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100 Background

100.1 In recent years, there has been much public attention focused on management's responsibility for internal control and on the auditor's responsibility to bring to management's attention certain information about internal control related matters identified during a financial statement audit. That interest in an auditor's responsibility to communicate deficiencies in an entity's internal control led the AICPA's Auditing Standards Board (ASB) to issue, in May 2006, SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*. SAS No. 112 provided guidance on communicating, to management and others, certain control deficiencies identified during a financial statement audit.

100.2 In June 2007, the PCAOB issued Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which superseded PCAOB Auditing Standard No. 2. To conform the definitions of the various kinds of internal control deficiencies and related guidance for evaluating the severity of such deficiencies in SAS No. 112 with the definitions and guidance in the PCAOB guidance, the ASB issued SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*, in October 2008. SAS No. 115 was subsequently superseded by AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, as part of the AICPA's clarity project.

100.3 AU-C 265 requires auditors to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses in internal control identified in an audit. It also establishes the auditor's responsibilities for evaluating the severity of deficiencies in internal control to determine whether they are significant deficiencies or material weaknesses. In addition, AU-C 265 conforms the terminology and definitions of the various kinds of control deficiencies with those contained in PCAOB Auditing Standard No. 5 and in 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*.[1] This *Guide* addresses the requirements of AU-C 265.

COSO's 2013 Framework

100.4 **Background**

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a report titled *Internal Control—Integrated Framework* (the original framework). The COSO framework defines internal control, describes the components of effective internal control, and provides criteria against which internal control can be evaluated. The COSO framework has become the most widely used internal control framework in the U.S. and is also widely used around the world. Since 1992, there have been dramatic changes in business and operating environments, making businesses more complex, technologically driven, and global than in the past. In addition, stakeholders have called for greater transparency and accountability in organizations' systems of internal control. For those reasons, COSO undertook a project to update the original 1992 Framework. In May 2013, COSO issued an updated framework, *Internal Control-Integrated Framework* (2013 Framework), to help entities design, implement, and evaluate internal control in light of the current business and regulatory environments and operations.

100.5 According to COSO, the 2013 Framework and supporting documents (see paragraph 100.8) are intended to (a) clarify the requirements of effective internal control, (b) update the context for applying internal control to reflect changes in business and operating environments, and (c) broaden the application of the COSO framework by expanding the operations and reporting objectives. Although many nonpublic organizations may not have formally adopted, or even be familiar with, the COSO Framework, the authors believe that auditors frequently turn to the COSO Framework as a reference and guide for understanding and evaluating internal control over financial reporting as it relates to their clients. Therefore, the remainder of this section provides an overview of COSO's 2013 Framework and other related COSO publications. In addition, the 2013 Framework has been integrated into this *Guide*.

100.6 An executive summary of the 2013 Framework, FAQs, and a PowerPoint presentation are available free of charge from the COSO website at **www.coso.org**. The 2013 Framework itself can be ordered from the AICPA at (888) 777-7077 or at **www.cpa.com**.

100.7 **Overview of COSO's 2013 Framework**

Like the 1992 Framework, COSO's 2013 Framework provides broadly accepted and practical criteria for establishing internal control and for assessing its effectiveness. The 2013 Framework addresses matters such as the definition of internal control; the requirements for effective internal control (including both components and relevant principles); and the approach users may follow when designing, implementing, and conducting internal control and assessing its effectiveness. (Appendixes within the 2013 Framework are provided for reference purposes; accordingly, they are not considered to be part of the 2013 Framework.) COSO makes it clear that the 2013 Framework applies to entities of all sizes, including large, mid-size, and small entities; for-profit and not-for-profit entities; and government bodies. However, it acknowledges that each entity may choose to implement internal control differently. For instance, a smaller entity's system of internal control may be less formal and less structured, yet still have effective internal control.

100.8 **COSO Supporting Documents**

Concurrently with the 2013 Framework, COSO issued the following documents:

• *Illustrative Tools for Assessing Effectiveness of a System of Internal Control.* This publication includes templates and scenarios of how principles are applied in preparing financial statements that can help users apply the 2013 Framework.

• *Internal Control over External Financial Reporting (ICEFR): A Compendium of Approaches and Examples (ICEFR Compendium).* The ICEFR Compendium includes approaches and examples intended to assist users responsible for designing and implementing a system of internal control over external financial reporting. The approaches and examples within the ICEFR Compendium illustrate how entities may apply the principles set forth in the 2013 Framework when preparing financial statements and other external financial reporting. COSO has indicated that many of the approaches included in the ICEFR Compendium were designed to be universal in nature and apply to entities of all sizes.

