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 AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, requires auditors to communicate, in writing, material weaknesses and significant deficiencies identified during the audit to management and those charged with governance. AU-C 265 also establishes requirements for auditors to communicate to management *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) [1] 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 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 be all inclusive, 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 **Relationship between This *Guide* and *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 2-19 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—Prepaids 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.

• Chapter 19—Specialized Industries.

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 104.20.

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 **Overview of Chapter 1**

The remainder of this chapter discusses the following matters:

- Section 101 discusses COSO's internal control framework, which is the most widely used criteria for designing, implementing, and maintaining internal controls.

- Section 102 presents an overview of the authoritative literature that provides requirements for communication of internal control related matters identified in an audit. It also defines *other internal control deficiencies* and discusses the specific 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 103 discusses other matters an auditor may wish to communicate to management in connection with the financial statement audit.

- Section 104 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 105 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.

- Section 106 discusses new and proposed auditing or other authoritative literature that might affect the content of certain illustrative comments included in this *Guide*. The section also clarifies whether such guidance is reflected in the comments appearing in the current edition of the *Guide*.

[1] *PPC's Guide to Internal Control Communications* provides guidance on auditors' 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 **tax.thomsonreuters.com**.

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101 COSO's 2013 Internal Control Framework

Background

101.1 In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a report titled *Internal Control—Integrated Framework* (the 1992 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. 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.

101.2 In May 2013, COSO issued its updated *Internal Control—Integrated Framework* (2013 Framework) to help organizations design, implement, and evaluate internal control in light of the changes affecting businesses. While similar to the 1992 Framework in many ways, the 2013 Framework enhances and clarifies a number of the concepts in the 1992 Framework, intending to make it easier to use and apply. For example, fundamental concepts in the 2013 Framework are expressed as principles. The 2013 Framework articulates 17 principles, which are associated with the five components of internal control. The principles aid in understanding the requirements for effective internal control and provide clarity when designing and implementing systems of internal control. Each principle has several underlying points of focus for evaluating the principle. Concurrently with the 2013 Framework, COSO issued several related documents that provide tools, approaches, and examples to assist entities when designing, implementing, and assessing effectiveness of a system of internal control.[2]

101.3 **Considerations in This *Guide***

Because many of your clients use the COSO framework as the foundation for designing, implementing, and maintaining their companies' internal controls, the remainder of this section provides a brief overview of COSO's 2013 Framework and discusses how to implement it within their organizations. In addition, paragraph 1803.79 presents a comment that may be used to provide clients with an overview of that framework.

101.4 **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. COSO makes it clear that the 2013 Framework applies to entities of all sizes, including large, mid-size, and small organizations; for-profit and not-for-profit organizations; and government bodies. However, it acknowledges that each organization 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.

101.5 **Components of Internal Control and Related Principles**

The five components of internal control—control environment, risk assessment, information and communication, monitoring activities, and control activities—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 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.

101.6 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 principles supporting each of the five components of internal control are listed in Exhibit 1-1.

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.

101.7 *PPC's Guide to Internal Control and Fraud Prevention* provides a detailed discussion of COSO's 2013 Framework. The *Guide* may be ordered by calling your Thomson Reuters representative at (800) 431-9025 or from the PPC website at **tax.thomsonreuters.com**.

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[2] An executive summary of the 2013 Framework, FAQs, and a PowerPoint presentation and related tools 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.cpa2biz.com**.

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102 Authoritative Literature

Generally Accepted Auditing Standards

102.1 Auditors of nonpublic entities should conduct their engagements in accordance with GAAS developed by the American Institute of Certified Public Accountants (AICPA). The AICPA *Code of Professional Conduct* requires members to comply with SASs. Auditors are responsible for awareness and timely implementation of new pronouncements. The authors recommend that firms have a system in place to ensure staff members are informed about current authoritative literature.

102.2 **Defining Professional Responsibility**

The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (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 when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

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.

102.3 **Use of the Terms *Must* and *Should***

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*.

AICPA *Code of Professional Conduct*

102.4 The AICPA *Code of Professional Conduct* applies to all professional services a CPA provides. It also applies to other people in the CPA's firm. The AICPA *Code of Professional Conduct* provides guidance and rules that auditors need to comply with in connection with an audit engagement; it sets forth the fundamental principles of professional ethics, including objectivity and independence.

