

CHECKPOINT LEARNING

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- OCBOAs
- Generative AI

EXECUTIVE SUMMARY

PART 1. ACCOUNTING

FASB Update Segment Reporting..... 3

Russ Madray, CPA reviews recent accounting improvements for segment reporting disclosures.
[Running time: 30:32]

Learning Objectives: Upon completion of this segment, the user should be able to:

- Identify the intended improvements to reportable segment disclosure requirements under ASU 2023-07
- Define the term "significant segment expenses"
- Define easily computable under ASU 2023-07
- Identify the effective date of ASU 2023-07

PART 2. AUDITING

IT Risk and Audit Risk Assessment..... 16

Jennifer Louis, CPA reviews recent guidance focusing on IT risk and its impact on audit risk assessment.
[Running time: 26:39]

Learning Objectives: Upon completion of this segment, the user should be able to:

- Identify the requirements for auditors to understand during the risk assessment process
- Identify general IT controls
- Determine factors making the risks of the use of IT more likely
- Identify when an IT specialist may be needed in the audit

PART 3. SMALL BUSINESS

Communicating Internal Control Deficiencies..... 33

Kurt Oestrieher, CPA, discusses requirements to communicate internal control deficiencies to management and those charged with governance.
[Running time: 30:13]

Learning Objectives: Upon completion of this segment, the user should be able to:

- Define a deficiency in internal control
- Identify the two main actions an auditor must take when they become aware of a deficiency in internal control

ABOUT THE SPEAKERS

Russ Madray, CPA, CGFM, has more than 30 years of professional experience, including stints at two Big 4 accounting firms. Russ is a nationally-known accounting and auditing thought leader, writer, and advisor helping CPAs throughout the country understand and implement technical accounting and auditing issues.

Jennifer Louis, CPA, is a CPA and president of Emergent Solutions Group, LLC. She has more than 25 years experience in designing and instructing high-quality training programs. Ms. Louis was previously executive vice president and director of training services at AuditWatch Inc., a premier training and consulting firm serving the auditing profession. She also served as financial/operational audit manager for the AARP, and as an audit manager for Deloitte.

Kurt Oestrieher, CPA, is a CPA and partner with the accounting firm of Oestrieher and Company in Alexandria, Louisiana. He is in charge of accounting and auditing services, and is also involved in litigation support and small business consulting engagements. In addition to his client responsibilities, Kurt has served as a discussion leader for numerous accounting and auditing courses. He has served on the AICPA Accounting and Review Services Committee and is currently serving a three-year term on the AICPA Council.

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Date of Class (MM/DD/YYYY)	
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Program Description (Refer to executive summary)	
Instructional delivery method	Group Live
Recommended CPE credit	3.0 Credits
Recommended field of study(ies) (Refer to executive summary)	
Program Level	Update
Prerequisites (Circle One)	<ul style="list-style-type: none"> • Basic Accounting and Auditing professional experience • Basic Tax professional experience • Basic Governmental professional experience
Advance preparation	None required
Course registration and, where applicable, attendance requirements ⁽¹⁾	

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—From a Declaration of Principles jointly adopted by a *Committee of the American Bar Association* and *Committee of Publishers and Association*

PART 1. ACCOUNTING

FASB Update Segment Reporting

In November 2023, the Financial Accounting Standards Board issued a new ASU to improve the disclosures on reportable segments. This guidance applies to all public entities required to report information under ASC Topic 280, and is effective for fiscal years beginning after December 15, 2023. It requires additional incremental information to be disclosed for the benefit of investors performing financial analyses.

For more on this new guidance from the FASB, let's join Russ Madray, a CPA in South Carolina, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

So today we want to talk about a recent ASU related to reportable segment disclosures. And we've had some guidance on that for quite some time, but they've added some improvements. So in ASU 2023-07, they in theory have done that. Could you give us an overview of that particular standard?

Mr. Madray

Sure, I'd be glad to. And yes, we kind of laugh about this. I love it when they give the title of the new ASU. It is actually, *Improvements to Reportable Segment Disclosures*. I suppose improvements depends on who you ask about that, but that is the intent at least. So, this was issued in November of 2023.

It's ASU-2023-07. As I said, the title is *Improvements to Reportable Segment Disclosures*. The amendments in this are intended to improve the reportable segment disclosure requirements, which have existed for quite some time, primarily through some enhanced disclosures about a concept called significant segment expenses, which we'll talk about.

Beyond that, the amendments also enhance the interim disclosure requirements. It clarifies some circumstances where an entity can disclose multiple segment measures of profit or loss, which is a new provision. It provides some new segment disclosure requirements for entities that have just a single reportable segment. And then there's some other things in here, some other improvements that are included in this as well.

The purpose, again, is to enable investors to better understand the entity's overall performance and assess potential future cash flows. This ASU will apply to all public entities that are required to report segment information under Topic 280, and segment reporting in general, is a requirement for public companies, not private entities. Under that guidance in Topic 280, public companies have to report for each reportable segment a measure of the segment profit or loss that its chief operating decision maker, (the CODM), uses to assess the segment's performance and make decisions about resource allocation to segments. However, in this new ASU, it notes that all the information about a segment's revenue and measure of profit or loss is disclosed in the entity financial statements under current requirements. There's generally limited information disclosed about a segment's expenses. That's where some of the call for these changes came from in the investor community, for more enhanced expense disclosures. This new ASU will require public companies to provide additional more detailed information about a reportable segment's expenses, and we'll go into some of that shortly. The amendments in this ASU are incremental to those requirements and they don't change how a public entity identifies its operating segments, how it aggregates those operating segments, or how it applies those quantitative thresholds to determine its reportable segments. It's focused on incremental requirements that already exist and doesn't change any of the ways in which we identify those segments, which was already in Topic 280.

Ms. Grove Casey

You mentioned segment expenses, and in particular, I think it talks about significant segment expenses. Could you explain what that means? Because my idea of significant might be different than somebody else's idea of significant.

Mr. Madray

Sure, and that's one of the new things, one of the biggest new parts of this ASU. On the next slide, you'll see how that's defined in this ASU, significant segment expenses defined as “expenses that are regularly provided to the chief operating decision maker and included within each reported measure of segment profit or loss, which are collectively referred to as a significant expense principle.”

So what this ASU does is it requires public companies to disclose for each reportable segment the significant expense categories and the amounts for those particular expenses. If a public company doesn't separately disclose expenses under this principle, then it's required to disclose the nature of the expense information that's used by that CODM to manage the segment's operations. This ASU focuses on information that's regularly provided to the CODM even if it's not regularly reviewed by the CODM.

Keep in mind, under the current guidance in Topic 280, public companies are only required to disclose certain expenses, for example, interest and depreciation, if they're included in the measure of the segment profit or loss that's regularly provided to the CODM. For example, even though selling expenses might have been included in an entity's measure of segment profit or loss, previous guidance didn't require public entities to disclose those selling expenses.

Under this new ASU, if the selling expenses are determined to be a significant segment expense that's regularly provided to the CODM, then they're going to have to disclose those selling expenses. So, reportable segments could have different categories of significant segment expenses as a result of the nature of their operations and what's regularly provided to the CODM. Now, speaking of significant, that threshold and what does regularly provided mean, ASU states that entities should consider relevant qualitative and quantitative factors when determining whether segment expense categories and amounts are significant under that principle and should identify segment expenses on the basis of amounts that are regularly provided to the CODM, and are included in that reported segment profit or loss.

The ASU, however, does not define that term “significant” and it also does not define “regularly provided” and it doesn't specify how public companies are supposed to interpret the meaning of those things. The FASB expects that when determining whether certain segment items and amounts provided to the CODM have to be disclosed, public companies have been asked to use their own judgment, similar to how they would use it under the existing disclosure requirements in Topic 280. With all that said, most believe that the term *regularly provided* would mean at least quarterly. With that said, public companies are going to need to review at transition to this new guidance and for every reporting period thereafter, financial information that's provided to the CODM. It could be through different means like electronically, dashboards, paper format, and so on, and evaluate that information to identify any significant expenses for what would be considered easily computable, which is another term used in these new disclosure requirements.

In addition, public companies are going to have to monitor for changes that could occur between periods and consider the recasting requirements depending on if something becomes a significant expense under that principle regularly provided to the CODM, and again, easily computable is another issue that comes into play in making these types of disclosures as well.

Ms. Grove Casey

What do they mean by easily computable? Because sometimes their idea of easily is not mine.

Mr. Madray

True. As I said, the ASU requires public companies to disclose segment expenses that are regularly provided. Again, we said that's not defined, but most would say quarterly. Or, and the phrase here is “easily computable from information that is regularly provided.” So in addition to easily computable information that's regularly provided to the CODM, the required disclosures include information about significant expenses that's expressed in a form other than actual amounts. That could be like a ratio or an expense as a percentage of revenue. So some examples on the

next slide. If the CODM is regularly provided a segment revenue amount and a segment gross margin, a segment cost of sales could be easily computed from that information. So if cost of sales is significant, it would need to be disclosed as a significant segment expense.

Another example, if the CODM has regularly provided a segment revenue amount and segment warranty expense expressed as a percentage of segment revenue, then segment warranty expense can be easily computed from this information. So if it were significant, it would need to be disclosed as a significant segment expense. Another example, if bad debt expense or marketing expense as a percentage of revenue is part of the measure of segment profit or loss and is considered significant, those expenditures would need to be disclosed as significant segment expenses.

So I've got an example to walk through this. If you've got company A that's identified two reportable segments, United States and Europe. The CODM uses segment gross profit to assess segment performance and allocate resources. The U.S. and European gross margin percentages are regularly provided to the CODM let's assume the cost of sales is considered both easily computable and significant. Because cost of sales is determined to be easily computable, significant segment expense is regularly provided to the CODM and is included in the segment measure of profit or loss, i.e. segment gross profit, then disclosure of that information would be required under this new ASU. That's how we go about kind of understanding that easily computable idea in the context of significant segment expenses.

Ms. Grove Casey

Well, are there other disclosure requirements added by this amendment?

Mr. Madray

There are. So for every reportable segment, this ASU requires public companies to disclose an amount for other segment items that represent the difference between reported segment revenues less the significant segment expenses that are disclosed and the reported segment profit or loss.

Public companies would also need to provide a qualitative disclosure describing the composition of the other segment items, including the nature and the type of the other segment items. But a quantification for each of those items that's identified is not actually required. That disclosure would be required even when a public company does not separately report any significant segment expenses. So some examples of things that...would be required under this disclosure requirement as other segment items. We have these on the next slide. The total amount of a reportable segment's expenses that are included in the reported measures of the segment's profit or loss but are not regularly provided to the CODM. The total amount of a segment's expenses that are not significant. The total amount of a reportable segment's gains, losses, other amounts that might...be included in each reported measure of the segment's profit or loss. Segment expense amounts that are required under Topic 280, for example, things like interest expense, depreciation, amortization expense, when those amounts are included in the reported measure of the segment profit or loss but are not considered significant segment expenses.

So another example here on the next slide, let's say company B has identified two reportable segments: one is computer hardware; one is computer software. The CODM uses segment earnings before interest, taxes, depreciation, or amortization, the segment EBITDA, to assess segment performance and allocate resources. Let's assume cost of sales and warranty expenses for computer hardware and hosting fees for computer software are regularly provided to the CODM. Let's assume bad debt expenses, marketing expenses expressed as a percentage of revenue are regularly provided to the CODM for both computer hardware and computer software segments.

In this scenario, bad debt expenses and marketing expenses are both considered easily computable. However, only the marketing expenses are considered significant because marketing is determined to be an easily computable significant segment expense regularly provided to the CODM and is included in the segment measure of profit or loss, the disclosure would be required of that particular amount. That's one area where we have some additional disclosure requirements that go beyond what was in Topic 280.

Another area that I mentioned earlier, some enhancement in the interim disclosures. Under this new ASU, public companies need to disclose significant segment expenses and these other segment items, as well as all of the existing segment information about profit or loss on an annual and an interim basis.

Those disclosures would include information that needs to be disclosed annually under Topic 280. For example, measure of the segment's profit or loss, total assets, interest revenue and expense, depreciation, amortization, and so on. In the basis for conclusions of this ASU, the FASB indicated that it expected this new interim disclosure requirement to give more timely useful information for users without placing a significant additional burden on the preparers because the interim segment information would generally be available from the entity's existing financial systems and records. Another area, that is new, and I mentioned this earlier, this ASU allows public companies to disclose more than one measure of segment profit or loss, provided that at least one of those reported measures includes the segment profit or loss measure that's most consistent with GAAP measurement principles. It's referred to as the required measure.

Specifically, we see the requirement on this next slide, ASC 280-10-50-28A, which was added by this ASU, it states that "if the CODM uses more than one measure of a segment's profit or loss in assessing segment performance and deciding how to allocate resources, a public company can report one or more of those additional measures of segment profit or loss. However, at least one of the reported segment profit or loss measures shall be that which management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the public company's consolidated financial statements."

So in addition to reconciling each reported measure to the consolidated financial statements, a public company that discloses multiple measures of a segment's profit or loss would provide all the existing disclosures about the segment's profit or loss as well as about segment assets if that information is provided to the CODM. This new requirement to provide significant segment expenses and other segment items would also apply to each of those additional reported measures. So a public company that reports an additional measure for a reportable segment in the current period should disclose the additional measure in the prior comparative periods if it was provided to the CODM in those prior periods. And, in addition to that, a public entity is not precluded from reporting the additional measure for the prior periods where the measure was not provided to the CODM.

Speaking of the CODM, there's some CODM-related disclosures that are added by this ASU. We have those on the next slide. We have to disclose the title and position of the individual or the name of the group or committee that's identified as the chief operating decision maker. We have to disclose how the CODM uses the reported measures of segment profit or loss in assessing segment performance and deciding how to allocate those resources. We have to disclose the method that's applied to allocate overhead expenses that are disclosed as a significant segment expense, regularly provided to the CODM and included in that measure of segment profit or loss. We have to include a separate disclosure of interest expense that's a significant segment expense even if the public company discloses interest expense as part of its net interest income.

So you asked if there's some other disclosure requirements. Yes, there's a whole host of those things that are added here by this new ASU.

Ms. Grove Casey

What about entities with only one reportable segment? We've had some of that in the past. How does this ASU affect their disclosures?

Mr. Madray

A public company that has a single reportable segment would provide all the disclosures that are required by this ASU, for example, the significant segment expenses, those other segment items that we mentioned, as well as those that are required by the existing guidance in Topic 280. So, in other words, if the measure of a segment's profit or loss that the CODM uses to allocate resources and assess segment performance is not a consolidated GAAP measure

and is not clearly evident from the disclosures provided, it would need to be reported and reconciled to the consolidated income before income taxes. Provided that those requirements are met, an entity with a single reportable segment can also report additional performance measures that the CODM uses to assess segment performance and determine resource allocation provided at least one of those reported measures includes that segment profit or loss that is most consistent with the GAAP measurement principles as we mentioned earlier. A public company with a single operating segment should identify the measure of the segment's profit or loss that the CODM uses in assessing segment performance and deciding how to allocate those resources.

Again, the FASB expects that those measures are generally going to be apparent from the internal management reports that are regularly provided to the CODM. When a consolidated GAAP measure is used, a public company would have to disclose the measure of profit or loss that's used, information about all the significant expenses that are regularly provided to the CODM and included in that measure along with any other segment items whose line items could differ from those that are presented on the face of the income statement. Beyond that, information about a single reportable entity, if it's regularly provided to the CODM and included in the measure of profit or loss, might need to take into account a category and amount for allocated corporate overhead as a significant segment expense.

As a side note here, before adopting this ASU, public companies that have a single reportable segment were not explicitly required to provide segment disclosures beyond those provided on an entity-wide basis. Those entities will now be required to expand their segment note disclosures by providing all the disclosures currently required for multiple segment entities as well as these new ones that have been added by this new ASU. As part of that requirement, the entity's segment revenue,...and profit and loss measure would need to be clearly disclosed and the entity needs to review the information that's regularly provided to the CODM for significant segment expenses and those other segment items. So it's going to add incrementally to the disclosures for companies with a single reportable segment.

Ms. Grove Casey

Are there any other details in this ASU that we should be aware of?

Mr. Madray

Yes, a couple of things. I'm glad you brought that up. This new ASU amends Topic 280 to replace the word *restate* with a new word, *recast*. The changes related to the recasting of prior period segment information basically touches on a couple of areas. An entity that changes the segment information that's regularly provided to the CODM in a manner that causes identification of significant segment expenses to change or that changes its internal reports and the segment expense information that's regularly provided changes in the current period, the company is required to recast all periods, including interim periods, unless it's impracticable to do so. On the other hand, recasting is not required for an entity that has significant changes from prior periods to the measurement methods of expenses, method of allocating expenses to a segment or changes in the method for allocating centrally incurred expenses. It is preferable to show all segment information on a comparable basis to the extent that it's practicable to do so.

Another item that comes to mind with regard to these changes for segment disclosures is for SEC reporting purposes. An SEC registrant's determination of reportable segments also provides a basis for its required disclosures in the business and MD&A sections of their regulatory filings. So for example, Regulation S-K, specifically item 101(c), states that a registrant needs to provide a narrative description of the business, "focusing on the registrant's...dominant segment or each reportable segment about which financial information is presented in the financial statements."

On the next slide, you see that SEC Regulation S-K, specifically item 303(b), provides guidance on the MD&A of the financial condition and results of operations. It states where in the registrant's judgment, a discussion of segment information and/or other subdivisions, for example geographic areas or product lines, of the registrant's business would be necessary to an understanding of such business, the discussion must focus on each relevant reportable segment and/or subdivision of the business and on the registrant as a whole. So to comply with that guidance, registrants will need to provide disclosures that are consistent with those of its reportable segments.

This is where it gets tricky. Historically, Topic 280 precluded an entity from disclosing more than one measure of segment profit or loss in the notes to the financial statements. Therefore, any additional measures of profit or loss that were used by the CODM could only be presented as non-GAAP measures outside the financial statements, for example, within the MD&A discussion, provided that they complied with the SEC's non-GAAP rules and regulations.

Because this new ASU now permits public companies to disclose multiple measures of profit or loss that are used by the CODM, it's unclear whether a registrant will be permitted or otherwise required to discuss more than one segment measure of profit or loss within the MD&A. Beyond that, the SEC's rules and regulations allow a segment measure to be discussed on a segment-by-segment basis outside the financial statements in MD&A without being considered a non-GAAP measure, so for example, segment EBITDA. But if this same segment performance measure is discussed on an aggregated segment basis, it would be considered a non-GAAP measure and the registrant would have to comply with the SEC's non-GAAP rules and regulations. This new ASU doesn't change that.

But, under the new ASU, a registrant with a single reportable segment may now report a segment performance measure that was not prepared by using measurement principles consistent with GAAP. Again, this is already creating some questions about complying with the requirements of the ASU, if they choose to disclose multiple measures of performance and how this will coalesce or will jive with the SEC requirements and whether it will fall under the non-GAAP rules and regulations or not. This is all still being sorted out. It's something to be aware of and watch going forward as to how the SEC comes down on how this information is presented and whether they will consider it to be non-GAAP and subject to those particular...sets of rules and regulations.

