

AU-C Section 940

An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements

Source: SAS No. 130.

Effective for integrated audits for periods ending on or after December 15, 2016.

NOTE

In May 2019, the Auditing Standards Board issued SAS No. 135, *Omnibus Statement on Auditing Standards — 2019*, which contains amendments to this section.

The amendments are effective for integrated audits for periods ending on or after December 15, 2020, and can be viewed in appendix B of section 700 until the effective date, when they will be applied to this section.

Introduction

Scope of This Section

.01 This section establishes requirements and provides guidance that applies only when an auditor is engaged to perform an audit of internal control over financial reporting (ICFR) that is integrated with an audit of financial statements (*integrated audit*). (Ref: par. .A1)

.02 Generally accepted auditing standards (GAAS) are written in the context of an audit of financial statements but are to be adapted as necessary in the circumstances when applied to an audit of ICFR that is integrated with an audit of financial statements.¹ This section includes special considerations related to performing an integrated audit.

Effective Date

.03 This section is effective for integrated audits for periods ending on or after December 15, 2016.

Objectives

.04 The objectives of the auditor in an audit of ICFR are to

- a. obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment about the effectiveness of ICFR (*as of date*) and

¹ Paragraph .02 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

- b. express an opinion on the effectiveness of ICFR in a written report, and communicate with management and those charged with governance as required by this section, based on the auditor's findings. (Ref: par. .A2–.A4)

Definitions

.05 For purposes of GAAS, the following terms have the meanings attributed as follows:

Audit of ICFR. An audit of the design and operating effectiveness of an entity's ICFR.

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

Criteria. The benchmarks used to measure or evaluate the subject matter. (Ref: par. .A5)

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

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

- i. pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity;
- ii. provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the applicable financial reporting framework, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and
- iii. provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

ICFR has inherent limitations. ICFR is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. ICFR also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented, or detected and corrected, on a timely basis by ICFR. (Ref: par. .A6–.A7)

Management's assessment about ICFR. Management's conclusion about the effectiveness of the entity's ICFR, based on suitable and available criteria. Management's assessment is included in management's report on ICFR. (Ref: par. .A8)

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

Requirements

Preconditions for the Audit of ICFR

.06 Section 210, *Terms of Engagement*, requires the auditor to establish whether the preconditions for an audit are present.² In an audit of ICFR, the auditor should

- a. obtain the agreement of management that it acknowledges and understands its responsibility for
 - i. designing, implementing, and maintaining effective ICFR.
 - ii. evaluating the effectiveness of the entity's ICFR using suitable and available criteria.
 - iii. providing management's assessment about ICFR in a report that accompanies the auditor's report (see paragraph .55).
 - iv. supporting its assessment about the effectiveness of the entity's ICFR with sufficient evaluations and documentation.
 - v. providing the auditor with
 - (1) access to all information of which management is aware that is relevant to management's assessment of ICFR, such as records, documentation, and other matters;
 - (2) additional information that the auditor may request from management for the purpose of the audit of ICFR; and
 - (3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence. (Ref: par. .A9–.A12)
- b. determine that the as of date corresponds to the balance sheet date (or period ending date) of the period covered by the financial statements. (Ref: par. .A13)

.07 The auditor should evaluate the effectiveness of the entity's ICFR using the same suitable and available criteria used by management for its assessment. (Ref: par. .A14–.A17)

Requesting a Written Assessment

.08 In accordance with paragraph .06a(iii), the auditor should request from management a written assessment about the effectiveness of the entity's ICFR.

² Paragraph .06 of section 210, *Terms of Engagement*.

Management's refusal to provide a written assessment represents a scope limitation, and the auditor should apply the requirements in paragraphs .74–.77.

Integrating the Audit of ICFR With the Financial Statement Audit

.09 Although the objectives of an audit of ICFR and an audit of financial statements are not the same, the auditor should plan and perform the integrated audit to achieve their respective objectives simultaneously. The auditor should design tests of controls

- a. to obtain sufficient appropriate audit evidence to support the auditor's opinion on ICFR as of the date specified in management's assessment about ICFR and
- b. to obtain sufficient appropriate audit evidence to support the auditor's control risk assessments for purposes of the audit of financial statements. (Ref: par. .A18–.A19)

.10 If the auditor is engaged to audit the effectiveness of an entity's ICFR for a period of time, the requirements and guidance in this section should be modified accordingly, and the auditor should integrate the audit of ICFR with an audit of financial statements covering the same period of time.

.11 The auditor should consider the effect of the results of the financial statement auditing procedures on the auditor's risk assessments and the testing necessary to conclude on the operating effectiveness of a control.

.12 If, during the audit of ICFR, the auditor identifies a deficiency in ICFR, the auditor should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an acceptably low level. See paragraphs .52–.54 for requirements on evaluating the effects of findings, including those from the financial statement audit, when forming an opinion on the effectiveness of ICFR.

.13 When concluding on the effectiveness of controls for the purpose of the financial statement audit, the auditor should evaluate the results of any additional tests of controls performed by the auditor to achieve the objective related to expressing an opinion on the entity's ICFR. (Ref: par. .A20)

Planning the Audit of ICFR

.14 In accordance with section 300, *Planning an Audit*, the auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit of ICFR and that guides the development of the audit plan.³ (Ref: par. .A21)

Role of Risk Assessment

.15 The auditor should focus more attention on areas of higher risk. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the entity's ICFR and the amount of attention that would be devoted to that area. In addition, an entity's ICFR is less likely to prevent, or detect and correct, a misstatement caused by fraud than a misstatement caused by error. It is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements. (Ref: par. .A22–.A24)

³ Paragraph .07 of section 300, *Planning an Audit*.

Addressing the Risk of Fraud

.16 The auditor should evaluate whether the entity's controls sufficiently address identified risks of material misstatement due to fraud and the risk of management override of other controls. (Ref: par. .A25)

.17 Section 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud.⁴ If the auditor identifies deficiencies in controls designed to prevent, or detect and correct, misstatements caused by fraud during the audit of ICFR, the auditor should take into account those deficiencies when developing the response to risks of material misstatement during the financial statement audit.⁵

Using the Work of Internal Auditors or Others

.18 The external auditor should obtain an understanding of the work of the internal audit function and others sufficient to identify those activities related to the effectiveness of ICFR that are relevant to planning and performing the audit of ICFR. (Ref: par. .A26)

.19 The external auditor should evaluate the extent to which the external auditor will use the work of internal auditors or others to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor. When using the work of internal auditors, section 610, *Using the Work of Internal Auditors*, is applicable. When the external auditor plans to use the work of others in obtaining audit evidence or to provide direct assistance in the audit of ICFR, the external auditor should apply the requirements in section 610 as if others were internal auditors. (Ref: par. .A27–.A30)

Materiality

.20 The auditor should use the same materiality for planning and performing the audit of ICFR and the financial statement audit. (Ref: par. .A31)

Using a Top-Down Approach

.21 The auditor should use a top-down approach to the audit of ICFR to select the controls to test. (Ref: par. .A32–.A33)

Entity-Level Controls

.22 The auditor should identify and test those entity-level controls that are important to the auditor's conclusion about whether the entity has effective ICFR. (Ref: par. .A34–.A37)

Evaluating the Components of ICFR

.23 In an integrated audit, the auditor should evaluate the components of ICFR and determine whether

- a. the components are present and functioning in the design, implementation, and operation of ICFR, and
- b. the components are operating together in an integrated manner to achieve the entity's financial reporting objectives. (Ref: par. .A38–.A48)

⁴ Paragraph .23 of section 240, *Consideration of Fraud in a Financial Statement Audit*.

⁵ See paragraphs .28–.33 of section 240.

Period-End Financial Reporting Process

.24 Because of its importance to financial reporting and to the integrated audit, the auditor should evaluate the period-end financial reporting process, which includes the following:

- a. Procedures used to enter transaction totals into the general ledger
- b. Procedures related to the selection and application of accounting policies
- c. Procedures used to initiate, authorize, record, and process journal entries in the general ledger
- d. Procedures used to record recurring and nonrecurring adjustments to the financial statements
- e. Procedures for preparing financial statements (Ref: par. .A49)

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

- a. the inputs, procedures performed, and outputs of the processes the entity uses to produce its financial statements;
- b. the extent of IT involvement in the period-end financial reporting process;
- c. who participates from management;
- d. the locations involved in the period-end financial reporting process;
- e. the types of adjusting and consolidating entries; and
- f. the nature and extent of the oversight of the process by management and those charged with governance.

Identifying Significant Classes of Transactions, Account Balances, and Disclosures, and Their Relative Assertions

.26 The auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions. To identify significant classes of transactions, account balances, and disclosures, and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. (Ref: par. .A50–.A52)

.27 As part of identifying significant classes of transactions, account balances, and disclosures, and their relevant assertions, the auditor should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. (Ref: par. .A53–.A54)

.28 When an entity has components, the auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions, based on the group financial statements. (Ref: par. .A55)

Understanding Likely Sources of Misstatement

.29 To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should

- a. understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, recorded, processed, and reported.

- b. identify the points within the entity's processes at which a misstatement, including a misstatement due to fraud, could arise that, individually or in combination with other misstatements, would be material (for example, points at which information is initiated, transferred, or otherwise modified).
- c. identify the controls that management has implemented to address these potential misstatements.
- d. identify the controls that management has implemented over the prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements. (Ref: par. .A56–.A57)

.30 Because of the degree of judgment necessary, the auditor should either directly perform the procedures that achieve the requirements in paragraph .29 or supervise the work of the internal auditors or others who provide direct assistance to the auditor.

.31 The auditor should understand how IT affects the entity's flow of transactions and, as required by section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, how the entity has responded to risks arising from IT.⁶ (Ref: par. .A58)

Selecting Controls to Test

.32 The auditor should identify and test those controls that are important to the auditor's conclusion about whether the entity's controls sufficiently address the assessed risk of material misstatement to each relevant assertion. (Ref: par. .A59–.A60)

Testing Controls

Evaluating Design Effectiveness

.33 The auditor should evaluate the design effectiveness of controls by determining whether the entity's controls, if operated as prescribed by persons possessing the necessary authority and competence to perform them effectively, satisfy the entity's control objectives, and can effectively prevent, or detect and correct, misstatements caused by errors or fraud that could result in material misstatements in the financial statements. (Ref: par. .A61–.A62)

Testing Operating Effectiveness

.34 The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. (Ref: par. .A63–.A64)

Relationship of Risk to the Evidence to Be Obtained

.35 As the risk associated with the control being tested increases, the sufficiency and appropriateness of evidence that the auditor obtains should also increase. (Ref: par. .A65–.A68)

.36 The auditor should obtain evidence about the effectiveness of selected controls for each relevant assertion. The auditor is not responsible for obtaining

⁶ Paragraph .22 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

sufficient appropriate audit evidence to support an opinion about the effectiveness of each individual control. (Ref: par. .A69–.A75)

.37 To obtain evidence about whether a selected control is effective, the auditor should test the control.