102.5 All CPAs should follow the rules in the AICPA *Code of Professional Conduct* (the Code). While the Code explicitly applies to members of the AICPA, the vast majority of state boards of accountancy have also adopted the AICPA's Code or have created their own. When specific types of standards have been established to address specific types of services, the CPA should also refer to those standards, but the Code still applies.

102.6 **Revised AICPA Code of Conduct**

In May 2014, the AICPA issued a revised *Code of Professional Conduct* (revised Code). The revised Code was effective on December 15, 2014, with the exception of the two broad conceptual frameworks, one for members in public practice and one for members in business, that are effective December 15, 2015. The revised Code is divided into three parts that separately apply to members in public practice, members in business, and other members (such as retired and unemployed members), as well as a preface that applies to all members. The revised Code also establishes a new numbering system with the reference preface of "ET." In addition, the revised Code provides a conceptual framework that sets forth requirements in those situations where the member has identified a threat to compliance with the rules in the revised Code and the relationship or circumstance creating the threat is not covered in an interpretation within the revised Code. As noted previously, the conceptual framework guidance is not effective until December 15, 2015, but early implementation is allowed. *PPC's Guide to Quality Control* provides detailed guidance on the revised Code.

102.7 When applicable, this *Guide* has been updated for, and provides references to, the revised Code. The remainder of this section provides a discussion of certain independence considerations relating to the performance of nonattest services.

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

102.8 **Objectives and Requirements**

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. 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 1-2

Requirements for Communicating Internal Control Related Matters Identified in an Audit

Requirements	Clarified AU-C Reference
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
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
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
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
The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis:	AU-C 265.12

• 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.	
The communications should be made no later than 60 days following the report release date.	AU-C 265.13
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. • 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.	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 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

102.9 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 **tax.thomsonreuters.com**.

102.10 **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.

102.11 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.

102.12 **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.

102.13 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.

102.14 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.

102.15 An auditor may become aware of control deficiencies while performing a variety of audit procedures, such as procedures performed to obtain an understanding of internal controls, risk assessment procedures, or test of controls. 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.

102.16 **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. [3]

102.17 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.

102.18 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.)

102.19 **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.

102.20 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.

102.21 **Examples of Control Deficiencies**

As discussed in paragraph 102.12, a control deficiency may be either a deficiency in design or a deficiency in operation. AU-C 265.A37 provides examples of both types of control deficiencies.

102.22 **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 102.31.

- 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. [4] Determining whether a significant deficiency exists is discussed beginning at paragraph 102.39.

• 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 102.40.)

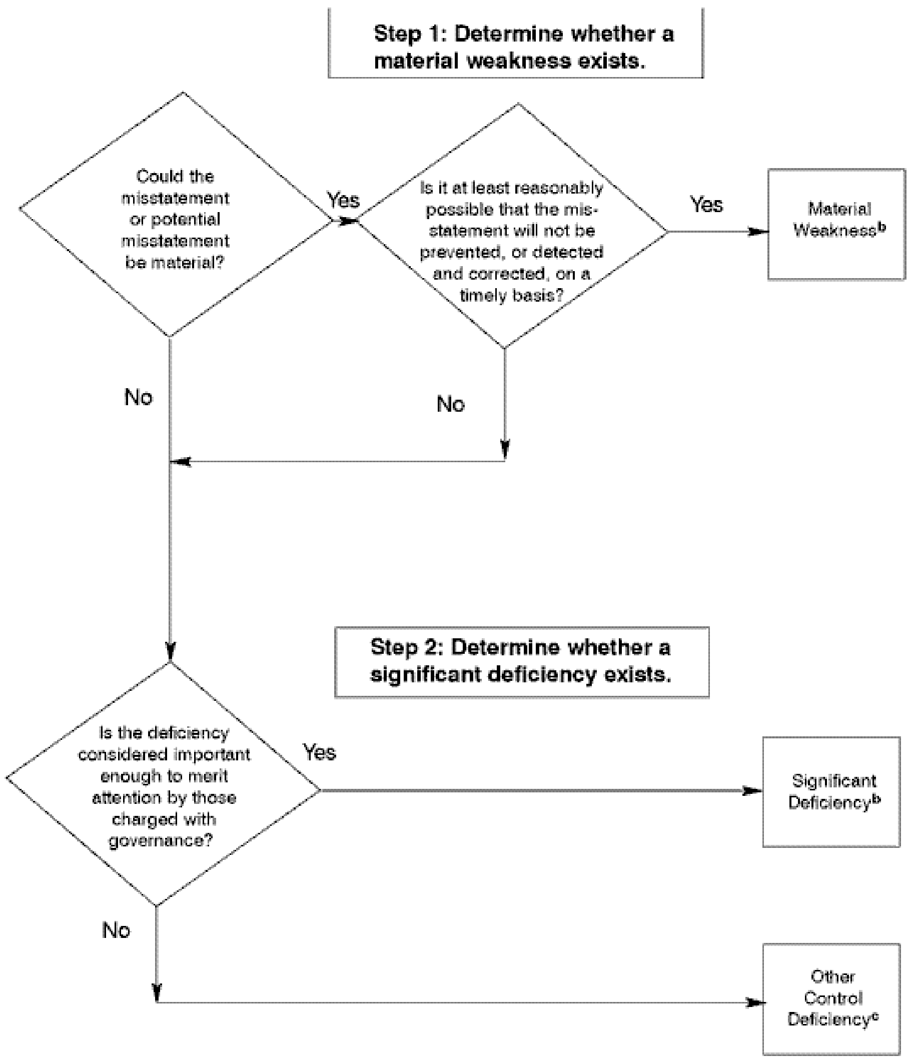
102.23 Finally, for other deficiencies in internal control not communicated as either material weaknesses or significant deficiencies, the auditor should consider whether to communicate them to management in accordance with the requirement in AU-C 265.12(b). (Communicating other deficiencies in internal control is discussed in section 105.)