Ms. Grove Casey

Let's talk a little bit about the effective date, because that's going to kind of give them some parameters on how soon they have to make a decision.

Mr. Madray

There's no time left. The amendments in this ASU are effective for all public companies for fiscal years that begin after December 15, 2023. For a calendar year public company, that would be annual periods beginning January 1, 2024, which will affect their December 31, 2024 Form 10-K, and also interim periods in the fiscal years that begin after December 15, 2024, which gets you into the quarterly filings in 2025. The enhanced segment disclosure requirements will apply retrospectively to all prior periods that are presented in those financial statements. The significant segment expense and the other segment item amounts disclosed in prior periods will need to be based on the significant segment expense categories that are identified and disclosed in the period of adoption. So, not much time to sort all of this out as it's, essentially, upon us right now for public companies that are required to make these disclosures.

SUPPLEMENTAL MATERIALS

ASU 2023-07, Improvements to Reportable Segment Disclosures

by J. Russell Madray, CPA, CGMA, CIA, CFM

Overview

In November 2023, the FASB issued ASU 2023-07, *Improvements to Reportable Segment Disclosures*. The amendments improve reportable segment disclosure requirements, primarily through enhanced disclosures about significant segment expenses. In addition, the amendments enhance interim disclosure requirements, clarify circumstances in which an entity can disclose multiple segment measures of profit or loss, provide new segment disclosure requirements for entities with a single reportable segment, and contain other disclosure requirements. The purpose of the amendments is to enable investors to better understand an entity's overall performance and assess potential future cash flows. The ASU applies to all public entities that are required to report segment information in accordance with ASC 280, *Segment Reporting*.

Under ASC 280, a public entity must report, for each reportable segment, a measure of the segment's profit or loss that its chief operating decision maker (CODM) uses to assess segment performance and make decisions about resource allocation. However, ASU 2023-07 notes that although information about a segment's revenue and measure of profit or loss is disclosed in an entity's financial statements under the current requirements, there generally is limited information disclosed about a segment's expenses and, therefore, investors supported enhanced expense disclosures. Accordingly, the ASU requires public entities to provide investors with additional, more detailed information about a reportable segment's expenses. The ASU's amendments are incremental to those requirements and do not change how a public entity identifies its operating segments, aggregates those operating segments, or applies the quantitative thresholds to determine its reportable segments.

Significant Segment Expenses

Significant segment expenses are defined in the ASU as "expenses that are regularly provided to the [CODM] and included within each reported measure of segment profit or loss (collectively referred to as the 'significant expense principle')." ASU 2023-07 requires public entities to disclose for each reportable segment the significant expense categories and amounts for such expenses. If a public entity does not separately disclose expenses under the significant expense principle, it is then required to disclose the nature of the expense information used by the CODM to manage the segment's operations. The ASU focuses on information that is regularly provided to the CODM even if it is not regularly reviewed by the CODM.

OBSERVATION: Under the current guidance in ASC 280-10-50-22, public entities are only required to disclose certain expenses (e.g., interest expense and depreciation) if they are included in the measure of segment profit or loss [or] otherwise regularly provided to the CODM. For example, even though selling expenses may have been included in an entity's measure of segment profit or loss, the previous guidance did not require public entities to disclose selling expenses. Under this ASU, if selling expenses are determined to be a significant segment expense that is regularly provided to the CODM, public entities must disclose selling expenses. Reportable segments may have different categories of significant segment expenses as a result of the nature of their operations and what is regularly provided to the CODM.

Significance Threshold and Regularly Provided Information

The ASU states that an entity should consider relevant qualitative and quantitative factors when determining whether segment expense categories and amounts are significant and should identify segment expenses on the basis of amounts that are regularly provided to the CODM and included in reported segment profit or loss. The ASU does not define the term "significant" or "regularly provided" or specify how public entities may interpret its meaning. The FASB expects that, when determining whether certain segment items and amounts provided to the CODM must be disclosed, public entities will be able to use judgment similarly to how they use it under the existing disclosure requirements in ASC 280. In general, most believe that "regularly provided" would mean at least quarterly. Public entities should review, both upon transition and for each reporting period, financial information (e.g., CODM packages, or segment information regularly provided to the CODM through different means such as electronically,

in dashboards, or in paper format) and evaluate such information for significant expenses and for what would be considered “easily computable.” In addition, public entities should monitor for changes that occur between periods and consider the recasting requirements.

Easily Computable Segment Expenses

The ASU requires public entities to disclose segment expenses that are “regularly provided” to the CODM or “easily computable from information that is regularly provided.” In addition to easily computable information that is regularly provided to the CODM, required disclosures include information about significant expenses that is expressed in a form other than actual amounts, for example, as a ratio or an expense as a percentage of revenue. Examples of such disclosures would include:

- If the CODM is regularly provided a segment revenue amount and a segment gross margin amount, segment cost of sales can be easily computed from this information. Accordingly, if cost of sales is significant, it would need to be disclosed as a significant segment expense.
- If the CODM is regularly provided a segment revenue amount and segment warranty expense expressed as a percentage of segment revenue . . . segment warranty expense can be easily computed from this information. Accordingly, if warranty expense is significant, it would need to be disclosed as a significant segment expense.
- Similarly, if bad-debt expense or marketing expense as a percentage of revenue is part of the measure of segment profit or loss and is considered significant, these expenditures would need to be disclosed as significant segment expenses.

Example 1 – Easily Computable Segment Expenses

- Company A has identified the following reportable segments: United States and Europe.
- The CODM uses segment gross profit to assess segment performance and allocate resources.
- U.S. and European gross margin percentages are regularly provided to the CODM.
- Cost of sales is considered both easily computable and significant.

Because cost of sales is determined to be an easily computable significant segment expense regularly provided to the CODM and is included in the segment measure of profit or loss (segment gross profit), disclosure is required.

Other Segment Items

For each reportable segment, the ASU requires public entities to disclose an amount for other segment items that represents the difference between reported segment revenues less the significant segment expenses disclosed and reported segment profit or loss. A public entity would also need to provide a qualitative disclosure describing the composition of the other segment items, including the nature and type of the other segment items; however, a quantification for each item identified is not required. This disclosure would be required even when a public entity does not separately report any significant segment expenses. The following are some examples of other segment items:

- The total amount of a reportable segment’s expenses that are included in the reported measure(s) of a segment’s profit or loss but are not regularly provided to the CODM.
- The total amount of a segment’s expenses that are not significant.
- The total amount of a reportable segment’s gains, losses, or other amounts that also are included in each reported measure of a segment’s profit or loss.
- Segment expense amounts required under ASC 280-10-50-22 (e.g., interest expense, depreciation, and amortization expense), when those specified amounts are included in the reported measure of segment profit or loss but are not considered significant segment expenses.

Example 2 – Significant Segment Expenses and Other Segment Items

- Company B has identified the following reportable segments: computer hardware and computer software.
- The CODM uses segment earnings before interest, taxes, depreciation, and amortization (segment EBITDA) to assess segment performance and allocate resources.
- Cost of sales and warranty expenses for computer hardware and hosting fees for computer software are regularly provided to the CODM.
- Bad-debt expenses and marketing expenses expressed as a percentage of revenue are regularly provided to the CODM for both the computer hardware and software segments.

Bad-debt expenses and marketing expenses are both considered easily computable; however, only marketing expenses are considered significant. Because marketing expense is determined to be an easily computable significant segment expense regularly provided to the CODM and is included in the segment measure of profit or loss (segment EBITDA), disclosure is required.

Interim Disclosures

Under the ASU, public entities must disclose significant segment expenses and other segment items, as well as all existing segment information about profit or loss, on an annual and interim basis. Such disclosures include information that must be disclosed annually in accordance with ASC 280-10-50-22 through 50-26C (e.g., a measure of a segment's profit or loss and total assets, interest revenue and expense, depreciation and amortization expense). In the ASU's Basis for Conclusions, the FASB indicates that it expects this new interim disclosure requirement to result in more timely decision-useful information for users without placing significant additional burden on preparers because the interim segment information is generally expected to be available from an entity's existing financial systems and records.

Multiple Measures of a Segment's Profit or Loss

The ASU permits public entities to disclose more than one measure of segment profit or loss, provided that at least one of the reported measures includes the segment profit or loss measure that is most consistent with GAAP measurement principles (the "required measure"). Specifically, ASC 280-10-50-28A (added by the ASU) states that "[i]f the [CODM] uses more than one measure of a segment's profit or loss in assessing segment performance and deciding how to allocate resources, a public entity may report one or more of those additional measures of segment profit [or loss]. However, at least one of the reported segment profit or loss measures . . . shall be that which management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in a public entity's consolidated financial statements."

In addition to reconciling each reported measure to the consolidated financial statements, a public entity that discloses multiple measures of a segment's profit or loss should provide all existing disclosures about the segment's profit or loss as well as about segment assets if such information is provided to the CODM. The new requirement to provide significant segment expenses and other segment items would also apply to each of these additional reported measures. A public entity that reports an additional measure for a reportable segment in the current period should disclose this additional measure in the prior comparative periods if it was provided to the CODM in those prior periods. Further, a public entity is not precluded from reporting the additional measure or measures for the prior periods in which the measure or measures were not provided to the CODM.

CODM-Related Disclosures

Other notable disclosures that the ASU requires public entities to provide include:

- The title and position of the individual or the name of the group or committee identified as the CODM.
- How the CODM uses the reported measure(s) of segment profit or loss in assessing segment performance and deciding how to allocate resources.

- The method applied to allocated overhead expenses disclosed as a significant segment expense, regularly provided to the CODM, and included within the measure of segment profit or loss.
- Separate disclosure of interest expense that is a significant segment expense, even if a public entity discloses interest expense as part of net interest income.

Entities With a Single Reportable Segment

A public entity that has a single reportable segment should provide all disclosures required by the ASU (e.g., significant segment expenses and other segment items) as well as those required by the existing segment guidance in ASC 280. In other words, if the measure of a segment's profit or loss that the CODM uses to allocate resources and assess segment performance is not a consolidated GAAP measure and is not clearly evident from the disclosures provided, it would need to be reported and reconciled to consolidated income before income taxes. Provided that these requirements are met, an entity with a single reportable segment also may report additional performance measures that the CODM uses to assess segment performance and determine resource allocation, provided that at least one of the reported measures includes the segment profit or loss measure that is most consistent with GAAP measurement principles.

A public entity with a single operating segment should identify the measure or measures of the segment's profit or loss that the CODM uses in assessing segment performance and deciding how to allocate resources. The FASB expects that those measures generally will be apparent from the internal management reports that are regularly provided to the CODM.

When a consolidated GAAP measure is used, a public entity would have to disclose the measure of profit or loss used, information about all significant expenses that are regularly provided to the CODM and included within that measure, and any other segment items whose line items could differ from those that are currently presented on the face of the income statement. Further, information about a single reportable entity, if regularly provided to the CODM and included in the measure of profit or loss, might need to take into account a category and amount for allocated corporate overhead expenses as a significant segment expense.

OBSERVATION: Before adopting this ASU, entities with a single reportable segment were not explicitly required to provide segment disclosures beyond those provided on an entity-wide basis. Such entities will now be required to expand their segment footnote disclosures by providing all the disclosures currently required for multiple-segment entities as well as those required by the ASU. As part of this requirement, the entity's segment revenue and profit or loss measure should be clearly disclosed and the entity must review information regularly provided to the CODM for significant segment expenses and other segment items.

Recasting of Prior-Period Segment Information

The ASU amends ASC 280 to replace the word "restate" with "recast." The ASU's changes related to the recasting of prior-period segment expense information can be summarized as follows:

- An entity that changes the segment information that is regularly provided to the CODM in a manner that causes the identification of significant segment expenses to change, or that changes its internal reports and the segment expense information that is regularly provided to the CODM changes in the current period, is required to recast all periods, including interim periods, unless it is impracticable to do so in a manner consistent with the existing recasting requirements related to a change in composition of the entity's reportable segments.
- Recasting is not required for an entity that has significant changes from prior periods to the measurement methods of expenses, the method for allocating expenses to a segment, or changes in the method for allocating centrally incurred expenses. However, it is preferable to show all segment information on a comparable basis to the extent it is practicable to do so in a manner consistent with the existing recasting requirements for reflecting a change in measurement of a segment's profit or loss.

SEC Reporting Considerations

An SEC registrant's determination of reportable segments provides the basis for its required disclosures in the business and MD&A sections of its filing. For example, SEC Regulation S-K, Item 101(c), states that a registrant should provide a narrative description of the business, "focusing upon the registrant's dominant segment or each reportable segment about which financial information is presented in the financial statements." In addition, SEC Regulation S-K, Item 303(b), provides guidance on MD&A of financial condition and results of operations. It states, in part:

Where in the registrant's judgment a discussion of segment information and/or of other subdivisions (e.g., geographic areas, product lines) of the registrant's business would be necessary to an understanding of such business, the discussion must focus on each relevant reportable segment and/or other subdivision of the business and on the registrant as a whole.

To comply with this guidance, a registrant should provide disclosures that are consistent with those of its reportable segments. Historically, ASC 280 precluded a registrant from disclosing more than one measure of segment profit or loss in the notes to the financial statements. Therefore, any additional measures of profit or loss that were used by the CODM could only be presented as non-GAAP measures outside the financial statements (e.g., within MD&A), provided that they comply with the SEC's non-GAAP rules and regulations. Because the ASU now permits public entities to disclose multiple measures of profit or loss that are used by the CODM, it is unclear whether a registrant will be permitted or otherwise required to discuss more than one segment measure of profit or loss within MD&A.

Further, the SEC's rules and regulations allow a segment measure to be discussed on a segment-by-segment basis outside the financial statements in MD&A without being considered a non-GAAP measure (e.g., segment EBITDA). However, if this same segment performance measure is discussed on an aggregated segment basis, it is considered a non-GAAP measure and the registrant would be required to comply with the SEC's non-GAAP rules and regulations. The ASU does not change this. However, under the ASU, a registrant with a single reportable segment may now report a segment performance measure that was not prepared by using measurement principles consistent with GAAP (e.g., consolidated segment EBIDTA).

Effective Date and Transition

The amendments in ASU 2023-07 are effective for all public entities for fiscal years beginning after December 15, 2023 (e.g., for calendar-year-end public entities, annual periods beginning on January 1, 2024 — i.e., December 31, 2024, Form 10-K), and interim periods within fiscal years beginning after December 15, 2024 (e.g., for calendar-year-end public entities, interim periods beginning on January 1, 2025 — i.e., Form 10-Q for the first quarter of 2025). Early adoption is permitted.

The enhanced segment disclosure requirements apply retrospectively to all prior periods presented in the financial statements. The significant segment expense and other segment item amounts disclosed in prior periods shall be based on the significant segment expense categories identified and disclosed in the period of adoption.

GROUP STUDY MATERIALS

A. Discussion Problems

1. Discuss the measures of profit or loss permitted to be disclosed under ASU 2023-07.
2. Discuss how ASU 2023-07 changes the disclosure requirements for entities with a single reportable segment.
3. Discuss how ASU 2023-07 moves from restating to recasting.

B. Suggested Answers to Discussion Problems

1. The ASU permits public entities to disclose more than one measure of segment profit or loss, provided that at least one of the reported measures includes the segment profit or loss measure that is most consistent with GAAP measurement principles (the “required measure”). Specifically, ASC 280-10-50-28A (added by the ASU) states that “[i]f the [CODM] uses more than one measure of a segment’s profit or loss in assessing segment performance and deciding how to allocate resources, a public entity may report one or more of those additional measures of segment profit [or loss]. However, at least one of the reported segment profit or loss measures . . . shall be that which management believes is determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in a public entity’s consolidated financial statements.”

In addition to reconciling each reported measure to the consolidated financial statements, a public entity that discloses multiple measures of a segment’s profit or loss should provide all existing disclosures about the segment’s profit or loss as well as about segment assets if such information is provided to the CODM. The new requirement to provide significant segment expenses and other segment items would also apply to each of these additional reported measures. A public entity that reports an additional measure for a reportable segment in the current period should disclose this additional measure in the prior comparative periods if it was provided to the CODM in those prior periods. Further, a public entity is not precluded from reporting the additional measure or measures for the prior periods in which the measure or measures were not provided to the CODM.

2. Before adopting ASU 2023-07, entities with a single reportable segment were not explicitly required to provide segment disclosures beyond those provided on an entity-wide basis. Such entities will now be required to expand their segment footnote disclosures by providing all the disclosures currently required for multiple-segment entities as well as those required by the ASU. As part of this requirement, the entity’s segment revenue and profit or loss measure should be clearly disclosed and the entity must review information regularly provided to the CODM for significant segment expenses and other segment items.
3. The ASU’s changes related to the recasting of prior-period segment expense information can be summarized as follows:
 - An entity that changes the segment information that is regularly provided to the CODM in a manner that causes the identification of significant segment expenses to change, or that changes its internal reports and the segment expense information that is regularly provided to the CODM changes in the current period, is required to recast all periods, including interim periods, unless it is impracticable to do so in a manner consistent with the existing recasting requirements related to a change in composition of the entity’s reportable segments.
 - Recasting is not required for an entity that has significant changes from prior periods to the measurement methods of expenses, the method for allocating expenses to a segment, or changes in the method for allocating centrally incurred expenses. However, it is preferable to show all segment information on a comparable basis to the extent it is practicable to do so in a manner consistent with the existing recasting requirements for reflecting a change in measurement of a segment’s profit or loss.

PART 2. AUDITING

IT Risk and Audit Risk Assessment

AU-C section 315 requires the auditor to look at the entity's use of IT, the risk associated with that use, and any controls in place to address those risks.

For more on audit risk assessment and IT risk, let's join Jennifer F. Louis, a CPA with Emergent Solutions Group, LLC, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

So today we want to talk a little bit about IT risk as part of that audit risk assessment that we, not that we didn't have before, but that has been brought to the focus, let's say a little bit more. How does IT benefit an entity's system of internal control?

Ms. Louis

Well, generally a system of internal controls that involves IT does have some capabilities like enhancing maybe the timeliness of when information can be made available or even just the general availability of information or the accuracy of it. It facilitates the ability to do additional analyses of information that you...couldn't do otherwise. But also it does enhance the ability to perhaps achieve segregation of duties in a better way or just reducing the risk that certain controls might be able to be overwritten or circumvented.

Ms. Grove Casey

How are the new risk-based auditing standards impacted by a reporting entity's use of IT?

Ms. Louis

The use of IT can introduce some risks as well, as we think about an entity's use of technology and controls that need to exist. During the risk assessment process, the audit standards say that the auditors have to gain an understanding of how information flows through an entity's information system, including how transactions are initiated and how they are processed and recorded and reconciled and reported into the financial statements. These information processing controls are certainly things that would include your IT environment and the applications that might be a part of that. And so there can be risks of material misstatement that might be identified as you are gathering and understanding about those issues.

Ms. Grove Casey

How is a risk arising from the use of IT defined?

Ms. Louis

As we think about risks arising from the use of IT, it does relate to the susceptibility of information processing controls to either be ineffectively designed or ineffective in their operation. Or it can be the risks to just the integrity of the information in the entity's information system because of an ineffective designed or ineffectively operating control that exists within an entity's processes.

