

SAS 112: The New Internal Control Reporting Standard

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Auditors and management of many commodity pools and hedge funds are still in the process of grappling with the impact of the latest auditor to management communication requirements. Although the latest requirements have been published for almost a year, the application in practice is still emerging, and the interpretation of the requirements is the subject of much on-going debate among auditors.

In May 2006, The American Institute of Certified Public Accountants (AICPA) Auditing Standards Board issued a new auditing standard to specifically address the communication of internal control issues noted by auditors in the performance of their audit engagements. This new standard appears to be yet another move by the AICPA to align the standards for audits of privately held entities with the Public Company Accounting Oversight Board's (PCAOB) standards for audits of publicly-traded entities. The new standard, *SAS 112 Communicating Internal Control Related Matters Identified in an Audit*, is intended to be consistent with PCAOB Auditing Standard No. 2 *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements*. SAS 112 replaces SAS 60 and is effective for financial statement periods ending on or after December 15, 2006. It is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion).

Essentially the new standard revives the concept of the auditor issuing management letters in many situations where verbal discussions have been considered sufficient in recent years. Not only does SAS 112 increase the auditor's responsibility to formally communicate certain control weaknesses to management, the standard also increases the auditor's required level of documentation for internal control and his/her related assessment of the design and operation of internal control as part of the audit of the financial statements.

SAS 112 does not change the auditor's requirements or responsibilities related to audit procedures; rather it provides guidance for reporting control deficiencies noted during the auditor's performance of audit

procedures. The auditor is not required to perform procedures to identify deficiencies in internal control or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing audit procedures as well as through communications with management or others (for example, internal auditors or governmental authorities). The auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors. SAS 112 requires the auditor to provide written communication to management and "those charged with governance," of any significant deficiencies and material weaknesses identified in an audit.

A control deficiency, under SAS 112 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. A deficiency in *design* exists when (i) a control necessary to meet the control objective is missing, or (ii) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met. A deficiency in *operation* 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.

A significant deficiency is defined under SAS 112 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 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.

A material weakness is 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.

In determining whether a potential misstatement would be more than inconsequential, the auditor must consider qualitative and quantitative factors. The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of an identified misstatement does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor is required under SAS 112 to consider the likelihood and magnitude of potential misstatement.

In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or material weakness, the auditor also should evaluate the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements, resulting in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls may mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

SAS 112 indicates that the auditor should conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency. SAS 112 lists the following examples of areas in which deficiencies would be considered at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles (having sufficient expertise in selecting and applying accounting principles is an aspect of such controls);
- Antifraud programs and controls;
- Controls over non-routine and non-systematic transactions;
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

SAS 112 indicates that each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance;
- Restatement of previously issued financial statements to reflect the correction of a material misstatement;
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control; this includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts;
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities;
- For complex entities in highly regulated industries, an ineffective regulatory compliance function; this relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting;
- Identification of fraud of any magnitude on the part of senior management;

- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected;
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

Significant deficiencies or material weaknesses identified by the auditor must be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and which have not yet been remediate.

As the surrounding environment in which the industry operates comes under increased scrutiny from investors and regulators, the pressures on management to provide transparency and a strong control environment are ever increasing. Management of all entities must be cognizant of emerging reporting requirements and ensure that the strongest feasible safeguards and controls are being utilized and monitored for effectiveness.