PROPOSED STATEMENT ON AUDITING STANDARDS

AMENDMENT TO AU-C SECTION 935

(Amends Statement on Auditing Standards [SAS] No. 117, Compliance Audits, as amended [AICPA, Professional Standards, AU-C sec. 935])

February 7, 2022

Comments are requested by May 16, 2022

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

Comments should be addressed to Sherry Hazel at CommentLetters@aicpa-cima.com.
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Exposure Draft

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Explanatory Memorandum

Introduction

This memorandum provides background to the proposed Statement on Auditing Standards (SAS) Amendment to AU-C Section 935. If issued as final, the proposed SAS will amend SAS No. 117, Compliance Audits, as amended (AICPA, Professional Standards, AU-C sec. 935).

Background

AU-C section 935, Compliance Audits,¹ addresses the application of generally accepted auditing standards (GAAS) to a compliance audit. AU-C sections 200–900 address audits of financial statements as well as other kinds of engagements. Generally, these AU-C sections can be adapted to the objectives of a compliance audit. However, certain AU-C sections, or portions thereof, are not applicable to a compliance audit because (a) they are not relevant to a compliance audit environment, (b) the procedures and guidance would not contribute to meeting the objectives of a compliance audit, or (c) the subject matter is specifically covered in AU-C section 935. These AU-C sections, or specified requirements thereof, are identified in the appendix to AU-C section 935, “AU-C Sections That Are Not Applicable to Compliance Audits” (the appendix).

This exposure draft proposes to amend AU-C section 935 to update the appendix and conform AU-C section 935 to reflect the issuance of the following SASs:

- SAS No. 142, Audit Evidence (AU-C section 500)
- SAS No. 145, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (AU-C section 315)

The Auditing Standards Board (ASB) has determined that no amendment is necessary to AU-C section 935 to reflect the issuance of the following SASs:

- SAS No. 143, Auditing Accounting Estimates and Related Disclosures (AU-C section 540)
- SAS No. 144, Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources

SAS No. 143 is codified in AU-C section 540, which is listed in the appendix as not applicable in its entirety to a compliance audit. SAS No. 144 amends only certain application material that is not relevant to AU-C section 935.

Effective Date

If issued as final, the proposed amendment to the appendix with regard to AU-C section 501, Audit Evidence — Specific Considerations for Selected Items, would be effective for compliance audits

¹ All AU-C sections can be found in AICPA Professional Standards.
for fiscal periods ending on or after December 15, 2022. All other proposed amendments in this proposed SAS would be effective for compliance audits for fiscal periods ending on or after December 15, 2023. Early implementation is permitted.

See the discussion of the effective date in the “Explanation of Proposed Changes” section that follows.

**Explanation of Proposed Changes**

*Proposed Revisions Arising From SAS No. 142*

SAS No. 142 superseded SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, section 500, *Audit Evidence* (AU-C sec. 500A), and amended various AU-C sections, including AU-C section 501, *Audit Evidence — Specific Considerations for Selected Items*. Extant AU-C section 501 does not apply to a compliance audit. However, the amendments in SAS No. 142 moved what had been paragraph .08 of AU-C section 500A, relating to using the work of a management’s specialist, to become paragraph .27 of AU-C section 501, without any substantive changes to that paragraph. This paragraph was applicable to compliance audits when it was in AU-C section 500A, and that applicability didn’t change when it was relocated. Accordingly, the appendix is proposed to be revised to reflect the continued applicability of this paragraph in a compliance audit. No other paragraph in AU-C section 501 applies to a compliance audit.

*Proposed Revisions Arising From SAS No. 145*

- Paragraphs .12c, .26–.30, and .33c of AU-C section 315A are not applicable to a compliance audit. The appendix was updated to include comparable paragraphs (19b, 20, 32–34, 36, and 42d) of SAS No. 145 as not applicable to a compliance audit.
- Paragraphs 27a of SAS No. 145, which relates to controls over significant risks, and paragraph 40, which relates to classes of transactions, account balances, and disclosures that are not significant but are material, were added to the appendix as not applicable in a compliance audit. Historically, the concept of significant risks has not been applicable to a compliance audit. Likewise, the concept of classes of transactions, account balances, and disclosures that are material is not applicable to a compliance audit.
- Paragraphs 26 and 27b–.30 of SAS No. 145, which address requirements related to the control activities component, apply to a compliance audit. In particular, paragraph 27b–d addresses certain controls that the auditor is required to identify. A new requirement has been proposed to AU-C section 935 to address the auditor’s responsibility in adapting and applying paragraphs 27b–.30 of SAS No. 145 in a compliance audit. This new requirement also includes controls over compliance that are required to be tested for operating effectiveness by a governmental audit requirement (paragraph .20 of extant AU-C section 935). Thus, the new requirement combines the auditor’s responsibilities under AU-C section 315 and AU-C section 935. Paragraphs .28–.29 of AU-C section 315 include additional requirements related to control activities related to risks arising from the use of IT that also apply to a compliance audit.
• For ease of use and clarity of the requirements related to identifying and assessing risks of material noncompliance, paragraphs 35 and 37–38 of SAS No. 145, adapted as necessary, were added as requirements directly in AU-C section 935 and, consequentially, included in the appendix as not applicable when applying AU-C section 315 to a compliance audit. Application material was added to AU-C section 935 that references the 22 relevant application material paragraphs for paragraphs 35 and 37–38 in SAS No. 145.