.38 When the auditor identifies control deviations, the auditor should determine the effect of the deviations on the auditor's assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control. (Ref: par. .A76)

Timing and Extent of Tests of Controls

.39 To express an opinion on ICFR as of a point in time, the auditor should obtain evidence that ICFR has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the entity's financial statements. The auditor should balance performing the tests of controls closer to the as of date with the need to test controls over a sufficient period of time to obtain sufficient appropriate audit evidence of operating effectiveness. (Ref: par. .A77–.A80)

Rollforward Procedures

.40 When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, the auditor should determine what additional evidence concerning the operation of the controls for the remaining period is necessary. (Ref: par. .A81–.A82)

Special Considerations for Subsequent Years' Audits

.41 In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits performed by the auditor of the entity's ICFR into the decision-making process for determining the nature, timing, and extent of testing necessary. (Ref: par. .A83–.A85)

.42 The auditor should vary the nature, timing, and extent of testing of controls from period to period to introduce unpredictability into the testing and respond to changes in circumstances. (Ref: par. .A86)

Identifying Deficiencies in ICFR

.43 The auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in ICFR. (Ref: par. .A87)

Determination of Whether Material Weaknesses Exist as of the Date Specified in Management's Assessment About ICFR

.44 For purposes of forming an opinion on the effectiveness of ICFR, the auditor should evaluate the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a material weakness as of the date specified in management's assessment about ICFR. In performing such evaluation, the auditor should determine whether deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR, collectively result in a material weakness. (Ref: par. .A88–.A94)

.45 The auditor should evaluate the effect of compensating controls when determining whether a deficiency, or combination of deficiencies, in ICFR is a material weakness as of the date specified in management's assessment about ICFR. The auditor should test the operating effectiveness of such compensating

controls to determine whether they operate at a level of precision that would prevent, or detect and correct, a material misstatement. (Ref: par. .A95)

.46 If the auditor initially determines that a deficiency, or a combination of deficiencies, in ICFR 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. (Ref: par. .A96)

Determination of Whether Significant Deficiencies Exist During the Integrated Audit

.47 The auditor should evaluate the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a significant deficiency. In performing such evaluation, the auditor should determine whether deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR collectively result in a significant deficiency. (Ref: par. .A97–.A98)

Subsequent Events

.48 The auditor should inquire of management and, when appropriate, those charged with governance, about whether there were any changes in ICFR or conditions that might significantly affect ICFR subsequent to the as of date but before the date of the auditor's report. To obtain additional information about changes in ICFR or other conditions that might significantly affect the effectiveness of the entity's ICFR, the auditor should inquire about and read, for this subsequent period, the following: (Ref: par. .A99)

- a. Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period
- b. Reports regarding deficiencies issued by other independent auditors
- c. Regulatory agency reports on the entity's ICFR
- d. Information about the effectiveness of the entity's ICFR obtained through other engagements performed for the entity by the auditor

.49 If, as a result of the subsequent events procedures, the auditor obtains knowledge about a material weakness that existed as of the date specified in management's assessment about ICFR, the auditor should issue an adverse opinion, as required by paragraph .68. The auditor should also follow paragraph .72 if management's assessment about ICFR states that ICFR is effective. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the entity's ICFR as of the date specified in management's assessment about ICFR, the auditor should disclaim an opinion. The auditor should disclaim an opinion on management's disclosures about corrective actions taken by the entity, if any. (Ref: par. .A100)

.50 If the auditor obtains knowledge about conditions that did not exist at the as of date but arose subsequent to that date and before the release of the auditor's report and such subsequent information has a material effect on the entity's ICFR, the auditor should include in the auditor's report an emphasis-of-matter paragraph directing the reader's attention to the subsequently discovered fact and its effects as disclosed in management's report or an other-matter paragraph describing the subsequently discovered fact and its effects. (Ref: par. .A101)

.51 The auditor has no responsibility to keep informed of events subsequent to the date of the auditor's report; however, the auditor should respond appropriately to facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.

Concluding Procedures

Forming an Opinion

.52 The auditor should form an opinion on the effectiveness of ICFR by evaluating evidence obtained from all sources, including

- a. the auditor's testing of controls for the ICFR audit,
- b. any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements,
- c. misstatements detected during the financial statement audit, and
- d. any identified deficiencies.

.53 As part of evaluating evidence obtained from all sources, the auditor should review reports issued during the year by the internal audit function (or similar functions) that address controls related to ICFR and evaluate deficiencies identified in those reports.

.54 In addition to evaluating the findings from the auditor's testing of controls for the audit of ICFR, the auditor should evaluate the effect of the findings of the substantive procedures performed in the audit of financial statements on the effectiveness of ICFR. This evaluation should include, at a minimum,

- a. the risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud;
- b. findings with respect to noncompliance with laws and regulations;
- c. findings with respect to related party transactions and complex or unusual transactions;
- d. indications of management bias in making accounting estimates and selecting accounting principles; and
- e. the nature and extent of misstatements detected by substantive procedures.

.55 After forming an opinion on the effectiveness of the entity's ICFR, the auditor should evaluate management's report, which will accompany the auditor's report, to determine whether it contains the following:

- a. A statement regarding management's responsibility for ICFR
- b. A description of the subject matter of the audit (for example, controls over the preparation of the entity's financial statements in accordance with accounting principles generally accepted in the United States of America)
- c. An identification of the criteria against which ICFR is measured
- d. Management's assessment about ICFR
- e. A description of the material weakness(es), if any
- f. The date as of which management's assessment about ICFR is made

.56 If the auditor determines that any required element of management's report is incomplete or improperly presented, the auditor should request management to revise its report. (Ref: par. .A102)

Obtaining Written Representations

.57 In an audit of ICFR, the auditor should obtain written representations from management

- a. acknowledging management's responsibility for establishing and maintaining effective ICFR;
- b. stating that management has performed an assessment of the effectiveness of the entity's ICFR and specifying the criteria;
- c. stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assessment about ICFR;
- d. stating management's assessment about the effectiveness of the entity's ICFR based on the criteria as of a specified date;
- e. stating that management has disclosed to the auditor all deficiencies in the design or operation of ICFR, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses;
- f. describing any fraud resulting in a material misstatement to the entity's financial statements and any other fraud that does not result in a material misstatement to the entity's financial statements, but involves senior management or management or other employees who have a significant role in the entity's ICFR;
- g. stating whether the significant deficiencies and material weaknesses identified and communicated to management and those charged with governance during previous engagements pursuant to paragraph .59 have been resolved and specifically identifying any that have not; and
- h. stating whether there were, subsequent to the date being reported on, any changes in ICFR or other conditions that might significantly affect ICFR, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses (Ref: par. .A103)

.58 If management does not provide the written representations required by paragraph .57, the auditor should apply the requirements in paragraph .73. (Ref: par. .A104)

Communicating ICFR-Related Matters

.59 The auditor should communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit, including those that were remediated during the integrated audit and those that were previously communicated but have not yet been remediated. (Ref: par. .A105–.A107)

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

.61 The written communications referred to in paragraphs .59–.60 should be made by the report release date, which is the date the auditor grants the entity permission to use the auditor's report. For a governmental entity, if such written communications would be publicly available prior to management's report on ICFR, the entity's financial statements, and the auditor's report thereon, the auditor is not required to make the written communications by the report release date. In that circumstance, the written communications

should be made as soon as practicable, but no later than 60 days following the report release date. (Ref: par. .A108–.A109)

.62 The auditor should communicate in writing to management all deficiencies identified during the integrated audit on a timely basis, but no later than 60 days following the report release date, and inform those charged with governance when such a communication was or is expected to be made. In making the written communication referred to in this paragraph, the auditor is not required to communicate those deficiencies that are not material weaknesses or significant deficiencies that were included in previous written communications, regardless of whether those communications were made by the auditor, internal auditors, or others within the organization. (Ref: par. .A110–.A112)

.63 Because the integrated audit does not provide the auditor with reasonable assurance that the auditor has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were identified during the integrated audit. Also, because the auditor issues a report that expresses an opinion on the effectiveness of the entity's ICFR, the auditor should not issue a report indicating that no material weaknesses were identified during the integrated audit.

Reporting on ICFR

.64 The auditor's report on the audit of ICFR should be in writing and should include the following elements:

- a. A title that includes the word *independent* to clearly indicate that it is the report of an independent auditor
- b. An addressee as required by the circumstances of the engagement
- c. An introductory paragraph that includes the following:
 - i. Identification of the entity whose ICFR has been audited
 - ii. A statement that the entity's ICFR has been audited
 - iii. Identification of the as of date
 - iv. Identification of the criteria against which ICFR is measured
- d. A section with the heading "Management's Responsibility for Internal Control Over Financial Reporting" that includes the following:
 - i. A statement that management is responsible for designing, implementing, and maintaining effective ICFR
 - ii. A statement that management is responsible for its assessment about the effectiveness of ICFR
 - iii. A reference to management's report on ICFR
- e. A section with the heading "Auditor's Responsibility" that includes the following:
 - i. A statement that the auditor's responsibility is to express an opinion on the entity's ICFR based on the audit
 - ii. A statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America (Ref: par. .A113)
 - iii. A statement that such standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective ICFR was maintained in all material respects

- iv. A description of the audit by stating that
 - (1) an audit of ICFR involves performing procedures to obtain audit evidence about whether a material weakness exists
 - (2) the procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists
 - (3) an audit includes obtaining an understanding of ICFR and testing and evaluating the design and operating effectiveness of ICFR based on the assessed risk
- v. A statement about whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the audit opinion
- f. A section with the heading "Definition and Inherent Limitations of Internal Control Over Financial Reporting" or other appropriate heading that includes the following:
 - i. A definition of ICFR (the auditor should use the same description of the entity's ICFR as management uses in its report)
 - ii. A paragraph stating that because of inherent limitations, ICFR may not prevent, or detect and correct, misstatements and that projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate
- g. A section with the heading "Opinion" that includes the auditor's opinion on whether the entity maintained, in all material respects, effective ICFR as of the specified date, based on the criteria
- h. The manual or printed signature of the auditor's firm
- i. The city and state where the auditor practices
- j. The date of the auditor's report, as required by paragraph .66

.65 If the auditor issues a separate report on ICFR, the auditor should add the following paragraph, in an other-matter paragraph with an appropriate heading, in accordance with section 706A, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, to the auditor's report on the financial statements:

We also have audited, in accordance with auditing standards generally accepted in the United States of America, [entity name]'s internal control over financial reporting as of December 31, 20X8, based on [identify criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinion].

The auditor also should add the following other-matter paragraph to the report on ICFR:

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of [entity name] and our report dated [date of report, which should be the same as the date of the report on ICFR] expressed [include nature of opinion]. (Ref: par. .A114–.A116)

Report Date

.66 The auditor should date the report on ICFR no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion, including evidence that the audit documentation has been reviewed. Because the audit of ICFR is integrated with the audit of the financial statements, when issuing separate reports on the entity's financial statements and on ICFR, the dates of the reports should be the same.

Report Modifications

.67 The auditor should modify the report on ICFR if any of the following conditions exist:

- a. One or more material weaknesses exist.
- b. Elements of management's report are incomplete or improperly presented.
- c. There is a limitation on the scope of the engagement. (Ref: par. .A117)
- d. The auditor decides to refer to the report of a component auditor as the basis, in part, for the auditor's own opinion.
- e. There is other information contained in management's report.