102.24 **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 [a]



Notes:

[a] This flowchart describes PPC's process for evaluating the severity of each individual control deficiency identified during the

financial statement audit. However, 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.

[b] 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.

[c] 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.

102.25 **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.”

102.26 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.

102.27 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.

102.28 **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.

102.29 While AU-C 265 provides a list of deficiencies that are indicators of material weaknesses (see paragraph 102.26), it does not provide a list of deficiencies that should be considered significant deficiencies. However, a previously-issued risk alert included the following examples of deficiencies that might indicate the existence of significant deficiencies in internal control: [5]

- 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.

102.30 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.

102.31 **Determining Whether There Is a Material Weakness**

As outlined in PPC's process described in paragraph 102.22, 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 102.26. 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 102.33); 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 102.38).

102.32 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

102.33 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.

102.34 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.

102.35 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.

102.36 Other than the indicators of material misstatements discussed in paragraph 102.26, 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.

102.37 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.

102.38 Factors Affecting Whether There Is a Reasonable Possibility of a Misstatement[6].

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 cause and frequency of exceptions detected as a result of the deficiency (ies).

• 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).

102.39 **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.

102.40 **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 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 **tax.thomsonreuters.com**.

102.41 Section 104 of this *Guide* discusses developing comments related to other internal control deficiencies (that is, those that do not rise to the level of significant deficiencies or material weaknesses). 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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[3] 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.

[4] 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 **tax.thomsonreuters.com**.

[5] A previously-issued AICPA Risk Alert, *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (the AICPA Risk Alert), provided guidance on identifying, evaluating, and communicating identified control deficiencies. While the AICPA Risk Alert applied specifically to the requirements of SAS No. 115, which was superseded by AU-C 265, the authors believe some of its guidance continues to be relevant to auditors complying with AU-C 265. Therefore, this *Guide* continues to include selected guidance from that AICPA Risk Alert, even though it is no longer publicly available.

[6] AU-C 265.A9 also clarifies that the auditor can evaluate probability without *quantifying* its occurrence as a specific percentage or range.

END OF DOCUMENT -

103 Other Matters

103.1 In addition to other internal control deficiencies that auditors are *required* to communicate, as discussed in section 102, 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 auditing/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.

103.2 As discussed in section 100, this *Guide* is organized to help auditors identify all possible management letter comments, including comments about such other matters. The “Control Deficiency Comment and Management Comment Development Worksheet” at Appendix 1A also 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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104 Content of the Management Comments

104.1 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

104.2 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

104.3 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 2-19 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 104.4.

• 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.

104.4 **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.