The *Illustrative Tools for Assessing Effectiveness of a System of Internal Control and Internal Control over External Financial Reporting (ICEFR): A Compendium of Approaches and Examples* can be ordered from the AICPA at (888) 777-7077 or at **www.cpa.com**.

100.9 Components of Internal Control and Related Principles..

The five components of internal control are the same in both the 1992 and 2013 Frameworks. Although the components and the concepts underlying them are the same in both COSO versions, the 2013 Framework updates the components for broad-based changes in the business and operating environments since the 1992 Framework was issued. The 2013 Framework describes the components as follows:

• *Control Environment*— The set of standards, processes, and structures that provide the basis for carrying out internal control across the entity. The board of directors and senior management establish the tone at the top regarding the importance of internal control and expected standards of conduct.

• *Risk Assessment*— Involves a dynamic and iterative process for identifying and analyzing risks to achieving the entity's objectives, forming a basis for determining how risks should be managed. Management considers possible changes in the external environment and within its own business model that may impede its ability to achieve its objectives.

• *Control Activities*— Actions established by policies and procedures to help ensure that management directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity and at various stages within business processes, and over the technology environment.

• *Information and Communication*— Information is necessary for the entity to carry out internal control responsibilities in support of achievement of its objectives. Communication occurs both internally and externally and provides the entity with the information needed to carry out day-to-day controls. Communication enables personnel to understand internal control responsibilities and their importance to the achievement of objectives.

• *Monitoring Activities*— Ongoing evaluations, separate evaluations, or some combination of the two are used to determine whether each of the five components of internal control, including controls to affect the principles within each component, is present and functioning. Findings are evaluated and deficiencies are communicated in a timely manner, with serious matters reported to senior management and to the board.

The five components are inherent in the way management runs a company. They apply to every company regardless of size, but small and mid-size companies tend to implement the components in a less formal and less structured manner.

100.10 Principles..

Although the 2013 Framework retains the five components of internal control in the 1992 Framework, it codifies 17 principles representing the fundamental concepts associated with each component of internal control. An entity can achieve effective internal control by applying all of the principles because they are drawn directly from the components. The 17 principles within the five components of internal control are presumed to be suitable and relevant to all entities. The 2013 Framework notes that there may be rare situations when management determines that a principle is not relevant to an internal control component (for example, relating to governance or technology). However, the 2013 Framework states that "management must support its determination that a principle is not relevant with the rationale of how, in the absence of the principle, the associated component can be present and functioning." The principles supporting each of the five components of internal control are listed in Exhibit 1-1. Because this *Guide* focuses primarily on identifying, evaluating, and communicating internal control deficiencies in objectives and controls relevant to financial reporting and safeguarding of assets, the authors have modified certain of the COSO principles listed in that exhibit to focus on those objectives and controls.

Exhibit 1-1

17 Principles of Internal Control by Component

Control Environment

1. The entity demonstrates a commitment to integrity and ethical values.

2. The board of directors or audit committee demonstrates independence from management in exercising oversight of the development and performance of internal control over financial reporting.

3. With board oversight, management establishes, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of financial reporting objectives.

4. The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with financial reporting objectives.

5. The entity holds individuals accountable for their internal control responsibilities.

Risk Assessment

6. The entity specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to financial reporting objectives.

7. The entity identifies risks to achieving its objectives and analyzes risks to determine how the risks should be managed.

8. The entity considers the potential for fraud in assessing risks to the achievement of financial reporting objectives.

9. The entity identifies and assesses changes that could significantly impact the system of internal control.

Control Activities

10. The entity selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

11. The entity selects and develops general control activities over technology to support the achievement of financial reporting objectives.

12. The entity deploys control activities through policies that establish what is expected and procedures that put policies into action.

Information and Communication

13. The entity obtains or generates and uses relevant, quality information to support the functioning of internal control over financial reporting.

14. The entity internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control over financial reporting.

15. The entity communicates with external parties regarding matters affecting the functioning of internal control.

Monitoring Activities

16. The entity selects, develops, and performs ongoing and/or separate evaluations to determine whether the components of internal control are present and functioning.

