

# State of North Carolina

## Department of State Treasurer

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**Memorandum #1070**

May 21, 2007

TO: Local Government Finance Officials and Auditors

FROM: Sharon Edmundson, Director  
Fiscal Management Section

SUBJECT: Statement on Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit.*

The Auditing Standards Board (ASB) has issued Statement on Auditing Standards (SAS) No. 112 *Communicating Internal Control Related Matters Identified in an Audit*. This statement establishes standards and provides guidance on the auditor's responsibilities for identifying, evaluating, communicating matters related to an entity's internal control over financial reporting identified in the audit of the financial statements. The new standard replaces SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. **SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006**, which is for fiscal year ending June 30, 2007 for most governments and public authorities in North Carolina.

The AICPA has issued Audit Risk Alert: *Understanding SAS No. 112 and Evaluating Control Deficiencies: A Companion to SAS No. 112* to help auditors understand this important SAS. This nonauthoritative publication is geared for issues for audits of small entities and includes case studies that may be useful in understanding how to apply SAS No. 112. One may be obtained at <https://www.cpa2bitz.com/stores/sas112>.

The Standard has two unconditional requirements:

- The auditor must evaluate identified control deficiencies and then determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses.
- The auditor must communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

*Governmental Auditing Standards* (GAGAS), the Yellow Book, has adopted new terminology as well in the recent January 2007 Revision. All significant deficiencies and material weaknesses are to be included in the Yellow Book report. Therefore, audits performed under *Governmental Auditing Standards* would not require a SAS No. 112 report since the Yellow Book report would note any significant deficiencies that exist. For Yellow Book audits, deficiencies in internal control that are not significant deficiencies would go in a management letter unless clearly inconsequential.

The ASB believes that SAS No. 112 will enhance the auditor's ability to evaluate and identify significant deficiencies and material weaknesses in internal control. Also it is believed that there will be an improvement in the quality of the communication to the governing board and management. Most experts agree that this new

standard will result in more control deficiencies being reported as significant deficiencies or material weaknesses. Also, general consensus is that the auditors may need to gather more information to make the SAS No. 112 determinations.

The LGC expects that auditors of smaller units of governments will be issuing a SAS No. 112 report that includes at the very least significant deficiencies in the area of lack of segregation of duties and lack of expertise in financial accounting and reporting. This will be addressed later in this memorandum. Also, the LGC has been informed that SAS No. 112 may increase the audit engagement fees because of the new requirements. In addition, the auditor may incur additional time, not directly related to SAS No. 112, for training staff and developing internal process to assess the severity of identified control deficiencies.

The LGC encourages auditors to educate the governing board and managers of their governmental clients so there will no surprises at future board meetings if significant deficiencies or material weaknesses are later brought to their attention. The LGC plans to issue a memorandum aimed at local government boards of directors and management explaining the impact of SAS No. 112, including the potential benefits of better understanding internal control weaknesses. Units of government should understand that the auditor must be independent of their client's internal control. The auditor cannot be part of the client's internal control over financial reporting by providing a compensating control. Becoming part of the client's internal control impairs the auditor's independence. Therefore units of government, especially smaller governments, should evaluate the cost versus benefit implications of improving their internal control, including training their personnel to be more knowledgeable. An auditor can help their client with this.

The LGC also urges the auditors and their governmental clients to work together so that the audit can be submitted timely. The LGC does not plan at this time to extend deadlines as a result of SAS No. 112.

To properly apply SAS No. 112, the auditor has to have a working knowledge of the COSO framework. COSO, the Committee of Sponsoring Organization, is a voluntary private sector organization dedicated to improving the quality of financial reporting, including effective internal controls. COSO Internal Control-Framework describes the elements of internal control over financial reporting. COSO is explained in more detail later in the memorandum.

### **SAS No. 112 Terminology**

SAS No. 112 establishes important terms (underlined) that are necessary in understanding this standard.

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 misstatements on a timely basis.

- A deficiency in design exists when: a) a control necessary to meet the control objectives is missing or b) an existing control is not properly designed so that, even if it operates as designed, the control objectives 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.

Control deficiencies may involve one or more of the five interrelated components of internal control: a) the control environment, b) risk assessment, c) control activities, d) information and communication, and e) monitoring.

A significant deficiency is a control deficiency, or a 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.

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.

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 a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements that would result in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the objectives which includes reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

The term those charged with governance is "the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting and disclosure process." This would be the governing board of directors or a committee of board of directors.

### **Evaluating Control Deficiencies Identified as Part of the Audit under SAS No. 112**

SAS No. 112 directs the auditor to evaluate control deficiencies when identified, and communicate certain deficiencies to management and those charged with governance.