Adverse Opinions

.68 If there are deficiencies that, individually or in combination, result in one or more material weaknesses as of the date specified in management's assessment about ICFR, the auditor should express an adverse opinion on the entity's ICFR, unless there is a limitation on the scope of the engagement. (Ref: par. .A118–.A119)

.69 When ICFR is not effective because one or more material weaknesses exist, the auditor's report should include

- a. the definition of a material weakness and
- b. a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's assessment about ICFR. (Ref: par. .A120)

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

.71 The auditor should determine the effect an adverse opinion on ICFR has on the auditor's opinion on the financial statements. Additionally, the

auditor should disclose, in an other-matter paragraph or as part of the paragraph that identifies the material weakness, whether the auditor's opinion on the financial statements was affected by the material weakness. (Ref: par. .A121)

Elements of Management's Report Are Incomplete or Improperly Presented

.72 If the auditor determines that any required element of management's report, as described in paragraph .55, is incomplete or improperly presented and management does not revise its report, the auditor should modify the report on ICFR to include an other-matter paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about one or more material weaknesses is not fairly presented in all material respects, the auditor should apply the requirements in paragraph .70.

Scope Limitations

.73 If, after accepting the integrated audit engagement, there is a limitation on the scope of the engagement with respect to ICFR, the auditor should withdraw from the integrated audit engagement or disclaim an opinion on ICFR and consider the implications on the financial statement audit.

.74 When a scope limitation arises because management refuses to furnish a written assessment about the effectiveness of ICFR, the auditor should withdraw from the integrated audit engagement. When withdrawal is not possible under applicable law or regulation, the auditor should disclaim an opinion on ICFR and consider the implications on the financial statement audit. (Ref: par. .A122)

.75 When disclaiming an opinion because of a scope limitation, the auditor should state that the auditor does not express an opinion on the effectiveness of ICFR and the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of ICFR, as described in paragraph .64e; to do so might overshadow the disclaimer. (Ref: par. .A123–.A124)

.76 When the auditor disclaims an opinion but has concluded that one or more material weaknesses exist, the auditor's report also should include

- a. the definition of a material weakness and
- b. a description of any material weaknesses identified in the entity's ICFR. This description should address the requirements in paragraph .69 and should provide the users of the report with specific information about the nature of any material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness.

The auditor also should apply the requirements in paragraph .71. (Ref: par. .A125)

.77 If the auditor concludes that the auditor cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to management and those charged with governance that the audit of ICFR cannot be satisfactorily completed.

Making Reference to a Component Auditor and Assuming Responsibility for the Work of a Component Auditor

.78 When an entity includes one or more components, the group engagement partner should evaluate whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement

team's work or use of the work of component auditors (that is, through assuming responsibility for the work of component auditors or making reference to the audit of ICFR of a component auditor in the auditor's report) to act as the auditor of the ICFR over the group financial statements and report as such on the ICFR over the group financial statements, as required by section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.⁷ (Ref: par. .A126)

.79 As required by section 600, the group engagement partner should determine whether to make reference to a component auditor in the report on the ICFR over the group financial statements.⁸ Reference to the audit of a component auditor in the auditor's report on the ICFR over the group financial statements should not be made unless

- a. the engagement partner has determined that the component auditor has performed an audit of the component's ICFR in accordance with the relevant requirements of GAAS (or, if applicable, the standards promulgated by the PCAOB) and
- b. the component auditor has issued an auditor's report on ICFR that is not restricted as to use. (Ref: par. .A127–.A128)

Additional Information

.80 When management includes, either within management's report or in a document containing management's report, information in addition to the elements that are subject to the auditor's evaluation as described in paragraph .55, the auditor should

- a. disclaim an opinion, in an other-matter paragraph, on the additional information when such information is included in management's report. (Ref: par. .A129)
- b. read the additional information to identify material inconsistencies with management's report and material misstatements of fact when such information is included outside management's report in a document containing management's report and the related auditor's report. If, upon reading the additional information, the auditor becomes aware of an apparent material inconsistency or misstatement of fact, the auditor should apply the requirements in section 720A, *Other Information in Documents Containing Audited Financial Statements*, adapted as necessary, to the audit of ICFR. (Ref: par. .A130)

Special Topics

Entities With Multiple Components

.81 In determining the components at which to perform tests of controls, the group engagement team should assess the risk of material misstatement to the financial statements associated with the component and correlate the amount of attention devoted to the component with the degree of risk. (Ref: par. .A131–.A133)

.82 In assessing and responding to risk, the group engagement team should test, or have a component auditor test on the group engagement team's

⁷ Paragraph .15 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

⁸ Paragraph .24 of section 600.

behalf, controls over specific risks that present a reasonable possibility of material misstatement to the group financial statements. (Ref: par. .A134)

.83 In applying the requirement in paragraph .42 regarding special considerations for subsequent years' audits, the group engagement team should vary the nature, timing, and extent of tests of controls at components from year to year.

Special Situations

.84 For equity method investment components, the scope of the audit should include controls over the reporting in the entity's financial statements of the entity's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures, in accordance with the applicable financial reporting framework. (Ref: par. .A135)

.85 Except as indicated in paragraph .86, the scope of the audit should include entities that are acquired on or before the date specified in management's assessment about ICFR and operations that are accounted for as discontinued operations on the date specified in management's assessment about ICFR that are reported in accordance with the applicable financial reporting framework in the entity's financial statements.

.86 In situations in which management elects to limit its assessment by excluding certain entities, the auditor should evaluate whether it is appropriate, in the auditor's judgment, to do so. If the auditor concludes that it is appropriate, the auditor should include in the introductory paragraph of the report a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment about ICFR and the auditor's audit of ICFR. Additionally, the auditor should evaluate the appropriateness of management's disclosure related to such a limitation. (Ref: par. .A136)

.87 If the auditor believes that management's disclosure about the limitation requires modification, the auditor should communicate the matter to the appropriate level of management. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform those charged with governance of the matter as soon as practicable. If management and those charged with governance do not respond appropriately, the auditor should modify the auditor's report on the audit of ICFR to include an other-matter paragraph describing the reasons why the auditor believes management's disclosure requires modification.

Use of Service Organizations

.88 When the entity uses the services of a service organization, the auditor should consider the activities of the service organization when determining the evidence required to support the auditor's opinion on the effectiveness of an entity's ICFR. (Ref: par. .A137–.A138)

.89 The auditor is required to perform the procedures in section 402, *Audit Considerations Relating to an Entity Using a Service Organization*, with respect to the activities performed by the service organization.⁹ In an audit of ICFR, the auditor should also obtain evidence that controls at the service organization that are relevant to the auditor's opinion on ICFR are operating effectively. (Ref: par. .A139–.A140)

⁹ Paragraphs .09–.19 of section 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.90 If the auditor plans to use a type 2 report as audit evidence that controls are operating effectively, the auditor should determine whether the type 2 report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the auditor's opinion by evaluating

- a. the time period covered by the tests of controls and its relation to the as of date;
- b. the scope of the service auditor's work and the services and processes covered, the controls tested, and the tests that were performed and the way in which tested controls relate to the entity's controls; and
- c. the results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls. (Ref: par. .A141)

.91 The auditor should determine whether complementary user entity controls identified in the type 2 report are relevant in addressing the risks of material misstatement and, if so, evaluate the entity's design and implementation of the relevant complementary user entity controls and test their operating effectiveness. (Ref: par. .A142)

.92 In determining whether the type 2 report provides sufficient appropriate audit evidence to support the auditor's opinion on ICFR, the auditor should be satisfied regarding the following:

- a. The service auditor's professional competence and independence from the service organization. (Ref: par. .A143)
- b. The adequacy of the standards under which the type 2 report was issued. (Ref: par. .A144)

.93 The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report. If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the entity's ICFR. The auditor also should evaluate whether the results of other procedures the auditor performed indicate that there have been changes in the controls at the service organization. (Ref: par. .A145)

.94 The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors:

- a. The elapsed time between the time period covered by the tests of controls in the service auditor's report and the as of date
- b. The significance of the activities of the service organization
- c. Whether there are errors that have been identified in the service organization's processing
- d. The nature and significance of any changes in the service organization's controls identified by management or the auditor (Ref: par. .A146)

.95 When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the as of date, additional procedures should be performed to obtain sufficient appropriate audit evidence about the operating effectiveness of the controls at the service organization that are relevant to the auditor's opinion on ICFR.

.96 The auditor should not refer to the service auditor's report when expressing an opinion on ICFR.

Benchmarking of Automated Controls

.97 To determine whether to use a benchmarking strategy for testing an automated application control, the auditor should assess the following risk factors:

- a. The extent to which the application control can be matched to a defined program within an application
- b. The extent to which the application is stable (that is, there are few changes from period to period)
- c. The availability and reliability of a report of the compilation dates of the programs placed in production (Ref: par. .A147–.A150)

.98 When using a benchmarking strategy, the auditor should obtain evidence to determine that the automated application control has not changed. (Ref: par. .A151–.A152)

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

- a. The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls, and computer operations
- b. The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls
- c. The nature and timing of other related tests
- d. The consequences of errors associated with the application control that was benchmarked
- e. Whether the control is sensitive to other business factors that may have changed (Ref: par. .A153)

Application and Other Explanatory Material

Scope of This Section (Ref: par. .01–.02)

.A1 Certain regulatory bodies, such as the FDIC, require the audit of ICFR and the audit of financial statements to be performed by the same auditor.¹⁰ Inherent difficulties exist when integrating the audit of ICFR and the audit of the financial statements to meet the requirements of this section when the audit of the financial statements is performed by a different auditor. Nonetheless, if the audit of the financial statements and the audit of ICFR are performed by different auditors, the audits are required by this section to be integrated.

Objectives (Ref: par. .04)

.A2 See section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, for additional explanation related to the auditor's objective to obtain reasonable assurance.¹¹

¹⁰ See Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (Section 36 of the Federal Deposit Insurance Act [FDI Act], 12.U.S.C. 1831m) and its implementing regulation, 12 CFR Part 363.3(b).

¹¹ Paragraph .06 of section 200.

.A3 Effective ICFR provides an entity with reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with the applicable financial reporting framework. If one or more material weakness exists, the entity's ICFR cannot be considered effective. The evaluation of the effectiveness of the entity's ICFR required by this section encompasses all relevant control objectives of the entity's ICFR; therefore, the identification of one material weakness in ICFR does not justify the auditor ceasing to perform procedures to evaluate the effectiveness of all relevant control objectives of the entity's ICFR.

.A4 The auditor is not required to plan and perform the integrated audit to identify deficiencies that, individually or in combination, are less severe than a material weakness.

Definitions (Ref: par. .05)

Criteria

.A5 For purposes of this section, the subject matter is ICFR.

Internal Control Over Financial Reporting

.A6 The auditor's procedures performed as part of the integrated audit are not part of an entity's ICFR.