17. The entity evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors or audit committee, as appropriate.

100.11 The 2013 Framework also describes *points of focus* that are important characteristics of the principles and can help management in designing, implementing, and conducting internal control, as well as in assessing whether relevant principles are present and functioning. However, the 2013 Framework notes that companies may determine that some of the points of focus are not suitable or relevant, and may identify others that are appropriate for the entity. In addition, the 2013 Framework does not require companies to separately assess whether points of focus are in place to assess a principle as effective.

100.12 While a more detailed discussion of COSO's 2013 Framework is beyond the scope of this *Guide*, *PPC's Guide to Internal Control and Fraud* and *PPC's Guide to Nontraditional Engagements* provide further guidance on using the COSO Framework as the criteria for evaluating the effectiveness of internal control over financial reporting. Both guides may be ordered by calling (800) 431-9025 or by visiting **tax.thomsonreuters.com**.

100.13 **2013 COSO Small Business Considerations**

The 2013 Framework states that the principles underlying internal control components are as applicable for smaller entities as for larger ones. Appendix C of the 2013 Framework, *Considerations for Smaller Entities*, discusses the characteristics of smaller entities and considerations when implementing the COSO principles. The 2013 Framework notes that implementation approaches may vary for smaller entities regardless of whether the entities are public, nonpublic, governmental, or not-for-profit. For instance, all public companies have boards of directors or other similar governing bodies that have oversight responsibilities over reporting. However, the less complex management operating model and entity structure of a smaller entity may enable it to have a different approach to board oversight. Similarly, while a larger public company may have a whistle-blower program requiring that the initial reporting be made to an identified internal staff function, a smaller entity may allow the initial reporting to be made directly to the audit committee chair.

100.14 The 2013 Framework recognizes that smaller entities may have unique advantages that can contribute to effective internal control. For instance, management of a smaller company often has a wider span of control and greater direct interaction with personnel. Therefore, informal staff meetings in a smaller entity may be highly effective for communicating information relevant to operating performance, whereas larger companies may need more formal mechanisms when making such communications. However, Appendix C notes that a downside of the concentration of knowledge and authority often found in smaller entities is the ability of management to override controls.

100.15 Conversely, smaller entities may lack certain economies of scale, which often affect support functions, unlike that found in larger entities. For example, establishing an internal audit function within a smaller entity likely would require a larger percentage of that entity's economic resources than would be the case for a larger entity. As a result, a smaller entity may not have an internal audit department or might rely on outsourcing to provide needed skills, where the larger entity might have a significantly broader range of experienced in-house personnel. Appendix C recognizes that the relative cost of designing, implementing, and conducting internal control is usually higher for a smaller entity than for a larger one.

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[1] AU-C 265 applies whenever an auditor expresses (or disclaims) an opinion on financial statements, *except when* the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of an entity's internal control in accordance with SSAE No. 15 (AT 501).

AT 501 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). As part of the AICPA's project to clarify the attestation standards, the AICPA's Auditing Standard Board has issued an exposure draft of a new SAS that would move and modify the guidance in AT 501 from the attestation standards into the auditing standards. That guidance is not expected to be finalized until later in 2015. As proposed, the standard would be effective for integrated audits for periods ending on or after December 15, 2016. Future editions of this *Guide* will update the status of that proposed standard. *PPC's Guide to Nontraditional Engagements* discusses that project and provides detailed guidance and illustrations for performing engagements under SSAE No. 15. The *Guide* may be ordered by calling (800) 431-9025 or by visiting **tax.thomsonreuters.com**.

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101 Overview of AU-C 265

Introduction

101.1 AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies that they have identified during the audit. Control deficiencies that are, in the auditor's judgment, *significant deficiencies* or *material weaknesses* should be communicated in writing to management and those charged with governance.[2]

Objectives and Requirements

101.2 The following paragraphs summarize the objectives and requirements for the communication of internal control matters under AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

101.3 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. The requirements that should be followed to achieve that objective are summarized in Exhibit 1-2.