The auditor must evaluate control deficiencies identified during the course of the audit. The auditor is not required to perform procedures to identify control deficiencies or to express an opinion on the effectiveness of the entity's internal control. SAS No. 112 does not increase the auditor's responsibility to "look for" control deficiencies.

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 further audit procedures to respond to assessment risk, or
- communicating with management or others, such as 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.

The auditor must determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The significance of a control deficiency depends on whether there is potential for a misstatement in financial reporting, not on whether a misstatement actually occurred. If the auditor has determined that there is not a misstatement, this is not proof that an identified control deficiency is not a significant deficiency or material weakness.

When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of a misstatement.

Likelihood refers to the probability that a control, or combination of controls, could have failed to prevent or detect a misstatement in auditing the financial statements. The term remote likelihood as used in the definition of significant deficiencies and material weaknesses has the same meaning as the term *remote* as used in *Accounting for Contingencies*, Financial Accounting Standard Board Statement of Financial Accounting Standards No. 5<sup>1</sup>. Remote is the chance of the future event or events occurring are slight. More than remote likelihood means that the event occurring is reasonably possible. That is the chance of occurring is more than remote but less than likely. Therefore the likelihood of an event is more than remote when it is at least reasonably possible. The auditor must use his or her professional judgment to determine whether a misstatement could have occurred because of a missing control or because of the failure of a control or combinations of controls. If this is the case, then the likelihood is more than remote. **If the likelihood is more than remote, then consideration as a significant deficiency is triggered, again assuming that the effect of the deficiency is more than inconsequential.**

The phrase more than inconsequential as used in the definition of a significant deficiency, describes the magnitude of potential misstatement that could occur as a result of a significant deficiency and serves as a threshold for evaluating whether a control deficiency or combination of control deficiencies is a significant deficiency. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

The following are examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect a misstatement:

- The nature of the financial statement accounts, disclosures, and assertions involved. For example, suspense accounts and related party transactions involved greater risk.
- The susceptibility of the related assets or liabilities to loss or fraud.
- The subjectivity and complexity of the amounts involved, and the extent of judgment needed to determine that amount.
- The cause and frequency of any known or detected exceptions related to the operating effectiveness of a control.
- The interaction or relationship of the control with other controls.
- The interaction of the control deficiency with other control deficiencies.

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<sup>1</sup> The term *remote likelihood* as used in the definitions of the terms *significant deficiency* and *material weakness* has the same meaning as the term *remote* as used in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Paragraph 3 of FASB Statement No. 5 states:

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This section uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

- a. *Probable*. The future event or events are likely to occur.
- b. *Reasonably possible*. The chance of the future event or events occurring is more than remote by less than likely.
- c. *Remote*. The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is “more than remote” when it is at least reasonably possible.

- The possible future consequences of the deficiency.

Several factors affect the magnitude of a misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency.
- The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods.

An auditor should consider qualitative and quantitative factors in determining whether a potential misstatement would be more than inconsequential. For example, for the purpose of evaluating control deficiencies, a potential misstatement that is less than 20 percent of the overall financial statement materiality may be considered inconsequential, before considering qualitative factors. However, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered more than inconsequential as a result of qualitative factors.

The maximum amount by which an account balance or total of transactions exposed can be overstated generally is the recorded amount. However, because of the potential for unrecorded amounts, the recorded amount is not a limitation on the amount of potential understatement.

Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually significant. Accordingly, the auditor should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control to determine whether they collectively result in a significant deficiency or material weakness.

In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the possible effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit. For example, as a compensating control, the department head reviews the supporting documentation for all disbursements exceeding \$1,000. The auditor could evaluate the effect of this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency in the account payable function. In order to determine whether a compensating control has a mitigating affect on a control deficiency to prevent it from becoming, at the very least, a significant deficiency, the auditor must perform tests on the compensating control and not rely on the fact that the compensating control is in place.

Prudent Individual: Once the auditor has completed evaluation of the deficiency; he must apply the prudent individual test. 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. Though "prudent individual" is not defined in the standard, the auditor is recommended to "step back" and look at how each control deficiency, significant deficiency, or material weakness was classified and make sure that he/she is objective in how they came to their professional judgment, considering both the quantitative and qualitative factors. This does not require anything elaborate, but should be documented in the workpapers.

SAS No. 112 includes a list of deficiencies in the following areas which ordinarily qualify at least as significant deficiencies in internal control. Below are selections from that list:

- 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 nonroutine and nonsystematic transactions.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transactions totals in 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 No. 112 includes a list of indicators of control deficiencies that should be regarded at least as significant deficiencies and as strong indicators of material weaknesses in internal control. Below are selections from that list:

- 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, which includes misstatements due to error or fraud. It does not include restatements to reflect a change in accounting principle to comply with a new principle or a voluntary change from one generally accepted accounting principle to another.
- 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 amount. Even though management subsequently corrects the misstatement, this is a strong indicator of a material weakness.
- 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.