.A7 For insured depository institutions (IDIs) subject to the internal control reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), ICFR includes controls over the preparation of the IDI's financial statements in accordance with generally accepted accounting principles (GAAP) and with the instructions to the Consolidated Financial Statements for Bank Holding Companies. ICFR also includes controls over the preparation of the IDI's financial statements in accordance with GAAP and controls over the preparation of schedules equivalent to the basic financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (Call Report Instructions).

Management's Assessment About ICFR

.A8 Exhibit C, "Illustrative Management Report," includes an illustration of a management report.

Preconditions for the Audit of ICFR (Ref: par. .06–.07)

.A9 Management is responsible for identifying and documenting the controls and the control objectives that they were designed to achieve. Such documentation serves as a basis for management's assessment about ICFR. Documentation of the design of controls, including changes to those controls, is evidence that controls upon which management's assessment about ICFR is based are

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

.A10 Management's documentation may take various forms, for example, entity policy manuals, accounting manuals, narrative memoranda, flowcharts,

decision tables, procedural write-ups, or completed questionnaires. No one particular form of documentation is prescribed, and the extent of documentation may vary depending upon the size and complexity of the entity and the entity's monitoring activities.

.A11 Management's monitoring activities also may provide evidence of the design and operating effectiveness of ICFR in support of management's assessment about ICFR. Monitoring of controls is a process to assess the effectiveness of ICFR performance over time. It involves assessing the effectiveness of controls on a timely basis, identifying and reporting deficiencies to appropriate individuals within the organization, and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing evaluations, separate evaluations, or a combination of the two.

.A12 Ongoing evaluations are often built into the normal recurring activities of an entity and include regular management and supervisory activities. The greater the degree and effectiveness of ongoing evaluations, the less need for separate evaluations. Management may perform a combination of ongoing and separate evaluations. The scope and frequency of separate evaluations is a matter of management judgment.

.A13 Ordinarily, the auditor is engaged to audit the effectiveness of the entity's ICFR as of the end of the entity's fiscal year; however, management may select a different date. If the auditor is engaged to audit the effectiveness of an entity's ICFR at a date different from the end of the entity's fiscal year, the audit is, nevertheless, required by paragraph .06b to be integrated with a financial statement audit as of the date specified in management's assessment.

.A14 Appropriate criteria are both suitable and available to the intended users of management's report on ICFR. Suitable criteria exhibit all of the following characteristics:

- *Relevance.* Criteria are relevant to ICFR.
- *Objectivity.* Criteria are free from bias.
- *Measurability.* Criteria permit reasonably consistent measurements, qualitative or quantitative, of ICFR.
- *Completeness.* Criteria are complete when the evaluation of the effectiveness of ICFR prepared in accordance with the criteria does not omit relevant factors that could reasonably be expected to affect decisions of the intended users made on the basis of management's report on ICFR.

.A15 Management may select criteria for ICFR that are available publicly in published frameworks or criteria that are available only to specified parties (for example, terms of a contract or criteria issued by an industry association that are available only to those in the industry). When criteria are available only to specified parties, section 905, *Alert That Restricts the Use of the Auditor's Written Communication*, requires that the auditor's report include an other-matter paragraph that restricts the use of the auditor's report.¹²

.A16 *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 COSO framework) and the U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* (the Green Book), provide suitable and available criteria against which management may evaluate and report on the

¹² Paragraph .06 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*.

effectiveness of the entity's ICFR. If management selects another framework, see paragraph .A14 for guidance on evaluating the suitability of the framework selected by management.

.A17 *Internal control*, as defined by the framework used by management, may be more broadly defined than ICFR. However, this section focuses only on ICFR.

Integrating the Audit of ICFR With the Financial Statement Audit (Ref: par. .09–.13)

.A18 Obtaining sufficient appropriate audit evidence to support the operating effectiveness of controls for purposes of the financial statement audit ordinarily allows the auditor to modify the substantive procedures that otherwise would have been necessary to opine on the financial statements.

.A19 Section 500, *Audit Evidence*, provides additional explanation with respect to obtaining sufficient appropriate audit evidence.

.A20 Consideration of the results of tests of controls may cause the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified deficiencies.

Planning the Audit of ICFR (Ref: par. .14)

.A21 Evaluating whether the following matters are important to the entity's financial statements and ICFR and, if so, how they may affect the auditor's procedures may assist the auditor in planning the audit of ICFR:

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

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

Role of Risk Assessment (Ref: par. .15)

.A22 Risk assessment underlies the entire audit process described by this section, including the determination of significant classes of transactions, account balances, and disclosures, and their relevant assertions, the selection of controls to test, and the determination of the evidence necessary to conclude on the effectiveness of a given control. The risk assessment procedures described in section 315 support both the financial statement audit and the audit of ICFR.

Scaling the Audit

.A23 The size and complexity of the entity, its business processes, and structure may affect the way in which the entity achieves many of its control objectives. Many smaller entities have less complex operations. Additionally, some larger, complex entities may have less complex units or processes. Factors that might indicate less complex operations include fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control. Accordingly, a smaller, less complex entity, or even a larger, less complex entity might achieve its control objectives differently from a more complex entity.

.A24 The size and complexity of the entity, its business processes, and structure also may affect the auditor's risk assessment and the determination of the necessary procedures and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to audits of all entities.

Addressing the Risk of Fraud (Ref: par. .16–.17)

.A25 Section 240 addresses the auditor's identification and assessment of the risks of material misstatement due to fraud.¹³ Controls that might address these risks include

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

Using the Work of Internal Auditors or Others (Ref: par. .18–.19)

.A26 The extent of the procedures necessary to obtain the understanding required by paragraph .18 will vary, depending on the nature of those activities. In performing risk assessment procedures, the auditor is required to inquire of appropriate individuals within the internal audit function (if such function

¹³ Paragraphs .25–.27 of section 240.

exists).¹⁴ Section 315 provides guidance with respect to such inquiries and certain additional procedures based on the responses to such inquiries.¹⁵

.A27 In an audit of ICFR, the external auditor may use the work of the internal audit function in obtaining audit evidence or use internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor. For purposes of the audit of ICFR, however, the auditor also may use the work performed by, or receive direct assistance from, others. Others include entity personnel (in addition to internal auditors) and third parties working under the direction of management or those charged with governance that provide evidence about the effectiveness of ICFR. In an integrated audit, the auditor also may use the work of internal auditors or others to obtain evidence supporting the assessment of control risk for purposes of the financial statement audit.

.A28 As the risk associated with a control increases, the need for the auditor to directly perform work on the control increases (for example, for controls that address specific fraud risks, use of the work of the internal audit function or others would be limited, if it could be used at all).

.A29 For purposes of evaluating the competence and objectivity of others in accordance with section 610, *competence* means the attainment and maintenance of a level of understanding, knowledge, and skills that enables that person to ably perform the tasks assigned to them, and *objectivity* means the ability to perform those tasks impartially and with intellectual honesty, without allowing bias, conflict of interest, or undue influence of others to override professional judgments.¹⁶ The more objective and the higher level of competence, the more likely the external auditor may use the work of others and make use of it in more areas.

.A30 Others may have an approach that differs from that of an internal audit function, particularly with respect to the level of formality. However, it would be inappropriate to use the work of others that do not have a systematic and disciplined approach, including quality control, as required by section 610. Section 610 provides additional requirements and guidance in determining when to use the work, in which areas, and to what extent.

Materiality (Ref: par. .20)

.A31 Section 320, *Materiality in Planning and Performing an Audit*, provides additional explanation of materiality.

Using a Top-Down Approach (Ref: par. .21)

.A32 The *top-down approach* describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the audit procedures.

.A33 A top-down approach involves

- beginning at the financial statement level;
- using the auditor's understanding of the overall risks to ICFR;
- focusing on entity-level controls;

¹⁴ Paragraph .06a of section 315.

¹⁵ Paragraphs .A9–.A13 of section 315.

¹⁶ Paragraphs .13 and .A5–.A9 of section 610, *Using the Work of Internal Auditors*.

- working down to significant classes of transactions, account balances, and disclosures, and their relevant assertions;
- directing attention to classes of transactions, accounts, disclosures, and assertions that present a reasonable possibility of material misstatement of the financial statements;
- verifying the auditor's understanding of the risks in the entity's processes; and
- selecting controls for testing that sufficiently address the assessed risk of material misstatement to each relevant assertion.

Entity-Level Controls (Ref: par. .22)

.A34 The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

.A35 Entity-level controls include

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

.A36 Entity-level controls vary in nature and precision:

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

Considerations Specific to Smaller, Less Complex Entities

.A37 Controls over management override are important to effective ICFR for all entities and may be particularly important at smaller, less complex entities because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller, less complex entities, the controls that address the risk of management override might be different from those at a larger entity. For example, a smaller, less complex entity might rely on more detailed oversight by those charged with governance that focuses on the risk of management override.

Evaluating the Components of ICFR (Ref: par. .23)

.A38 ICFR is often described as consisting of five components: control environment, risk assessment, control activities, information and communication, and monitoring. The components are necessary to an effective system of ICFR.¹⁷ This description does not necessarily reflect how an entity designs, implements, and maintains ICFR nor how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of ICFR and their effect on the audit other than those used in this section, provided that all the components described in this section are addressed. Entities select and develop controls within each component. Controls are inter-related and may support multiple objectives.

.A39 The 2013 COSO framework includes principles related to each component that are suitable to all entities. The 2013 COSO framework presumes that all principles are relevant because they have a significant bearing on the presence and functioning of an associated component. There may be a rare industry, operating, or regulatory situation in which management has determined that a principle is not relevant to a component. Considerations in applying this judgment may include the entity structure recognizing any legal, regulatory, industry, or contractual requirements for governance of the entity, and the level of use and dependence on technology used by the entity. The 2013 COSO framework states that management must support its determination that a principle is not relevant with the rationale of how, in the absence of that principle, the associated component can be present and functioning.¹⁸

.A40 When management uses the 2013 COSO framework, the guidance described in paragraphs .A41–.A48 to evaluate the five components is applicable. When management uses the Green Book or another framework, the auditor may adapt the guidance in paragraphs .A41–.A48, as necessary, based on the criteria contained in the framework used by management. For example, when management uses the Green Book, the auditor assesses the relevant principles in the Green Book in lieu of the principles listed in paragraphs .A41–.A48.

Control Environment

.A41 The following principles are relevant to the auditor's evaluation of whether the control environment is present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

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

¹⁷ Some material in this section relies upon the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control—Integrated Framework*. The copyright is held by COSO, and the material is used with COSO's permission.

¹⁸ "Suitability and Relevance of Components and Principles" in section 3, "Effective Internal Control" of *Internal Control—Integrated Framework* (COSO, 2013).

- Those charged with governance demonstrate independence from management and exercise oversight of the development and performance of ICFR.
- Management establishes, with oversight of those charged with governance, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of the entity's financial reporting objectives.
- The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with the entity's financial reporting objectives.
- The entity holds individuals accountable for their ICFR responsibilities in the pursuit of the entity's financial reporting objectives.