Ms. Grove Casey

Are there any other important definitions that SAS 145 clarified related to IT?

Ms. Louis

They did in the fact of looking at general IT controls that are the controls over the entity's IT processes that support the continued operation of the IT environment. This includes the continued effective functioning of the information processing controls, but also just the integrity of the information system as a whole. So the general IT controls are meant to support the continued effective functioning of specific information processing controls within a system. And

as we look at information processing controls, those are the controls that relate to the processing of IT applications, but it also can be manual information processes that also might directly affect the risks of having integrity in the information that's being

Ms. Grove Casey

Does the difference between automated and manual information processing controls matter in the context of SAS 145?

Ms. Louis

Well, they certainly recognize that you're going to have both, right? As you think about automated controls that are embedded within IT applications, but then there are also manual things that happen as you're inputting information into the system or manual things that are happening based on the output that's coming from the information. So your information processing controls does need to take into account both the manual and the automated elements as they're both relevant to the auditor's ability to understand a system in order to properly identify and evaluate where there's risk of material misstatement, so that we can properly design our further audit procedures accordingly. They do emphasize that automated IT controls tend to be more reliable than your manual controls as they're not as easily ignored or bypassed or overridden. So they do emphasize those as seeing that they're probably going to be more effective than manual controls, but they also understand that there does need to be typically some level of manual intervention within an overall system.

Ms. Grove Casey

What else is relevant to gain an understanding of as it relates to the IT environment?

Ms. Louis

Well, we talked about things being relevant as far as the information flow, the information processing. As I look at the nature and the characteristics of an IT application itself, but it also needs to include things like understanding the level of customization of an IT application. You need to think about outsourcing and third-party hosting arrangements. And...data warehousing and the use of interfaces or report writers, that those would also be things that would be included as you're thinking about really understanding the IT environment from a bigger point of view.

Ms. Grove Casey

What internal control framework should be applied when ensuring that transactions are validly recorded in an IT environment?

Ms. Louis

Well, they will fall back on using the guidance that's encompassed within COSO's *Internal Control--Integrated Framework* from 2013. There are also other frameworks that exist such as the government accountability offices, standards for internal control in the federal government, what's called the Green Book. The standards themselves don't prescribe a particular framework.

But yet the concepts and the principles that are a part of those frameworks are things that they would fall back on to say yes, as you think about the components and the principles and the guidelines that generally these frameworks can be used as an appropriate guide as you're trying to figure out what's necessary to gain an understanding of.

Ms. Grove Casey

What are IT applications and how are they important to understand in order to properly identify and assess risk?

Ms. Louis

An IT application is a program or it could be a set of programs that's used in initiating, processing, recording, reporting information and transactions. The IT applications though do include the data warehousing or report writers that also could be employed. The IT infrastructure is the actual network operating systems that relates to the environment.

And so what's critical is that we do need to think about the applications that are being used to think about the software packages that are being used maybe to record fixed asset purchases or to keep track of the number of hours that an employee works. These applications are critical as we now have to figure out, well, how do we now restrict access to those applications that would really also be a part of the general IT controls that we mentioned earlier.

Ms. Grove Casey

Well, talking about the general IT controls, tell me more about the importance of those controls.

Ms. Louis

Well, it is because we are trying to look at the IT environment as a whole. And so there is risk that can come from the IT environment as we think about what's occurring with the ongoing effectiveness and reliability of the information that is being processed. We want to make sure that we're not having unauthorized changes to the applications. We want to make sure that there is backups and that there is other things that would be important as we think about the general well functioning of the environment in which all these information processing activities actually function.

Ms. Grove Casey

How else can general IT controls be a factor in what the auditor does during the risk assessment phase of the engagement?

Ms. Louis

Well, it may be that as we think about the information system, that as we're getting evidence, it may be that I need to test controls over a system generated report to get comfortable about the completeness and accuracy of that report. If I need to test controls, then I do need to think about not just the application controls itself, but also thinking about the general IT controls that also address risks, such as the ability for somebody to make source code changes or tamper with the data that's put into that system. And so there does need to be a focus on both of them as they really complement each other, as we really think about the IT environment as a whole.

Ms. Grove Casey

Sometimes in an audit, the auditor decides up front that they're not going to rely on controls. Does an auditor only have to be concerned with general IT controls if they plan to take a control reliance strategy?

Ms. Louis

Regardless of whether or not you plan to actually rely on the controls by testing operating effectiveness, the standards do presume that you would perform procedures to evaluate the design of identified controls and determine whether or not they've been implemented. That's going to better inform the auditor's decisions related to your further audit procedures to make sure that we're comfortable with the plan that we're going to be putting in place.

So if the auditor does not plan on relying on controls to lower the amount of work that needs to be done to satisfy my detection risk components, you still need to have an understanding at least of the design and implementation of those controls in order to have a basis for your other conclusions.

Ms. Grove Casey

Yes, it's just that when you have an audit, you have to gain that understanding, and that's part of understanding how their internal controls work. What factors would influence the auditor's process for identifying risks arising from IT?

Ms. Louis

Well, when we understand an entity's environment, that's going to help us determine what IT applications the entity is actually using and relying on in order to generate information. Understanding the entity's business model will help you understand how it integrates IT and will provide context around the nature and extent of IT that you're expected to see within those information systems. Now some...applications are going to have more risk than others as we look at those circumstances. And certainly there's different levels of risk, such as a commercial off-the-shelf package

compared to something that's been customized and developed internally. So it is important that we start with the auditor's understanding of the IT environment to understand the nature and number of IT applications that are being used, and other aspects of the environment that will help us then further make decisions about how much more information you need to gather.

Ms. Grove Casey

How does an entity's use of IT factor into identifying significant classes of transactions, account balances, and disclosures?

Ms. Louis

Well, you may identify the IT applications and the supporting infrastructure as you are understanding how information related to significant accounts, class of transactions, disclosures actually flow through the entity's information system.

Ms. Grove Casey

What are characteristics of an IT application that would likely make IT risks more likely?

Ms. Louis

Well, certainly as we have interfacing between applications, if there is a significant volume of data or transactions, the complexity of an application's functionality, does it automatically initiate transactions, for example? Does it have complex calculations that relate to these automated entries? So these are things that would make a risk from IT being more likely compared to something that's a standalone application or has transactions that are supported by original hard-copy documents. We do have to use our judgment as we're determining where there's a risk and where it is that we need to gain an understanding about the design and implementation of those relevant controls.

Ms. Grove Casey

Can you give some specific risks that may occur?

Ms. Louis

Well, as we think about information processing and we think about accurate data processing, we do need to consider access. Like would there be unauthorized access to data where somebody could change or destroy data? Could they record unauthorized or non-existent transactions? Particularly when you have multiple users that can access a common database.

How do we make sure that there's not unauthorized access to that database? But also, we need to think about unauthorized changes to data in a master file or unauthorized changes to the applications themselves. Other things that could be considered as we think about risks could be just the inability to access data as we need it or potentially losing that data.

Ms. Grove Casey

Is there a scalability factor to consider when identifying IT risks?

Ms. Louis

In all cases, as we think about risk-based audits, that they're all scalable, right? The extent of my understanding of the IT environment and the IT processes will vary in the circumstances, right? To think about the nature and circumstances of the audited entity, but also just the nature and circumstances of its IT environment itself, and it will be based on what the auditor believes is relevant and necessary in order for me to have an appropriate understanding to have a better chance of being able to identify risks that need to be responded to. So we do need to think about if it's a less complex entity, they're probably less likely to have some sort of sophisticated system. They are likely to have a less complex system, but even in that less complex environment, it is still likely that information systems still

play some role in their accounting financial reporting process. So just because it's a smaller, less complex entity doesn't preclude you from having to gain an appropriate understanding, it just might be that there's less effort that's involved. As we are doing that understanding, as we have a basis for the design of our further...procedures.

Ms. Grove Casey

Could you give a specific example of how scalability may apply?

Ms. Louis

Well, we talked about how they might use some sort of commercial software package and they don't have access to the source code. They can't make program changes. So there may be that as we think about that, there, we still need to understand how it is they configure the software, maybe within the functionality that was created by the vendor. But we are less likely to have to spend effort understanding the process for program changes. Because they just don't have access to the source code, it's less relevant in the circumstances. But there does still need to think about in general though who has access to the specific applications. And there is still some information that would have to be gathered, even though we're dealing with a commercial off-the-shelf package.

Ms. Grove Casey

Is there an example of when an auditor may not identify any IT application subject to risks arising from the use of IT?

Ms. Louis

If management is not relying on automated controls or general IT controls to support the complete and accurate processing of transactions or maintaining data. I have not identified any information processing controls that depend on IT, then I, obviously, don't have anything to gain an understanding of. There may not be any risks that arise from the entity's use of IT. But when management is relying on IT applications, which generally they are these days, then I would have to subject those IT environments to an understanding. But it is important that we recognize that you can scale what you're doing, but we do need to address it when it is relevant.

Ms. Grove Casey

Do general IT controls need to be considered when an entity only uses a commercial off-the-shelf software package?

Ms. Louis

When we're looking at the commercial package, there still needs to be controls over that package related to how do you do your upgrades, as there is maybe an upgrade or a patch that needs to be updated within the operating system or the application. We need to still think about backups as we think about backing up critical data and programs. There still needs to be...logical access to the systems, the network, the databases, the applications. Even if it's an off-the-shelf commercial package, there still has to be some basic understanding of those general IT controls.

Ms. Grove Casey

When does an IT specialist need to be involved in the audit?

Ms. Louis

Well, when we're looking at cases where in the auditor's judgment, I think I need to bring somebody in that's got a higher level of knowledge than myself. The more complex, obviously, the IT environment, the more likely it is that you're going to have to bring in that specialist. They can help you either with looking at the general IT controls or the specific applications and the information processing.

So definitely as we think about complexity, as we think about the fact that they may have customized applications, significant new systems, significant e-commerce activities, maybe they're using emerging technologies to process financial information, or information is only available in electronic form. Those would be examples of things where there would be potentially more need to bring in somebody that has a specific understanding about IT.

Ms. Grove Casey

How does the auditor's understanding of IT risks impact other decisions that the auditor makes, such as whether to take a control reliance strategy, for example.

Ms. Louis

Well, you're only going to take a control reliance strategy of a system of internal controls where you're comfortable with the design of it, right? So part of it, right, as we gain this understanding is to say, well, is there even something that could be reliable as we look at the design and implementation of controls? That's going to be a factor. And also though, we need to think about the general IT controls. If they're not...properly designed or effectively implemented. There's not controls that prevent or detect, say, unauthorized access to IT applications that also can affect my decision about whether or not to rely on the automated controls within its specific IT application. So it is something that we do need to think about and to understand the whole IT environment that will be a consideration as we may be determining that we do want to try to reduce our control risk.

Ms. Grove Casey

Are there any other decisions that the auditor makes in designing the detailed audit plan that may be impacted?

Ms. Louis

Well, certainly, as we're thinking about our inherent risk assessments that have to be done at the relevant assertion level, if there are significant programming changes that were done to an IT application, or if there's a new reporting requirement of an applicable framework, that could affect my financial statements and the extensiveness of any type of programming or data changes.

It would mean that IT application is more likely to have a risk arising from the entity's use of IT. But also, as you look at designing further audit procedures, the information processing controls that depend on general IT controls would be something that we want to consider, whether or not we should be testing the operating effectiveness of general IT controls, so that if we are thinking about where it is that we should take a control reliance strategy or where we could, because it would be efficient, those do need to be factors of consideration as we're thinking about the aspects of that IT environment and where there could be a risk that's arriving from that entity's use of IT.

Ms. Grove Casey

What are some other applicable IT risks that may be relevant?

Ms. Louis

When we're thinking about also service providers, it could be an internal service provider, it could be an external service provider as we're outsourcing maybe certain hosting in my IT environment, there might be shared service centers or third parties. And it is something that as the volume or complexity of our IT environment goes up, there's going to be more risk that might arise from the use of that IT. And that, you know, might involve things like cybersecurity risks as well.

Ms. Grove Casey

Let's talk a little bit more about the importance of the information system and communication component of a system of internal control.

Ms. Louis

We mentioned about how you're using the components and the principles that are based on the COSO *Internal Control--Integrated Framework* and the control activities component of it would include your information processing activities but also the information system and communication component would be relevant as we think about the IT environment and as we think about the data and information.

How do we know that it's complete and accurate? And how do we know that it's something that is properly captured and processed? So that overlapping element with the control activities element is something that is important when we're thinking about that IT environment.

SUPPLEMENTAL MATERIALS

Focus on IT Risk as a Part of Audit Risk Assessment

By Jennifer F. Louis, CPA

Overview

The widespread use of information technology (IT) can introduce various risks that affect financial reporting and the audit process. AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* requires the auditors to consider the reporting entity's use of technology, the risks related to technology, and any controls the entity has designed and implemented to address those risks.

Generally, IT benefits an entity's system of internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations when processing large volumes of transactions or data.
- Enhance the timeliness, availability, and accuracy of information.
- Facilitate the additional analysis of information.
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures.
- Reduce the risk that controls will be circumvented.
- Enhance the ability to achieve effective segregation of duties by implementing security controls in IT applications, databases, and operating systems.

During the risk assessment procedures, SAS No. 145 instructs auditors to gain an understanding of "how information flows through the entity's information system, including how transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated into the general ledger, and reported in the financial statements."

Auditors should identify which applications and other aspects of the entity's IT environment pose risks. Then, auditors will identify specific risks arising from the use of IT and general IT controls to address these risks for each identified application or aspect. Next, auditors will identify controls and perform procedures around those controls.

Important Definitions

The definitions "risks arising from the use of IT" and "general IT controls" are important. Risks arising from the use of IT relate to the "susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes."

General IT controls relate to "controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information in the entity's information system." General IT controls support the continued, effective functioning of specific information-processing controls or manual information processes in the entity's information system.

Information-processing controls are controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information.

Automated and Manual Elements of an Information System

Information-processing controls may be automated (i.e., embedded in IT applications) or manual (e.g., input or output controls) and may rely on other controls, including other information-processing controls or general IT controls.

The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement and design of further audit procedures. Automated controls may be more reliable than manual controls because they cannot be as easily bypassed, ignored, or overridden, and they are also less prone to simple errors and mistakes.

Automated controls may be more effective than manual controls in the following circumstances:

- High volume of recurring transactions, or in situations in which errors that can be anticipated or predicted can be prevented, or detected and corrected, through automation.
- Controls in which the specific ways to perform the control can be adequately designed and automated.

The entity's information system may include the use of manual and automated elements, which also affect the way transactions are initiated, recorded, processed, and incorporated in the general ledger and reported in the financial statements. Procedures to initiate, record, process, and report transactions may be enforced through the IT applications used by the entity and how the entity has configured those applications. Records in the form of digital information may replace or supplement records in the form of paper documents.

In obtaining an understanding of the IT environment relevant to the flows of transactions and information processing in the information system, the auditor gathers information about the nature and characteristics of the IT applications used as well as the supporting IT infrastructure and IT. This may include, for example, the complexity or level of customization related to IT applications, third-party hosting or outsourcing, and the use of interfaces, data warehouses, or report writers.

The integrity of information may include the completeness, accuracy, and validity of transactions and other information.

Framework to Apply

Although the standards do not prescribe the use of a particular internal control framework, the auditor may find the guidance regarding the concepts encompassed in COSO's 2013 *Internal Control—Integrated Framework* (COSO framework) useful. The U.S. Government Accountability Office's Standards for Internal Control in the Federal Government (the Green Book) provides similar guidance.

Recorded transactions represent economic events that actually occurred and were executed according to prescribed procedures. Validity is generally achieved through control activities that include the authorization of transactions as specified by an organization's established policies and procedures (i.e., approval by a person having the authority to do so).

Risks to the integrity of information arise from susceptibility to ineffective implementation of the entity's information policies, which are policies that define the information flows, records, and reporting processes in the entity's information system. Information-processing controls are procedures that support effective implementation of the entity's information policies.

Business processes result in the transactions that are recorded, processed, and reported by the information system. Information-processing controls are also known as transaction controls. Such controls directly support the actions to mitigate information-processing risks in an entity's business processes.

The Importance of General IT Controls

Auditors are required to identify the IT applications and other aspects of the entity's IT environment that are subject to risks arising from the use of IT, the specific related risks arising from the use of IT, and the general IT controls that address those risks. The IT environment includes the IT applications and supporting IT infrastructure, as well as the IT processes and personnel involved in those processes, that an entity uses to support business operations and achieve business strategies.

An IT application is a program or a set of programs that is used in the initiation, processing, recording, and reporting of transactions or information. IT applications include data warehouses and report writers. The IT infrastructure comprises the network, operating systems, and databases and their related hardware and software. The IT processes are the entity's processes to manage access to the IT environment, manage program changes or changes to the IT environment, and manage IT operations.

Risks arising from the use of IT lead to the susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.

For example, a client may use a software package that records fixed asset purchases or keeps track of employee hours worked. A software package may write checks or initialize electronic payments to vendors. Access restrictions to such systems would be a general IT control auditors would expect to be designed and implemented. Elements such as robust password management and access privilege policies lower the risk of fraud and misappropriation of assets.

The auditor's decision to test controls at the assertion level may be influenced by the presence or absence of effective general IT controls. For example, if general IT controls are not designed or implemented properly to address risks associated with IT, the auditor may choose not to rely on automated controls within the affected IT applications.

The ongoing effectiveness of information processing controls may depend on general IT controls that prevent unauthorized program changes. The expected effectiveness of these general IT controls can impact the auditor's assessment of control risk. If the general IT controls are expected to be ineffective, control risk may be higher, and the auditor may need to plan additional tests.

When the entity's information system relies on IT applications to obtain audit evidence, the auditor may need to test controls over system-generated reports, for example, to gain comfort over the completeness and accuracy of the report. This includes identifying and testing general IT controls that address risks, such as unauthorized program changes or data tampering.

Significant programming changes made to an IT application to comply with reporting requirements can indicate complexity and potential risks associated with IT. Understanding these changes helps the auditor assess inherent risk at the assertion level.

The design of further audit procedures can be influenced by the relationship between information-processing controls and general IT controls. If information-processing controls rely on general IT controls, the auditor may need to test the effectiveness of those controls and design tests accordingly. If general IT controls are expected to be ineffective, the related risks arising from IT may need to be addressed through substantive procedures. However, this may not provide sufficient appropriate audit evidence for certain risks, and the auditor may need to consider the implications for the audit opinion.

Performing Procedures on General IT Controls

Regardless of whether they plan to rely on controls, the auditor needs to perform procedures to evaluate the design of the identified controls and determine whether they have been implemented. Evaluating the design of these controls and determining whether they have been implemented will inform the auditor's decisions regarding further audit procedures. If the auditor does not plan to rely on controls to lower the amount of substantive work to be performed, or if substantive procedures will provide sufficient appropriate audit evidence for the audit opinion, the requirements stop at the auditor's evaluation of the design and implementation. Otherwise, further audit procedures will include performing appropriate steps to test the operating effectiveness of identified controls.