104.5 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), which are the focus of this *Guide*. 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 rising to the level of material weaknesses and significant deficiencies). If so, they may adopt firm policies also requiring auditors to follow such requirements when developing management letter comments.

104.6 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, an explanation of the potential effects 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.

104.7 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.

104.8 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

104.9 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.[7] 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.

104.10 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.

104.11 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.

104.12 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).

104.13 **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. ET Section 1.295 of the revised AICPA Code 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.

ET Section 1.295 also sets certain general requirements for remaining independent if performing nonattest services that the Interpretation identifies as not impairing independence. A detailed discussion of the requirements of ET Section 1.295 is beyond the scope of this *Guide*. However, ET Section 1.295 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.

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

104.14 An example of a well-developed and well-worded management comment follows (Chapters 2-19 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. [a] Payment of trade liabilities during discount periods could generate substantial savings. [b] 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. [c] 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. [d] We believe that situation may be easily remedied if vendor invoices are filed by discount date rather than by due date. [e] 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. [f]

Notes:

[a] specific description of the condition,

[b] a reason for improving the condition,

[c] a description of the cause of the problem,

[d] a description of the potential effect of the problem,

e a specific recommendation for action to be taken, and

f a discussion of the benefits that could result from implementing the recommendation.

Inclusion of the Client's Comments in the Management Letter

104.15 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

104.16 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 104.3. 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.

104.17 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.

104.18 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.

104.19 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

104.20 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.”

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

104.22 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.

104.23 As discussed in paragraph 105.10, 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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[7] 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 **tax.thomsonreuters.com**.

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105 Communication of Management Comments

Oral versus Written Communication

105.1 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.

105.2 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

105.3 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

105.4 As discussed at paragraph 102.11, 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 other deficiencies in internal control and 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 105.5.)

• *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*.

105.5 **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.

105.6 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 104.13 about offers of assistance.)

• An appropriate alert, similar to the one required by AU-C 265 in a written communication of significant deficiencies and material weaknesses, restricting the use of the communication to management, those changed with governance, and others within the organization.

105.7 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.

This communication is intended solely for the information and use of management, [Identify the body or individual(s) charged with governance.] , and others within the Company, and is not intended to be, and should not be, used by anyone other than these specified parties.

Sincerely,

Firm Name
City, State

March 14, 20X2

105.8 **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 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.

105.9 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 105.8 and assumes that *only* significant deficiencies were identified during the audit (that is, no material weaknesses were identified).[8] [9] 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

105.10 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.

105.11 As discussed in paragraph 104.23, 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

105.12 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.

105.13 *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.”

105.14 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.

105.15 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.)

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[8] *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 **tax.thomsonreuters.com**.

[9] 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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106 New and Proposed Authoritative Literature

106.1 As indicated in section 103, auditors sometimes elect to communicate other matters to management in addition to internal control deficiencies. Some of those matters include new accounting and/or auditing pronouncements that might have an effect on the company and when they must be adopted. Some of the illustrative comments in this *Guide* address such topics. For example, several comments in Chapter 4 address controls over accounting for leases based on the current requirements contained in FASB ASC 840-10. However, for the past number of years, the FASB has been working on new requirements that, if adopted, would dramatically change existing requirements for lease accounting. If and when that happens, those comments would have to be revised to reflect the new lease requirements.

106.2 This section provides auditors with a brief overview of certain new and proposed auditing or accounting standards that might affect the content of certain illustrative comments in this *Guide*. It will also identify whether the new/proposed guidelines are reflected in those comments, based on the status of the projects and the effective dates of the new requirements. This section will be updated annually to provide auditors with the most recent information with which to develop management letter comments.

New Accounting Standard on Revenue Recognition

106.3 In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The new guidance establishes a single revenue recognition standard that applies across many industries and capital markets. ASU No. 2014-09 eliminates inconsistencies in current revenue recognition standards and practices, and removes existing industry-specific revenue recognition requirements. The guidance is based on the principle that revenue from contracts with customers should be recognized when an entity transfers goods or services to the customer at the amount the entity expects to be entitled to receive from the customer. For those transactions determined to be exchange transactions, FASB ASC 958-605-25-1 specifies that exchange transactions are to be accounted for in accordance with FASB ASC 606 on revenue from contracts with customers.