• Extant AU-C section 935 excludes, within the appendix, the documentation requirement related to the identified and assessed risks at the financial statement level and assertion level (paragraph .33c of AU-C section 315A). The ASB believes that this requirement, adapted as necessary, is applicable to a compliance audit and has added a new requirement to AU-C section 935 based on paragraph 42d of SAS No. 145, which, consistent with other revisions, excludes significant risks. Accordingly, paragraph 42d of SAS No. 145 has been included in the appendix (and thereby is not applicable in a compliance audit).

Other Proposed Revisions

• There is an inconsistency in extant AU-C section 935 whereby the requirements in AU-C section 315 with respect to significant risks were scoped out of a compliance audit, but the requirements in AU-C section 330 with respect to significant risks were not. This inconsistency has been removed by adding paragraphs .15 and .22 of AU-C section 330 to the appendix.

• Paragraph .18 of AU-C section 330 was also added to the appendix, as performing substantive procedures for each relevant assertion of each significant class of transactions, account balance, and disclosure is not applicable in a compliance audit.

• Certain other editorial revisions were made for clarity or consistency with other AU-C sections.

Explanation of Effective Date

As noted previously, if issued as final, the proposed amendment to the appendix with regard to AU-C section 501 would be effective for compliance audits for fiscal periods ending on or after December 15, 2022. All other proposed amendments in this proposed SAS would be effective for compliance audits for fiscal periods ending on or after December 15, 2023. Early implementation is permitted.

The effective date of the proposed amendment to the appendix with regard to AU-C section 501 is aligned with the effective date of SAS No. 142, because, as explained previously, this proposed amendment arises from SAS No. 142. This amendment is not intended to change current practice, as there were no changes to the underlying requirement; only its placement within GAAS changed. All other proposed amendments in this proposed SAS arise from SAS No. 145 and, accordingly, their effective date is aligned with the effective date of SAS No. 145.

Request for Comment

1. Are the proposed amendments to AU-C section 935 appropriate and complete, including the proposed amendments to the appendix?
2. Is the effective date of the proposed amendments clear? If not, please suggest specific revisions.

Guide for Respondents

Respondents are asked to comment on the proposed changes and whether they are consistent with SAS Nos. 142 and 145.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, when appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the ASB to be made aware of this view, as well.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available on the AICPA’s website after May 16, 2022 until a final standard is issued. Responses should be sent to commentletters@aicpa-cima.com and received by May 16, 2022. Responses may be submitted in Word format or directly in the body of the email with an appropriate signature (name, firm). Respondents may also submit a PDF version of their Word document for posting to the AICPA website.

Comment Period

The comment period for this exposure draft ends May 16, 2022.
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(2021–2022)

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Audit and Attest Standards — Public Accounting
Amendment to AU-C Section 935, Compliance Audits

1. This amendment is effective for compliance audits for fiscal periods ending on or after December 15, 2023, except as indicated in the appendix in renumbered paragraph .A45.

[No amendment to paragraph .01.]

.02 This section addresses the application of GAAS to a compliance audit. Compliance audits usually are performed in conjunction with an audit of financial statements, but may also be performed in conjunction with an audit of a single financial statement or an audit of a specific element, account, or item of a financial statement. This section does not apply to the financial statement audit component of such engagements. Although certain AU-C sections are not applicable to a compliance audit, as identified in the appendix “AU-C Sections That Are Not Applicable to Compliance Audits,” all AU-C sections other than this section are applicable to the audit of financial statements performed in conjunction with a compliance audit.

[No amendment to paragraph .03–.11.]

Requirements

Adapting and Applying the AU-C Sections to a Compliance Audit (Ref: par. .A5 and .A40/2)

.12 When performing a compliance audit, the auditor, using exercising professional judgment, should adapt and apply the AU-C sections to the objectives of a compliance audit, except for the AU-C sections listed in the appendix.