SAS No. 112 contains a list of circumstances that may be considered control deficiencies, significant deficiencies, or material weaknesses. The auditor should consider using this as a check list. A duplication of this list may be found on page 10 (1070A) of this memorandum.

### **Communication**

The auditor is required to report all control deficiencies identified during the audit that are considered significant deficiencies or material weaknesses under SAS No. 112 in writing to management and those in charge of governance as part of each audit. Any significant deficiencies and material weaknesses that were communicated to management and the governing board in previous audits, and have not yet been remediated, must be communicated in writing as well. The latter may be communicated in writing by referring to the previous issued written communication and the date of that communication.

The existence of significant deficiencies or material weaknesses may already be known to management and may represent a conscious decision by management or the board to accept that degree of risk due to the cost of mitigating that risk or other considerations. Management and the board should understand that the auditor is presenting a situation concerning the internal controls and is communicating this in accordance with the requirements of SAS No. 112.

A request may be made to the auditor to issue a SAS No. 112 report indicating that no material weaknesses were identified during the audit of the financial statements. However the auditor should not issue a written

communication stating that no significant deficiencies were identified during the audit because of the potential misinterpretation of the limited degree of assurance provided by such communication.

***Governmental Auditing Standards*** as revised January 2007

Revised January 2007 GAGAS has adopted similar terminology as that of SAS No. 112 concerning deficiencies in internal control that are significant deficiencies and material weaknesses. Deficiencies in internal control that are considered significant deficiencies or material weaknesses are required to be reported by the auditor in the Yellow Book report. Issuing a separate SAS No. 112 report is not necessary for audits performed under Yellow Book since information concerning significant deficiencies and material weaknesses are addressed as findings. The auditor should identify these as findings and develop the elements of the findings to the extent necessary to achieve the audit objectives. Unlike SAS No. 112 reports, the yellow book report is required to accompany the financial statements.

**Timing of Communication**

It is preferred by the Local Government Commission that the SAS No. 112 report be issued along with the audited financial statements. However the standard allows the report to be issued no later than 60 days following the report release date. If a SAS No. 112 report is to be issued, then the report is considered part of the audit content and the audit will not be approved until our office reviews the SAS No. 112 report. As mentioned above, a SAS No. 112 report is not required for Yellow Book reports; Yellow Book reports must be issued when the audit is released; and as such the 60 day window does not apply to Yellow Book reports.

The auditor may feel that some matters should be communicated to management and to the board, such as identified significant deficiencies or material weaknesses, during the audit. Early communication is allowed and may be made orally. However regardless of how the early communication is delivered, all significant deficiencies or material weaknesses must be communicated in writing to management and the board.

SAS No. 112 provides illustrative communication that encompasses the requirements found in the standards. The requirements are not noted in this memorandum, but may be found in the SAS. It is not required that this form be used. The illustrations may be found beginning on page 12 (1070B) of this memorandum.

**Common Concerns of SAS No. 112**

Auditor prepared financial statements: For smaller units of governments or public authorities, auditors are questioning whether their preparation of draft financial statements should be considered a material weakness or at the very least a significant deficiency. The LGC's understanding is that the auditor can be contracted to assist management with the preparation and drafting of financial statements and related notes to the financial statement and not have either a significant deficiency or material weakness if, in the professional judgment of the auditor, the unit of government has adequate controls in place to take responsibility for the financial statements (i.e., controls that adequately prevent, detect and correct misstatements in the financial statements).

In order for the auditor to assist in the preparation of the draft financial statements and notes, and maintain his/her independence, the unit of government must take responsibility for the statements and notes. The fact that the auditor is contracted to draft the financial statements may be an indications of a potential control deficiency. The auditor cannot be a control and be independent. Therefore the unit of government must have someone that possesses the necessary accounting expertise to prevent, detect, and correct a potential misstatement in the financial statements or notes drafted by the auditor (i.e., to take responsibility for the internal controls related to the preparation of the financial statements). This may be someone employed within the unit of government or

outsourced that the auditor concludes, in their professional judgment, is capable of preventing, detecting, and correcting a potential misstatement in the financial statements or notes.