106.4 Under the new standards, an organization would be required to take a five-step approach, including identifying performance obligations in a contract and recognizing revenue as performance obligations are satisfied. An organization satisfies a performance obligation when it transfers a good or service to a customer, and a good or service would be considered transferred when the customer obtains control of the good or service.

106.5 The five steps are:

1 Identify the contract(s) with a customer.

2 Identify the performance obligations in the contract(s).

3 Determine the transaction price.

4 Allocate the transaction price among the performance obligations in the contract(s).

5 Recognize revenue when (or as) the entity satisfies a performance obligation.

Each step is described briefly in the following paragraphs.

106.6 **Identify the Contract(s) with a Customer**

A contract creates rights and obligations that are enforceable. The following criteria are required for an agreement to be a contract within the scope of the new standards:

- The parties have approved the contract and are committed to perform their obligations under the contract.

- The rights of the parties can be identified.

- The payment terms can be identified.

- The contract has commercial substance.

- It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

106.7 **Identify the Performance Obligations in the Contract(s)**

In FASB ASC 606-10-20, a performance obligation is defined as a promise in a contract with a customer to transfer goods or services to the customer. If multiple goods and services are being transferred, there may be multiple performance obligations, each of which will be accounted for separately if it is distinct. A good or service is considered distinct if both of the following criteria are met:

- The good or service is capable of being distinct, which means that the customer can benefit from the good or service on its own or the customer has, or can readily obtain, resources that would make it work.

- The good or service is distinct within the contract itself, which means that the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

If performance obligations are not distinct, they are bundled together until a distinct performance obligation is identified.

106.8 **Determine the Transaction Price**

The transaction price is the amount of consideration that an entity expects to receive from the customer in exchange for transferring goods or services. ASU No. 2014-09 recommends considering the effects of each of the following on the transaction price:

- *Variable Consideration.* If the amount of consideration in a contract is variable, an entity determines the amount of variable consideration to include in the transaction price by estimating either the expected value (that is, a probability-weighted amount) or the most likely amount. The method used is the one that is expected to better predict the amount of consideration to which the entity will be entitled.

• *Constraining Estimates of Variable Consideration.* Variable consideration would be recognized only to the extent that it is probable that the entity would not have to reverse a significant amount of revenue when the uncertainty associated with the variable consideration is subsequently resolved.

• *Existence of a Significant Financing Component.* If a financing component is a factor, it should not be recorded as contractual revenues, but as interest. A contract has a financing component if the period between the payment by the customer and the transfer of the promised goods or services to the customer will be more than one year.

• *Noncash Consideration.* If a customer promises consideration in a form other than cash, an entity should measure the noncash consideration (or promise of noncash consideration) at fair value, if estimable.

• *Consideration Payable to the Customer.* If an entity pays, or expects to pay, consideration to a customer, the entity should account for the payment (or expectation of payment) as a reduction of the transaction price or as a payment for a distinct good or service (or both). If the consideration payable to a customer is a variable amount and accounted for as a reduction in the transaction price, an entity should consider the guidance on constraining estimates of variable consideration.

106.9 **Allocate the Transaction Price to the Performance Obligations in the Contract(s)**

If there are multiple performance obligations, an entity allocates the transaction price to each distinct performance obligation in an amount that represents the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation. The consideration is typically allocated on a relative standalone selling price basis. If a standalone selling price is not observable, an entity must estimate it.

106.10 **Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation**

Revenue is recognized when (or as) the entity satisfies its performance obligation by transferring a promised good or service to a customer. In many cases, revenue is recognized at the point in time at which a customer obtains control of the transferred good or service. However, an entity recognizes revenue over time if one of the following criteria is met:

• The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

• The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.

• The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

106.11 For each performance obligation that an entity satisfies over time, the entity recognizes revenue by consistently applying a method of measuring the progress toward complete satisfaction of that performance obligation. Appropriate methods of measuring progress include output methods and input methods. Output methods recognize revenue on the basis of measurements of the value to the customer of the goods or services transferred. Input methods recognize revenue on the basis of measurements of the entity's efforts toward satisfying the performance obligation(s). As circumstances change over time, an entity would update its measure of progress to represent the entity's performance completed to date.