Exhibit 1-2

Requirements for Communicating Internal Control Related Matters Identified in an Audit

Requirements	AU-C Reference	*Guide* Reference—Practice Aids
Determination of Whether Deficiencies in Internal Control Have Been Identified		

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	Appendix 2A and Appendix 4A
Evaluating Identified Deficiencies in Internal Control		
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	Appendix 2A
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	Appendix 2A
Communication of Deficiencies in Internal Control		
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	Appendix 3A-1 through 3A-3
The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis— • 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. • 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.	AU-C 265.12	Appendix 3A-1 through 3A-3
The communications should be made no later than 60 days following the report release date.	AU-C 265.13	Appendix 3A-1 through 3A-3
The auditor should include in the written communication of significant deficiencies and material weaknesses— • The definition of the term *material weakness* and, when relevant, the definition of the term *significant deficiency*. • A description of the significant deficiencies and material weaknesses and an explanation of their potential effects.	AU-C 265.14	Appendix 3A-1 through 3A-3

• 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— •• The purpose of the audit was for the auditor to express an opinion on the financial statements. •• 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. •• The auditor is not expressing an opinion on the effectiveness of internal control. •• 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. • In accordance with AU-C 905, *Alert That Restricts the Use of an Auditor's Report*, 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.		
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	Appendix 3A-3
The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.	AU-C 265.16	Appendix 3A-1 through 3A-3
For audits of group financial statements, the group engagement team should communicate to group management and those charged with governance material weaknesses and significant deficiencies 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 600.46	Appendix 3A-1 through 3A-3

Identifying Control Deficiencies

101.4 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. An auditor may become aware of control deficiencies while performing a variety of audit procedures, including obtaining an understanding of the entity's internal control, performing risk assessment procedures, or performing tests of the operating effectiveness of controls (that is, tests of controls). Accordingly, an auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed.

Evaluating Identified Deficiencies

101.5 If the auditor has identified one or more deficiencies in internal control, AU-C 265.09 states that 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. Auditors should evaluate control deficiencies individually and in combination with other deficiencies affecting the same significant 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, relevant assertion or component of internal control increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

Communicating Identified Deficiencies

101.6 AU-C 265.11 states that the auditor should communicate significant deficiencies and material weaknesses identified during the audit in writing to those charged with governance. In addition, AU-C 265.12 states that the auditor should communicate the following to management:

- 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.

- 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.

101.7 Making such communications in writing reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities. AU-C 260, *The Auditor's Communication With Those Charged With Governance* (AU-C 260.09), establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.

[2] AU-C 260, *The Auditor's Communication With Those Charged With Governance*, defines *those charged with governance* as “the person(s) or organization(s) (for example, a corporate trustee) 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. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager.” Deciding to whom the internal control communication should be made is discussed further in Chapter 3.

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102 Scope of This *Guide*

102.1 This *Guide* is designed for audits of nonpublic entities and is not intended to provide guidance for audits of public companies. Auditors of public companies should refer to *PPC's Guide to PCAOB Audits*. Also, this *Guide* does not provide specific guidance for auditors engaged to perform an audit of an entity's financial statements and internal control over financial reporting under AT 501 (that is, an integrated audit). Although many requirements are the same when communicating deficiencies under AU-C 265 and AT 501, certain requirements are different. For example, the language used in the auditor's communication of material weaknesses and significant deficiencies is different when an integrated audit is performed. In addition, an auditor is prohibited from issuing a letter indicating there are no material weaknesses in an integrated audit. As part of the AICPA's project to clarify the attestation standards, the AICPA's Auditing Standard Board has issued an exposure draft of a new SAS that would move and modify the guidance in AT 501 from the attestation standards into the auditing standards. That guidance is not expected to be finalized until later in 2015. As proposed, the standard would be effective for integrated audits for periods ending on or after December 15, 2016. Future editions of this *Guide* will update the status of that proposed standard. Auditors who perform an AT 501 integrated audit should refer to Chapter 10 of *PPC's Guide to Nontraditional Engagements* for a discussion of that project and for guidance and illustrative communications. Both guides may be ordered by calling (800) 431-9025 or by visiting **tax.thomsonreuters.com**.

How to Use This *Guide*

102.2 This *Guide* is designed as a package of tools—technical guidance, best practices, and practice aids—developed to give firms everything necessary to effectively apply AU-C 265. The *Guide* can be used in a variety of ways. For example, a firm may use the *Guide* as a quick reference tool to help auditors understand the requirements of AU-C 265 or to address specific questions about applying the requirements. With its detailed guidance on identifying and evaluating control deficiencies and communicating significant deficiencies and material weaknesses, it provides an excellent source of reference material for those purposes. Auditors can also use the drafting forms to create the written communication under AU-C 265. In addition, auditors can refer to the hundreds of sample comments as a source for how to word comments and can use the index or table of contents to find just the right comment.