Understanding which IT applications are in place and other characteristics of the IT environment, the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks will affect the audit plan. For example, the type of application and the reliance the entity places on that application may affect the audit

plan. In addition, the results when testing the design and implementation of a particular IT general control may affect the audit plan, potentially calling into question the reliability of information that is produced by or involves information from that application.

Identifying Risks Arising from IT in IT Applications

The type of an entity's IT application and its risks, controls, and use will likely affect the auditor's assessment of control risk (and possibly the assessment of inherent risk) at the assertion level and will influence the amount of further audit procedures the auditor will need to perform to achieve the desired reduction of audit risk.

An understanding of the entity and its environment will assist in determining which IT applications the entity is relying on to accurately process and maintain the integrity of information in the entity's information system. The understanding of the entity's business model and how it integrates the use of IT may also provide useful context to the nature and extent of IT expected in the information system.

Some IT applications may have risks arising from the use of IT. Identifying the IT applications subject to risks due to IT use involves considering the controls identified, because those controls may involve the use of IT or rely on IT. The bottom line is that IT applications most likely to have risks are those for which you identified controls.

The auditor's understanding of the IT environment may focus on identifying, and understanding the nature and number of, the specific IT applications and other aspects of the IT environment that are relevant to the flows of transactions and processing of information in the information system. Changes in the flow of transactions, or information within the information system, may result from program changes to IT applications or direct changes to data in databases involved in processing or storing those transactions or information.

The auditor may identify the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances, and disclosures flow throughout the entity's information system.

Characteristics of an IT application that make risks arising from IT use more likely include:

- Applications are interfaced.
- The volume of data or transactions is significant.
- The application's functionality is complex, automatically initiates transactions, or has a variety of complex calculations underlying automated entries.

Characteristics of an IT application that make risks arising from IT use less likely include:

- It is a stand-alone application.
- The volume of data or transactions is not significant.
- The application's functionality is not complex.
- Each transaction is supported by original hard copy documentation.

Risks arising from the use of IT include risks related to inappropriate reliance on IT applications that are inaccurately processing data, processing inaccurate data, or both. They commonly include:

- Unauthorized access to data, which may destroy or improperly change data, such as the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions (particularly when multiple users access a common database).
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down the segregation of duties.
- Unauthorized changes to data in master files.

- Unauthorized changes to IT applications or other aspects of the IT environment.
- Failure to make necessary changes to IT applications or other aspects of the IT environment.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

Scalability of Risk

The extent of the auditor's understanding of the IT processes, including the extent to which the client has general IT controls in place, will vary with the nature and circumstances of the client and its IT environment. It will also be based on the nature and extent of controls the auditor identifies.

The information system, and related business processes, in less complex entities are likely to be less sophisticated than in larger entities and are likely to involve a less complex IT environment. However, the role of the information system is just as important. For example, less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies.

Understanding the relevant aspects of the entity's information system may require less effort in an audit of a less complex entity and may involve a greater amount of inquiry than observation or inspection of documentation. However, the need to obtain an understanding remains important to provide a basis for the design of further audit procedures and may further assist the auditor in identifying or assessing risks of material misstatement.

The extent of the auditor's understanding of the IT processes, including the extent to which the entity has general IT controls in place, will vary with the nature and circumstances of the entity and its IT environment and will also be based on the nature and extent of controls identified by the auditor. The number of IT applications that are subject to risks arising from the use of IT also will vary based on these factors.

For example, an entity that uses commercial software and does not have access to the source code to make any program changes is unlikely to have a process for program changes but may have a process or procedures to configure the software (e.g., the chart of accounts, reporting parameters, or thresholds). In addition, the entity may have a process or procedures to manage access to the application (e.g., a designated individual with administrative access to the commercial software). In such circumstances, the entity is unlikely to have formalized general IT controls.

Alternatively, an entity may use multiple IT applications, and the IT processes to manage the IT environment may be complex (e.g., a dedicated IT department exists that develops and implements program changes and manages access rights). In such circumstances, the entity likely has implemented formalized general IT controls over its IT processes.

When management is not relying on automated controls or general IT controls to support complete and accurate transaction processing or maintain the data, and the auditor has not identified any automated controls or other information-processing controls (or any that depend on general IT controls), the auditor may plan to directly test any information produced by the entity involving IT and may not identify any IT applications that are subject to risks arising from the use of IT.

When management relies on an IT application to process or maintain data and the volume of data is significant, and management relies upon the IT application to perform automated controls that the auditor has also identified, the IT application is likely to be subject to risks arising from the use of IT.

The auditor's professional judgment is key to recognizing where they can properly scale their procedures.

General IT controls likely still need to be considered even if the entity uses a commercial software and does not modify these programs. There are often general IT controls found in less complex entities. They commonly include the following:

- Controls to secure logical access to critical applications, databases, operating systems, and networks.
- Controls related to significant upgrades to the IT operating system or to significant packaged applications (e.g., significant upgrades that are tested before they are put into production).
- Controls to back up critical data and programs.

Use of an IT Specialist

There may be circumstances in which, in the auditor's professional judgment, an IT specialist may need to be involved. When an entity has greater complexity in its IT environment, identifying the IT applications and other aspects of the IT environment, determining the related risks arising from the use of IT, and identifying general IT controls is likely to require the involvement of team members with specialized skills or knowledge in IT. Such involvement is likely to be essential and may need to be extensive for complex IT environments.

The following are examples of when an IT professional is more likely to be required:

- Relatively complex IT systems and custom applications.
- Significant changes.
- Implementation of significant new systems.
- Significant sharing of data among systems.
- Significant e-commerce activities.
- Significant use of emerging technologies to process financial information.
- Significant information available only in electronic form.

Impact on Risk Assessment Process

SAS No. 145 allows auditors to effectively address the complexities of IT systems and conduct audits that prioritize risk assessment. In understanding the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks, various parts of the risk assessment process will be impacted.

The auditor's decision about whether to test the operating effectiveness of controls to address risks of material misstatement at the assertion level may be impacted. For example, when general IT controls are not designed effectively or appropriately implemented to address risks arising from the use of IT (e.g., controls do not appropriately prevent or detect unauthorized program changes or unauthorized access to IT applications), this may affect the auditor's decision to rely on automated controls within the affected IT applications.

The auditor's assessment of control risk at the assertion level may be impacted. For example, the ongoing operating effectiveness of an information-processing control may depend on certain general IT controls that prevent or detect unauthorized program changes to the IT information-processing control (i.e., program change controls over the related IT application). In such circumstances, the expected operating effectiveness (or lack thereof) of the general IT control may affect the auditor's assessment of control risk (e.g., control risk may be higher when such general IT controls are expected to be ineffective or if the auditor does not plan to test the general IT controls).

The auditor's strategy for testing information produced by the entity that is produced by or involves information from the entity's IT applications may be impacted. For example, when information produced by the entity to be used as audit evidence is produced by IT applications, the auditor may determine to test controls over system-generated reports, including identification and testing of the general IT controls that address risks of inappropriate or unauthorized program changes or direct changes to the data in such reports.

The auditor's assessment of inherent risk at the assertion level may be impacted. For example, when there are significant or extensive programming changes to an IT application to address new or revised reporting requirements of the applicable financial reporting framework, this may be indicative of the complexity of the new requirements and their effect on the entity's financial statements. When such extensive programming or data changes occur, the IT application is also likely to be subject to risks arising from the use of IT.

The design of further audit procedures may be impacted. For example, if information-processing controls depend on general IT controls, the auditor may determine to test the operating effectiveness of the general IT controls, which will then require the design of tests of controls for such general IT controls. If, in the same circumstances, the auditor determines not to test the operating effectiveness of the general IT controls, or the general IT controls are expected to be ineffective, the related risks arising from the use of IT may need to be addressed through the design of substantive procedures. However, in such circumstances, the risks arising from the use of IT may not be able to be addressed when such risks relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. In addition, the auditor may need to consider the implications for the audit opinion.

The other aspects of the IT environment that may be subject to risks arising from the use of IT include the network, operating system and databases, and, in certain circumstances, interfaces between IT applications. Other aspects of the IT environment are generally not identified when the auditor does not identify IT applications that are subject to risks arising from the use of IT. When the auditor has identified IT applications that are subject to risks arising from the use of IT, other aspects of the IT environment (for example, database, operating system, network) are likely to be identified because such aspects support and interact with the identified IT applications.

In identifying the risks arising from the use of IT, the auditor may consider the nature of the identified IT application or other aspect of the IT environment and the reasons for it being subject to risks arising from the use of IT. For some identified IT applications or other aspects of the IT environment, the auditor may identify applicable risks arising from the use of IT that relate primarily to unauthorized access or unauthorized program changes as well as risks related to inappropriate data changes (e.g., the risk of inappropriate changes to the data through direct database access or the ability to directly manipulate information).

The extent and nature of the applicable risks arising from the use of IT vary depending on the nature and characteristics of the identified IT applications and other aspects of the IT environment. Applicable IT risks may result when the entity uses external or internal service providers for identified aspects of its IT environment (e.g., outsourcing the hosting of its IT environment to a third party or using a shared service center for central management of IT processes in a group). It is more likely that there will be more risks arising from the use of IT when the volume or complexity of automated application controls is higher and management is placing greater reliance on those controls for effective processing of transactions or the effective maintenance of the integrity of underlying information. Applicable risks arising from the use of IT may also be identified related to cybersecurity.

Information System and Communication Component

The auditor should, through performing risk assessment procedures, obtain an understanding of the entity's information system and communication relevant to the preparation of the financial statements by understanding the entity's information-processing activities, including its data and information, the resources to be used in such activities and the policies for significant classes of transactions, account balances, and disclosures.

This includes how information flows through the entity's information system, including how:

- Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger, and reported in the financial statements and
- Information about events and conditions, other than transactions, is captured, processed, and disclosed in the financial statements.

An understanding also includes understanding the accounting records, specific accounts in the financial statements, and other supporting records relating to the flows of information in the information system, the financial reporting process used to prepare the entity's financial statements, including disclosures, and the entity's resources, including the IT environment.

The auditor should identify the IT applications and the other aspects of the entity's IT environment that are subject to risks arising from the use of IT.

For each control identified to address risks of material misstatement at the assertion level, the auditor should evaluate whether the control is designed effectively to address the risk of material misstatement at the assertion level or effectively designed to support the operation of other controls. The auditor will also determine whether the control has been implemented by performing procedures in addition to inquiry of the entity's personnel.

GROUP STUDY MATERIALS

A. Discussion Problems

1. Discuss the need for the auditor to perform procedures to evaluate the design of the identified controls and determine whether they have been implemented, related to IT and planning the audit.
2. Discuss the characteristics of an IT application that increase or decrease risks arising from its use more or less likely.
3. Discuss the scalability of risk of material misstatement as it relates to an entity's use of IT.

B. Suggested Answers to Discussion Problems

1. Regardless of whether they plan to rely on controls, the auditor needs to perform procedures to evaluate the design of the identified controls and determine whether they have been implemented. Evaluating the design of these controls and determining whether they have been implemented will inform the auditor's decisions regarding further audit procedures. If the auditor does not plan to rely on controls to lower the amount of substantive work to be performed, or if substantive procedures will provide sufficient appropriate audit evidence for the audit opinion, the requirements stop at the auditor's evaluation of the design and implementation. Otherwise, further audit procedures will include performing appropriate steps to test the operating effectiveness of identified controls.

Understanding which IT applications are in place and other characteristics of the IT environment, the risks arising from the use of IT and the general IT controls implemented by the entity to address those risks will affect the audit plan. For example, the type of application and the reliance the entity places on that application may affect the audit plan. In addition, the results when testing the design and implementation of a particular IT general control may affect the audit plan, potentially calling into question the reliability of information that is produced by or involves information from that application.

2. Characteristics of an IT application that make risks arising from IT use more likely include:
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- Unauthorized access to data, which may destroy or improperly change data, such as the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions (particularly when multiple users access a common database).
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down the segregation of duties.
- Unauthorized changes to data in master files.
- Unauthorized changes to IT applications or other aspects of the IT environment.
- Failure to make necessary changes to IT applications or other aspects of the IT environment. Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

3. The extent of the auditor's understanding of the IT processes, including the extent to which the client has general IT controls in place, will vary with the nature and circumstances of the client and its IT environment. It will also be based on the nature and extent of controls the auditor identifies.

The information system, and related business processes, in less complex entities are likely to be less sophisticated than in larger entities and are likely to involve a less complex IT environment. However, the role of the information system is just as important. For example, less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies.

Understanding the relevant aspects of the entity's information system may require less effort in an audit of a less complex entity and may involve a greater amount of inquiry than observation or inspection of documentation. However, the need to obtain an understanding remains important to provide a basis for the design of further audit procedures and may further assist the auditor in identifying or assessing risks of material misstatement.

The extent of the auditor's understanding of the IT processes, including the extent to which the entity has general IT controls in place, will vary with the nature and circumstances of the entity and its IT environment and will also be based on the nature and extent of controls identified by the auditor. The number of IT applications that are subject to risks arising from the use of IT also will vary based on these factors.

PART 3. SMALL BUSINESS

Communicating Internal Control Deficiencies

The purpose of internal controls is to correct and-or prevent errors and irregularities resulting in material misstatements in the financial statements as part of normal financial operations. Controls have two aspects—design and operation—and failure may occur with either. When a control deficiency or group of deficiencies exist and there is a reasonable possibility a material misstatement will occur, management and those charged with governance should be notified. Auditors need to communicate both material weaknesses and significant deficiencies identified when conducting a financial statement audit.

For more on when communication is needed, let's join Kurt Oestrieher, a CPA and a partner with Oestrieher and Company in Alexandria, Louisiana, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

Today we want to talk a little bit about communicating internal control deficiencies. So to begin with, maybe give us a little bit of an overview of where the authoritative guidance is on that.

Mr. Oestrieher

Well, fortunately we get a little narrower scope here because in a preparation, compilation, or review, we don't do anything with internal controls. We make a few general inquiries in a review, but nothing like we do in an audit. So obviously there is no anticipation that we are going to become aware of any deficiencies in a review, compilation, or preparation. So there's no guidance other than just saying, hey, if you become aware and you want to communicate it. But in an audit, because there are specific requirements to understand a system of internal control over financial reporting and even doing walkthroughs of those controls now, certainly it is likely that we will become aware of deficiencies should they exist. And so therefore we have specific guidance in our auditing standards in AU-C 265 that tells us what we need to do to communicate and be aware of deficiencies as they may occur.

Ms. Grove Casey

So what are our actual requirements when it comes to this?

Mr. Oestrieher

There's no requirement to find a deficiency or to look for a deficiency. The requirement is once we become aware of it, there's two things we have to do. There's two verbs. We have to evaluate and then potentially communicate based on that evaluation. So when we evaluate, and we're going to get into all the gory details of what we evaluate and what becomes communicate, but it's evaluate and communicate. And the interesting, part of this entire equation is because we're not specifically looking for them, we need to kind of know what it is so we don't step on it. In other words, you might be hiking out in West Texas and you might be, I don't know if you've ever seen these rattlesnake derbies, but there are people that actually go looking for rattlesnakes and want to catch the rattlesnake and put it in a bag and bring it back to this big pit where they put thousands of rattlesnakes and then people are pushing those rattlesnakes around now. That's not my thing. It's not for me to say it's a good thing or bad thing. It's just something that it's not like exactly on my bucket list, but those people are specifically looking for rattlesnakes. They know what the definition of a rattlesnake is and they're looking for them.

When we're doing an audit we're not looking for control deficiencies. We just gain an understanding and to be perfectly blunt in a small business audit, when you've already made the decision that we're not going to rely on the controls and assess control risk at maximum, I would say it is a tendency for an auditor to maybe not be on the highest alert when they are obtaining an understanding of internal controls or doing their walkthroughs because they know they're not going to use them. They're just like, okay, how much do I have to document to make my peer viewer

happy? And again, I'm not saying that happens all the time. I'm just saying I've talked to enough people that could be the case. So that would be a lot different perspective than someone that is like, oh, we are going to rely on the controls. Okay, this is a big company or this is a publicly traded company. So you're on higher audit alert, and first of all, in those companies, it's less likely that you'd become aware of a deficiency because they're required by law for a publicly traded company. So, the people auditing the public companies, they're like the rattlesnake hunters. They know what it is.

They know if they find a deficiency, they can't rely on them, so they're looking hard for them, and they're going to round them up, okay? Whereas people like me in the non-public business world, I'm just the person taking the hike in West Texas, and I prefer not to hear a rattle. I'm not looking for the rattlesnakes. I know they're out there, but if you leave me alone, how about I leave you alone? And we just call it a truce and let me take my camera and pretty picture. So that's the reason why we see issues here, because people don't even know what they're looking for.

Ms. Grove Casey

So let's talk about what a deficiency in internal control is, because obviously it does help if you know what it is you're looking for.

Mr. Oestriecher

Right, because that's what we have to evaluate. We only have to evaluate when we become aware of a deficiency in internal control. And when you look at that definition, and again, it has, it changed a little bit with SAS 112 and then SAS 114, and then when the standards were clarified. But first of all, it is a deficiency in internal control over financial reporting. So if we, people could have, like I had a trucking company one time, and they had...internal controls all over the place to comply with Department of Transportation regulations as far as the weight of the truck, the driver hour, drug testing for the driver. But that has nothing to do with financial reporting. It has everything to do with compliance. So it is, first of all, it's a deficiency in internal control over financial reporting. It exists when either one of two things happen. You either have a design deficiency or an operational deficiency. So that's the first thing we have to do is that if I'm asking you a question, and saying, okay, do you reconcile bank accounts? And the client says, no, that's a design problem because we just general knowledge know that reconciling a bank account is a good internal control over a multitude of things on cash, including cutoff and completeness from some other management assertion. So just that alone tells me no. If they say, oh, we do it, but you find out that the same person that handles cash and deposits cash is also doing the bank reconciliation, so you're doing one, but there's also a design issue because it's not segregated, so that is a design [issue]. An operational deficiency is you have something that's properly designed, but the client isn't doing what they're supposed to do. So they have a policy that bank accounts are reconciled within five days of the end of the month by a separate person and approved by supervisors. They have all these great policies, but then when you get in there, you realize they're not reconciling the bank account or even better, they think they're reconciling the bank account because their computer system produces a report where two numbers are the same. QuickBooks is famous for this. But ultimately, it's not a bank reconciliation. It's just a recapitulation of the entries in what should have happened assuming things had cleared the bank. If there's a bank reconciliation and part of the things that make it balanced, it says un-reconciled items, then you really don't have a bank reconciliation. So that's an example of an operational one where we have where... they just aren't doing a bank reconciliation. So you either have something that is not designed at all or improperly designed or is not operating effectively. So that's the first thing you become aware of. And when you're rattlesnake hunting, it's a lot easier for you to identify operational things because the client affirmatively told you this is what we're supposed to do. There's supposed to be an approval for every purchase order or whatever it is.