106.12 **Effective Date and Transition**

As originally issued, ASU No. 2014-09 was to be effective for nonpublic entities for annual periods beginning after December 15, 2017. However, on July 9, 2015, the FASB approved a one-year deferral of the effective date. As a result, the revised effective date for nonpublic entities is for annual periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Thus, for calendar year-end nonpublic entities, the guidance would first be applied for the year ended December 31, 2019. Entities may choose to adopt the guidance early but not earlier than annual and interim reporting periods beginning after December 15, 2016.

106.13 ASU No. 2014-09 requires adopting the new standards using one of two approaches:

• *Full Retrospective Approach.* All prior reporting periods are presented as though the new guidance had always been effective in accordance with the guidance in FASB ASC 250-10-45 for retrospective application of a change in accounting principle. If this option is chosen, ASU No. 2014-09 provides certain practical expedients the organization may choose to apply. The date of the cumulative effect adjustment would be the start of the reporting period of the earliest period presented (i.e., January 1, 2017, for a calendar year nonpublic entity that chooses not to early adopt and presents comparative statements).

• *Modified Retrospective Approach.* The cumulative effect of adopting the new guidance is recognized on the date of initial application (i.e., January 1, 2018, for a calendar year organization that chooses not to early adopt). If this option is chosen, comparative periods are not restated. The authors believe most organizations will choose this approach.

106.14 **Joint Transition Resource Group for Revenue Recognition**

The FASB and the International Accounting Standards Board (IASB) have formed the Joint Transition Resource Group for Revenue Recognition (JTRG) to seek feedback, consider stakeholder issues, and inform the FASB and IASB of implementation issues related to the new revenue recognition standards. The JTRG will not issue guidance, but the FASB and IASB will use information obtained from the JTRG to determine what, if any, actions are required.

106.15 The FASB's narrower research topics related to revenue recognition under the new standards are as follows:

• Identifying performance obligations and licenses.

• Narrow scope improvements and practical expedients.

106.16 The FASB website indicates the FASB staff will provide updates on the results of its research on the above four topics when research is complete. Information about the JTRG including its meeting schedule, meeting materials, and archived webcasts is available from the FASB at **www.fasb.org/jsp/FASB/Page/LandingPage&cid=1176164065747**.

106.17 **AICPA Resources for Understanding and Implementing ASU No. 2014-09**

The AICPA's Financial Reporting Center (FRC) has a webpage at **www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/RevenueRecognition.aspx** that brings together the resources being developed to assist accountants in understanding and implementing ASU No. 2014-09.

106.18 The FRC's webpage also has information about 16 industry task forces formed by the AICPA to help develop a new AICPA accounting guide on revenue recognition. The task forces will provide illustrative examples and nonauthoritative guidance for applying the requirements of ASU No. 2014-09.

106.19 **Approach in This *Guide***

Some comments in this *Guide* deal specifically with the new revenue recognition standard (see paragraphs 400.88 and 401.16). Those comments have been updated to include the most recent guidance as discussed in this section. Auditors who would like to include a more comprehensive discussion of the standard in the management letter can use the guidance in this section to elaborate on those comments. However, general comments relating to revenue recognition issues throughout this *Guide* have not been updated for the new standard. Those comments will be updated in a future update, closer to the effective date of the new standard.

Proposed New Accounting Standard on Leases

106.20 In May 2013, the FASB issued a revised proposed ASU, *Leases* (Topic 842)—a revision of the 2010 proposed FASB Accounting Standards Update, *Leases* (Topic 842). The FASB is currently redeliberating the proposal. For lessee accounting, the tentative decisions reached during redeliberations call for leases (other than short-term leases of 12 months or less) to be categorized as Type A or Type B with the recognition of a right-of-use asset and a lease liability. For a Type A lease, amortization of the asset would be recognized along with the interest on the lease liability. For a Type B lease, a single lease expense would be recognized on a straight line basis. Most existing capital/finance leases would be Type A leases; most existing operating leases would be Type B. Lessors would also categorize leases as either Type A or Type B considering whether the lease is effectively a financing or sale versus an operating lease similar to existing GAAP. As of the date of this *Guide*, the FASB expects to issue a final ASU in the fourth quarter of 2015. Additional information on the project is available at **www.fasb.org**.

106.21 **Approach in This *Guide***

Because the proposed standard has not yet been finalized, the comments in this *Guide* dealing with leases have not been revised to reflect the FASB's current positions. However, when the standard is finalized, future editions of the *Guide* will be revised to reflect the new requirements.

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