.A42 The evaluation of whether those charged with governance demonstrate independence from management and exercise oversight of the development and performance of ICFR is performed in the context of the entity's governance structure. As described in section 260, *The Auditor's Communication With Those Charged With Governance*, governance structures may vary by entity, reflecting influences such as size and ownership characteristics.¹⁹ For example, in some smaller entities, those charged with governance and management may be the same people. In such smaller entities, the independence of those charged with governance from management may not be necessary to support the achievement of the entity's financial reporting objectives.

.A43 The Green Book refers to those charged with governance as the oversight body.

Risk Assessment

.A44 The following principles are relevant to the auditor's evaluation of whether the entity's risk assessment is present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

- a. The entity specifies financial reporting objectives with sufficient clarity to enable the identification and assessment of risks related to these objectives.
- b. The entity identifies risks to the achievement of financial reporting objectives across the entity and analyzes risks as a basis for determining how the risks need to be managed.
- c. The entity considers the potential for fraud in assessing risks to the achievement of financial reporting objectives.
- d. The entity identifies and assesses changes that could significantly impact ICFR.

Control Activities Relevant to the Audit of ICFR

.A45 The following principles are relevant to the auditor's evaluation of whether the entity's control activities relevant to the audit of ICFR are present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

- a. The entity selects and develops control activities that contribute to the mitigation of risks to the achievement of financial reporting objectives to acceptable levels.

¹⁹ Paragraph .A6 of section 260, *The Auditor's Communication With Those Charged With Governance*.

- b. The entity selects and develops general control activities over technology to support the achievement of financial reporting objectives.
- c. The entity deploys control activities through policies that establish what is expected and procedures that put policies into action.

.A46 Control activities relevant to the audit of ICFR include those related to each significant class of transactions, account balance, and disclosure, and its relevant assertions (see paragraphs .26–.28).

Information and Communication

.A47 The following principles are relevant to the auditor's evaluation of whether the entity's information and communication, including the related business processes relevant to financial reporting, is present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:

- a. The entity obtains or generates and uses relevant, quality information to support the functioning of ICFR.
- b. The entity internally communicates information, including financial reporting objectives and responsibilities, necessary to support the functioning of ICFR.
- c. The entity communicates with external parties regarding matters affecting the functioning of ICFR.

Monitoring Activities

.A48 The following principles are relevant to the auditor's evaluation of whether the entity's monitoring activities are present and functioning in the design, implementation, and operation of ICFR to achieve the entity's financial reporting objectives:²⁰

- a. The entity selects, develops, and performs ongoing or separate evaluations to ascertain whether the components of internal control are present and functioning.
- b. The entity evaluates and communicates deficiencies in ICFR in a timely manner to those parties responsible for taking corrective action, including senior management and those charged with governance, as appropriate.

Period-End Financial Reporting Process (Ref: par. .24–.25)

.A49 Because the annual period-end financial reporting process normally occurs after the as of date, those controls usually cannot be tested until after the as of date.

Identifying Significant Classes of Transactions, Account Balances, and Disclosures, and Their Relative Assertions (Ref: par. .26–.28)

.A50 Risk factors relevant to the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions include

- size and composition of the account;
- susceptibility to misstatement due to errors or fraud;

²⁰ Paragraphs .A102–.A107 and appendix B, "Internal Control Components," of section 315.

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

.A51 The risk factors in paragraph .26 that the auditor is required to evaluate in the identification of significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in the audit of ICFR as in the audit of the financial statements; accordingly, significant classes of transactions, account balances, and disclosures, and their relevant assertions, are the same in an integrated audit.

.A52 The risk assessment procedures performed in connection with a financial statement audit are described in section 315.

.A53 The auditor might determine the likely sources of potential misstatements by asking himself or herself "What could go wrong?" within a given significant class of transactions, account balance, or disclosure.

.A54 The components of a potential significant class of transactions, account balance, or disclosure might be subject to significantly different risks. If so, different controls might be necessary to adequately address those risks.

.A55 Multiple components are discussed further beginning in paragraphs .78 and .81.

Understanding Likely Sources of Misstatement (Ref: par. .29–.31)

.A56 Performing walk-throughs will frequently be the most effective way of achieving the objectives in paragraph .29. A *walk-through* involves following a transaction from origination through the entity's processes, including information systems, until it is reflected in the entity's financial statements, using the same documents and IT that entity personnel use. Walk-through procedures are inquiry of appropriate personnel, observation of the application of specific controls, inspection of relevant documentation, and control reperformance. The auditor may choose any combination of these procedures; however, inquiry alone is not sufficient for achieving the objectives in paragraph .29.

.A57 A walk-through includes questioning the entity's personnel about their understanding of what is required by the entity's prescribed procedures and controls at the points at which important processing procedures occur. These probing questions, combined with the other walk-through procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walk-through may provide an understanding of the different types of significant transactions handled by the process.

.A58 The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify likely sources of misstatement and the controls to test, as well as to assess risk and allocate audit effort.

Selecting Controls to Test (Ref: par. .32)

.A59 There might be more than one control that addresses the assessed risk of material misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of material misstatement to more than one relevant assertion. It may not be necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is, itself, a control objective.

.A60 The decision concerning whether a control would be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of material misstatement to a given relevant assertion rather than on how the control is labeled (for example, entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control).

Testing Controls

Evaluating Design Effectiveness (Ref: par. .33)

.A61 Procedures performed to evaluate design effectiveness may include a mix of inquiry of appropriate personnel, observation of the application of specific controls, and inspection of relevant documentation. Walk-throughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Considerations Specific to Smaller, Less Complex Entities

.A62 A smaller, less complex entity might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex entity might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the entity to implement different controls to achieve its control objectives.

Testing Operating Effectiveness (Ref: par. .34)

.A63 Procedures performed to test operating effectiveness may include a mix of inquiry of appropriate personnel, observation of the application of specific controls, inspection of relevant documentation, and reperformance of the control. Inquiry alone, however, is not sufficient for such purposes. Section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, provides additional guidance on other audit procedures, in combination with inquiry, which may be appropriate when testing the operating effectiveness of controls.²¹

.A64 In some situations, particularly in smaller, less complex entities, an entity might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for an entity's financial reporting and associated controls, the auditor may take into account the combined competence of entity personnel and other parties that assist with functions related to financial reporting.

²¹ Paragraphs .A28–.A30 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

Relationship of Risk to the Evidence to Be Obtained (Ref: par. .35–.38)

.A65 For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness exists.

.A66 Factors that affect the risk associated with a control may include

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

.A67 Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

Considerations Specific to Smaller, Less Complex Entities

.A68 A smaller, less complex entity or component with simple business processes and centralized accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas where off-the-shelf software is used, the auditor's testing of IT controls might focus on the application controls built into the prepackaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

.A69 The auditor's objective is to express an opinion on the entity's ICFR overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

.A70 The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the

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

.A71 Walk-throughs might provide sufficient appropriate audit evidence of operating effectiveness, depending on

- the risk associated with the control being tested,
- the frequency of operation of the control,
- whether the control is an IT application control,
- the specific procedures performed as part of the walk-through, and
- the results of those procedures.

.A72 The operating effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, informs the auditor's risk assessments in determining the testing necessary to conclude on the operating effectiveness of a control.

Nature of Tests of Controls

.A73 Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and reperformance of a control. Inquiry alone, however, does not provide sufficient appropriate audit evidence to support a conclusion about the effectiveness of a control.

.A74 The nature of the tests of effectiveness that will provide sufficient appropriate audit evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Considerations Specific to Smaller, Less Complex Entities

.A75 A smaller, less complex entity or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of the application of specific controls, inspection of less formal documentation, or reperformance of certain controls, might provide sufficient appropriate audit evidence about whether the control is effective.

.A76 A *control deviation* occurs when a control does not operate as designed. Control deviations are evaluated when determining whether a deficiency in internal control exists. Because effective ICFR cannot and does not provide absolute assurance of achieving the entity's control objectives, an individual control does not necessarily have to operate without any deviation to achieve the entity's control objectives and to be considered effective.

Timing and Extent of Tests of Controls (Ref: par. .39)

.A77 The objective of the tests of controls in an audit of ICFR is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the entity's ICFR. The auditor's opinion relates to the effectiveness of the entity's ICFR as of a point in time and as a whole. Accordingly, an audit of ICFR may entail testing the design and operating effectiveness of controls not tested when expressing an opinion only on the financial statements; however, in both an audit of ICFR and a financial statement audit, the auditor directs attention

to controls that present a reasonable possibility that, if missing or deficient, would result in a material misstatement of the financial statements.

.A78 Testing controls over a longer period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the as of date provides more evidence than testing performed earlier in the year.

.A79 The more extensively a control is tested, the greater the evidence obtained from that test.

.A80 Prior to the as of date, management might implement changes to the entity's controls to make them more effective or efficient or to address deficiencies. If the auditor determines that the new controls achieve the related objectives of the criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, the auditor will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on ICFR. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment in the financial statement audit, the auditor tests the design and operating effectiveness of those superseded controls, as appropriate.

Rollforward Procedures (Ref: par. .40)

.A81 The additional evidence that is necessary to update the results of testing from an interim date to the entity's period-end depends on the following factors:

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

.A82 In some circumstances, such as when evaluation of these factors indicates a low risk that the controls are no longer effective during the rollforward period, inquiry alone might be sufficient as a rollforward procedure.

Special Considerations for Subsequent Years' Audits (Ref: par. .41–.42)

.A83 Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph .A66 and the following:

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

.A84 After taking into account the risk factors identified in paragraphs .A66 and .A83, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

.A85 The auditor also may use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning in paragraph .97.

.A86 The auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Identifying Deficiencies in ICFR (Ref: par. .43)

.A87 The findings from audit work performed on the financial statements and on ICFR are relevant in determining whether the auditor has identified any deficiencies in ICFR.

Determination of Whether Material Weaknesses Exist as of the Date Specified in Management's Assessment About ICFR (Ref: par. .44-.46)

.A88 The severity of a deficiency, or a combination of deficiencies, in ICFR depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies and
- whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of a class of transaction, an account balance, or a disclosure.

A material weakness may exist even though the auditor has not identified misstatements during the integrated audit. Paragraph .A96 provides indicators of material weaknesses.

.A89 Factors that affect the magnitude of a misstatement that might result from a deficiency, or deficiencies, in ICFR include, but are not limited to, the following:

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

.A90 In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated is generally the recorded amount, whereas understatements could be larger.

.A91 Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in ICFR will result in a misstatement of an account balance or a disclosure. The factors include the following:

- The nature of the financial statement, classes of transactions, account balances, disclosures, and assertions involved
- The cause and frequency of the exceptions detected as a result of the deficiency, or deficiencies, in ICFR
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control(s) with other controls
- The interaction with other deficiencies in ICFR

- The possible future consequences of the deficiency, or deficiencies, in ICFR
- The importance of controls, such as the following, to the financial reporting process:
 - General monitoring controls (such as oversight of management)
 - Controls over the prevention and detection of fraud
 - Controls over the selection and application of significant accounting policies
 - Controls over significant transactions with related parties
 - Controls over significant transactions outside the entity's normal course of business
 - Controls over the period-end financial reporting process (such as controls over nonrecurring journal entries)

.A92 The evaluation of whether a deficiency in ICFR presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

.A93 Controls may be designed to operate individually, or in combination, to effectively prevent, or detect and correct, misstatements. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance.