So, and then when you do your walkthroughs, you see, well, nothing's approved. That's an operational issue. The design issue, it's actually going to be a more experienced auditor that will probably become aware of those because you just have to look at what the client's doing and go, no, you need to do more. Either it's poorly designed or you should be doing something, right? I mean, it's harder to find the negative. So that's where you have. But then if you have either one of those deficiencies, an operation or design that doesn't allow management or employees so someone within the organization, because it is internal, so management or employees, in the normal course of performing their

assigned functions. Okay, so we're not looking for superhumans. So part of what they should be doing every day. So it does not allow management or employees in the normal course of performing their assigned functions to either prevent a misstatement from occurring, material, or detect it and correct it on a timely basis.

So those are all the elements. I know there's that, count them slowly, but it's design or operation that doesn't allow management or employees acting in their normal capacity. We either want to prevent them, and we would rather prevent things from ever entering into the accounting system. We can't prevent everything. So the things we can't prevent, we want to detect and correct in a timely manner. So that is a deficiency in internal control. That is the rattlesnake that you are looking for. And if I had 100 CPAs in the room and asked them to give me the definition of a deficiency in internal control, the only ones that would pass it are the newer people that probably just sat for the CPA exams or nerds like me that write this stuff and lecture on it on a normal basis. If I went and asked my staff, they could give me something kind of close because when we are performing our risk assessment and we're talking about, okay, we're going to assess control risk at maximum, but we're going to go get the understanding.

I really, we talk about this. I said, now look, when you're out there, I want you to think, don't just be writing all the piece of paper. In other words, I don't want to be that complacent auditor just trying to get the minimum amount there for my peer reviewer. I'm trying to say, okay, we need to be thinking about it because this is an area that, when we talk about communication, if there was a glaring thing that any reasonable CPA should be aware of and we don't evaluate it, yes, you can bring in a question, due professional care. In other words, if I became aware the bank accounts weren't reconciled and I never considered that. And that's as basic as it gets. So that's why we want to make sure we understand what we're looking for. So those are the, that is the definition of your deficiency and internal control.

Ms. Grove Casey

So let's talk a little bit about what is a material weakness because that's one of the things that we need to communicate.

Mr. Oestrieher

Right, so once we define, you know, we find one of these things based on that definition, now we look at, when we evaluate it, there's one of three options that ultimately we will make on this evaluation. And there are only three options. Either it just remains a deficiency in internal control and does not rise to the level of a material weakness or significant deficiency. And if it just stays as a deficiency in internal control, you're not required to communicate it.

Now you may want to communicate it in a management letter or some other form, but you're not required to. So that is option one. It doesn't rise to the level of a significant deficiency or material weakness. But when you're evaluating, normally you would think just logically you would say, okay, is it the lowest level, just a deficiency in internal control, and if it's not, then let's go up to significant deficiency. And if it's not that, then let's go up to material weakness. That's the way logically you might approach this. But when you read the definitions, it's a top-down approach. You actually, your evaluation, you start to see if it is a material weakness. And if it doesn't meet that criteria, then you go and say, okay, is it a significant deficiency? And then if it doesn't meet that criteria, now you say, oh, I'm just left with a plain old vanilla, deficiency in internal control that I don't have to report. So we start from the top down. And again, just like we were looking for that rattlesnake, we needed to know how to define that rattlesnake. Well, if we're going to look for the biggest, baddest rattlesnake out there, the kind that would kill you if we're talking about rattlesnakes, we're probably talking about the size of the rattlesnake and things like that because they can inject more venom. The worst possible scenario for your rattlesnake catcher and that is the material weakness. The definition of a material weakness is a deficiency or a combination of deficiencies and that is key because you may have noted seven internal control or deficiencies when you're gathering your knowledge and your understanding of internal controls, but two or three of them lumped together might say, okay, these together are the function on the cutoff and completeness of cash. So now we can evaluate three of these together. So it can be a deficiency or a combination of deficiencies in internal control over financial reporting. And I'm going to go through the definition here one time and then when you get the key elements. But this is kind of a word salad.

A material weakness is a deficiency or a combination of deficiencies in internal control over financial reporting such that there is at least 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. Then it further goes on to say a reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable, and then, they use the terms that we still have in contingency accounting for reasonably possible or probable, so that's the word salad, but now let's break it down piece by piece. It becomes much more manageable. Basically, it is a two-pronged test. It is a likelihood test and a magnitude test. The likelihood is that it is at least a reasonable possibility and the magnitude is a material mistake. So any potential misstatements that are not material will not meet the magnitude test, and therefore, it can't be a material weakness. Both of those things have to be present.

So let's talk about reasonable possibilities. So I become aware that the entity has no controls over classification of expenses, that whatever the clerk puts on the invoice that's going to be paid, that's what gets paid, or that's how it gets coded. So if the code, if an invoice comes in and the clerk puts code 6640, because that's what he or she believes it should be, then there is a design operation because there's no internal control. There's no review of that to ensure it is properly classified and coded. So that would be an operational deficiency. So now the first thing I have to ask myself, okay, is what is the likelihood that that control deficiency, would cause a misstatement? And then if it's more than reasonably possible, in other words, at least reasonably possible, you can say either way, more than reasonably possible or at least reasonably possible are the same things. And again, we use this from the same context that we use for contingencies. So more likely than not, where would some people put this? Is that 50%? It's somewhere between zero and 100%, right? So, you know, some people say, well, we got remote, reasonably possible and probable. So they say between 0 and 33 is remote, between 33 and 66 2/3 is reasonably possible, and 66 2/3 to 100% is probable because we just want to be linear like that. I don't look at it that way. I probably put less than 5% is remote, between 5 and 50 is reasonably possible, and more than 50% is probable. And the way I defend that position, is if I flip a quarter a hundred times, it is probable that it'll be 50 heads and 50 tails, right? That's the probability. So that's why I put when Kurt Ostricheer thinks of the term probable, I think more likely than not 50%. So if we want to express this from a percentage standpoint, it would be a control deficiency that the way I perceive things would be between a five and 50% chance of occurring. That's at least reasonably possible.

That's the way Kurt would look at this. So I document and say, okay, if this person's not doing that or if bank statements are not being reconciled or payroll's not being approved, what is that possibility? Okay. Probably going to be higher for the payroll approval because if a company processes payroll and there's absolutely no oversight whatsoever and there's no, when I say there's no internal controls, you know how people use biometrics now and fingerprints and all that for time control and the manager looks over it. Let's just say that employees have a manual time card, a sheet of paper and every payroll, they just turn it in for payroll and they get paid. If they said that they work 43 hours a week, they get their 40-hour straight time and three hours overtime. There's no approval, no clock, no nothing. First of all, you have pretty serious design deficiency. Then I look at human nature that people are probably going to fudge. So I think it is at least reasonably possible that people are going to get overpaid. I think that's a very fair statement if that were the scenario that I had. So it's at least reasonably possible. But now the question is, let's use that payroll example, now it has to result in a material misstatement of the financial statements. So now I say, okay, if everyone is fudging one hour a week, okay, well, that doesn't sound like a lot, but what is that? That's 2.5% right, of a 40-hour work week. So if payroll, which is a million dollars could be two and a half percent misstated, then I can kind of translate that to dollars and say, would that make someone's difference? Remember, we're not doing this from the perspective of would management be mad that they're overpaying people? It is from the users of the financial statement. Is it a material misstatement to the financials? And if you come to that conclusion that it's maybe two and a half percent of payroll, but you don't believe that's material, then you do not have a material weakness. While I've met the first test, at least reasonably possible, you don't think it could be a material misstatement. So at that point, it is not a material weakness. And you will make this evaluation for every single control deficiency you have or combination ones, you can lump them together. Of course, we do everything now digitally, but when the standard first came out, and people used third-party practice aids, they have these management point development worksheets, I would tell them one way that you can envision this is, first of all, every time you . . . identify a control deficiency, stop what you're doing and fill out one of those worksheets and reference back to whatever work paper where you became aware of it. It is most likely that you're going to become aware of these things when you're

understanding the controls or you're doing the walkthrough. Now later on when you're performing further audit procedures, if you are not going to test and not rely on controls, that means you're not going to test controls. So it's highly likely that you're not going to become aware of any control deficiencies because you shouldn't be paying attention to the controls at that point. Now you might stumble across some, but at any time during the audit, you can become aware of a control deficiency. It's just much more likely in the planning. But as soon as you find one, stop and document. Then at the end of the audit, now you have seven of these control development worksheets you've worked up together, okay?

And then let's say that five of them stand alone and then the last two can be combined with some. So I've got five different independent evaluations I have to make. Remember we evaluate and communicate. So I just described the one that I would evaluate on the payroll when I found out that there's non-existence that everyone is on the honor system when it comes to payroll. And based what I just did on my walkthrough or the way that I walked through it, I concluded. Now some people, if you think, hey, maybe up to five hours, maybe you relate this back to your analytical procedures and they had just gone on the honor system this past year and you notice that overtime has increased 735% over budgeted in previous years. Well, now you put that together and you go, you know, that could be material. Again, I cannot tell you exactly what is going to be considered to meet both of those thresholds. You have to apply your judgment and you want to document.

But let's say that I determine that I do not believe it could be material. Absolutely, it's more than reasonably possible someone's going to cheat with their time card, but I don't believe it'll be material. So it does not meet the definition of a material weakness. So now you have to go look at the definition of a significant deficiency, because that's the next thing you have to evaluate. And a significant deficiency by definition is a deficiency or a combination of deficiencies over internal control over financial reporting that is less severe than a material weakness, yet warrants the attention of those charged by governance. So I'm probably going to decide that payroll thing is in fact, warrants the attention of those charged with governance because it is potentially fraud, because if you put in more time than you work, that's a form of fraud. And that's just the way that I would see it. Somebody else might say, yeah, but management knows that they don't care because they said, hell, if we pay someone an hour extra a week that's still less money than we're paying for all that biometric stuff, or the time for them to approve. So they may have looked at it from a cost benefit and management may have already told you that, yeah, we know about that card and we're okay. You know, it's, it's the, one of the funniest, but most real things that I've ever heard back when Don King was the height of his promoting years, this was 20 or 25 years ago, some boxer it wasn't like Mike Tyson, but you know, like somebody way up there switched promoters to Don King and a reporter was asking and said, well, yeah, but he kind of has a shady background, you know, and there's rumors that he might steal from his own people. And the guy said, he will make me so much money, even if he steals an extra 10%, I'm still ahead. I mean, it's just a business. It's like Don, steal 10% on here. You're going to make me twice as much money. If you take 10%, I'm still ahead. And that's the way some of our clients look at these. They go, yeah, we know you could put more controls in place. But the cost is, you know, I'd rather pay.

The employees are happier, they're not someone watching their time sheet, I'm paying them an extra hour, what the hell, I'm okay with it. So, if you know that that's management's attitude already, or those charged with governance, then you say, well, it doesn't warrant their attention because we've talked about this. But if it is a governmental entity where you're talking about state or local funds, well, now it's a whole different meaning because governance wants to know about it because the constituents would probably want them to do something about it. So if I'm governance, I'd say, yeah, you need to tell me about those things. So that is how you evaluate it. And we use worksheets within our firm and you document your reasons. So you can't, don't just say, oh, I think it's a material weakness because it's really big or it's a big deal. You must look at the magnitude test and the likelihood test and document your reasons on both of those. And if it meets both, it has to be both, has to meet both those criteria. If it doesn't meet both, then you say, Is this something those charged with governance would want to be aware of? So here's a kind of a unique thing, in a small business world, if it doesn't meet the definition of a significant material weakness, usually it's not even a significant deficiency because management and those charged with governance are the same people. They're going to run their business how they want to. But you still want to consider it because if it's something that they don't, they aren't even aware that a potential control could be there that would help.

I still think you're going to want to call that a significant deficiency in most cases, but you absolutely have to have, you have to understand if you do not know the definition of a deficiency in internal control, a definition of material weakness, and the definition of a significant deficiency, it is my opinion you cannot properly evaluate it. And then demonstrate in your documentation that you understand those definitions because it is your judgment. All of those are your judgment. So that's why documentation is so important.

Ms. Grove Casey

Well, let's talk about the communication. You mentioned that we have to talk about it with governance, of course. And so what exactly do those communications need to have in them?

Mr. Oestrieher

Well, it has to be in writing and in address to those charged with governance. And again, in small business world, you understand management, those charged with governance must be the same thing, but communicated to anyone with appropriate responsibility also. But there are specific things you must include the definition of a deficiency in internal control that has to be in there because you're telling people this is what we're talking about. And then you must include a definition of material weakness.

You only include a definition of significant deficiency if you are reporting a significant deficiency. Now the standards actually say when applicable, you only have to include a definition of significant deficiency when applicable, but if you go back and look in the very first auditing standard that had this, like I said, it was updated, then it was clarified, but the sample reports for significant deficiencies are always in italic, meaning if you're not reporting a significant deficiency, then you don't have to include it. You can if you want to, but you don't have to. And I've actually seen this on peer review. Peer review checklist 10 years ago was wrong on this because they were telling people, oh, you didn't have your definition of significant deficiency. Well, all they were reporting were material weaknesses. So you didn't have to have it in there. So first of all, make sure you have those first two definitions. And then if you're reporting on a significant deficiency, you have to have the definition there. Then you will list them. If you do not have any material weaknesses and you do not have any significant deficiencies, then you will not be issuing this letter if you're only doing the audit under AICPA standards.

If you're under Yellow Book standards, the AICPA gave a caveat because Yellow Book standards require this communication, you may issue a no material weaknesses. So you can say that there are no material weakness, but you can never say there are no significant deficiencies. You can only say no material weaknesses. The reason why significant deficiencies are so, it's such a broad spectrum of consideration and potential differences of opinion. That's why you cannot affirmatively state there are no significant deficiencies, but you can issue a no material weaknesses, which you have to have those definitions in there. Once you are, and by the way, if it's under Yellow Book, and there are no significant deficiencies or material weaknesses, then you just say no material weakness, and then there's nothing to report. But if you have, if this is a non-governmental entity, and you're not under Yellow Book standards, now you will simply list the deficiencies and you will list what the deficiency is.

Now this is where I suggest you use the models that you see in Yellow Book, because you can first of all just say, you don't have proper segregation of duties on bank reconciliation. But instead, I think it's better to say, okay, here's the criteria. You talk about why segregation of duties is good, then talk about was it an operational deficiency, meaning you do not have anything designed, or there's a procedure designed and we...based on our walkthrough, determine that bank reconciliations either were not being performed timely or were being performed at all, whatever you find, and then you give a recommendation. Now here's where we probably don't worry about management's response and some of these other things you might see in Yellow Book, but what is the criteria? Why is this important? What you found that you believe is a deficiency in internal control that you believe meets the threshold of either material weakness or a significant deficiency, and then you might want to...put in your auditor's recommendation, again, not required, but it's just kind of a best practices type thing. It differentiates firms and it keeps our clients a little bit happier. Also, there's wording in there. You have to let everyone know, hey, the purpose of the audit was to express an opinion on the financial statements, not an opinion on the internal controls. We did not look, and this is

not designed to detect all control deficiencies. And that's very important because when you give this communication, people might believe it's comprehensive and all-inclusive. And if you didn't say anything, in other words, if they fixed the three things you talked about, then they have a perfect system. That would be a tremendous misunderstanding. So that's why you need to make sure that they understand the limitations. It wasn't an overall evaluation of their internal control. You're restricted to those known users. And it needs to be within 60 days of the completion of the report release date. But the reality is this is almost always released with the audit.

We will actually typically go over these issues when we hand the draft financial statements to the client and give them the rep letter. That's usually when we will also give this communication and give them the letter at that point. I don't ever see any reason to wait 60 days. I believe they just need to have a reasonable period of time within the audit standards, but most people will do it immediately.

SUPPLEMENTAL MATERIALS

Communicating Internal Control Deficiencies

by Kurt Oestrieher, CPA

Introduction

The AICPA Auditing Standards Board issued SAS 112 in 2007, which was later updated and amended with SAS 115, then eventually re-codified as AU-C 265 when the clarity standards were adopted by the Auditing Standards Board. The required communications which began with SAS 112 were one of the first steps in bringing back many required communications with those charged with governance and management. This segment will focus on both the requirements to discover internal control deficiencies and the communications.

Requirements

Procedures performed by the Auditor

AU-C 265 does not require the auditor to perform any additional procedures beyond those embodied in AU-C 315, *Understanding the Entity and Its Environment, Including the Entity's Internal Control*. AU-C 265 requires that at any time an auditor **becomes aware** of a deficiency in internal control, the auditor is required to evaluate the deficiency in internal control. If the auditor concludes that a deficiency in internal control is either a **material weakness** or a **significant deficiency**, then the auditor is required to make certain communications to those charged with governance and management.

Relationship of the Auditor and Management

The auditor performs audit procedures independent of management. It is management's responsibility to design, implement, and monitor internal controls, and the auditor's responsibility to gain an understanding of all five elements of internal control, including monitoring. In no way is it intended that these required audit procedures cause an independent CPA to become part of the internal control system of the client. Care should be taken to ensure that notations in the audit documentation do not imply that audit procedures performed by the CPA are considered to be a substitute of either the monitoring or information and communication elements of the entity's internal control.

Definition of a control deficiency

Because the standards require an entity to evaluate control deficiencies identified in an audit, it is important that the auditor understand how a control deficiency is defined in AU-C 265.

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

In order to gain a full understanding of the requirements, a further discussion of the following concepts within the definition are necessary.

Design or Operation

This element of the definition makes it clear that deficiencies in internal control are not only operational deficiencies, but also include a deficiency of control by either poor design, or omission of a control. The second half of the definition further explains what the standards imply when discussing design or operational issues.

A deficiency in **design** exists when

- a. A control necessary to meet the control objective is missing
- b. An existing control is not properly designed so that even if the control were operating as designed, the control objective would not be met.

A deficiency in **operation** exists when a properly designed control does not:

- a. Operate as designed
- b. The person performing the control does not possess the necessary authority or competence to perform the control correctly.

Management or employees

This element of the definition limits the responsibility of the operation of controls to management or employees. While not specified, if management outsources components of internal control to contractors, these contractors would fit within this definition.

Normal course of assigned functions

Management or employees may occasionally stumble onto issues that would alert the entity to potential misstatements in the financial statements. The definition of deficiency in internal control makes it clear that if the design of a control will not alert management to potential misstatements in the normal course of business, a deficiency exists.

Prevent

The best possible course of action is to design controls so that all material misstatements are prevented from occurring. This is typically the first objective addressed when designing internal controls. However, because of the cost/benefit relationship, not all misstatements can be prevented.

Detect and correct

Because it is typically not cost effective to design internal controls to prevent every possible material misstatement from occurring, the internal control activities of a company will typically include detection controls. A key element of this portion of the definition is that misstatements that are detected must also be corrected.

Timely basis

While not specifically defined, it is obvious that “timely basis” means before the financial statements are either issued by management, or presented to a third party for audit. Because the auditor is not “management or employees,” they cannot be part of the internal control structure of the entity. If financial statements are considered “complete” by management, and a misstatement is present, the internal controls in place did not detect and correct the misstatement in a timely manner.

Based on the understanding of the definition, it is most likely that the auditor will become aware of a control deficiency during two phases of the audit: (1) when obtaining an understanding of the internal controls related to financial reporting and (2) testing of such controls, if the auditor intends to rely on the controls.