Overview of This *Guide*

102.3 Chapter 2 provides guidance on understanding what constitutes a control deficiency, how auditors might identify control deficiencies during the audit, and how they should evaluate the severity of the identified deficiencies in accordance with AU-C 265. The chapter includes a flowchart that illustrates PPC's process for evaluating the severity of control deficiencies under AU-C 265. Chapter 2 also discusses how an auditor should evaluate the severity of identified control deficiencies by considering both the probability of the occurrence of a misstatement and the magnitude of potential misstatements in the financial statements. In addition, Chapter 2 describes how qualitative factors or the views of a prudent official might cause the auditor to increase the severity of identified deficiencies. Finally, it discusses the AICPA's *Code of Professional Conduct*, certain issues related to auditors' independence, and other practice issues. Some of the issues discussed include the circumstances in which an auditor might be able to prepare financial statements for the client while maintaining independence and whether, in that situation, the auditor would automatically be required to communicate a material weakness to the client. Appendix 2A contains the "Control Deficiency Evaluation Worksheet," which has been designed to help auditors summarize identified control deficiencies and evaluate whether those deficiencies, both individually or in combination, are significant deficiencies or material weaknesses.

102.4 Chapter 3 discusses the auditor's required communications, including to whom the communications should be made, the timing of the auditor's communications, and the contents of the required communications. It also contains illustrative letters that auditors can use when preparing these communications and addresses how such communications may be modified in certain situations, including when the auditor wishes to include additional language to explain the limitations of internal control and when other auditors have participated in the audit. Chapter 3 also discusses some unique situations that might affect the auditor's communication, such as when management's response to the auditor's comments is included in the written communication and when there are no material weaknesses identified during the audit. Finally, Appendix 3A contains a number of illustrative letters the auditor may use to make the required internal control communications.

102.5 Chapter 4 provides guidance on how to develop a comment that the auditor determines is either a significant deficiency or a material weakness. It also provides hundreds of sample comments that might be helpful to auditors when evaluating and communicating significant deficiencies and material weaknesses to management and those charged with governance. Those comments are categorized by significant account balance and disclosure and internal control component. In addition, this *Guide* presents a section of comments that have been tailored specifically for auditors of nonprofit organizations, employee benefit plans, and governmental organizations. The examples in Chapter 4 are designed to be helpful to the auditor when developing comments related to specific significant deficiencies and material weaknesses identified during an audit. Appendix 4A includes the "Control Deficiency Comment and Management Point Development Worksheet," which was designed to help auditors develop information about a control deficiency for communication to management and those charged with governance.

102.6 The Appendixes—Case Studies section contains two case studies. Appendix A presents a case study involving a midsized nonpublic manufacturing entity in the technology sector, while Appendix B presents a case study of a small, privately held manufacturing entity. The case studies expand on the case studies included in Appendix A and B, respectively, of *PPC's Guide to Audit Risk Assessment* (GRA), which illustrate how auditors might document their risk assessments by presenting a variety of completed PPC forms. The case studies in this *Guide* illustrate how auditors might evaluate the severity (both individually and in combination) of the various control deficiencies identified while performing their audits. They also illustrate how auditors might use various PPC practice aids to document their evaluations. Finally, they illustrate how auditors might communicate the identified deficiencies to management and those charged with governance in accordance with AU-C 265.

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103 Definitions

103.1 The following definitions may be helpful in understanding the process an auditor follows when identifying, evaluating, and communicating controls, as discussed throughout this *Guide*:

• *Internal Control* —A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives (AU-C 315.04). According to COSO's 2013 Framework, there are five components of internal control: control environment, risk assessment, control activities, information and communication systems, and monitoring activities.

• *Internal Control over Financial Reporting* —A process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with the applicable financial reporting framework and that includes those policies and procedures that—

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

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

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

Internal control has inherent limitations. Internal control is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented, or detected and corrected on a timely basis by internal control. However, these inherent limitations are known aspects of the financial reporting process (AT 501.07).

• *Deficiency in Internal Control* —A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively (AU-C 265.07).

• *Significant Deficiency* —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 (AU-C 265.07).

• *Material Weakness* —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 (AU-C 265.07).

• *Those Charged with Governance* —The person(s) or organization(s) (for example, a corporate trustee) 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. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager (AU-C 260.06).

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