[No amendment to paragraphs .13–.14.]

Performing Risk Assessment Procedures (Ref: par. .A12–.A15/7)
For each of the government programs and applicable compliance requirements selected for
testing, the auditor should perform risk assessment procedures to obtain a sufficient
understanding of the applicable compliance requirements and the entity’s internal control
over compliance with the applicable compliance requirements.\footnote{1}

In adapting and applying the requirements of section 315 to identify controls that address
risks of material noncompliance,\footnote{2} the auditor should perform risk assessment
procedures, beyond inquiry, to evaluate whether the following controls that address
risks of material noncompliance are effectively designed and determine whether those
controls have been implemented:

a. Controls over journal entries and other adjustments as required by section 240,
   Consideration of Fraud in a Financial Statement Audit

b. Controls for which the auditor plans to test operating effectiveness in
determining the nature, timing, and extent of substantive procedures, which
   include
   
i. controls that address risks for which substantive procedures alone do not
      provide sufficient appropriate audit evidence, and

   ii. controls that are required to be tested for operating effectiveness by the
       governmental audit requirement as required by paragraph 24 of this section

c. Other controls that, based on the auditor’s professional judgment, the auditor
   considers are appropriate to enable the auditor to identify and assess risks of
   material noncompliance and design further audit procedures.

\footnote{2} Paragraphs .27b–d and .30 of section 315.

[Subsequent footnotes are renumbered. No amendment to paragraph .16, which is renumbered as
paragraph .17.]

Identifying and Assessing the Risks of Material Noncompliance (Ref: par. .A16 A17–
.A48A19)

The auditor should identify and assess the risks of material noncompliance whether due
to fraud or error for each applicable compliance requirement and should consider whether
any of those risks are pervasive to the entity’s compliance because they may affect the
entity’s compliance with many compliance requirements.

Assessing Inherent Risk

For identified risks of material noncompliance for each applicable compliance
requirement, the auditor should assess inherent risk by assessing the likelihood and
magnitude of noncompliance. In doing so, the auditor should take into account how, and
the degree to which, inherent risk factors affect the susceptibility of compliance requirements to noncompliance.

.20 The auditor should determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material noncompliance.

Assessing Control Risk

.21 For identified risks of material noncompliance for each applicable compliance requirement, the auditor should assess control risk based on the auditor’s understanding of controls and the auditor’s plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should assess control risk at the maximum level such that the assessment of the risk of material noncompliance is the same as the assessment of inherent risk.

Performing Further Audit Procedures in Response to Assessed Risks

[No amendment to former paragraphs .18–.19, which are renumbered as paragraphs .22–.23.]

.24 The auditor should design and perform further audit procedures in response to the assessed risks of material noncompliance. These procedures should include performing tests of controls over compliance if

a. the auditor’s risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirements;

b. substantive procedures alone cannot provide sufficient appropriate audit evidence; or

c. such tests of controls over compliance are required by the governmental audit requirement.

If any of the conditions in this paragraph are met, the auditor should test the operating effectiveness of controls over each applicable compliance requirement to which the conditions apply in each compliance audit. (Ref: par. .A24–.A25)

[No amendment to former paragraphs .21–.39, which are renumbered as paragraphs .25–.43.]

Documentation (Ref: par. .A40)

.44 The auditor should document

a. the risk assessment procedures performed, including those related to gaining obtaining an understanding of internal control over compliance, and

fn 12
b. the identified and assessed risks of material noncompliance, including risks for which
substantive procedures alone cannot provide sufficient appropriate audit evidence, and
the rationale for the significant judgments made.

[fn 12] Paragraph .33a–b and .33d.42a–c of section 315A.

[No amendment to former paragraphs .41–.44, which are renumbered as paragraphs .45–.48.]

Application and Other Explanatory Material

[No amendment to paragraphs .A1–.A11.]

Performing Risk Assessment Procedures (Ref: par. .15–.16/7)

.A12 Obtaining an understanding of the government program, the applicable compliance
requirements, and the entity’s internal control over compliance establishes a frame of
reference within which the auditor plans the compliance audit and exercises professional
judgment about identifying and assessing risks of material noncompliance and
responding to those risks throughout the compliance audit. The auditor is also
responsible for evaluating the audit evidence obtained from the risk assessment
procedures and, as applicable, revising the identification or assessment of risks of
material noncompliance. fn15

[fn 15] Paragraphs .39 and .41 of section 315.

[Subsequent footnotes are renumbered. No amendment to paragraph .A13.]