It is common in small business audits to assess control risk at maximum, thus eliminating the need to test controls. Because this testing focuses on the operation of internal controls, it is rare that operating deficiencies are identified for the simple fact that the auditor has not performed any procedures to determine if the controls are operating properly.

However, because audit standards require the auditor to obtain an understanding of internal controls, design deficiencies are often identified by the auditor, with the most typical design deficiency being the absence of some controls, such as segregation of duties. It is possible the auditor may also determine operating deficiencies during this phase of the audit when the auditor is performing the required “walk-through” procedures.

Evaluation of Control Deficiencies

AU-C 265 requires that the auditor evaluate identified control deficiencies to determine whether or not those control deficiencies are considered material weaknesses or significant deficiencies. If the auditor determines that material weakness or significant deficiencies exist, those deficiencies are required to be communicated to those charged with governance and management.

The evaluation process should be performed near the conclusion of the audit and consists of the following steps:

- Consolidate all identified control deficiencies into categories that are homogenous
- Evaluate aggregated control deficiencies to determine if it is a material weakness
- For control deficiencies that are not deemed material weaknesses, evaluate to determine if they are a significant deficiency
- Document the assessment

Step 1- Consolidate identified control deficiencies

During the course of an audit, many control deficiencies may be identified that are similar in nature. These control deficiencies may be treated as one deficiency during the evaluation process. Examples of these types of deficiencies are:

- Lack of segregation of duties
- Reconciliations not performed in a timely manner
- Lack of proper approval of transactions
- Pre-numbered documents not used when required

Step 2 – Evaluate to determine if a control deficiency is a material weakness

In order to perform this procedure, an auditor must understand the two qualities that are required in order for a control deficiency to be considered a material weakness. These two qualities are in the definition of a material weakness, and two tests are extrapolated from this definition. The first test is a likelihood test, and the second test is a magnitude test.

Likelihood Test

The definition of a material weakness contains the following phrase: “such that there is at least a reasonable possibility.” This phrase is the basis of the likelihood test. In applying this test, auditing standards first referred the auditor to legacy accounting standards SFAS 5, *Accounting for Contingencies*. This standard described “reasonable possibility” as being between remote and probable. While no exact percentage is provided in the standard in general practice, many auditors apply a percentage range of 10% - 50% as reasonably possible. If the auditor that is evaluating a control deficiency uses this range, he or she will assess whether or not the possibility of a control deficiency not preventing, or detecting and correcting a misstatement is greater than 10%. If the auditor believes the likelihood is greater than 10%, the likelihood test is met. If the auditor believes the probability is less than 10%, the control deficiency is not considered to be a material weakness, however the control deficiency must be further evaluated to determine if it is a significant deficiency in step 3.

Magnitude test

If the auditor assesses the likelihood of a misstatement is at least reasonably possible, the magnitude test must be performed. In performing this test, the auditor must determine if the misstatement that was not prevented, or detected

and corrected, would be material to the financial statements. Auditor judgment is extremely important in this test, and many factors will influence this decision. AU-C 265.A6 provides the following guidelines in assisting the auditor:

- 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.

If the auditor believes the magnitude of the potential misstatement is material, the magnitude test is met, and the control deficiency is considered a material weakness. If the magnitude test is not met, the auditor must evaluate whether or not the control deficiency is a significant deficiency.

Prudent Official Test

When an auditor determines that a control deficiency, or a combination of control deficiencies, is not a material weakness or significant deficiency, the auditor should then consider whether prudent officials, having knowledge of the same set of facts and circumstances, would reach the same conclusion. If the auditor believes that a prudent official would reach the same conclusion, then the control deficiency is not considered a material weakness.

Step 3 – Determination of a Significant Deficiency

When an auditor concludes that a deficiency, or combination of deficiencies, is not a material weakness, the auditor must determine whether or not the deficiency, or combination of deficiencies, merits attention by those charged with governance. If that auditor concludes that attention is merited, the deficiency or deficiencies are considered significant deficiencies, and must be communicated to those charged with governance.

This determination is solely based on the judgment of the auditor. Many factors may influence the decision, including the following:

- Structure of governance within the entity
- Prior experience with the client
- Nature of the control deficiency
- Regulatory or legal requirements
- Potential litigation

The process of determining whether or not a control deficiency merits attention by those charged with governance has led to discrepancies in the types of deficiencies reported, especially in the governmental realm. Because of this issue, many practitioners have stated a preference for the Auditing Standards Board to provide an absolute list where common control deficiencies are defined by the standards as either a material weakness or a significant deficiency. Not only has the Board decided that this is not appropriate, they have “watered down” language that had been contained in SAS 112 that had implied certain control deficiencies were classified as either material weaknesses or significant deficiencies within the standard.

Step 4 – Document the Assessment

AU-C 265 requires that audit documentation provide evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements. While AU-C 265 is silent on specific documentation requirements, most firms use either PPC or other third-party forms and checklists to guide the documentation process. The documentation is actually a two-step process: (1) documenting the control deficiency, and (2) documenting the evaluation of the control deficiency or combination of control deficiencies.

Documentation of control deficiencies identified

Because control deficiencies can be identified at any time during the audit, this is an on-going process. Most firms have a standard form that requires the auditor that identifies the control deficiency to document the following:

- Description of the deficiency
- Type of deficiency (design or operational)
- Accounts or items affected
- Audit procedures that were being performed when the control deficiency was discovered

The aforementioned information will be useful in the evaluation process, which is usually one of the concluding steps in the audit.

Documentation of the evaluation of control deficiencies

Standardized forms have been used by most firms to document the evaluation of control deficiencies. Whatever documentation process is chosen by the auditor, the evaluation should include the auditor conclusions on magnitude, likelihood, and the reasons why the control deficiency would warrant the attention of those charged with governance.

Communication of Significant Deficiencies and Material Weaknesses**Communication Requirements**

AU-C 265 requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit. This includes significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated, and those that were remediated during the audit.

While not specifically defined in AU-C 265, those charged with governance and management were previously defined in SAS 115 as follows:

Management– Means the person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

Those charged with governance – Means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process.

In many smaller entities, those charged with governance and management may be the same person or persons. In this case, one communication to that party will be adequate to comply with this standard.

Content of Communication

The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should include the following:

- Include the definition of the term *material weakness* and, where relevant, the definition of the term *significant deficiency*.
- A description of the significant deficiencies and material weaknesses and an explanation of their potential effects

- Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor should include in the communication the following:
 - The purpose of the audit was for the auditor to express an opinion on the financial statements.
 - The audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the internal control.
 - The auditor is not expressing an opinion on the effectiveness of internal control.
 - The auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

Timing of Communication

AU-C 265 requires that the communication be made no later than 60 days following the report release date. Common practice is to provide the communication very near or on the report date. For practical purposes, governmental entities will be provided with the communication in conjunction with the issuance of the financial statements in order to comply with Yellow Book requirements.

Nothing precludes an auditor from orally communicating material weaknesses or significant deficiencies to management or those charged with governance during the course of the audit. However, the oral communication will not suffice as the only communication, and the written communication is still required.

Summary

In order to comply with AU-C 265, an auditor must have sufficient understanding of the relevant definitions of a control deficiency, material weakness, and significant deficiency. The audit team should be alert at all times during the audit for potential control deficiencies and properly document the deficiencies for further evaluation. The final step is drafting the appropriate communication and delivering in a timely manner to management and/or those charged with governance.

GROUP STUDY MATERIALS

A. Discussion Problems

1. Discuss the difference between a design deficiency and operational deficiency in internal control.
2. Discuss the auditor's evaluation and documentation of internal control deficiencies.
3. Discuss the auditor communication of internal control deficiencies to management and those charged with governance.

B. Suggested Answers to Discussion Problems

1. A deficiency in *design* exists when

- A control necessary to meet the control objective is missing
- An existing control is not properly designed so that even if the control were operating as designed, the control objective would not be met.

A deficiency in *operation* exists when a properly designed control does not:

- Operate as designed
 - The person performing the control does not possess the necessary authority or competence to perform the control correctly.
2. Because control deficiencies can be identified at any time during the audit, this is an on-going process. Most firms have a standard form that requires the auditor that identifies the control deficiency to document the following: description of the deficiency; type of deficiency (design or operational); accounts or items affected; audit procedures that were being performed when the control deficiency was discovered

The aforementioned information will be useful in the evaluation process, which is usually one of the concluding steps in the audit. Standardized forms have been used by most firms to document the evaluation of control deficiencies. Whatever documentation process is chosen by the auditor, the evaluation should include the auditor conclusions on magnitude, likelihood, and the reasons why the control deficiency would warrant the attention of those charged with governance.

3. A written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should include the following:

- The definition of the term *material weakness* and, where relevant, the definition of the term *significant deficiency*.
- A description of the significant deficiencies and material weaknesses and an explanation of their potential effects
- Sufficient information to enable those charged with governance and management to understand the context of the communication.

In particular, the auditor should include the purpose of the audit being for the auditor to express an opinion on the financial statements; that the audit included consideration of internal control over financial reporting to design audit procedures but not for the purpose of expressing an opinion on the effectiveness of the internal control; no opinion on the effectiveness of internal control is being expressed; and the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.

GLOSSARY OF KEY TERMS

CODM—Chief Operating Decision Maker

Design Deficiency—A deficiency in design exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

Internal Control Deficiency—A deficiency in internal control over financial reporting 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.

IT Use Risk—Susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.

Material Weakness—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.

Operational Deficiency—A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Significant Deficiency—A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Choose the best response and record your answer in the space provided on the answer sheet.

1. According to Russ Madray, under ASU 2023-07, which of the following is **not** one of the intended improvements to the reportable segment disclosure requirements?
 - A. Enhanced disclosures about significant segment expenses.
 - B. Enhanced interim disclosure requirements.
 - C. Clarification on circumstances where an entity can disclose multiple segment measures of profit or loss.
 - D. Elimination of the requirement to disclose total assets for each reportable segment.
2. According to Russ Madray, how is the term "significant segment expenses" defined?
 - A. Expenses that are regularly provided to the chief operating decision maker and included within each reported measure of segment profit or loss.
 - B. Expenses that exceed a certain percentage of total segment expenses.
 - C. Expenses that are deemed material to the overall financial statements.
 - D. Expenses that are incurred by the segment and not allocated from corporate overhead.
3. According to Russ Madray, which of the following is an example of an expense that could be considered "easily computable" under the new ASU?
 - A. Segment cost of sales, if the CODM is regularly provided segment revenue and gross margin.
 - B. Segment research and development expenses, if the CODM is provided a narrative description of ongoing projects.
 - C. Segment depreciation expense, if the CODM is provided a list of segment fixed assets.
 - D. Segment interest expense, if the CODM is provided the segment's outstanding debt balances.
4. According to Russ Madray, which of the following is correct under ASU 2023-07 for a public company with a single reportable segment?
 - A. It is exempt from providing any segment disclosures beyond those provided on an entity-wide basis.
 - B. It must provide all disclosures required by the ASU, including significant segment expenses and other segment items.
 - C. It is only required to disclose the measure of segment profit or loss used by the CODM.
 - D. It can choose to provide segment disclosures at its discretion.
5. According to Russ Madray, the amendments in ASU 2023-07 are effective for public companies for fiscal years beginning after which of the following?
 - A. December 15, 2022.
 - B. June 15, 2023.
 - C. December 15, 2023.
 - D. June 15, 2024.

Continued on next page

6. According to Jennifer Louis, how can an entity's system of internal controls involving IT enhance its operations?
 - A. By improving the timeliness, availability, and accuracy of information.
 - B. By eliminating the need for manual controls and processes.
 - C. By replacing the need for a segregation of duties.
 - D. By automatically detecting and correcting all errors.
7. According to Jennifer Louis, what do the audit standards require auditors to understand during the risk assessment process?
 - A. Only the automated controls within the IT environment.
 - B. Only the manual controls outside of the IT environment.
 - C. Only the general IT controls supporting the IT environment.
 - D. How information flows through an entity's information system, including both automated and manual controls.
8. According to Jennifer Louis, which of the following is an example of a general IT control?
 - A. Input controls for specific transactions.
 - B. Automated calculations within an application.
 - C. Controls over the entity's IT processes that support the continued operation of the IT environment.
 - D. Manual reconciliations of system outputs.
9. According to Jennifer Louis, when identifying risks arising from the use of IT, which of the following factors would make such risks more likely?
 - A. The use of a standalone, off-the-shelf software package.
 - B. Transactions supported by original, hard-copy documents.
 - C. Significant volume of data, complex calculations, or automated initiation of transactions.
 - D. Limited number of users with access to the system.
10. According to Jennifer Louis, when might an auditor need to involve an IT specialist in the audit?
 - A. When the entity has a simple IT environment with no customized applications.
 - B. When the auditor has a high level of IT knowledge and expertise.
 - C. When the entity has a complex IT environment, customized applications, or uses emerging technologies.
 - D. When the entity outsources all of its IT functions to a third-party provider.
11. According to Kurt Oestrieher, what are the two main actions an auditor must take when they become aware of a deficiency in internal control?
 - A. Ignore it and continue with the audit.
 - B. Report it to regulatory authorities immediately.
 - C. Evaluate the deficiency and potentially communicate it.
 - D. Resign from the engagement.

Continued on next page

12. According to Kurt Oestrieher, how is a deficiency in internal control defined?
- A. A deficiency in the design or operation of controls that does not allow management or employees to prevent, detect, or correct misstatements on a timely basis.
 - B. Any mistake made by an employee.
 - C. A weakness in controls that always results in a material misstatement.
 - D. A lack of controls that only affects compliance with laws and regulations, not financial reporting.
13. According to Kurt Oestrieher, what are the two criteria that must be met for a deficiency to be considered a material weakness?
- A. It must be a deficiency in design and a deficiency in operation.
 - B. It must result in a misstatement that is material and probable.
 - C. It must have at least a reasonable possibility of resulting in a material misstatement.
 - D. It must warrant the attention of those charged with governance and be less severe than a significant deficiency.
14. According to Kurt Oestrieher, when communicating internal control deficiencies to those charged with governance, which of the following must be included in the written communication?
- A. The definitions of a deficiency in internal control and a material weakness.
 - B. The definition of a significant deficiency, even if none are being reported.
 - C. Management's response to the deficiencies.
 - D. A statement that the audit was designed to detect all control deficiencies.
15. According to Kurt Oestrieher, under which circumstances can an auditor issue a report stating there are no significant deficiencies?
- A. When the audit is conducted under Yellow Book standards.
 - B. When no deficiencies in internal control are identified.
 - C. When only material weaknesses are identified.
 - D. An auditor can never state there are no significant deficiencies.

Subscriber Survey

Evaluation Form

Please take a few minutes to complete this survey related to **CPE Network® A&A Report** and return with your quizzer or group attendance sheet to CeriFi, LLC. All responses will be kept confidential. Comments in addition to the answers to these questions are also welcome. Please send comments to CPLgrading@cerifi.com.

How would you rate the topics covered in the June 2024 **CPE Network® A&A Report**? Rate each topic on a scale of 1–5 (5=highest):

	Topic Relevance	Topic Content/ Coverage	Topic Timeliness	Video Quality	Audio Quality	Written Material
FASB Update Segment Reporting	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
IT Risk and Audit Risk Assessment	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>
Communicating Internal Control Deficiencies	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>

Which segments of the June 2024 issue of **CPE Network® A&A Report** did you like the most, and why?

Which segments of the June 2024 issue of **CPE Network® A&A Report** did you like the least, and why?

What would you like to see included or changed in future issues of **CPE Network® A&A Report**?

How would you rate the effectiveness of the speakers in the June 2024 **CPE Network® A&A Report**? Rate each speaker on a scale of 1–5 (5 highest):

	Overall	Knowledge of Topic	Presentation Skills
Russ Madray	_____	_____	_____
Jennifer Louis	_____	_____	_____
Kurt Oestrieher	_____	_____	_____

Are you using **CPE Network® A&A Report** for: CPE Credit ☐ Information ☐ Both ☐

Were the stated learning objectives met? Yes ☐ No ☐ _____

If applicable, were prerequisite requirements appropriate? Yes ☐ No ☐ _____

Were program materials accurate? Yes ☐ No ☐ _____

Were program materials relevant and contribute to the achievement of the learning objectives? Yes ☐ No ☐

Were the time allocations for the program appropriate? Yes ☐ No ☐ _____

Were the supplemental reading materials satisfactory? Yes ☐ No ☐ _____

Were the discussion questions and answers satisfactory? Yes ☐ No ☐ _____

Specific Comments: _____

Name/Company _____

Address _____

City/State/Zip _____

Email _____

Once Again, Thank You...

Your Input Can Have a Direct Influence on Future Issues!

CPE Network®

Firm/Company Name: _____

Account #:

Location:

Program Title: _____ Date: _____

[illegible]

I certify that the above individuals viewed and were participants in the group discussion with this issue/segment of the CPE Network® newsletter, and earned the number of hours shown.

Instructor Name: _____

Date: _____

E-mail address:

License State and Number:

CPE Network/Webinar Delivery Tracking Report

Course Title	
Course Date:	
Start Time:	
End Time:	
Moderator Name, Credentials, and Signature Attestation of Attendance:	
Delivery Method:	Group Internet Based
Total CPE Credit:	3.0
Instructions:	During the webinar, the moderator must verify student presence a minimum of <u>3 times per CPE hour</u> . This is achieved via polling questions. Sponsors must have a report which documents the responses from each student. The timing of the polling questions should be random and not made known to students prior to delivery of the course. Record the polling question responses below. Refer to the CPL Network User Guide for more instructions. Partial credit will not be issued for students who do not respond to at least 3 polling questions per CPE hour.
Brief Description of Method of Polling	Example: Zoom: During this webinar, moderator asked students to raise their hands 3 times per CPE hour. The instructor then noted the hands that were raised in the columns below.

[illegible]

CHECKPOINT LEARNING NETWORK

CPE NETWORK[®]

USER GUIDE

REVISED December 31, 2023

Welcome to CPE Network!

CPE Network programs enable you to deliver training programs to those in your firm in a manageable way. You can choose how you want to deliver the training in a way that suits your firm's needs: in the classroom, virtual, or self-study. You must review and understand the requirements of each of these delivery methods before conducting your training to ensure you meet (and document) all the requirements.

This User Guide has the following sections:

- **“Group Live” Format:** The instructor and all the participants are gathered into a common area, such as a conference room or training room at a location of your choice.
- **“Group Internet Based” Format:** Deliver your training over the internet via Zoom, Teams, Webex, or other application that allows the instructor to present materials that all the participants can view at the same time.
- **“Self-Study” Format:** Each participant can take the self-study version of the CPE Network program on their own computers at a time and place of their convenience. No instructor is required for self-study.
- **Transitioning From DVDs:** For groups playing the video from the online platform, we suggest downloading the video from the Checkpoint Learning player to the desktop before projecting.
- **What Does It Mean to Be a CPE Sponsor?:** Should you decide to vary from any of the requirements in the 3 methods noted above (for example, provide less than 3 full CPE credits, alter subject areas, offer hybrid or variations to the methods described above), Checkpoint Learning Network will not be the sponsor and will not issue certificates. In this scenario, your firm will become the sponsor and must issue its own certificates of completion. This section outlines the sponsor's responsibilities that you must adhere to if you choose not to follow the requirements for the delivery methods.
- **Getting Help:** Refer to this section to get your questions answered.

