are documented as they are encountered. By using the worksheet at Appendix 1A to document the facts and details relating to potential comments while fresh in their minds, auditors will have important information available when the management letter is drafted. The authors believe that using the worksheet to accumulate management comments will prompt the auditors to focus on the soundness of the management recommendation (for example, on its practicality, costs, and benefits) and yet minimize the temptation to spend excessive time during the audit drafting the comment in final form.

103.22 Also, some audit staff members might have sufficient experience, training, or expertise to recognize a problem but not enough to propose a solution to it. Using the worksheet allows the condition to be brought to the attention of an appropriate firm member who can suggest a recommendation.

103.23 The authors recommend that auditors consider having other appropriate firm personnel review comments for completeness, technical accuracy, and practicality. For example, tax specialists might review tax-related comments and computer consultants might review computer-related comments.

### **Organization of Management Comments**

103.24 Auditors should avoid the tendency to present comments in financial statement or audit area order in the management letter. Such an organization can result in less significant comments being interspersed among (and perhaps obscuring) more significant ones. Instead, comments should be presented in order of importance, perceived client interest or concern, functional area, etc. Less important comments should be presented together toward the end of the letter under a heading such as “Other Comments.”

103.25 Comments should have action-oriented headings rather than financial statement captions, for example, “Safeguard Physical Assets” rather than “Inventory.”

103.26 Unless only a few comments are presented, comments are typically presented in a separate memorandum accompanying, and referred to in, the transmittal letter and not in the body of the letter. It may also be appropriate to present a table of contents to the comments.

103.27 As discussed in paragraph 104.10, the authors believe that it is generally preferable for the letter to repeat prior-year recommendations that have not been adopted and remain appropriate. If this is done, there should be an indication that the same comments were made in prior years. For convenience, such comments may be presented separately from new comments under a heading such as “Prior-year Comments.” Prior-year comments typically are presented after new comments, although some auditors present them first if they are more significant or numerous than the new comments.

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<sup>6</sup> Auditors engaged to perform an audit of an entity's internal control over financial reporting (for example, in connection with an audit of the entity's financial statements in an integrated audit) cannot issue an unqualified opinion on internal control when there is a material weakness in internal control. Auditors engaged to perform integrated audits should refer to Chapter 10 of *PPC's Guide to Nontraditional Engagements*. The *Guide* may be ordered by calling (800) 431-9025 or by visiting [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).

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Chapter 1 Communication of Management Comments

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## 104 Communication of Management Comments

### Oral versus Written Communication

104.1 While AU-C 265 establishes requirements for auditors to communicate to management *other deficiencies in internal control*, it does not require auditors to make such communications in writing. Therefore, management comments may be communicated orally or in written form. Auditors might communicate management comments to clients on an informal (oral) basis during the audit as part of normal, ongoing contact with client personnel. For example, at lunch with the client, auditors might discuss a condition noted during the morning's audit work. Those discussions obviously are desirable; however, it is usually a good idea to summarize management comments for presentation to the client after the audit has been completed. For example, instead of issuing a written report, the auditor could hold a discussion with the client using only a list of discussion points or *PowerPoint* slides that summarize the matters to be discussed. A more formal process probably will result in more complete and thorough management comments. Also, the client is more likely to give the comments undivided attention than when they are communicated sporadically, and the client's memory can be refreshed about matters previously discussed informally. The authors believe that written management comments are preferable for the following reasons:

- Written comments are likely to be better thought out and better prepared and presented than oral comments.
- Management letters may make a stronger impression on the client because they are more formal than a casual discussion.
- Management can route applicable portions of the letter to other personnel involved in the areas addressed.

- A letter gives the auditors a record of what comments were made that can be referred to when ascertaining what action the client took and when preparing management letter comments in subsequent years.

104.2 If management comments are communicated orally, AU-C 265 requires auditors to document the communication in their workpapers. The authors recommend that the documentation include the date, content, and recipient of the communication. A list of discussion points or hard copies of *PowerPoint* slides used in an oral presentation could document the content. The “Control Deficiency Comment and Management Comment Development Worksheet” at Appendix 1A can be used to capture and document relevant information about management comments. If completed, it is a good way to document an oral communications. Also, although a written management letter is preferred, this does not mean that the auditors should not be creative when presenting the comments, particularly to an audit committee or similar group. For example, the auditors might prepare a presentation using *PowerPoint* or other computer software that captures key points and includes graphics. Or, the auditor might log on to a website referred to or discussed in a management comment to demonstrate the site's features and use. The management letter can be provided as part of, or after, the presentation.

#### **Discussion of Preliminary Draft with the Client**

104.3 The authors recommend that a preliminary draft of the management letter be discussed with appropriate client personnel (such as employees involved in the area or likely to be directly affected by the proposed recommendations) before the letter is issued. Such a discussion may reduce the potential for client defensiveness and may also allow the auditors to determine whether they fully understand the factual circumstances related to their comments. Client personnel might be able to provide insight on the cause of the problems or the practicality or implications of proposed recommendations. However, the auditor should be wary of client pressure to “tone down” the management letter so that it will not “sound so harsh.”