.A14 Performing risk assessment procedures to obtain an understanding of the entity’s internal
control over compliance includes an evaluation of the design of controls and whether the
controls have been implemented. For purposes of GAAS, the system of internal control
consists of the following five interrelated components: the control environment, the
entity’s risk assessment process, information and communication systems, control
activities, and the entity’s process to monitoring the system of internal control, the
information system and communication, and control activities. Section 315A,
Understanding the Entity and Its Environment and Assessing the Risks of Material
Misstatement, contains a detailed discussion of these components. fn 1517

[fn 17] Paragraphs 15–25, 26, 27b–31, and appendix CB, “Understanding the Entity’s System of
Internal Control Components,” of section 315A.

.A15 Evaluating whether controls that address risks of material noncompliance are
effectively designed, and determining whether those controls have been implemented
involves considering whether the identified controls, individually or in combination,
are capable of effectively preventing, or detecting and correcting, material
noncompliance as well as establishing that the control exists, and that the entity is
using it. fn18

Section 315 includes additional requirements related to control activities related to risks arising from the use of IT that also apply to a compliance audit.  

Paragraphs .28–.29 of section 315.

[Subsequent footnotes are renumbered. No amendment to former paragraph .A15, which is renumbered as paragraph .A17.]

Identifying and Assessing the Risks of Material Noncompliance (Ref: par. .47/8)

Factors the auditor may consider in identifying and assessing the risks of material noncompliance are as follows:

- Criteria for identifying and assessing risks of material noncompliance identified by the governmental audit requirement as well as related communications from oversight organizations or regulators
- The complexity of the applicable compliance requirements
- The susceptibility of the applicable compliance requirements to noncompliance
- The length of time the entity has been subject to the applicable compliance requirements
- The auditor’s observations about how the entity has complied with the applicable compliance requirements in prior years
- The potential effect on the entity of noncompliance with the applicable compliance requirements
- The degree of judgment involved in adhering to the compliance requirements
- The auditor’s assessment of the risks of material misstatement in the financial statement audit

The auditor may find it helpful to consider the relevant application material in section 315, adapted as necessary for a compliance audit, when identifying and assessing the risks of material noncompliance and control risk of noncompliance individually or in combination.

[Subsequent footnotes are renumbered. No amendment to former paragraphs .A18–.A22, which are renumbered as paragraphs .A20–.A24.]
The use of substantive analytical procedures to obtain evidence in responding to assessed risks of material noncompliance is generally less effective in a compliance audit than it is in a financial statement audit. However, substantive analytical procedures may contribute some evidence when performed in addition to tests of transactions and other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence. (Ref: par. .4923)


Appendix — AU-C Sections That Are Not Applicable to Compliance Audits

The following AU-C sections and individually enumerated requirement paragraphs of specific AU-C sections are not applicable to a compliance audit performed under this section either because (a) they are not relevant to a compliance audit environment, (b) the procedures and guidance would not contribute to meeting the objectives of a compliance audit, or (c) the subject matter is specifically covered in this section. Where the table in this appendix specifies individual requirement paragraphs rather than an entire AU-C section, the application and other explanatory material paragraphs related to such requirement paragraphs also do not apply. However, an auditor may apply these AU-C sections and paragraphs if the auditor believes doing so will provide appropriate audit evidence in the specific circumstances to support the auditor’s opinion on compliance.

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<th>AU-C Section</th>
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*SAS No. 142, Audit Evidence, amended section 501, Audit Evidence — Specific Considerations for Selected Items, to add paragraph .27 to section 501. That amendment is effective for audits of financial statements for periods ending on or after December 15, 2022. Consequently, the proposed amendment relating to AU-C section 501 in this appendix would become effective for compliance audits for fiscal periods ending on or after December 15, 2022, to align with the effective date of SAS No. 142. All other proposed revisions to this appendix would become effective for compliance audits for fiscal periods ending on or after December 15, 2023.*
Exhibit — Illustrative Combined Report on Compliance With Applicable Requirements and Internal Control Over Compliance — (Unmodified Opinion on Compliance, No Material Weaknesses or Significant Deficiencies in Internal Control Over Compliance Identified)

[The amendment is contained in the second paragraph of the “Report on Internal Control Over Compliance” section of the illustrative independent auditor’s report.]

…

Independent Auditor’s Report

…

Report on Internal Control Over Compliance

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the section above and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies in internal control over compliance. Given these limitations, during our audit we did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above. However, material weaknesses or significant deficiencies in internal control over compliance may exist that have not been identified.

Our audit was not designed for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, no such opinion is expressed.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing.
based on the [insert the name of the governmental audit requirement or program-specific audit guide]. Accordingly, this report is not suitable for any other purpose.

[Signature of the auditor’s firm]
[City and state where the auditor’s report is issued]
[Date of the auditor’s report]