IMPORTANT: This User Guide outlines in detail what is required for each of the 3 formats above. Additionally, because you will be delivering the training within your firm, you should review the Sponsor Responsibilities section as well. To get certificates of completion for your participants following your training, you must submit all the required documentation. (This is noted at the end of each section.) Checkpoint Learning Network will review your training documentation for completeness and adherence to all requirements. If all your materials are received and complete, certificates of completion will be issued for the participants attending your training. Failure to submit the required completed documentation will result in delays and/or denial of certificates.

IMPORTANT: If you vary from the instructions noted above, your firm will become the sponsor of the training event and you will have to create your own certificates of completions for your participants. In this case, you do not need to submit any documentation back to CeriFi, LLC.

If you have any questions on this documentation or requirements, refer to the “Getting Help” section at the end of this User Guide **BEFORE** you conduct your training.

**We are happy that you chose CPE Network for your training solutions.
Thank you for your business and HAPPY LEARNING!**

Copyrighted Materials

CPE Network program materials are copyrighted and may not be reproduced in another document or manuscript in any form without the permission of the publisher. As a subscriber of the **CPE Network Series**, you may reproduce the necessary number of participant manuals needed to conduct your group study session.

“Group Live” Format

CPE Credit

All CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

***Effective November 1, 2018:** Checkpoint Learning CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by Checkpoint Learning Network. Checkpoint Learning Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as Checkpoint Learning Network will not issue certificates to your participants.

Advertising / Promotional Page

Create a promotion page (use the template after the executive summary of the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance

You must monitor individual participant attendance at “group live” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **attendance sheet**. This lists the instructor(s) name and credentials, as well as the first and last name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant arrives late, leaves early, or is a “no show,” the actual hours they attended should be documented on the sign-in sheet and will be reflected on the participant’s CPE certificate.

Real Time Instructor During Program Presentation

“Group live” programs must have a **qualified, real time instructor while the program is being presented**. Program participants must be able to interact with the instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A “group live” program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Make-Up Sessions

Individuals who are unable to attend the group study session may use the program materials for self-study online.

- If the emailed materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the email address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his/their CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant’s record of attendance and is awarded by Checkpoint Learning Network after the “group live” documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the “group live” session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether Checkpoint Learning Network is the sponsor for the “group live” session, it is required that the firm hosting the “group live” session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Group Study Attendance sheets; indicating any late arrivals and/or early departures)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations.

Finding the Transcript

Note: DVDs no longer ship with this product effective 3/1/2023.

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- <https://get.adobe.com/reader/>

The entire transcript is also available as a pdf in the Checkpoint Learning player in the resource toolbox at the top of the screen, or via the link in the email sent to administrators.

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your “group live” session should be sent to Checkpoint Learning Network by the following means:

Email: CPLgrading@cerifi.com

When sending your package to CeriFi, you must include ALL of the following items:

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Attendance Sheet		Use this form to track attendance during your training session.
Subscriber Survey Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to CeriFi any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Group Internet Based” Format

CPE Credit

All CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

***Effective November 1, 2018:** Checkpoint Learning CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by Checkpoint Learning Network. Checkpoint Learning Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as Checkpoint Learning Network will not issue certificates to your participants.

Advertising / Promotional Page

Create a promotion page (use the template following the executive summary in the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance in a Webinar

You must monitor individual participant attendance at “group internet based” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **Webinar Delivery Tracking Report**. This form lists the moderator(s) name and credentials, as well as the first and last name of each participant attending the seminar. During a webinar you must set up a monitoring mechanism (or polling mechanism) to periodically check the participants’ engagement throughout the delivery of the program. Participants’ two-way video should remain on during the entire presentation.

In order for CPE credit to be granted, you must confirm the presence of each participant **3 times per CPE hour and the participant must reply to the polling question**. Participants that respond to less than 3 polling questions in a CPE hour will not be granted CPE credit. For example, if a participant only replies to 2 of the 3 polling questions in the first CPE hour, credit for the first CPE hour will not be granted. (Refer to the Webinar Delivery Tracking Report for examples.)

Examples of polling questions:

1. You are using **Zoom** for your webinar. The moderator pauses approximately every 15 minutes and asks that participants confirm their attendance by using the “raise hands”

feature. Once the participants raise their hands, the moderator records the participants who have their hands up in the **webinar delivery tracking report** by putting a YES in the webinar delivery tracking report. After documenting in the spreadsheet, the instructor (or moderator) drops everyone's hands and continues the training.

2. You are using **Teams** for your webinar. The moderator will pause approximately every 15 minutes and ask that participants confirm their attendance by typing "Present" into the Teams chat box. The moderator records the participants who have entered "Present" into the chat box into the **webinar delivery tracking report**. After documenting in the spreadsheet, the instructor (or moderator) continues the training.
3. If you are using an application that has a way to automatically send out polling questions to the participants, you can use that application/mechanism. However, following the event, you should create a **webinar delivery tracking report** from your app's report.

Additional Notes on Monitoring Mechanisms:

1. The monitoring mechanism does not have to be "content specific." Rather, the intention is to ensure that the remote participants are present and paying attention to the training.
2. You should only give a minute or so for each participant to reply to the prompt. If, after a minute, a participant does not reply to the prompt, you should put a NO in the webinar delivery tracking report.
3. While this process may seem unwieldy at first, it is a required element that sponsors must adhere to. And after some practice, it should not cause any significant disruption to the training session.
4. **You must include the Webinar Delivery Tracking report with your course submission if you are requesting certificates of completion for a "group internet based" delivery format.**

Real Time Moderator During Program Presentation

"Group internet based" programs must have a **qualified, real time moderator while the program is being presented**. Program participants must be able to interact with the moderator while the course is in progress (including the opportunity to ask questions and receive answers during the presentation). This can be achieved via the webinar chat box, and/or by unmuting participants and allowing them to speak directly to the moderator.

Where individual participants log into a group live program they are required to enable two-way video to participate in a virtual face-to-face setting (with cameras on), elements of engagement are required (such as group discussion, polling questions, instructor posed questions with time for reflection, or a case study with engagement throughout the presentation) in order to award CPE credits to the participants. Participation in the two-way video conference must be monitored and documented by the instructor or attendance monitor in order to authenticate attendance for program duration. The participant-to-attendance

monitor ratio must not exceed 25:1, unless there is a dedicated attendance monitor in which case the participant-to-attendance monitor ratio must not exceed 100:1.

Make-Up Sessions

Individuals who are unable to attend the “group internet based” session may use the program materials for self-study either in print or online.

- If emailed materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Quizzer Answer Sheet. Send the answer sheet and course evaluation to the email address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual Checkpoint Learning account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant’s record of attendance and is awarded by Checkpoint Learning Network after the “group internet based” documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who may not have answered the required amount of polling questions.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the “group live” session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to Checkpoint Learning Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether Checkpoint Learning Network is the sponsor for the “group internet based” session, it is required that the firm hosting the session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Webinar Delivery Tracking Report)
- Copy of the program materials
- Timed agenda with topics covered
- Date and location (which would be “virtual”) of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations

Finding the Transcript

Note: DVDs are no longer shipped effective 3/1/2023

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. It should look something like the screenshot below. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- <https://get.adobe.com/reader/>

Alternatively, for those without a DVD drive, the email sent to administrators each month has a link to the pdf for the newsletter. The email may be forwarded to participants who may download the materials or print them as needed.

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your “group internet based” session should be sent to Checkpoint Learning Network by the following means:

Email: CPLgrading@CeriFi.com

When sending your package to CeriFi, you must include ALL the following items:

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Webinar Delivery Tracking Report		Use this form to track the attendance (i.e., polling questions) during your training webinar.
Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to CeriFi any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Self-Study” Format

If you are unable to attend the live group study session, we offer two options for you to complete your Network Report program.

Self-Study—Email

Follow these simple steps to use the printed transcript and video:

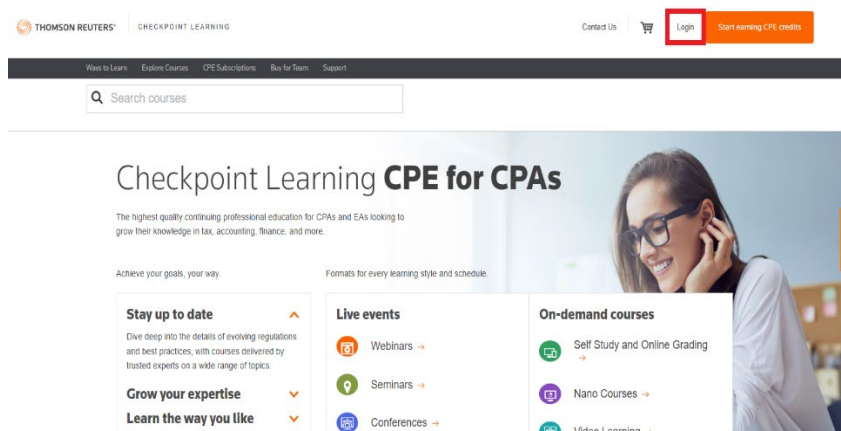
- Watch the video.
- Review the supplemental materials.
- Read the discussion problems and the suggested answers.
- Complete the quizzer by filling out the bubble sheet enclosed with the transcript package.
- Complete the survey. We welcome your feedback and suggestions for topics of interest to you.
- E-mail your completed quizzer and survey to:

CPLgrading@cerifi.com

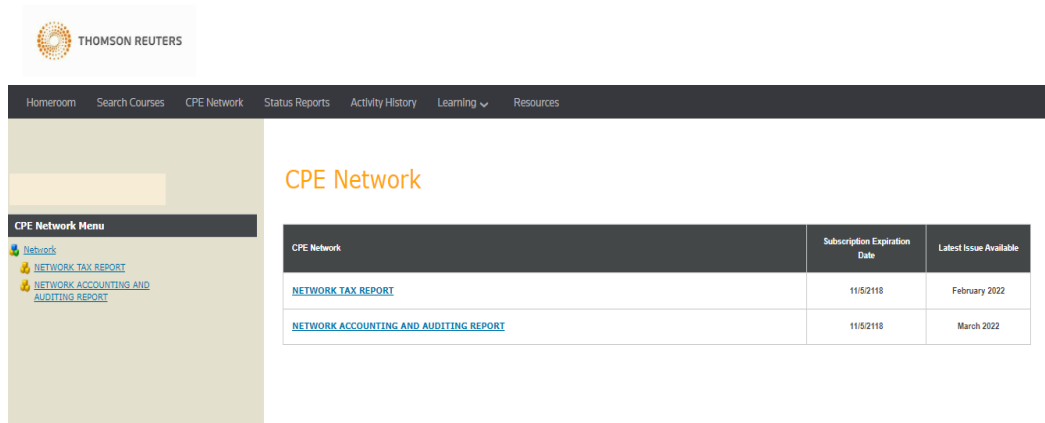
Self-Study—Online

Follow these simple steps to use the online program:

- Go to www.checkpointlearning.thomsonreuters.com.
- Log in using your username and password assigned by your firm’s administrator in the upper right-hand margin (“Login or Register”).

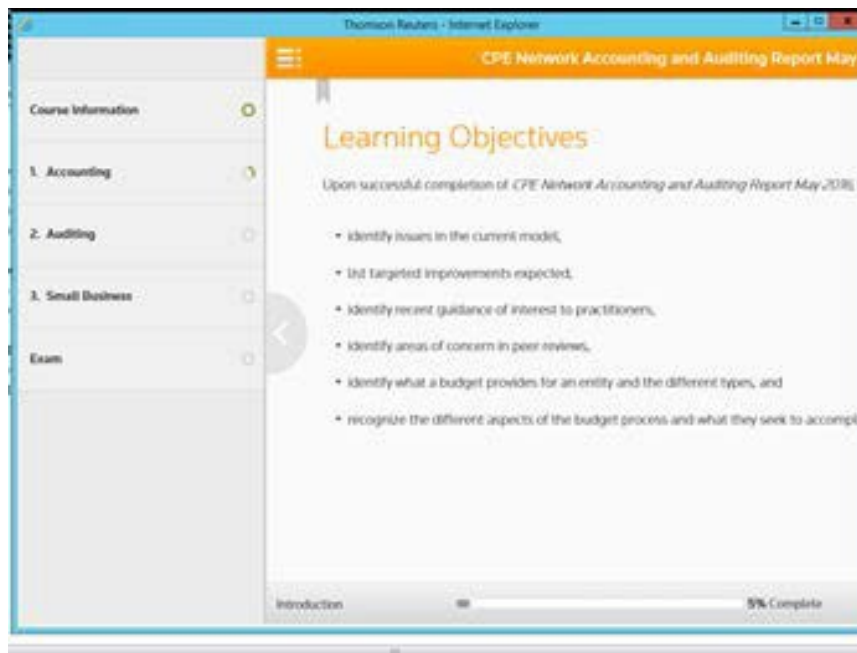


- In the **CPE Network** tab, select the desired Network Report and then the appropriate edition.



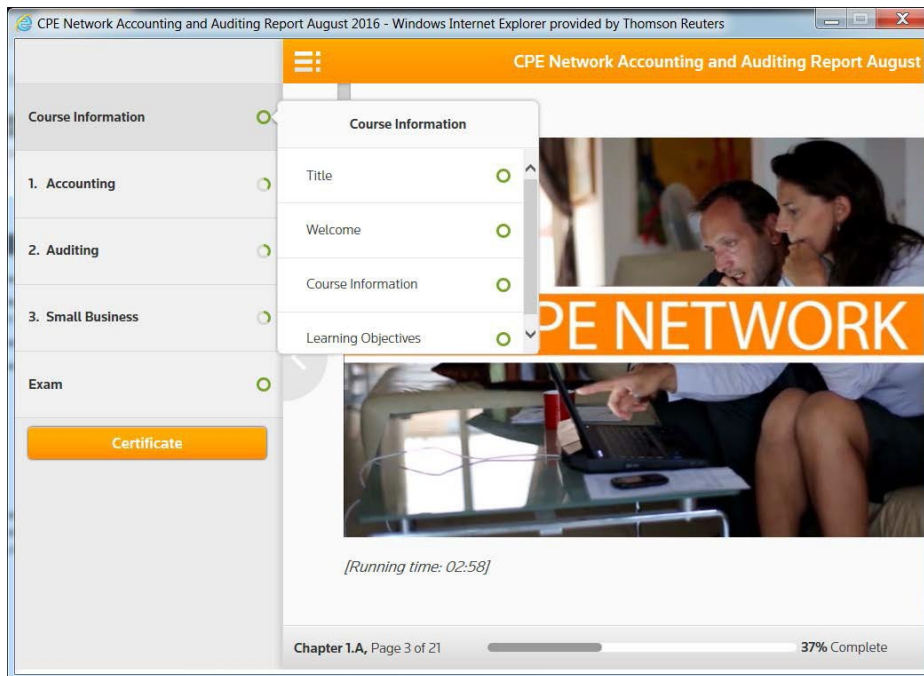
CPE Network	Subscription Expiration Date	Latest Issue Available
NETWORK TAX REPORT	11/5/2118	February 2022
NETWORK ACCOUNTING AND AUDITING REPORT	11/5/2118	March 2022

The Chapter Menu is in the gray bar at the left of your screen:

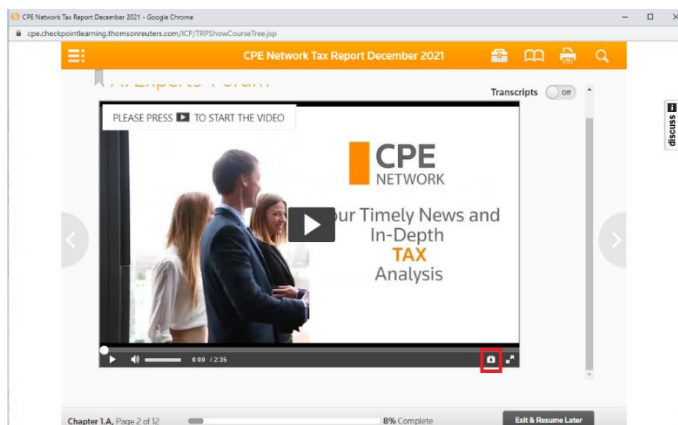


Click down to access the dropdown menu and move between the program Chapters.

- **Course Information** is the course Overview, including information about the authors and the program learning objectives



- **Each Chapter is self-contained.** Each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the discussion questions. This streamlined approach allows administrators and users to more easily access the related materials.



Video segments may be downloaded from the CPL player by clicking on the download button. Tip: you may need to scroll down to see the download button.

Thomson Reuters - Internet Explorer

CPE Network Accounting and Auditing Report May 2016

Transcripts ☒

Chapter 1 Liabilities and Equity: Another Look at the Model

Both the FASB and the AICPA have targeted improvements to the guidance related to liabilities and equity instruments. The current debt-equity model in U.S. GAAP is very complex, making it difficult for both preparers and accountants to implement.

For more on the targeted improvements in this area, let's join Paul Munter, professor in practice for the University of Colorado at Boulder, and CPE Network's Debi Grove Casey.

Ms. Grove Casey

Today, we want to talk a little bit

Please note that the transcript [Liabilities and Equity Transcripts](#) can also be found as a link and in the Tools section.

Chapter 1A, Page 4 of 21 8% Complete [Exit & Resume Later](#)

Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled **Transcripts** or via the link to the pdf below the video (also available in the toolbox in the resources section). The pdf will appear in a separate pop-up window.

D:\xml\production\working\U6015494\N... Network Accounting and Auditing Report May 2016

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STUDENT ANALYSIS AND COMMENTARY

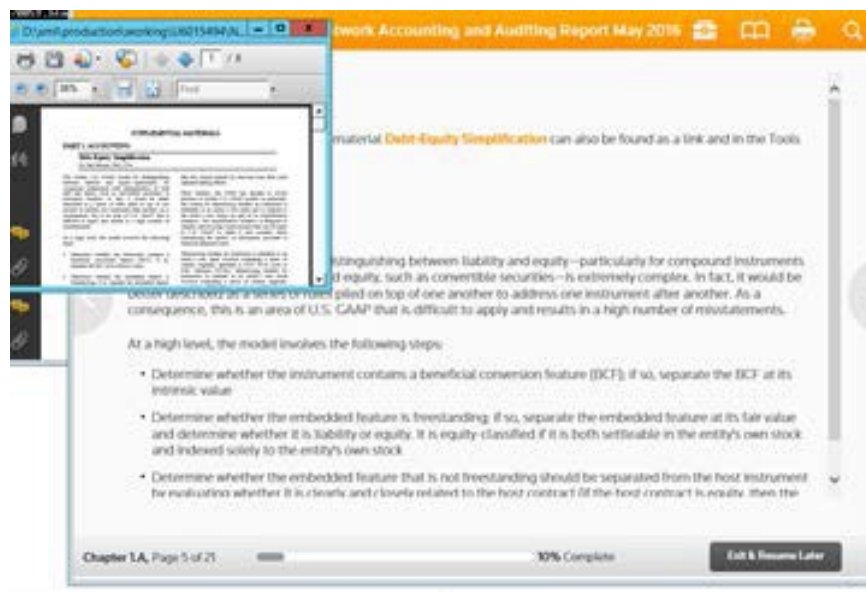
CHAPTER 1: ACCOUNTING

Liabilities and Equity: Another Look at the Model

The video in this segment discusses the targeted improvements to the guidance related to liabilities and equity instruments. The current debt-equity model in U.S. GAAP is very complex, making it difficult for both preparers and accountants to implement. The video discusses the targeted improvements to the guidance related to liabilities and equity instruments. The current debt-equity model in U.S. GAAP is very complex, making it difficult for both preparers and accountants to implement.

