



The Effects of AU 265

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June 3, 2025



Objectives

- ▶ **Gain an understanding of the audit standards affecting your audit engagement**
- ▶ **Understand and anticipate the impact and potential outcomes that result from this standard**



Why A New Standard?

- ▶ **The accounting profession believes AU 265 may:**
 - **Heighten your awareness of internal control over financial reporting**
 - **Increase your competency level on internal control over financial reporting**
 - **Enable management and those charged with governance to better assess the costs and benefits of implementing any new controls that would help minimize the risks of financial statement misstatements, including fraud**



What is AU 265?

- ▶ ***AU Section 265, *Communicating Internal Control Related Matters Identified in an Audit - (December 15, 2012)****
- ▶ ***Superseded SAS 112 and 115 (2006 and 2008).***
- ▶ **Establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements**

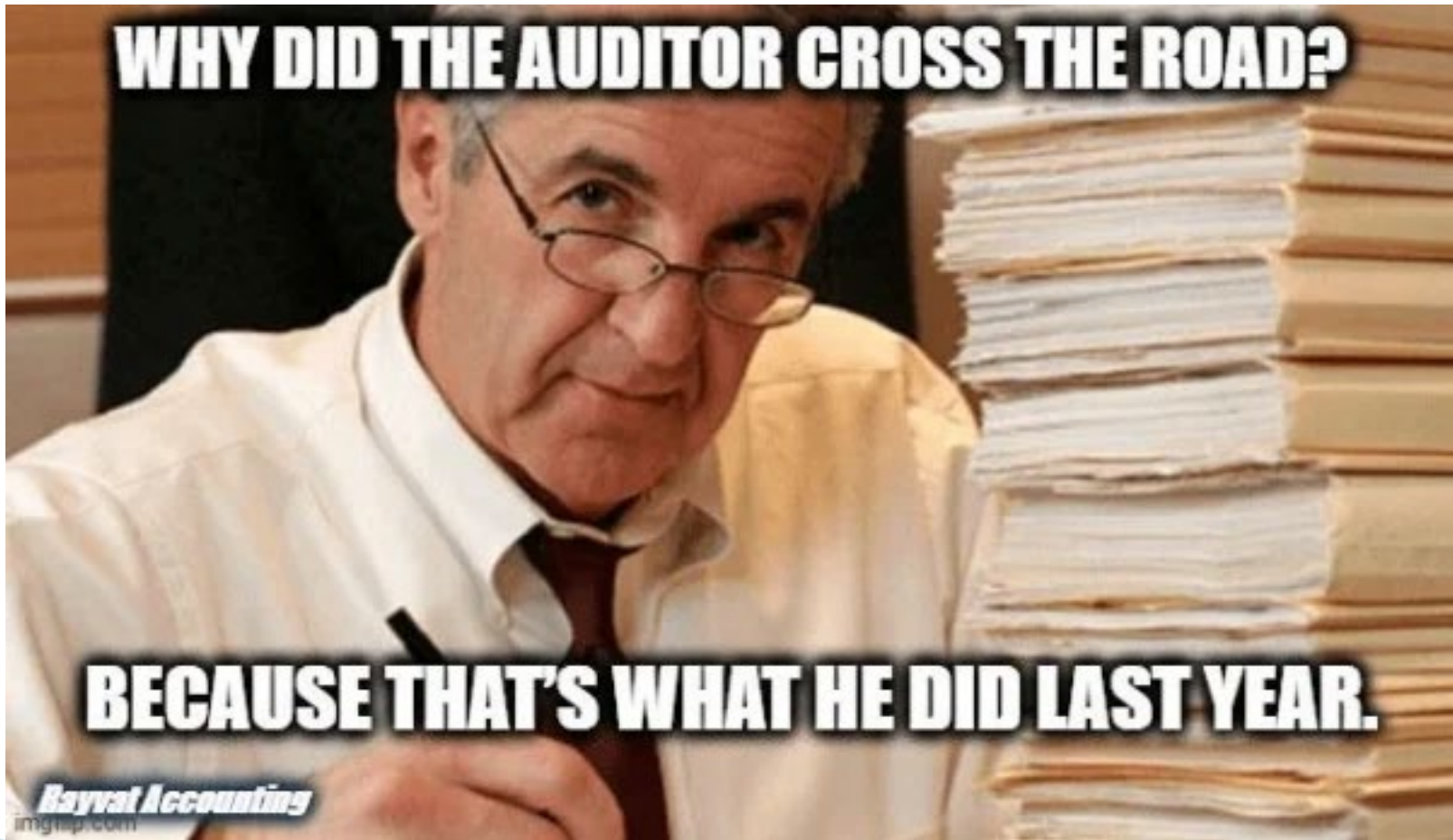


Components of AU 265

- ▶ The auditor must *evaluate* identified control deficiencies
- ▶ Then *determine* whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses
- ▶ The auditor must *communicate, in writing*, significant deficiencies and material weaknesses to management and those charged with governance
- ▶ This communication includes significant deficiencies and material weaknesses identified and communicated *to management and those charged with governance* in prior audits but not yet remediated



Control Deficiencies





Control Deficiencies

- ▶ **Significant Deficiencies**
- ▶ **Material Weakness**
- ▶ **Other Matters**



Definitions

▶ **Control Deficiency**

- ▶ **A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis**



Definitions

- ▶ **Significant Deficiency**
- ▶ **A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles, that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.**



Significant Deficiencies

- **AU 265 identifies areas in which deficiencies are ordinarily considered to be at least significant deficiencies and the two that are most likely to occur are:**
 - **Controls over the selection and application of accounting principles in conformity with GAAP**
 - **Controls over the period-end financial reporting process**
 - **Includes controls over procedures for entering totals into the General Ledger; initiating, authorizing, recording and processing journal entries into the General Ledger; and recording recurring and nonrecurring adjustments to the financial statements**