.A94 A deficiency in ICFR on its own may not be sufficiently important to constitute a material weakness. However, a combination of deficiencies affecting the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR may increase the risks of misstatement to such an extent to give rise to a material weakness. A combination of deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR also may collectively result in a significant deficiency.

.A95 A compensating control can limit the severity of a deficiency in ICFR and prevent it from being a material weakness. Only compensating controls that operate at a level of precision that would prevent, or detect and correct, a material misstatement are capable of having a mitigating effect. Although compensating controls can mitigate the effects of a deficiency in ICFR, they do not eliminate the deficiency.

.A96 Indicators of material weaknesses in ICFR include

- identification of fraud, whether or not material, on the part of senior management. For the purpose of this indicator, the term *senior management* includes the principal executive and financial officers as well as any other members of senior management who play a significant role in the entity's financial reporting process;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's ICFR; and

- ineffective oversight of the entity's financial reporting and ICFR by those charged with governance.

Determination of Whether Significant Deficiencies Exist During the Integrated Audit (Ref: par. .47)

.A97 Paragraphs .A88–.A95 provide guidance related to evaluating the severity of identified deficiencies in ICFR. Paragraph .A96 provides indicators of material weaknesses.

.A98 The evaluation of the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a significant deficiency is made for purposes of communicating in writing to management and those charged with governance significant deficiencies identified during the integrated audit. See paragraphs .59–.63 for the communication requirements.

Subsequent Events (Ref: par. .48–.51)

.A99 Section 560, *Subsequent Events and Subsequently Discovered Facts*, establishes requirements and provides guidance on subsequent events for a financial statement audit that are adapted and applied, as necessary, to the audit of ICFR. The auditor is required by paragraph .57 to obtain certain written representations from management relating to subsequent events.

.A100 Refer to paragraph .80 when disclaiming an opinion on management's disclosures about corrective actions.

.A101 The evaluation of such subsequently discovered facts is similar to the evaluation of subsequently discovered facts in an audit of financial statements, as described in section 560.

Concluding Procedures (Ref: par. .52–.56)

.A102 If management does not revise its report, paragraph .72 applies. Paragraph .70 also applies if the auditor determines that management's required disclosure about one or more material weaknesses is not fairly presented in all material respects. If management refuses to furnish a report that includes management's assessment about ICFR, paragraph .74 applies.

Obtaining Written Representations (Ref: par. .57–.58)

.A103 See section 580, *Written Representations*, for additional requirements and guidance with respect to obtaining written representations from management as part of an audit of financial statements. Section 580 addresses matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter.

.A104 Management's refusal to furnish written representations constitutes a limitation on the scope of the audit.

Communicating ICFR-Related Matters (Ref: par. .59–.63)

.A105 Section 265, *Communicating Internal Control Related Matters Identified in an Audit*, does not apply to integrated audits.

.A106 Early communication to management or those charged with governance may be important for some matters because of their relative significance and the urgency of corrective follow-up action. Regardless of the timing of the written communication of significant deficiencies and material weaknesses, the auditor may communicate these orally in the first instance to management and, when appropriate, those charged with governance to assist them in taking

timely remedial action to minimize the risks of material misstatement. However, oral communication does not relieve the auditor of the responsibility to communicate the significant deficiencies and material weaknesses in writing.

.A107 If a previously communicated significant deficiency or material weakness remains, the current year's communication may repeat the description from the previous communication or simply reference the previous communication and the date of that communication.

.A108 See section 230, *Audit Documentation*, for additional guidance related to the report release date.²²

.A109 The auditor's written communication for a governmental entity would generally not be made prior to management's report on ICFR, the entity's financial statements, and the auditor's report thereon, being made publicly available. This is in order to provide the user with the appropriate context to evaluate the significant deficiencies or material weaknesses identified during the integrated audit that are contained in the written communication.

.A110 The auditor is not required to perform procedures that are sufficient to identify all deficiencies; rather, the auditor need only communicate deficiencies of which the auditor is aware.

.A111 Unlike in an audit of financial statements that is not integrated with an audit of ICFR, the auditor is required to communicate in writing deficiencies that do not rise to the level of significant deficiencies or material weaknesses. This is because identifying deficiencies in ICFR is the focus of an audit of ICFR, whereas identifying deficiencies is incidental to an audit of financial statements (that is not integrated with an audit of ICFR), which is focused on identifying misstatements of the financial statements.

.A112 Because the auditor's written communication of deficiencies identified during the integrated audit forms part of the final audit file, the written communication is subject to the overriding requirement for the auditor to complete the assembly of the final audit file on a timely basis, no later than 60 days following the report release date.²³

Reporting on ICFR (Ref: par. .64–.65)

Considerations Specific to Governmental Entities

.A113 When the audit is also conducted in accordance with *Government Auditing Standards* (also known as the Yellow Book), the auditor may state that the audit was conducted in accordance with the auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. If significant deficiencies in ICFR are identified in such an audit and the auditor's report refers to *Government Auditing Standards*, those standards require the auditor to report such deficiencies. The following is an illustration of that communication through the addition of other-matter paragraphs to the auditor's report:

In accordance with *Government Auditing Standards*, we are required to report findings of significant deficiencies. 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

²² Paragraph .A2 of section 230, *Audit Documentation*.

²³ Paragraph .16 of section 230.

governance. We consider the deficiencies in ABC Company's internal control described below [or in the accompanying schedule of findings] to be significant deficiencies.

ABC Company's response to the findings identified in our audit is described below [or in the accompanying schedule of findings]. We did not audit ABC Company's response and, accordingly, we express no opinion on the response.

.A114 When an other-matter paragraph relating to ICFR is included in a financial statement audit report, the auditor may include a heading above the other-matter paragraph such as "Report on Internal Control Over Financial Reporting." When an other-matter paragraph relating to the financial statement audit is included in an ICFR report, the auditor may include a heading above the other-matter paragraph such as "Report on the Financial Statements."

.A115 The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and an opinion on ICFR) or separate reports on the entity's financial statements and on ICFR.

.A116 If the auditor issues a separate report on ICFR and expresses an adverse opinion on ICFR, the disclosure required by paragraph .71 related to the effect of the adverse opinion on ICFR on the auditor's opinion on the financial statements may be combined with the report language described in paragraph .65.

Report Modifications (Ref: par. .67)

.A117 A *limitation on the scope of the audit* refers to the auditor's inability to obtain sufficient appropriate audit evidence, which may arise from the following:

- Circumstances beyond the entity's control
- Circumstances relating to the nature or timing of the auditor's work
- Limitations imposed by management

Adverse Opinions (Ref: par. .68–.71)

.A118 Paragraphs .44–.47 describe the evaluation of deficiencies. See paragraphs .73–.77 when the scope of the engagement has been limited.

.A119 Section 705A, *Modifications to the Opinion in the Independent Auditor's Report*, establishes requirements and provides guidance on adverse opinions for a financial statement audit that are adapted and applied, as necessary, to the audit of ICFR. Exhibit A, "Illustrative Reports," of this section includes an illustration of the application of the reporting requirements in section 705A.²⁴

.A120 The auditor's report need only refer to the "material weaknesses described in management's report" and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report, as described in paragraph .70.

.A121 As described in paragraph .A116, if the auditor issues a separate report on ICFR in this circumstance, the disclosure required by paragraph .71 may be combined with the report language described in paragraph .65.

²⁴ Illustration 2, "Adverse Opinion on ICFR," of exhibit A, "Illustrative Reports."

Scope Limitations (Ref: par. .73–.77)

.A122 The auditor may be separately engaged to audit only the financial statements after withdrawing from the integrated audit. In such circumstances, the auditor cannot disregard knowledge obtained in the integrated audit engagement in determining whether to accept, or in performing, the financial statement audit.

.A123 Section 705A establishes requirements and provides guidance on disclaimers of opinion for a financial statement audit that are adapted and applied, as necessary, to the audit of ICFR. Exhibit A of this section includes an illustration of the application of the reporting requirements in section 705A.²⁵

.A124 In an audit of ICFR, the auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that the auditor will not be able to obtain sufficient appropriate audit evidence to express an opinion.

.A125 The auditor's report need only refer to the "material weaknesses described in management's report" and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report.

Making Reference to a Component Auditor and Assuming Responsibility for the Work of a Component Auditor (Ref: par. .78–.79)

.A126 Section 600 addresses special considerations that apply to group audits, in particular those that involve component auditors. Section 600 is applicable, adapted as necessary, to the audit of ICFR, considering the requirements and guidance related to multiple components discussed beginning in paragraphs .28 and .81.

.A127 The group engagement partner may decide to assume responsibility for the work of the component auditor or to make reference to the component auditor in the report on the ICFR over the group financial statements. The decision about whether to make reference to a component auditor in the report on the audit of ICFR might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the group financial statements may make reference to the audit of a significant equity investment performed by a component auditor, but the report on the ICFR over the group financial statements might not make a similar reference because management's assessment about ICFR ordinarily would not extend to controls at the equity method investee. See paragraph .84 for further discussion of the evaluation of the controls for an equity method investment.

.A128 Section 600 establishes requirements and provides guidance when assuming responsibility for the work of a component auditor and when making reference to a component auditor in the auditor's report on the financial statements that are adapted and applied, as necessary, to the audit of ICFR. Exhibit A of this section includes an illustration of the application of the reporting requirements in section 600.²⁶

Additional Information (Ref: par. .80)

.A129 The following is an example of wording used to disclaim an opinion on such additional information:

²⁵ Illustration 3, "Disclaimer of Opinion on ICFR," of exhibit A.

²⁶ Illustration 4, "Unmodified Opinion on ICFR Making Reference to a Component Auditor," of exhibit A.

Other Matter

We did not perform auditing procedures on [describe additional information, such as management's cost-benefit statement], and accordingly, we do not express an opinion or provide any assurance on it.

.A130 An entity may publish various documents that contain information in addition to management's report and the auditor's report on ICFR. Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, as well as section 720A, may require the auditor to take additional action.

Special Topics**Entities With Multiple Components (Ref: par. .81–.83)**

.A131 As indicated in paragraph .A126 of this section, section 600 is applicable, adapted as necessary, to the audit of ICFR, considering the requirements and guidance related to components discussed in this section.

.A132 In determining the components at which to perform tests of controls, the group engagement team may also take into account work performed by the internal audit function or others on behalf of management. For example, if the internal audit function's planned procedures include relevant audit work at various components, the auditor may coordinate work with the internal auditors and reduce the number of components at which the group engagement team, or a component auditor on the group engagement team's behalf, would otherwise need to perform audit procedures.

.A133 The group engagement team may eliminate from further consideration components that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the group financial statements.

.A134 In lower risk components, the group engagement team first might evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides sufficient appropriate audit evidence. The group engagement team or a component auditor on the group engagement team's behalf may test the operating effectiveness of controls over specific risks or group-wide controls.

Special Situations (Ref: par. .84–.87)

.A135 The audit of ICFR ordinarily would not extend to controls at the equity method investee.