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Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material. As with the transcripts, the supplemental materials are also available via the toolbox and the link will pop up the pdf version in a separate window.



Continuing to click the arrow to the right side of the screen will bring the user to the Discussion problems related to the segment.

The Suggested Answers to the Discussion Problems follow the Discussion Problems.

The screenshot displays a web-based interface for a CPE (Continuing Professional Education) report. The header bar is orange and contains the text "CPE Network Accounting and Auditing Report July 2016" along with icons for a menu, a printer, a book, a document, and a search function. Below the header, the main content area is titled "Suggested Answers to Discussion Problems". It contains three numbered items:

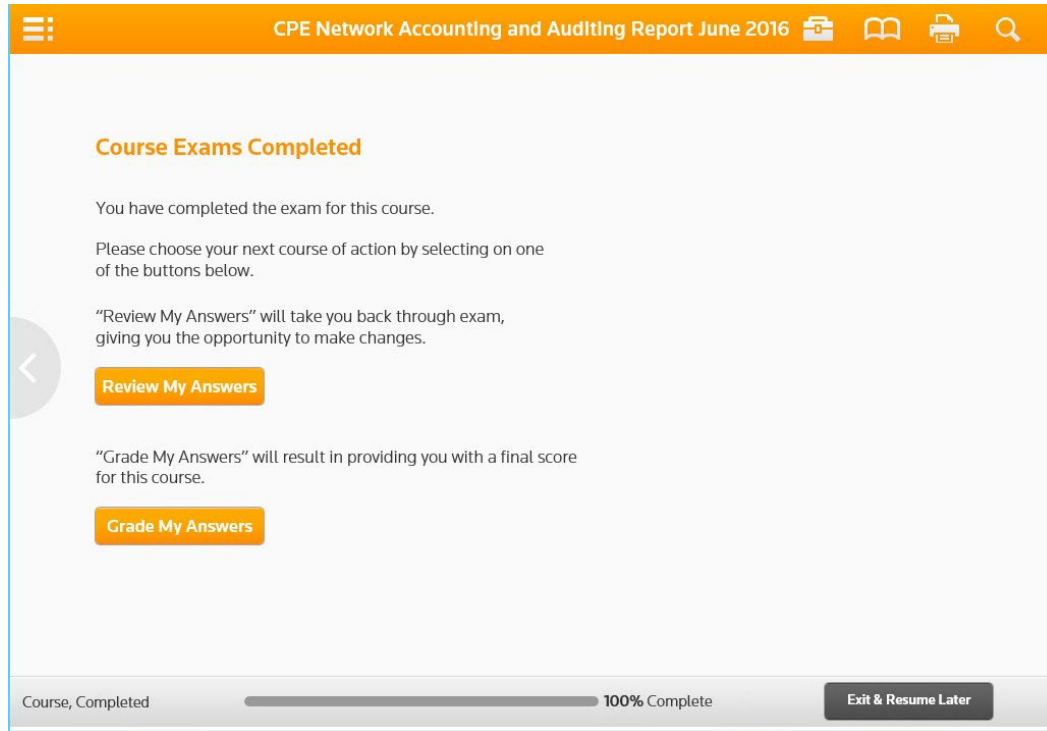
1. ASC 320 requires that, at acquisition, an enterprise classify debt and marketable equity securities into one of three categories:
 - Held-to-maturity
 - Trading
 - Available-for-sale

An entity decides how to classify securities based on its intended holding period for each individual security, using the framework in ASC 320. In establishing its intent, an entity should consider relevant trends and experience, such as previous sales and transfers of securities. Classification decisions should be made at acquisition and, preferably, formally documented. It is not appropriate to use "hindsight" to classify securities transactions, perhaps by considering changes in value after acquisition.
2. The trading securities category includes securities that are bought and held principally for the purpose of selling them in the short term. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. "Short-term," in this context, is intended to be measured in hours and days, rather than in months or years, according to ASC 320. However, an entity is not precluded from classifying as trading a security it plans to hold for a longer period, as long as that designation occurs at acquisition.
3. Impairment is recognized in earnings when a decline in value has occurred that is deemed to be other than temporary, and the current fair value becomes the new cost basis for the security. An investment is considered to be impaired if the fair value of the investment is less than its cost basis. Cost includes adjustments made for

At the bottom of the page, there is a footer bar. On the left, it says "Chapter 3.A, Page 20 of 20". In the center, there is a progress bar that is filled to the right and labeled "100% Complete". On the right, there is a button labeled "Exit & Resume Later".

The **Exam** is accessed by clicking the last gray bar on the menu at the left of the screen or clicking through to it. Click the orange button to begin.

When you have completed the quizzer, click the button labeled **Grade or the Review button**.



- Click the button labeled **Certificate** to print your CPE certificate.
- The final quizzer grade is displayed and you may view the graded answers by clicking the button labeled **view graded answer**.

Additional Features Search

Checkpoint Learning offers powerful search options. Click the **magnifying glass** at the upper right of the screen to begin your search. Enter your choice in the **Search For:** box.

Search Results are displayed with the number of hits.

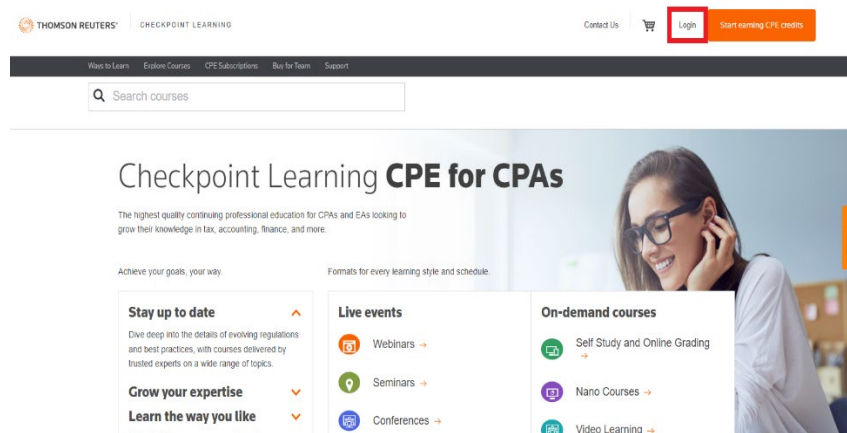
Print

To display the print menu, click the printer icon in the upper bar of your screen. You can print the entire course, the transcript, the glossary, all resources, or selected portions of the course. Click your choice and click the orange **Print**.

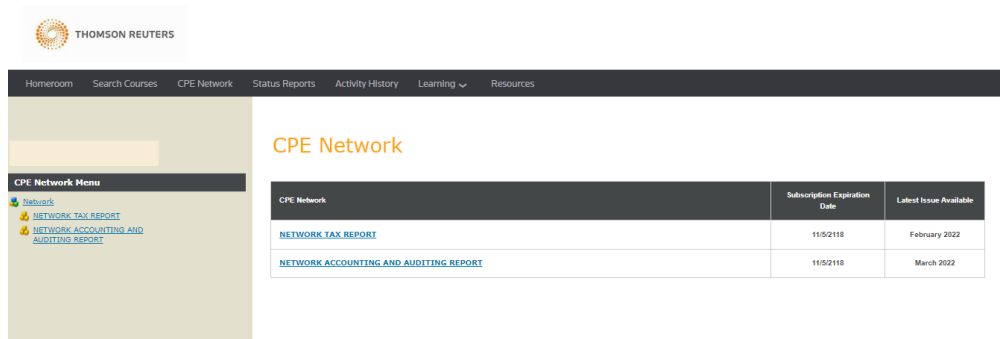
Transitioning From DVDs

Follow these simple steps to access the video and pdf for download from the online platform:

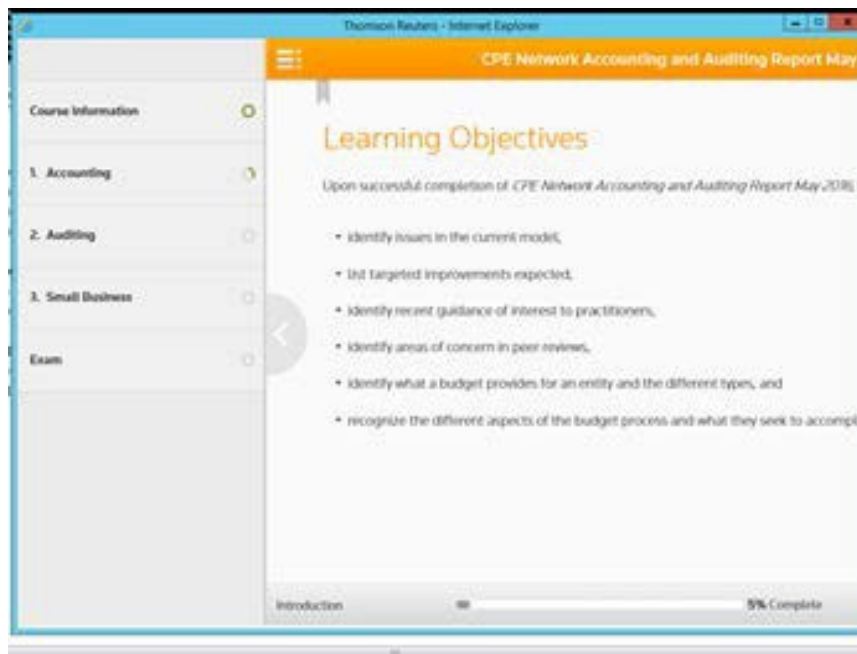
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm's administrator in the upper right-hand margin ("Login").



- In the CPE **Network** tab, select the desired Network Report by clicking on the title, then select the appropriate edition.

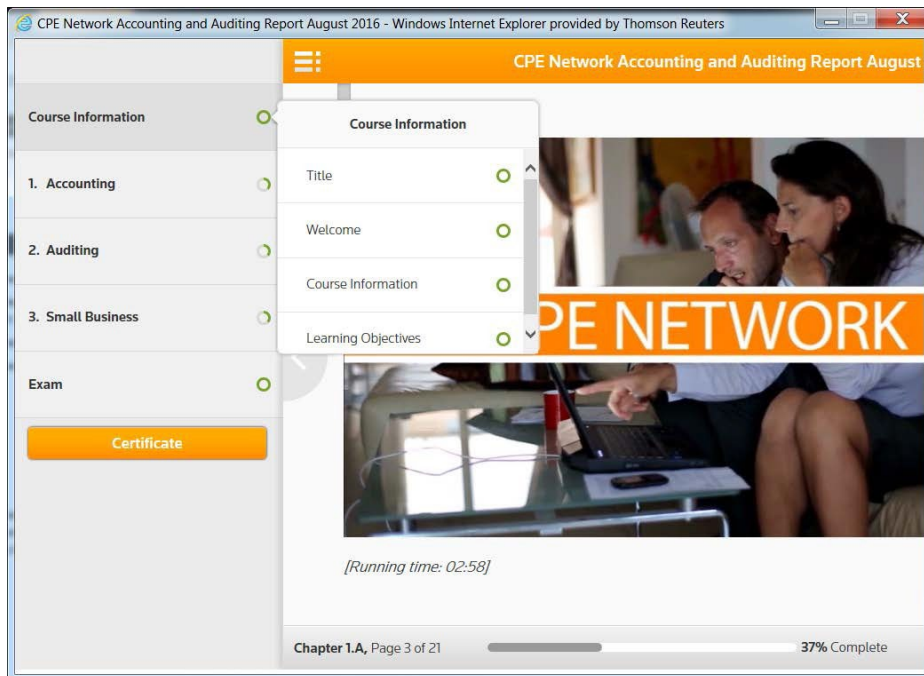


The Chapter Menu is in the gray bar at the left of your screen:

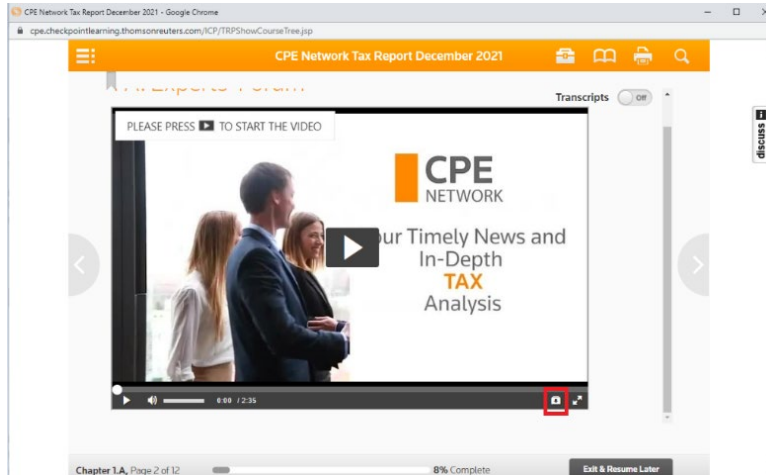


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PDFs may be downloaded from either the course toolbox in the upper right corner of the Checkpoint Learning screen or from the email sent to administrators with each release.

What Does It Mean to Be a CPE Sponsor?

If your organization chooses to vary from the instructions outlined in this User Guide, your firm will become the CPE Sponsor for this monthly series. The sponsor rules and requirements noted below are only highlights and reflect those of NASBA, the national body that sets guidance for development, presentation, and documentation for CPE programs. **For any specific questions about state sponsor requirements, please contact your state board. They are the final authority regarding CPE Sponsor requirements.** Generally, the following responsibilities are required of the sponsor:

- Arrange for a location for the presentation
- Advertise the course to your anticipated participants and disclose significant features of the program in advance
- Set the start time
- Establish participant sign-in procedures
- Coordinate audio-visual requirements with the facilitator
- Arrange appropriate breaks
- Have a real-time instructor during program presentation
- Ensure that the instructor delivers and documents elements of engagement
- Monitor participant attendance (make notations of late arrivals, early departures, and “no shows”)
- Solicit course evaluations from participants
- Award CPE credit and issue certificates of completion
- Retain records for five years

The following information includes instructions and generic forms to assist you in fulfilling your responsibilities as program sponsor.

CPE Sponsor Requirements

Determining CPE Credit Increments

Sponsored seminars are measured by program length, with one 50-minute period equal to one CPE credit. One-half CPE credit increments (equal to 25 minutes) are permitted after the first credit has been earned. Sponsors must monitor the program length and the participants' attendance in order to award the appropriate number of CPE credits.

Program Presentation

CPE program sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. CPE program sponsors must make the following information available in advance:

- Learning objectives.
- Instructional delivery methods.
- Recommended CPE credit and recommended field of study.
- Prerequisites.
- Program level.
- Advance preparation.
- Program description.
- Course registration and, where applicable, attendance requirements.
- Refund policy for courses sold for a fee/cancellation policy.
- Complaint resolution policy.
- Official NASBA sponsor statement, if an approved NASBA sponsor (explaining final authority of acceptance of CPE credits).

Disclose Significant Features of Program in Advance

For potential participants to effectively plan their CPE, the program sponsor must disclose the significant features of the program in advance (e.g., through the use of brochures, website, electronic notices, invitations, direct mail, or other announcements). When CPE programs are offered in conjunction with non-educational activities, or when several CPE programs are offered concurrently, participants must receive an appropriate schedule of events indicating those components that are recommended for CPE credit. The CPE program sponsor's registration and attendance policies and procedures must be formalized, published, and made available to participants and include refund/cancellation policies as well as complaint resolution policies.

Monitor Attendance

While it is the participant's responsibility to report the appropriate number of credits earned, CPE program sponsors must maintain a process to monitor individual attendance at group programs to assign the correct number of CPE credits. A participant's self-certification of attendance alone is not sufficient. The sign-in sheet should list the names of each instructor and her/his credentials, as well as the name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant leaves early, the hours they attended should be documented on the sign-in sheet and on the participant's CPE certificate.

Real Time Instructor During Program Presentation

“Group live” programs must have a qualified, real-time instructor while the program is being presented. Program participants must be able to interact with the real time instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A “group live” program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Awarding CPE Certificates

The CPE certificate is the participant’s record of attendance and is awarded at the conclusion of the seminar. It should reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early.

CFP credit is available if the firm registers with the CFP board as a sponsor and meets the CFP board requirements. IRS credit is available only if the firm registers with the IRS as a sponsor and satisfies their requirements.

Seminar Quality Evaluations for Firm Sponsor

NASBA requires the seminar to include a means for evaluating quality. At the seminar conclusion, evaluations should be solicited from participants and retained by the sponsor for five years. The following statements are required on the evaluation and are used to determine whether:

1. Stated learning objectives were met.
2. Prerequisite requirements were appropriate (if any).
3. Program materials were accurate.
4. Program materials were relevant and contributed to the achievement of the learning objectives.
5. Time allotted to the learning activity was appropriate.
6. Individual instructors were effective.
7. Facilities and/or technological equipment were appropriate.
8. Handout or advance preparation materials were satisfactory.
9. Audio and video materials were effective.

You may use the enclosed preprinted evaluation forms for your convenience.

Retention of Records

The seminar sponsor is required to retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (the original sign-in sheets, now in an editable, electronic signable format)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name(s) and credentials
- Results of program evaluations

Appendix: Forms

Here are the forms noted above and how to get access to them.

Delivery Method	Form Name	Location	Notes
"Group Live" / "Group Internet Based"	Advertising / Promotional Page	Transcript	Complete this form and circulate to your audience before the training event.
"Group Live"	Attendance Sheet	Transcript	Use this form to track attendance during your training session.
"Group Internet Based"	Webinar Delivery Tracking Report	Transcript	Use this form to track the 'polling questions' which are required to monitor attendance during your webinar.
"Group Live" / "Group Internet Based"	Evaluation Form	Transcript	Circulate the evaluation form at the end of your training session so that participants can review and comment on the training.
Self Study	CPE Quizzer Answer Sheet	Transcript	Use this form to record your answers to the quiz.

Getting Help

Should you need support or assistance with your account, please see below:

Support Group	Phone Number	Email Address	Typical Issues/Questions
Technical Support	844.245.5970	Cplsupport@cerifi.com	<ul style="list-style-type: none">• Browser-based• Certificate discrepancies• Accessing courses• Migration questions• Feed issues
Product Support	844.245.5970	Cplsupport@cerifi.com	<ul style="list-style-type: none">• Functionality (how to use, where to find)• Content questions• Login Assistance
Customer Support	844.245.5970	Cplsupport@cerifi.com	<ul style="list-style-type: none">• Billing• Existing orders• Cancellations• Webinars• Certificates