PKF PERSPECTIVES

SAS NO. 112: Communicating Internal Control Related Matters Identified in an Audit

The Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) recently issued Statement on Auditing Standards (SAS) No. 112 entitled ***Communicating Internal Control Related Matters Identified in an Audit***, superceding SAS No. 60. The new SAS establishes standards and provides guidance for auditors of privately-held entities and encompasses certain definitions and related guidance consistent with those contained in the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 2, ***An Audit of Internal Control over Financial Reporting Performed in Conjunction with the Audit of Financial Statements***.

The new guidance is effective for audits of financial statements for periods ending on or after December 15, 2006, which for entities with calendar year-ends is December 31, 2006.

The following is a summary of SAS No. 112. The provisions of SAS No. 112 have been incorporated in Statements on Standards for Attestation Engagements AT501 which can be downloaded from the AICPA's website at www.aicpa.org.

Auditor Requirement

Your independent auditor is required to issue to management and those charged with governance a written communication identifying any internal control deficiency over financial reporting which is considered a ***significant deficiency*** or a ***material weakness*** discovered during the conduct of the audit. This written communication is best made by the report release date, but not later than 60 days following such date.

Definitions

SAS No. 112 incorporates modifications to certain terms and references by replacing the term "audit committee" with "those charged with governance"; and deleting the term "reportable conditions". It also introduces the terms "control deficiency" and "significant deficiency" and replaces the definition of "material weaknesses" as follows:

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."

> Design deficiency exists when (1) a control necessary to meet the control objective is absent; or (2) an existing control is not properly designed so that even if it operates as designed the control objective is not always met.
>
> Operation deficiency 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 qualifications to perform the control effectively.

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** *(emphasis added by PKF)* of the entity's financial statements that is more than inconsequential will not be prevented or detected."

Material weakness: "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a **material misstatement** *(emphasis added by PKF)* of the financial statements will not be prevented or detected".

Auditor's Evaluation of Control Deficiencies

The significance of a control deficiency - whether individually or in combination - is dependent on the **potential** for misstatement not on whether a misstatement actually occurred. In determining whether control deficiencies are significant deficiencies or material weaknesses, the auditor should:

- Consider the likelihood of misstatement that could result from the control deficiency.
- Consider the magnitude of misstatement that could result from the control deficiency.
- Evaluate the individual control deficiencies that affect the same account balance, disclosure, relevant assertion or component of internal control to determine if they collectively result in significant deficiency or material weakness.
- Evaluate possible mitigating effects of compensating controls that have been tested and evaluated during the audit.
- Determine whether prudent officials with knowledge of the same facts and circumstances would concur with the auditor's classification of the deficiency.

Reporting Requirements and Inherent Limitations

Under SAS No. 112, control deficiencies identified during an audit that are considered significant deficiencies or material weaknesses, ***including matters that were communicated in previous audits that have not been remediated,*** must be communicated in writing to management and those charged with governance.

An audit is not designed to detect all internal control deficiencies - material or otherwise - and does not provide a basis for expressing such assurance. Therefore, the auditor should **not** issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation on the limited degree of assurance that would be provided by such a communication.

The auditor is not precluded from communicating to management and those charged with governance other matters that may be of potential benefit to the audit client, such as recommendations for operational or administrative efficiency or for improving internal control (where control deficiencies are not significant deficiencies or material weaknesses). Generally, such a letter is separate from, and not combined with, the letter communicating significant deficiencies or material weaknesses.

Client's Response

Management may wish, or may be required by a third party, to prepare a written response to the auditor's written communication concerning significant deficiencies or material weaknesses. Management may include a description of corrective actions, plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits derived.

If such a written response from the client is included in a document containing the auditor's written communication relative to significant deficiencies or material weaknesses, the auditor should add a paragraph to his/her written communication disclaiming an opinion on such information.

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