.A136 The auditor may conclude it is appropriate for management to limit the assessment by excluding certain entities when, for example, management has insufficient time to assess the controls at the as of date for a recently acquired business or does not have sufficient access to a consolidated variable interest entity. However, in the case of an acquired entity, it would not be appropriate for management to limit its assessment if the period of such limitation extends beyond one year from the date of acquisition, nor would it be appropriate for management's assessment to be limited for more than one annual management report on ICFR. Law or regulation may specifically address situations in which it is appropriate for management to limit its assessment by excluding certain entities and also may require specific disclosures in these cases. If, in the auditor's judgment, it is appropriate for management to limit its assessment by excluding certain entities, the auditor may limit the audit of ICFR in the same manner, and the auditor's opinion would not be affected by a scope limitation.

Use of Service Organizations (Ref: par. .88–.96)

.A137 Section 402 contains the requirements and application guidance for auditors of the financial statements of entities that use a service organization (user auditors). Section 402 addresses an auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of an entity that uses one or more service organizations (a user entity). Refer to section 402 for guidance when the service organization uses a subservice organization.²⁷

.A138 Section 402 identifies the situations in which a service organization's services and controls over them are part of a user entity's information system.²⁸ If the service organization's services are part of the user entity's information system, as described therein, then they are part of the user entity's ICFR.

.A139 Evidence that the controls that are relevant to the auditor's opinion on ICFR are operating effectively may be obtained by following the procedures described in section 402.²⁹ These procedures include one or more of the following:

- a. Obtaining and reading a service auditor's report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls, which includes a description of the service auditor's tests of controls and results (a type 2 report), if available
- b. Performing appropriate tests of controls at the service organization
- c. Using another auditor to perform tests of controls at the service organization on behalf of the auditor

.A140 A report on management's description of a service organization's system and the suitability of the design of controls (a type 1 report) does not include a description of the service auditor's tests of controls and results of those tests or the service auditor's opinion on the operating effectiveness of controls and, therefore, does not provide evidence of the operating effectiveness of controls. Type 1 and type 2 reports are described in section 402.

.A141 These factors are similar to factors the auditor would consider in determining whether the report provides sufficient appropriate audit evidence to support the auditor's assessed level of control risk in an audit of the financial statements, as described in section 402.³⁰

.A142 Section 402 defines *complementary user entity controls* as those controls that management of the service organization assumes, in the design of its service, will be implemented by user entities, and, if necessary to achieve the control objectives stated in management's description of the service organization's system, are identified as such in that description.

.A143 Appropriate sources of information concerning the service auditor's professional competence and independence are discussed in section 402.³¹

.A144 Standards promulgated by a body designated by Council, pursuant to the "Compliance With Standards Rule" of the AICPA Code of Professional

²⁷ Paragraph .A20 of section 402.

²⁸ Paragraph .03 of section 402.

²⁹ Paragraphs .16–.17 of section 402.

³⁰ Paragraphs .A32–.A39 of section 402.

³¹ Paragraphs .A21–.A22 of section 402.

Conduct, are presumed to be adequate. Although the International Auditing and Assurance Standards Board (IAASB) is not such a body, AT-C section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*, may be helpful when the service auditor's report is issued in accordance with International Standard on Assurance Engagements 3402, *Assurance Reports on Controls at a Service Organization*, promulgated by the IAASB.^[32] [Revised, April 2017, to reflect conforming changes necessary due to the issuance of SSAE No. 18.]

.A145 Changes in the service organization's controls may include

- changes communicated to management from the service organization, including those related to the service organization's processes and information systems.
- changes in personnel at the service organization with whom management interacts.
- changes in the design or implementation of controls that were necessary to achieve the control objectives.
- changes in reports or other data received from the service organization.
- changes in contracts or service level agreements with the service organization.
- errors identified in the service organization's processing or incidents of noncompliance with laws and regulations or fraud.

.A146 As risk increases, the need for the auditor to obtain additional evidence increases. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might include

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

Benchmarking of Automated Controls (Ref: par. .97–.99)

.A147 Entirely automated application controls are generally less susceptible to breakdowns due to human failure. This feature may allow the auditor to use a benchmarking strategy. *Benchmarking* is the process of testing an automated application control to establish a baseline that can be combined with effective IT general controls to allow the auditor to conclude that the automated application controls are effective without repeating the specific tests of operating effectiveness.

.A148 When the risk factors assessed in determining a benchmarking strategy indicate lower risk, the control being evaluated might be well-suited for benchmarking. When these factors indicate increased risk, the control being evaluated is less suited for benchmarking.

^[32] [Footnote deleted, April 2017, to reflect conforming changes necessary due to the issuance of SSAE No. 18.]

.A149 A report of the compilation dates of the programs placed in operation may be used as evidence that controls within the program have not changed.

.A150 Benchmarking automated application controls can be especially effective for entities using purchased software when the possibility of program changes is remote (for example, when the vendor does not allow access or modification to the source code).

.A151 If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor determines that the automated application control has not changed since the auditor established a baseline (that is, last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor obtains to determine that the control has not changed may vary depending on the circumstances, including the strength of the entity's program change controls.

.A152 The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

.A153 A control may be sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

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Exhibit A—Illustrative Reports

The following illustrate the report elements described in this section. The illustrations assume that the audit of internal control over financial reporting (ICFR) and the audit of the financial statements were performed by the same auditor. Report modifications are discussed beginning in paragraph .67 of this section.

Illustration 1 — Unmodified Opinion on ICFR

Illustration 2 — Adverse Opinion on ICFR

Illustration 3 — Disclaimer of Opinion on ICFR

Illustration 4 — Unmodified Opinion on ICFR Making Reference to a Component Auditor

Illustration 5 — Combined Report Expressing an Unmodified Opinion on ICFR and an Unmodified Opinion on the Financial Statements

Illustration 1—Unmodified Opinion on ICFR

The following is an illustrative report expressing an unmodified opinion on ICFR.

Independent Auditor's Report

[Appropriate Addressee]

Report on Internal Control Over Financial Reporting¹

We have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].²

Management's Responsibility for Internal Control Over Financial Reporting

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting, and for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

Auditor's Responsibility

Our responsibility is to express an opinion on the entity's internal control over financial reporting based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

¹ The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

² For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Definition and Inherent Limitations of Internal Control Over Financial Reporting

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

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

Opinion

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

Report on Financial Statements

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of ABC Company, and our report dated [date of report, which should be the same as the date of the report on the audit of ICFR] expressed [include nature of opinion].

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Illustration 2—Adverse Opinion on ICFR

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

Independent Auditor's Report

[Appropriate Addressee]

Report on Internal Control Over Financial Reporting¹

We have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].²

Management's Responsibility for Internal Control Over Financial Reporting

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting, and for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

Auditor's Responsibility

Our responsibility is to express an opinion on the entity's internal control over financial reporting based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Definition and Inherent Limitations of Internal Control Over Financial Reporting

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

¹ The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

² For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

necessary to permit preparation of financial statements in accordance with [applicable financial reporting framework, such as accounting principles generally accepted in the United States of America], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

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

Basis for Adverse Opinion

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

[Identify the material weakness described in management's report].³

Adverse Opinion

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

Report on Financial Statements

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of ABC Company, and our report dated [date of report, which should be the same as the date of the report on the audit of ICFR] expressed [include nature of opinion]. We considered the material weakness identified above in determining the nature, timing, and extent of audit procedures applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

³ See paragraphs .68–.71 of this section for specific reporting requirements. The auditor's report need only refer to the material weaknesses described in management's report and need not include a description of each material weakness, provided each material weakness is included and fairly presented in all material respects in management's report.

Illustration 3—Disclaimer of Opinion on ICFR

The following is an illustrative report expressing a disclaimer of opinion on ICFR. In this example, the auditor is applying paragraph .76 of this section because a material weakness was identified during the limited procedures performed by the auditor.

Independent Auditor's Report

[Appropriate Addressee]

Report on Internal Control Over Financial Reporting¹

We were engaged to audit ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].²

Management's Responsibility for Internal Control Over Financial Reporting

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting included in the accompanying [title of management's report].

Auditor's Responsibility

Our responsibility is to express an opinion on ABC Company's internal control over financial reporting based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Definition and Inherent Limitations of Internal Control Over Financial Reporting

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

¹ The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

² For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

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

Basis for Disclaimer of Opinion

[Provide a description of the matter giving rise to the disclaimer of opinion.]

Material Weakness

Because of the matter described above, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. However, a material weakness has been identified. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. If one or more material weaknesses exist, an entity's internal control over financial reporting cannot be considered effective. The following material weakness has been included in the accompanying *[title of management's report]*.

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

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the effectiveness of ABC Company's internal control over financial reporting.

Report on Financial Statements

We have audited, in accordance with auditing standards generally accepted in the United States of America, the *[identify financial statements]* of ABC Company, and our report dated *[date of report, which should be the same as the date of the report on the audit of ICFR]* expressed *[include nature of opinion]*. We considered the material weakness identified above in determining the nature, timing, and extent of audit procedures applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Illustration 4—Unmodified Opinion on ICFR Making Reference to a Component Auditor

The following is an illustrative report expressing an unmodified opinion on ICFR when the engagement partner decides to make reference to the report of a component auditor.

Independent Auditor's Report

[Appropriate Addressee]

Report on Internal Control Over Financial Reporting¹

We have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].²

Management's Responsibility for Internal Control Over Financial Reporting

Management is responsible for designing, implementing, and maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting included in the accompanying [title of management's report].

Auditor's Responsibility

Our responsibility is to express an opinion on the entity's internal control over financial reporting based on our audit. We did not audit the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risks that a material weakness exists. An audit includes obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

¹ The subtitle "Report on Internal Control Over Financial Reporting" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

² For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

Definition and Inherent Limitations of Internal Control Over Financial Reporting

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

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

Opinion

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

Report on Financial Statements

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [identify financial statements] of ABC Company, and our report dated [date of report, which should be the same as the date of the report on the audit of ICFR] expressed [include nature of opinion], based on our audit and the report of the other auditors.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Illustration 5—Combined Report Expressing an Unmodified Opinion on ICFR and an Unmodified Opinion on the Financial Statements

The following is an illustrative combined report expressing an unmodified opinion on ICFR and an unmodified opinion on the financial statements. The circumstances include an audit of a complete set of general purpose financial statements (single year) prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[Appropriate Addressee]

Report on the Financial Statements and Internal Control¹

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. We also have audited ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].²

Management's Responsibility for the Financial Statements and Internal Control Over Financial Reporting

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management is also responsible for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on the entity's internal control over financial reporting based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement and whether effective internal control over financial reporting was maintained in all material respects.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the

¹ The subtitle "Report on the Financial Statements and Internal Control" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

² For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

An audit of internal control over financial reporting involves performing procedures to obtain evidence about whether a material weakness exists. The procedures selected depend on the auditor's judgment, including the assessment of the risk that a material weakness exists. An audit of internal control over financial reporting also involves obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Definition and Inherent Limitations of Internal Control Over Financial Reporting

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

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

Opinions

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

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

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Exhibit B—Illustrative Written Communication of Significant Deficiencies and Material Weaknesses

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

To Management and *[identify the body or individuals charged with governance, such as the entity's board of directors]* of ABC Company:

In connection with our audit of ABC Company's (the Company) financial statements as of December 31, 20XX, and for the year then ended, and our audit of the Company's internal control over financial reporting as of December 31, 20XX (integrated audit), auditing standards generally accepted in the United States of America require that we advise you of the following matters relating to internal control over financial reporting (internal control) identified during our integrated audit.

