

## AU-C Section 9265

# ***Communicating Internal Control Related Matters Identified in an Audit: Auditing Interpretations of Section 265***

### **1. Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Participants in Office of Management and Budget Single Audit Pilot Project**

**.01 Question**—On October 7, 2009, the Office of Management and Budget (OMB) published the parameters of a pilot project, which is a collaborative effort between volunteer nonfederal entities expending American Recovery and Reinvestment Act of 2009 (ARRA) awards (auditees), the auditors performing compliance audits of auditees with ARRA expenditures under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and the federal government. For auditees that volunteer, the pilot project requires their auditors to issue to management an early written communication of significant deficiencies and material weaknesses in internal control over compliance at an interim date, prior to the completion of the compliance audit. Such communication would be based on internal control work performed on specified compliance requirements for two major programs with ARRA expenditures chosen from a list of approved ARRA pilot project programs. This communication also would be required to be submitted by management to the cognizant agency for audit. May an auditor issue such an interim communication in accordance with section 265, *Communicating Internal Control Related Matters Identified in an Audit*?

**.02 Interpretation**—Yes. Section 265 permits an auditor to communicate to management identified significant deficiencies and material weaknesses before the completion of a financial statement audit. It would be equally appropriate for a compliance audit. Regardless of how the early communication is delivered, the auditor should communicate all significant deficiencies and material weaknesses in writing to management and those charged with governance in accordance with section 265.<sup>1</sup>

**.03** The following is an illustrative communication that an auditor may use to comply with the pilot project communication requirement to inform management and those charged with governance of deficiencies in internal control over compliance related to ARRA funding that have been identified at an interim date prior to the completion of the compliance audit and are, or likely to be, in the auditor's judgment, significant deficiencies or material weaknesses in internal control over compliance:

This communication is provided pursuant to the parameters of the 2009 Office of Management and Budget (OMB) pilot project. Such project requires auditors

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<sup>1</sup> Paragraphs .11–.13 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

of entities that volunteer for the project to issue, in writing, an early communication of significant deficiencies and material weaknesses in internal control over compliance for certain federal programs having expenditures of American Recovery and Reinvestment Act of 2009 (ARRA) funding at an interim date, prior to the completion of the compliance audit. Accordingly, this communication is based on our audit procedures performed through [insert "as of date"], an interim period. Because we have not completed our compliance audit, additional significant deficiencies and material weaknesses may be identified and communicated in our final report on compliance and internal control over compliance issued to meet the reporting requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

In planning and performing our audit through [insert "as of date"] of [identify the federal programs selected to be tested as a major program from the federal list of approved ARRA pilot project programs], we are considering [Example Entity's] compliance with [list the applicable types of compliance requirements subject to the communication requirement in the pilot project (for example, activities allowed or unallowed, allowable costs and cost principles, cash management, eligibility, reporting, and special tests and provisions)] as described in the *OMB Circular A-133 Compliance Supplement* for the year ended June 30, 2009. We are also considering [Example Entity's] internal control over compliance with the requirements previously described that could have a direct and material effect on [identify the federal programs selected to be tested as a major program from the federal list of approved ARRA pilot project programs] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the [Example Entity's] internal control over compliance.

Our consideration of internal control over compliance is for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined in the following paragraph. However, as discussed subsequently, based on the audit procedures performed through [insert "as of date"], we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and other deficiencies that we consider to be material weaknesses.

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 with a type of compliance requirement<sup>2</sup> of a federal program on a timely basis. A *material weakness* in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control

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<sup>2</sup> Under Section 510(a)(1) of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the auditor's determination of whether a deficiency in internal control over compliance is a material weakness or significant deficiency for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *OMB Circular A-133 Compliance Supplement* (the *Compliance Supplement*). This reference to "type of compliance requirement" refers to the 14 types of compliance requirements (identified as A-N) described in part 3 of the *Compliance Supplement*. For purposes of reporting audit findings, auditors are alerted that certain of the types of compliance requirements may include multiple compliance requirements with multiple audit objectives (for example, compliance requirement "G" covers 3 separate requirements—matching, level of effort, and earmarking; and "N" covers separate requirements specific to each individual special test and provision).

over compliance, such that there is a reasonable possibility that material non-compliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. We consider the following deficiencies in internal control over compliance to be material weaknesses:

[Describe the material weaknesses that were identified either here or by reference to a separate schedule.]<sup>3</sup>

A *significant deficiency* in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in internal control over compliance to be significant deficiencies:

[Describe the significant deficiencies that were identified either here or by reference to a separate schedule.]<sup>4</sup>

[Example Entity's] responses to our findings are described [insert either "in the preceding paragraph" or "in the accompanying schedule"]. We did not audit [Example Entity's] responses and, accordingly, we express no opinion on the responses.<sup>5</sup>

This interim communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the entity, [identify the legislative or regulatory body], federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

[Issue Date: November 1994; Revised: March 2010; Revised: January 2012, effective for audits of financial statements for periods ending on or after December 15, 2012.]

