# State Auditor's Office

## Statement on Auditing Standards 112

### Communicating Internal Control Related Matters Identified in an Audit

June 19, 2008

Chuck Pfeil, CPA
Director of State & Local Audit

Washington
Brian Sonntag
State Auditor

# State Auditor’s Office
# New Standards

- New auditing standard prescribed by the American Institute of Certified Public Accountants (AICPA)
- Applies to our financial statement and single audits
- Effective for audit periods ending on or after December 15, 2006, which will include most audits of 2006 financial statements
- Provides guidance on identifying and communicating control deficiencies related to financial statement reporting



# New Standards

- New Terminology
  - Control deficiency
  - Significant deficiencies
  - Material weaknesses

- Control Deficiency
  - Design or operation does not prevent or detect misstatements timely



# New Standards

- Significant Deficiency
  - Control deficiency, or combination, adversely affects GAAP reporting
  - More than remote likelihood
  - More than inconsequential

- Material Weakness
  - Significant deficiency, or combination, with more than remote likelihood of material errors



# Some Underlying Concepts

- The auditor cannot be part of a client's internal control
- The auditor cannot be a compensating control for the client
- Does not require the auditor to search for control deficiencies
- A system of internal control over financial reporting does not stop at general ledger



# How do we know how to report ?

- The standards considers deficiencies in these areas as at least <u>significant deficiencies:</u>
  - Controls over the selection and application of accounting principals (GAAP)
  - Antifraud programs and controls
  - Controls over non-routine and nonsystematic transactions
  - Controls over the period-end financial process



# How do we know how to report ?

- The SAS gives 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 financial reporting and internal control by those charged with governance
  - Restatement of previously issued financial statements to reflect a correction of a material misstatement
  - Identification by the auditor of a material misstatement not initially identified by the controls (even if subsequently corrected)
  - Ineffective internal audit function or risk assessment function (large, complex entities)
  - Ineffective regulatory compliance function in highly regulated industries
  - Identification of fraud in any amount on the part of senior management
  - Failure to address a significant deficiencies communicated previously
  - An ineffective control environment



# How do we know how to report ?

A compensating control is not considered to be a solution for a control deficiency, but rather a mitigation of the effect.

| | Magnitude of Potential or Actual Misstatement | | |
|---|---|---|---|
| Likelihood of 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 do we know how to report ?

- SAS 112 reinforces the responsibility of management for internal control systems.
- It requires auditors to report deficiencies in internal controls over financial reporting and single audit in writing.
- 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 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.



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The Auditor's Communication with Those Charged with Governance

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Director of State & Local Audit

WASHINGTON
BRIAN SONNTAG
STATE AUDITOR

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# New Standards

- New auditing standard prescribed by the American Institute of Certified Public Accountants (AICPA)
- Applies to our financial statement
- Effective for audit periods beginning on or after December 15, 2006, which will include most audits of 2007 financial statements
- Provides guidance to auditors on matters to be communicated with those charged with governance



# New Standards

- Effective two-way communication stressed
- Auditor must whom to communicate particular matters with
- Required to communicate planned scope and timing and needed representations
- Guidance on the communication process
- Significant audit issues or results are to be communicated in writing
  - Uncorrected misstatements (both known & likely)
  - Material corrected misstatements
  - Significant difficulties encountered during the audit
  - Disagreements with management and their resolution



# New Standards

- Difficulties to be communicated to the governing body
  - Significant delays in information or evidence
  - Short timeframes for completing the audit
  - Extensive effort required to obtain evidence
  - Restrictions imposed by management
  - Unwillingness by management to be open or honest
- Only slight changes for audits done by SAO
- Communication with all members of governing board or audit committee
- A little more information at entrance and exit conferences
- Difficulties, delays, disagreements, restrictions



# State Auditor’s Office Contacts

**Brian Sonntag, CGFM**
State Auditor
sonntagb@sao.wa.gov
(360) 902-0360

**Chuck Pfeil, CPA**
Director of Audit
pfeilc@sao.wa.gov
(360) 902-0366

Web site: **www.sao.wa.gov**