

Statement on Auditing Standards 112
Communicating Internal Control Related Matters Identified in an Audit

What is it?

A new auditing standard called Statement on Auditing Standards (SAS) 112, prescribed by the American Institute of Certified Public Accountants (AICPA), *Communicating Internal Control Related Matters Identified in an Audit*, provides guidance on identifying and communicating control deficiencies related to financial statement reporting. It is effective for audits of periods ending on or after December 15, 2006.

What do the new terms mean?

The SAS defines the terms; “control deficiency”, “significant deficiencies” and “material weakness”. The term “reportable condition” is no longer used.

A **control deficiency** exists when the design or operation of a control does not allow management or employees to prevent or detect misstatements on a timely basis. Control deficiencies can be categorized in two different types: 1) deficiencies in **design**, and 2) deficiencies in **operation**.

A **significant deficiency** is defined as “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 a more than remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected.”

The standard provides definitions for these terms, based on the opinion of a “reasonable person”:

- “more than a remote likelihood” – at least reasonably possible
- “more than inconsequential” – more than clearly immaterial

A **material weakness** is defined as “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.” The magnitude of the potential misstatement is the determining factor between a significant deficiency and material weakness.

A deficiency is evaluated based on the **potential** for a misstatement in the financial statements, not whether one actually occurred. The evaluation includes two factors: 1) the likelihood of whether a particular control would have

prevented or detected a misstatement, and 2) the magnitude of the potential misstatement. “Magnitude” is the determining factor between a significant deficiency and material weakness.

Some Underlying Concepts

- The auditor cannot be part of a client’s internal control. Becoming part of a client’s internal control impairs the auditor’s independence.
- What the auditor does is independent of the client’s internal control over financial reporting. Therefore, the auditor cannot be a compensating control for the client.
- The client’s designation of an individual who possesses suitable skill, knowledge, and/or experience to oversee a service performed by the CPA ([Ethics Interpretation 101-3 Performance of Nonattest Services](#)) is not a control. Therefore, having such a designated person does not mean that the client does not have a control deficiency.
- [SAS No. 112](#) does not require the auditor to search for control deficiencies, but rather to evaluate them if they have been identified.
- A system of internal control over financial reporting does not stop at the general ledger; rather it includes controls over the preparation of the financial statements.
- To properly apply [SAS No. 112](#) the auditor has to have a working knowledge of the COSO framework. COSO’s Internal Control-Integrated Framework describes the elements of internal control over financial reporting. [SAS No. 112](#) directs the auditor to evaluate control deficiencies when identified, and communicate certain deficiencies to management and those charged with governance.

How do we know how to report?

The standard considers deficiencies in these areas as at least significant deficiencies:

- Controls over the selection and application of accounting principles (GAAP)
- Antifraud programs and controls
- Controls over nonroutine and nonsystematic transactions
- Controls over the period-end financial process

The SAS gives the following examples of “an indicator of a control deficiency should be regarded as a significant deficiency and a strong indicator of a material weakness”:

- Ineffective oversight of the entity’s financial reporting and internal control by those charged with governance
- Restatement of previously issued financial statements to reflect a correction of a material misstatement. (i.e. due to error or fraud)

- Identification by the auditor of a material misstatement in the financial statements under audit that was not initially identified by the entity's internal control (even if the entity subsequently corrects it).
- Ineffective internal audit function or risk assessment function (applies to larger, more complex entities)
- Ineffective regulatory compliance function in entities that are in highly regulated industries where noncompliance or material violations could have a material effect on the statements.
- Identification of fraud in any amount on the part of senior management.
- Failure by management or those charged with governance to address a significant deficiency communicated to them in the past (i.e. to correct it or to conclude that it will not be corrected).
- An ineffective control environment. Control deficiencies in various other components of internal control could lead to the conclusion that there are significant deficiencies or material weaknesses in the control environment.

A compensating control is not considered to be a solution for a control deficiency; rather, it attempts to mitigate the effect of the deficiency.

Likelihood of Misstatement	Magnitude of Potential or Actual Misstatement		
	Clearly immaterial	More than immaterial, but less than material	Material
Remote	Control deficiency	Control deficiency	Control deficiency
More than remote (at least reasonably possible)	Control deficiency	Significant Deficiency	Material Weakness

How does this impact the Single Audit?

On June 26, 2007, the U.S. Office of Management and Budget (OMB) revised Circular A-133 to adopt the internal control terminology that was introduced with SAS 112, Communicating Internal Control Related Matters Identified in an Audit. Accordingly, we began analyzing internal control deficiencies found in our single audits using the new terminology effective immediately. The change to Circular A-133 by OMB was made effective for audits of periods ending on or after December 15, 2006.

Is the same terminology used in the Single Audit?

As used in SAS 112, the term "significant deficiency" replaces the term "reportable condition" currently used in Circular A-133.

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 on a timely basis noncompliance with a compliance requirement of a federal program.

A **significant deficiency** is a control deficiency, or combination of control deficiencies, that adversely affects the entity’s ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected. A quantitative measure of “more than inconsequential” would be that aggregated instances of noncompliance (actual or potential) have an associated monetary value or effect that exceeds 5% of total program expenditures.

A **material weakness** is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected. A quantitative measure of “material noncompliance” would be that aggregated instances of noncompliance (actual or potential) have an associated monetary value or effect that exceeds 10% of total program expenditures. Note that noncompliance does not necessarily equate to questioned costs. We often find instances of material noncompliance where we do not necessarily question the costs (e.g., suspension and debarment certifications).

In addition to the quantitative measures described above, we also consider qualitative measures of materiality such as (1) the level of public or political sensitivity, (2) isolated exceptions with a low risk of pervasiveness, and (3) the perspective of the grantor agency as to the importance of the issue. The following chart summarizes how SAO will apply these definitions in our single audits:

Likelihood of Noncompliance	Magnitude of Potential or Actual Noncompliance		
	Clearly inconsequential (Less than 5% of total federal expenditures of the program)	More than inconsequential, but less than material (Between 5%-10% of total federal expenditures of the program)	Material (Greater than 10% of total federal expenditures of the program)
Remote	Control deficiency (Control Risk is LOW)	Control deficiency (Control Risk is LOW)	Control deficiency (Control Risk is LOW)
More than remote (at least reasonably possible)	Control deficiency (Control Risk is LOW)	Significant Deficiency (Control Risk is HIGH)	Material Weakness (Control Risk is HIGH)

What is happening?

SAS 112 reinforces the responsibility of management for internal control systems. It emphasizes that the auditors cannot be a part of the internal control process for preparing the financial statements during the audit.

It requires auditors to report deficiencies in internal controls over financial reporting and single audit in writing to those in management with responsibility over the control and “those charged with governance” over the entity. The auditor’s responsibility for the communication is not changed by the fact that the deficiency is known to and/or accepted by management or those charged with governance.

The SAS also sets a lower threshold for the types of deficiencies that must be reported. This has resulted in SAO reporting more internal control deficiencies as findings than in the past.

Compensating controls mitigate control deficiencies and can reduce the severity but they do not eliminate the control deficiency.