#### **Written Communications of Management Letter Comments**

104.4 As discussed at paragraph 101.12, AU-C 265 requires auditors to communicate *other deficiencies in internal control* when such deficiencies (a) have not been communicated to management by other parties and (b) are of sufficient importance to merit management's attention, in the auditor's professional judgment. In addition, auditors may wish to communicate other matters they became aware of during the audit. Although those other matters can be communicated orally, typically, auditors make such communications in one of two ways:

- *Include Them in a Separate Communication.* Appendix 1B-1 presents a drafting form for a transmittal letter that may be used when communicating management comments in a separate letter. (See paragraphs beginning at 104.5.)
- *Include Them in the AU-C 265 Communication.* The auditor may include the management letter comments in the AU-C 265 communication of material weaknesses and/or significant deficiencies noted

during the audit. In this case, such comments should be easily distinguishable from the comments that are considered *material weaknesses* and *significant deficiencies*.

#### 104.5 Include Them in a Separate Communication

The authors recommend that the management letter include certain introductory information designed to prevent client misunderstanding about the nature of the comments or whether the letter represents assurance about the adequacy of controls. Authoritative literature does not contain any required format for, or illustration of, management letters. However, the authors believe that the comments may be included in the body of the letter. This approach is appropriate if only a few comments are presented. In most cases, it is more appropriate to present the comments in an attachment to the transmittal letter that is referred to in the letter. Also, presenting an attachment allows for inclusion of a table of contents to the comments for the convenience of the reader as well as for inclusion of charts, tables, and other explanatory or illustrative material relating to particular comments.

104.6 The transmittal letter for management comments may also include the following elements:

- If a separate internal control (AU-C 265) communication has been issued, a reference to that communication.
  
- A statement that the management letter does not affect the report on the financial statements.
  
- A statement that the auditors will review the comments during the next audit engagement.
  
- A statement that the comments have been discussed with management and an offer to discuss them further at the client's convenience.
  
- An offer to perform any additional study of the matters commented on or to assist the client in implementing the recommendations. (However, see the caution in paragraph 103.13 about offers of assistance.)
  
- A restriction paragraph similar to the one that AU-C 265 requires in a written communication of significant deficiencies and material weaknesses. Such a paragraph would state that the comments and recommendations are intended solely for the information and use of management, those changed with governance, and others within the organization and is not intended to be, and should not be, used by anyone other than these specified parties.

#### 104.7 Illustrative Transmittal Letter.

The following is the authors' suggested transmittal letter for management comments. Appendix 1B-1 presents a drafting form of the letter.

To Management and  
Board of Directors of ABC Company

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

However, during our audit we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and suggestions regarding those matters. (We previously communicated to you about the Company's internal control in our letter dated February 15, 20X2. A separate report dated February 15, 20X2, contains our communication on material weaknesses and significant deficiencies in the Company's internal control.) This letter does not affect our report dated February 15, 20X2, on the financial statements of ABC Company.

We will review the status of these comments during our next audit engagement. We have already discussed many of these comments and suggestions with various Company personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Sincerely,

Firm Name

City, State

March 14, 20X2

#### 104.8 **Include Them in the AU-C 265 Communication**

If the auditor decides to include the management comments in the AU-C 265 communication, the written communication should adhere to the requirements of AU-C 265. Specifically, the communication should include the following:

- a. The definition of a material weakness and, when relevant, of a significant deficiency.

b. A description of the each significant deficiency and material weakness identified along with an explanation of their potential effects.

c. Sufficient information to allow those charged with governance and management to understand the context of the communication. In particular, the auditor's communication should include elements to explain that:

(1) The purpose of the audit was for the auditor to express an opinion on the financial statements.

(2) The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control.

(3) The auditor is not expressing an opinion on the effectiveness of internal control.

(4) The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

d. An appropriate alert restricting the use of the communication to management, those charged with governance, others within the organization, and any governmental authority to which the auditor is required to report, in accordance with AU-C 905, *Restricting the Use of an Auditor's Report*.

Appendix 1B-2 presents a drafting form for a letter that may be used to communicate significant deficiencies and management comments noted during the audit.

#### 104.9 Illustrative Communication.

The following is an illustrative communication when the auditor includes the management letter comments in the AU-C 265 communication. The communication encompasses the requirements of paragraph 104.8 and assumes that *only* significant deficiencies were identified during the audit (that is, no material weaknesses were identified).<sup>7 8</sup> A drafting form of this communication is presented in Appendix 1B-2.

To Management and the Board of Directors of ABC Company

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

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

During our audit, we also became aware of the following matters that we believe represent opportunities for strengthening internal controls and operating efficiency.

UPS is the primary shipping vendor for the Company. The Company uses UPS tracking software. UPS bills are sent to accounting for processing, where the bills are paid without reconciliation between Company and UPS data. We recommend that before paying UPS bills, the Company reconcile the carton count from the shipping department to the UPS billing to verify the accuracy of the bill. Such reconciliations will allow for the timely resolution of any differences.