Our responsibility is to plan and perform our integrated audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether due to fraud or error, and whether effective internal control was maintained in all material respects (that is, whether material weaknesses exist as of the date specified in management's assessment). The integrated audit is not designed to detect deficiencies that, individually or in combination, are less severe than a material weakness.

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 consider the following deficiencies in the Company's internal control to be material weaknesses:*

[Describe the material weaknesses that were identified during the integrated audit and provide an explanation of their potential effects. The auditor may separately identify those material weaknesses that exist as of the date specified in management's assessment about ICFR by referring to the auditor's report.]

[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 the Company's internal control over financial reporting to be significant deficiencies:]

[Describe the significant deficiencies that were identified during the integrated audit and provide an explanation of their potential effects.]

This communication is intended solely for the information and use of management, *[identify the body or individuals charged with governance]*, others within the organization, and *[identify any governmental authorities to which the*

auditor is required to report] and is not intended to be and should not be used by anyone other than these specified parties.¹

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date*]

¹ When the engagement is also performed in accordance with *Government Auditing Standards*, see paragraph .11 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*, for alternative reporting requirements.

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Exhibit C—Illustrative Management Report

The following is an illustrative management report containing the reporting elements described in paragraph .55 of this section with no material weaknesses reported.

Management's Report on Internal Control Over Financial Reporting

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

Management of ABC Company is responsible for designing, implementing, and maintaining effective internal control over financial reporting. Management assessed the effectiveness of ABC Company's internal control over financial reporting as of December 31, 20XX, based on [identify criteria].¹ Based on that assessment, management concluded that, as of December 31, 20XX, ABC Company's internal control over financial reporting is effective, based on [identify criteria].

Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

ABC Company
Report signers, if applicable
Date

¹ For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.A157

Exhibit D—Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act

1. The Federal Deposit Insurance Corporation (FDIC) has provided guidance on the meaning of the term *financial reporting* for purposes of compliance by insured depository institutions (IDIs) with Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) (Section 36 of the Federal Deposit Insurance Act [FDI Act], 12.U.S.C. 1831m), and its implementing regulation, 12 CFR Part 363. The FDIC's guidance indicates that financial reporting, at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles (GAAP) for the IDI (or its holding company) and financial statements prepared for regulatory reporting purposes. Financial statements prepared for regulatory reporting purposes include the schedules equivalent to the GAAP-based financial statements that are included in an IDI's (or its holding company's) appropriate regulatory report (for example, Schedules RC, RI, and RI-A in the Consolidated Reports of Condition and Income [Call Report]). Accordingly, to comply with the FDICIA and Part 363, management of the IDI (or its holding company) and the auditor are required to identify and test controls over the preparation of GAAP-based financial statements as well as the schedules equivalent to the GAAP-based financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report. Further, both management and the auditor are required to include in their report on the IDI's (or its holding company's) internal control over financial reporting (ICFR) a specific description indicating that the scope of ICFR included controls over the preparation of the IDI's (or its holding company's) GAAP-based financial statements as well as the schedules equivalent to the GAAP-based financial statements that are included in the IDI's (or its holding company's) appropriate regulatory report.¹

Definition of ICFR for FDICIA Purposes

2. In accordance with paragraph .64 of this section, the auditor's report is required to include a definition of ICFR that uses the same description of ICFR that management uses in its report. The following is an illustrative definition paragraph that may be used when an IDI that is an insured bank (which is not subject to Section 404 of the Sarbanes-Oxley Act of 2002) elects to report on controls for FDICIA purposes at the bank holding company level:

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our audit of [*Holding Company's*] internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding

¹ Refer to Section 36 of the Federal Deposit Insurance Act (FDI Act), Section 363.1: Scope and Definitions, for the requirements pertaining to compliance by subsidiaries of holding companies.

Companies (Form FR Y-9C).² An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Requirements When the IDI Is Required to Report on ICFR at the IDI Level

3. This paragraph and the following paragraphs are applicable and provide guidance when an IDI is required by 12 CFR Part 363 to report on ICFR at the IDI level. An IDI that is a subsidiary of a holding company may use the consolidated holding company's financial statements (group financial statements) to satisfy the audited financial statements requirement of 12 CFR Part 363, provided certain criteria are met.³ For some IDIs, however, an audit of ICFR is required at the IDI level. An audit of ICFR is required to be integrated with an audit of financial statements. Accordingly, to comply with the integrated audit requirements in this section, when the IDI elects to use the holding company's group financial statements to satisfy the audited financial statements requirement of 12 CFR Part 363 and the audit of ICFR is required to be performed at the IDI level, the auditor would be required to perform procedures necessary to obtain sufficient appropriate audit evidence to enable the auditor to express an opinion on the IDI's financial statements and on its ICFR. When the IDI does not prepare financial statements at the IDI level for external distribution, "financial statements" for this purpose may consist of the IDI's financial information in a reporting package or equivalent schedules and analyses that include the IDI information necessary for the preparation of the holding company's group financial statements, including disclosures. The measurement of materiality is determined based on the IDI's financial information rather than the holding company's group financial statements.⁴ If the auditor is unable to apply the procedures necessary to obtain sufficient appropriate audit evidence with respect to the IDI's financial information, the auditor is required by paragraph .73 of this section to withdraw from the engagement or disclaim an opinion on the effectiveness of ICFR at the IDI level.

Evaluation of IDI Financial Reporting Process

4. As previously described, the FDIC indicated that financial reporting, at a minimum, includes both financial statements prepared in accordance with generally accepted accounting principles (GAAP) for the IDI (or its holding company) and financial statements prepared for regulatory purposes. Financial statements prepared for regulatory reporting purposes include the schedules equivalent to the GAAP-based financial statements that are included in an IDI's

² This sentence would be modified if the insured depository institution (IDI) reports at the institution level rather than at the bank holding company level to refer to the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income instead of to the Form FR Y-9C. This sentence would also be modified if the IDI reports at a holding company level and employs another approach to reporting on controls over the preparation of regulatory reports as permitted by Section 36 of the FDI Act.

³ See footnote 1.

⁴ See paragraph .10 of section 320, *Materiality in Planning and Performing an Audit*.

(or its holding company's) appropriate regulatory report. When the IDI does not prepare financial statements for external distribution, the auditor is, nevertheless, required by paragraph .24 of this section to evaluate the IDI's period-end financial reporting process. This process includes, among other things, the IDI's procedures for preparing financial information for purposes of the holding company's group financial statements, which are prepared in accordance with GAAP, and the schedules equivalent to the GAAP-based financial statements that are included in the IDI's appropriate regulatory report.

Organization Structure

5. The period-end financial reporting process may occur either at the IDI or the holding company, or both. The organizational structure, including where the controls relevant to the IDI's financial information operate, may affect how the auditor evaluates this process. For example

- a. when the period-end financial reporting process occurs at the holding company and the IDI comprises substantially all of the consolidated total assets, there may be no distinguishable difference between the IDI's and its holding company's process for purposes of the integrated audit. This is because the auditor's risk assessment, including the determination of significant classes of transactions, account balances, and disclosures, and their relevant assertions, the selection of controls to test, and the determination of the evidence necessary to conclude on the effectiveness of a given control, would likely be the same for the IDI and the holding company.⁵ In this circumstance, the period-end financial reporting process of the holding company would be, in effect, the period-end financial reporting process of the IDI and, therefore, would be included in the scope of the integrated audit of the IDI.
- b. when the period-end financial reporting process occurs at the holding company and the IDI does not comprise substantially all of the consolidated total assets, the IDI's financial reporting process may be sufficient for the auditor to meet the requirement in paragraph .24 of this section, if the necessary GAAP information is prepared by the IDI or the holding company, and the process can be evaluated by the auditor. The auditor may determine that the IDI's preparation of the IDI's appropriate regulatory report, together with other financial information at the IDI level that is incorporated into the holding company's group financial statements, is sufficient for this purpose. In this circumstance, both the period-end financial reporting process of the holding company, as it relates to the financial information of the IDI, and the period-end financial reporting process of the IDI, with respect to the preparation of the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report, would be included in the scope of the integrated audit of the IDI.

IDI Not Subject to Section 404 of Sarbanes-Oxley Act of 2002

6. The illustrative reports in exhibit A, "Illustrative Reports," of this section may be used to report on the effectiveness of the IDI's ICFR. Because 12 CFR Part 363 does not require the auditor to issue a separate auditor's report on the IDI's financial statements, the requirement in paragraph .65 of this section to add an other-matter paragraph to the ICFR report that references the financial

⁵ See paragraph .A22 of this section.

statement audit will not apply when the auditor does not issue a separate auditor's report on the IDI's financial statements. In accordance with paragraph .64 of this section, the auditor's report on ICFR is required to include a definition of ICFR that uses the same description of ICFR as management uses in its report. The following is an illustrative definition paragraph that may be used when an IDI that is not subject to Section 404 of the Sarbanes-Oxley Act of 2002 is required to report on controls for FDICIA purposes at the IDI level, and the IDI uses the holding company's group financial statements to satisfy the audited financial statements requirement of 12 CFR Part 363:

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with generally accepted accounting principles. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our audit of [IDI's] internal control over financial reporting included controls over the preparation of financial information for purposes of [consolidated holding company's] financial statements in accordance with accounting principles generally accepted in the United States of America and controls over the preparation of schedules equivalent to basic financial statements in accordance with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income (Call Report Instructions). An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Use of the *Internal Control—Integrated Framework* (2013) (COSO)

7. Management may evaluate and report on the effectiveness of the IDI's ICFR based on the report *Internal Control—Integrated Framework* (2013), issued by Committee of Sponsoring Organizations of the Treadway Commission's (COSO). For purposes of reporting under Section 112 of FDICIA, the COSO criteria relevant to internal reporting objectives are appropriate only for the IDI and its regulatory agencies that are presumed to have an adequate understanding of the level of the auditor's service on historical financial information, considering the IDI does not prepare external GAAP-based financial statements. Accordingly, the report is required to include an other-matter paragraph, under an appropriate heading, that restricts its use.⁶ An example of such a restriction is as follows:

Restriction on Use⁷

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, the Federal Deposit Insurance Corporation and [*other federal bank*

⁶ See paragraphs .06a and .07 of section 905, *Alert That Restricts the Use of the Auditor's Written Communication*. Although reports on internal control issued in accordance with the guidance in this appendix are required to be restricted as to use, Section 36 of the FDI Act and Title 12 U.S. Code of Federal Regulations Part 363 require that these reports be available for public inspection.

⁷ Another appropriate heading may be used.

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

8. Likewise, the auditor's report and management's assessment about ICFR refer to the COSO criteria relevant to internal reporting objectives. For example, the following may be used to identify the criteria: "criteria established in the *Internal Control—Integrated Framework* (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) relevant to internal reporting objectives for the express purpose of meeting the regulatory requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)."