## 2. Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Auditors That Are Not Participants in Office of Management and Budget Pilot Project

**.04 Question**—Part 6, "Internal Control," of the *OMB Circular A-133 Compliance Supplement* (the *Compliance Supplement*) stresses the importance of internal control testwork over major programs with ARRA expenditures and encourages early communication to management and those charged with governance of any significant deficiencies or material weaknesses in internal control:

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<sup>3</sup> The OMB pilot project requires the auditee, upon receipt of the interim communication from the auditor, to provide it to the federal cognizant agency for audit. Federal agencies are required to follow-up with the auditee concerning actions taken or needed to correct the finding. Therefore, to assist the federal agencies with this responsibility, significant deficiency and material weakness finding descriptions should include the level of detail required by both *Government Auditing Standards* and Section 510(b) of OMB Circular A-133. This would require the inclusion of, among other things, the views of responsible officials (see footnote 5).

<sup>4</sup> See footnote 3.

<sup>5</sup> The OMB pilot project requires the auditor to obtain management responses to the internal control matters identified and to include them in the interim communication.

Early communication by auditors to management, and those charged with governance, of identified control deficiencies related to ARRA funding that are, or likely to be, significant deficiencies or material weaknesses in internal control will allow management to expedite corrective action and mitigate the risk of improper expenditure of ARRA awards. Therefore, auditors are encouraged to promptly inform auditee management and those charged with governance during the audit engagement about control deficiencies related to ARRA funding that are, or likely to be, significant deficiencies or material weaknesses in internal control. The auditor should use professional judgment regarding the form of such interim communications.

**.05** Although not required, if an auditor decides to make such a communication in writing at an interim date, may the auditor issue the interim communication in accordance with section 265?

**.06 Interpretation**—Yes. As noted in the previous question, section 265 permits an auditor to communicate to management and those charged with governance identified significant deficiencies and material weaknesses before the completion of a financial statement audit. It would be equally appropriate for a compliance audit. The auditor is reminded that, regardless of how the early communication is delivered, the auditor should communicate all significant deficiencies and material weaknesses in writing to management and those charged with governance in accordance with section 265.<sup>6</sup>

**.07** If the auditor decides to make the interim communication encouraged in part 6 of the *Compliance Supplement* in writing, the following is an illustrative communication that an auditor may use to inform management and those charged with governance of deficiencies in internal control over compliance related to ARRA funding that have been identified at an interim date prior to the completion of the compliance audit and that are, or likely to be, in the auditor's judgment, significant deficiencies or material weaknesses in internal control:

This communication is provided pursuant to the *Office of Management and Budget (OMB) Circular A-133 Compliance Supplement*, which encourages auditors to communicate, at an interim date, control deficiencies related to federal programs with expenditures of American Recovery and Reinvestment Act of 2009 (ARRA) funding that are, or likely to be, significant deficiencies or material weaknesses in internal control over compliance. Accordingly, this communication is based on our audit procedures performed through [insert "as of date"], an interim period. Because we have not completed our compliance audit, additional significant deficiencies and material weaknesses may be identified and communicated in our final report on compliance and internal control over compliance issued to meet the reporting requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

In planning and performing our audit through [insert "as of date"] of [identify the federal programs with ARRA expenditures selected by the auditor to be tested as a major program], we are considering [Example Entity's] compliance with the applicable types of compliance requirements as described in the *OMB Circular A-133 Compliance Supplement* for the year ended June 30, 20XX. We are also considering [Example Entity's] internal control over compliance with the requirements previously described that could have a direct and material effect on [identify the federal programs with ARRA expenditures selected by the auditor to be tested as a major program] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test

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<sup>6</sup> See footnote 1.

and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the [Example Entity's] internal control over compliance.

Our consideration of internal control over compliance is for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined in the following paragraph. However, as discussed subsequently, based on the audit procedures performed through [insert "as of date"], we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and other deficiencies that we consider to be material weaknesses.

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 with a type of compliance requirement<sup>7</sup> of a federal program 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 type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. We consider the following deficiencies in internal control over compliance to be material weaknesses:

[Describe the material weaknesses that were identified either here or by reference to a separate schedule.]

A *significant deficiency* in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in internal control over compliance to be significant deficiencies:

[Describe the significant deficiencies that were identified either here or by reference to a separate schedule.]

This interim communication is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the entity, [identify the legislative or regulatory body], federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

[Issue Date: November 2009; Revised: March 2010; Revised: January 2012, effective for audits of financial statements for periods ending on or after December 15, 2012.]

### 3. Appropriateness of Identifying No Significant Deficiencies or No Material Weaknesses in an Interim Communication

**.08 Question**—In either of the previously described scenarios, may the auditor issue an interim communication in accordance with section 265 stating that as of the interim communication date, no significant deficiencies or material weaknesses have been noted?

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<sup>7</sup> See footnote 2.

**.09 Interpretation**—No. Section 265 states that the auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.<sup>8</sup> Such guidance would also apply to the interim communication contemplated in the previous two questions. Therefore, it would not be appropriate for an auditor to issue an interim communication stating that no significant deficiencies were identified.

**.10** Although section 265 would permit the auditor to issue a communication at the end of an audit stating that no material weaknesses were identified by the auditor, it would not be appropriate for an auditor to do so at an interim date.<sup>9</sup> Making such a communication at an interim date could lead to misinterpretation by management and those charged with governance, that there are no identified material weaknesses when, in fact, material weaknesses could be identified before completion of the compliance audit.

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<sup>8</sup> Paragraph .16 of section 265.

<sup>9</sup> Paragraph .15 of section 265.