Definitions

- ▶ **Material Weakness**
- ▶ **A material weakness is a deficiency, or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.**



Material Weaknesses

- ▶ **AU 265 identifies indicators of deficiencies that are at least significant deficiencies and strong indicators of a material weakness and the three that are most likely to occur are:**
 - **Ineffective oversight of financial reporting and internal control by those charged with governance**
 - **Identification by the auditor of a material misstatement in financial statements not initially identified by the entity's internal control**
 - **Lack of segregation of duties – especially around electronic disbursements**



Control Deficiency Examples

- ▶ **Examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses include:**
 - **Inadequate design of internal control over the preparation of the financial statements being audited**
 - **Employees or management who lack the qualifications and training to fulfill their assigned functions**



Control Deficiency Examples

- **Inadequate design of information technology (IT) general and application controls**
- **Inadequate documentation of the components of internal control**
- **Inadequate design of monitoring controls that assess the design and operating effectiveness of the entity's internal control over time**
- **Inadequate design of internal control over a significant account or process**

TSB Control Deficiency Examples

Auditor: Do you guys have controls?

Client: Yeah we have controls

The controls:





Control Deficiency Examples

- **Absent or inadequate segregation of duties within a significant account or process**
- **Absent or inadequate controls over the safeguarding of assets**

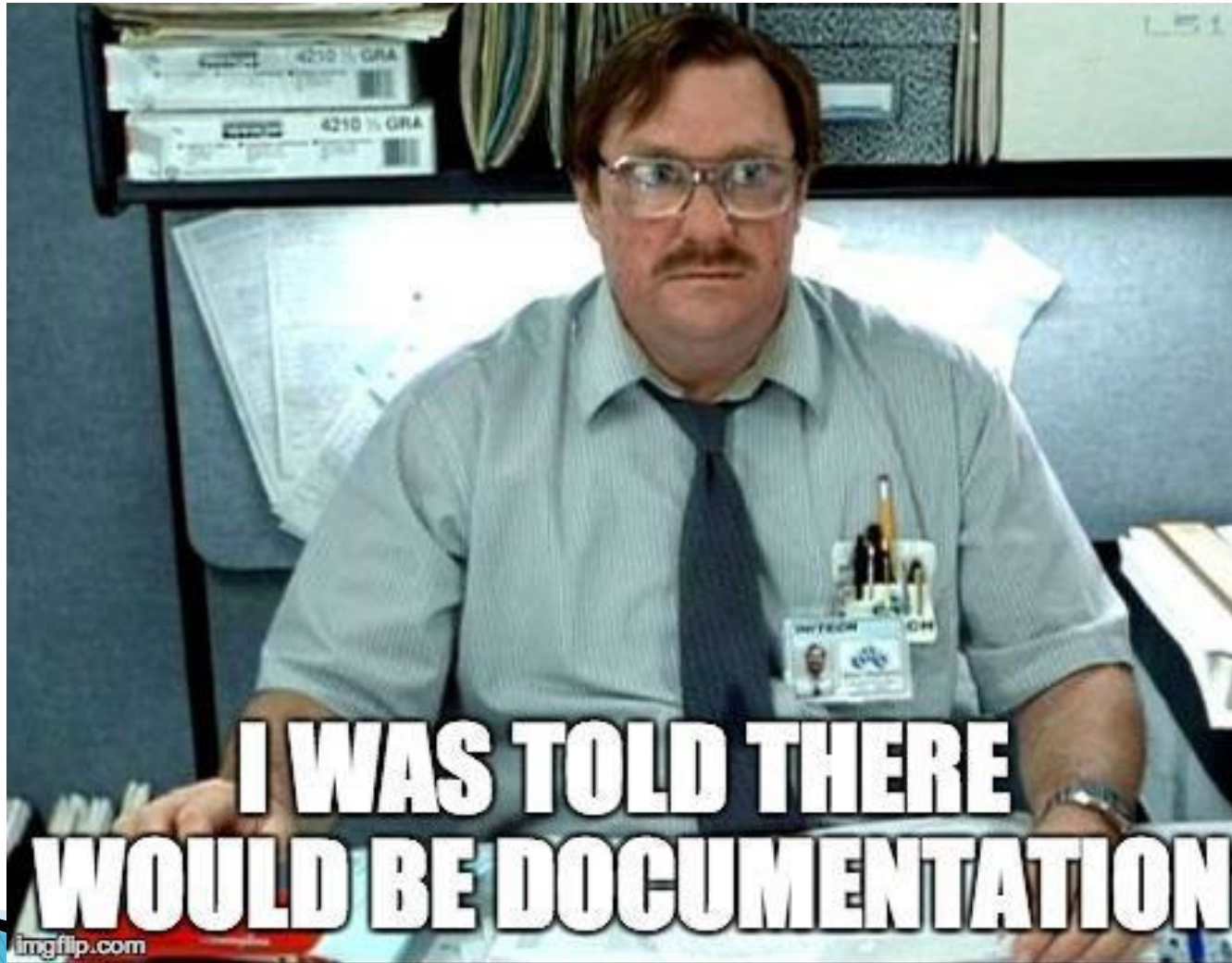


Evaluating Control Deficiencies

- **In any given example, remember, the auditor will determine the likelihood and magnitude of a misstatement to determine if it is a significant deficiency or material weakness**
- **Auditors are only required to communicate in writing those control deficiencies identified during the audit and determined to be significant deficiencies or material weaknesses**



Evaluating Control Deficiencies





Thank You!

Enjoy the Workshop