During our audit, management represented to us that it had approved the acquisition of certain pieces of equipment; however, the Company was unable to produce written documentation of the approval. We recommend that requisitions for property additions be prepared that include the nature, estimated cost, purpose, and benefit of the item to be acquired. If the new item will replace an existing asset, the existing asset should be identified and the means of its disposal and any expected sales proceeds indicated. The requisition should be approved by management and the board of directors, as appropriate. (The recommended documentation will provide a basis for

making an informed decision about approval.) A copy of the approved requisition should be sent directly to the accounting department to use as a basis for recording the asset when it is received.

This communication is intended solely for the information and use of management, the audit committee, and others within the organization, and is not intended to be, and should not be, used by anyone other than these specified parties.

Firm Name

City, State

February 14, 20X2

### **Communication of Recurring Matters**

104.10 If the auditor has communicated the same matters to management in a prior period, but management has chosen not to remedy them for cost or other reasons, the auditor is not required to repeat the communication in the current period. The auditor also is not required to repeat information about such matters if the information has been previously communicated to management by others such as internal auditors or regulators. However, the auditor may decide to recommunicate these other deficiencies when there has been a change of management or when new information has come to the auditor's attention that alters the auditor's and management's prior understanding regarding the deficiencies. Nevertheless, the auditor should use professional judgment when determining whether management's failure to remedy other deficiencies in internal control that were previously communicated is a significant deficiency requiring communication with those charged with governance.

104.11 As discussed in paragraph 103.27, when recurring matters are identified, the authors believe it is generally preferable for the letter to repeat prior-year recommendations that have not been adopted and remain appropriate. If this is done, there should be an indication that the same comments were made in prior years. For convenience, such comments may be presented separately from new comments under a heading such as "Prior-year Comments." Prior-year comments typically are presented after new comments, although some auditors present them first if they are more significant or numerous than the new comments.

### **Communications with those Charged with Governance**

104.12 In some circumstances, those charged with governance may request that the auditor also communicate information about these other deficiencies in internal control to them as well as management. In this situation, the auditor may elect to inform those charged with governance of the nature of the other deficiencies communicated, or may inform them when a communication of other deficiencies has been made to management. In either case, the auditor uses professional judgment to determine whether to communicate this information orally or in writing.

104.13 *Those charged with governance* is defined in AU-C 260, *The Auditor's Communication With Those Charged With Governance*, as "the persons or organizations with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process." The authoritative guidance further states that those charged with governance may

include management personnel, such as executive members of a governance board or an owner-manager. The use of the phrase, “or organizations,” is a revision to the definition under AU-C 260 and the authoritative guidance indicates that a corporate trustee is one example of an organization that could serve as “those charged with governance.”

104.14 In some nonpublic entities, the appropriate person(s) with whom to communicate may not be clearly identifiable. In this situation, the auditor and the engaging party need to discuss and agree on who are the appropriate person(s) within the governance structure. Also, if all of those charged with governance are involved in managing the business, the auditor should consider whether communication with the person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise have to communicate because of their governance role.

104.15 Many governing bodies have subgroups (e.g., audit committees or similar groups). The auditor should evaluate whether communication with a subgroup of those charged with governance (or with an individual), adequately meets the auditor's responsibility to communicate with those charged with governance. When making this determination, the auditor may want to consider matters such as:

- The various responsibilities of the governing body and the subgroup.
  
  - The nature of matters to be communicated.
  
  - Relevant legal or regulatory requirements.
  
  - Whether the subgroup is authorized to act in relation to the information communicated.
  
  - Whether the subgroup can provide the auditor with further information and explanations.
  
  - Whether the auditor knows of any potential conflicts between the subgroup and other members of the governing body.
  
  - Whether the auditor decides there is also a need to communicate the information, in full or summary form, to the governing body. (Regardless of whether the auditor communicates with a subgroup, the auditor retains the right to communicate with the governing body.)
-

<sup>7</sup> *PPC's Guide to Internal Control Communications* includes illustrative communications that may be used to communicate when material weaknesses also have been identified during the audit. The auditor may tailor those communications in a manner similar to that illustrated here when he or she decides to include management letter comments in the same communication. The *Guide* may be ordered by calling Thomson Reuters at (800) 431-9025 or online at [ppc.thomsonreuters.com](http://ppc.thomsonreuters.com).

<sup>8</sup> SSAE No. 15 (AT 501), *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*, establishes standards and provides guidance to auditors performing an examination of an entity's internal control over financial reporting (internal control) in the context of an integrated audit (an audit of an entity's financial statements and an examination of its internal control). Auditors engaged to perform an integrated audit of an entity's financial statements under SSAE No. 15 should not use this letter to communicate significant deficiencies noted during the audit. Instead, they should refer to Chapter 10 of *PPC's Guide to Nontraditional Engagements* for guidance and illustrative communications.

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