

Statement on Auditing Standards 112

*Communicating Internal
Control Related Matters
Identified in an Audit*

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How we got here

- Supersedes SAS No. 60, which used “reportable conditions” and “material weaknesses”
- Incorporates definitions used in PCAOB No. 2
- Effective for Fiscal Years Ending after December 15, 2006
 - All June 30, 2007 year end audits!

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Basic Effect of Standard

Old Definitions (SAS 60)	New Definitions (SAS 112)
Material Weakness	Material Weakness
Reportable Condition	
Management Letter Comment	Significant Deficiency
	Control Deficiency

New Definitions

- 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 misstatements on a timely basis

New Definitions, cont.

- Significant Deficiency –
 - 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 such that there is **more than a remote** likelihood that a misstatement of the entity’s financial statements that is **more than inconsequential** will not be prevented or detected by the entity’s internal control
 - Replaces the term “reportable condition”
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New Definitions, cont.

- *Material Weakness* –
 - A significant deficiency, or combination of significant deficiencies, that results in **more than a remote** likelihood that a **material** misstatement of the financial statements will not be prevented or detected by the entity's internal control

Evaluating Deficiencies

- Likelihood
 - Remote, reasonably possible, or probable
- Magnitude
 - Inconsequential, more than inconsequential but less than material, and material
- Prudent Official Standard – There can be no hard and fast rule as to what qualifies as a significant deficiency or material weakness. Must use prudent official standard.
- Must consider qualitative and quantitative factors

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Evaluating Deficiencies, cont.

Likelihood	Magnitude of Misstatement That Occurred or Could Occur		
	Inconsequential ($< 20\%$ ML)	More than Inconsequential but less than material ($20\% - ML$)	Material ($> ML$)
Remote	Not a significant deficiency or material weakness	Not a significant deficiency or material weakness	Not a significant deficiency or material weakness
More than Remote	Not a significant deficiency or material weakness	Significant Deficiency	Material Weakness

Evaluating Deficiencies, cont.

- We are required to evaluate all identified control deficiencies *individually* and *in the aggregate* by *significant account balance, disclosure, and component* of internal control
- Then consider the *likelihood* and *magnitude* of the deficiency

Evaluating Deficiencies, cont.

- Other Factors to Consider
 - Nature of accounts, disclosures and assertions involved
 - Susceptibility of the related assets to loss or fraud
 - Complexity, subjectivity, and extent of judgment needed to determine the amount involved
 - The frequency and cause of exceptions related to the controls operating effectiveness
 - Relationship and interaction with other controls
 - Relationship and interaction of deficiency with other deficiencies
 - Future consequences of deficiency

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Evaluating Deficiencies, cont.

- Mitigating Effects of Compensating Controls
 - Compensating controls should be evaluated to determine if they mitigate the significance of a control deficiency such that it does not rise to the level of significant deficiency or material weakness
 - ***Compensating controls can only mitigate, not eliminate, a control deficiency***

Reporting Requirements

- Must communicate, in writing, all significant deficiencies and material weaknesses
- Prior conditions that still exist must be reported
- Control deficiencies may be communicated orally or in writing
- Communication must be to management and those charged with governance
- Should be dated as of report release date, but standard allows 60 days after that

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Reporting Requirements, cont.

- Management is allowed to respond to these deficiencies and this response is allowed to be included in our letter
 - If this is the case, we must disclaim an opinion on the information
 - Management's response may be that it deems correcting the deficiency not to be cost effective
 - This will prevent a significant deficiency from rising to material weakness in the subsequent year, but will not eliminate the deficiency

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Specific Examples Given by SAS 112

- Control Deficiencies
 - Inadequate design of IC over preparation of financial statements and disclosures
 - Inadequate documentation of the IC components
 - Inadequate segregation of duties
 - Inadequate design of IT controls
 - Absence of a process to report deficiencies timely to management

Specific Examples Given by SAS 112, cont.

- Ordinarily at Least Significant Deficiencies
 - Lacking expertise in selecting and applying accounting principles
 - Lacking antifraud programs and controls
 - No controls over non-routine and nonsystematic transactions
 - No controls over the period-end financial reporting process

Specific Examples Given by SAS 112, cont.

- Strong Indicators of Material Weaknesses
 - Ineffective oversight by those charged with governance
 - Restatement of financial statements
 - The auditor's identification of material misstatements that were not detected by the entities internal control
 - Identification of fraud of any magnitude
 - Failure by the client to assess the effect of significant deficiencies previously reported
 - Ineffective control environment

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The Most Frequently Asked Question in Response to This Standard

- Can the auditor prepare the financial statements without it being a significant deficiency or material weakness?
- Short answer: YES
- Long answer:

The Most Frequently Asked Question in Response to This Standard, cont.

- Question hinges on whether the client is *capable* of preparing the financial statements
- Must have the skills and competencies necessary to prevent, detect, and correct misstatements
- If the client is not capable, then the fact that we prepare the financial statements is a material weakness

Yellow Book, A-133 & HUD audits

- GAO adopted SAS 112 terminology for all Yellow Book audits
- OMB and HUD also adopted terminology for all A-133 audits as well
- Guidance can be found on the GAO website
 - www.gao.gov/govaud/ybk01.htm

Effects of the Standard

- More items being reported as significant deficiencies and material weaknesses
- This will effect an entity by more than the opinion we give it:
 - Debt covenants
 - Low risk auditee status
 - Noncompliance w/ donor restrictions/conditions
 - Potential need for new staff to eliminate deficiencies

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Additional SAS' issued this year

- SAS 103 was recently passed
 - Report dating and release of representation letters, attorney letters, etc.
- SAS 114
 - Basically, an update for the SAS 61 letter, this requires us to communicate significant items with those in charge of governance, not just audit committees. Effective along with SAS 112.

Questions and Answers

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