Small governments in North Carolina may have competent finance staff able to perform the day to day functions of the financial department. However some units may not have staff that have the technical ability to prevent, detect, and correct a potential misstatement in the financial statements or notes drafted by the auditor. Therefore the auditor should carefully evaluate his/her independence and consider the need to report a significant deficiency or material weakness for inadequate design of internal control over the preparation of the financial statements being audited. This may be a situation the unit of government may have to accept, based on the cost versus benefit of supplying the necessary control in order to prevent this significant deficiency or material weakness. It is imperative that the auditor explain this to the government officials so they can understand the role of the auditor and the responsibility of management and the board of the unit of government.

Case studies that can help the auditor understand whether the unit of government's lack of expertise in financial accounting and reporting is a significant deficiency or material weakness can be found in Audit Risk Alert: *Understanding SAS No. 112 and Evaluating Control Deficiencies: A Companion to SAS No. 112.*

Converting cash financials to accrual, audit adjustments, and other non audit services provided by the auditor: The same controls that apply to the drafting of the financial statements may apply to other non audit services provided by the auditor for the client. The auditor must determine if the unit of government has adequate controls to prevent and detect financial misstatements.

Suggested guidelines to determine whether a client has sufficient accounting competence and knowledge to detect or prevent a misstatement or mistake. Guidance from the AICPA's frequency asked questions concerning SAS No. 112 states that the auditor is not required to test the competency of their client. The competency may be questioned if the auditor is unsure as to whether adequate controls are in place to prevent and detect financial statement misstatements. The client may request the auditor to perform certain services for the client's convenience and not due to lack of competency. If the auditor feels that the unit of government could not perform the service themselves and/or does not have the suitable skills, knowledge, and experience to review the work in such a manner that the unit's control would prevent or detect a material misstatement, a control deficiency has been identified.

Designating a person on staff to review financial reports, adjustments, etc.: From the AICPA's frequently asked questions, assigning a person by itself is not a control. The control is the process or procedure that is carried out by an individual or third party to prevent, detect, and correct a potential misstatement.

If a unit of government issues a Yellow Book report, is a SAS No. 112 required as well? *Governmental Auditing Standards*, January 2007 revisions, contain the significant deficiencies and material weaknesses that would normally be included in the SAS No. 112 report, then the SAS No. 112 would not be necessary.

Would the SAS No. 112 Report replace the Management Letter? The auditor may list items that are considered control deficiencies, but not significant deficiencies or material weaknesses, in a separate report. *Government Auditing Standards* require that control deficiencies that are not clearly inconsequential be communicated to management in a separate letter and the report on internal control refer to this management letter.

SAS No. 112 states that nothing precludes the auditor from communicating to management and those in charged with governance other matters that the auditor believes to be of potential benefit to the entity or has been requested to communicate. This can be done orally or in writing within the SAS No. 112 report or in a separate management letter.

What about Single Audits performed under federal and State requirements? What action will the U.S. Office of Management and Budget will take concerning audits under Circular A-133 remains uncertain at the date of this memorandum. Currently Circular A-133 requires a report to include reportable conditions and material weaknesses that relate to federal programs. Type A programs cannot be considered low-risk if it had a reportable condition. Also, unit of governments cannot be considered a low-risk auditee if it had deficiencies in internal control over financial reporting that would be considered material weaknesses, in either of the two preceding years.

ASB has developed a draft of audit interpretations that would provide updated definitions and terminology for control deficiencies in a single audit environment that are consistent with SAS No. 112. OMB has the interpretation for review. The LGC will be issuing guidance for audits performed under the State Single Audit Act shortly after OMB announces revisions to Circular A-133.

In order to implement SAS No. 112, what other concepts must an auditor be familiar with? The auditor must be familiar the concepts of internal control that are contained in the following:

- Ethics Interpretation 101-3 *Performance of Nonattest Services*.
- Other existing SASs including SAS No. 55 and the new risk assessments (SAS 104 through 111)
- COSO Internal Control – Integrated Framework

What is the COSO Internal Control - Integrated Framework? COSO, the Committee of Sponsoring Organization, is a voluntary private sector organization dedicated to improving the quality of financial reporting, including effective internal controls. More information on COSO can be found at <http://www.coso.org>. The landmark report Internal Control – Integrated Framework, which often referred to as “COSO” outlines five essential components of Internal Control: The Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring.

New guidance was completed and issued entitled *Internal Control over Financial Reporting – Guidance for Smaller Companies*. It consists of a three volume set containing an executive summary, guidance for applying the concepts in the framework and illustrative evaluation tools. The objective of the three volume set is to help smaller companies and their auditors apply the framework when assessing and reporting on the effectiveness of internal control.

The guidance provides a set of 20 basic principles representing the fundamental concepts associated with and drawn directly from the five components of internal control describe in the framework. A free copy of the executive summary may be downloaded from <http://www.coso.org/publications.htm>.

We will be issuing another memorandum that discusses the impact of SAS 112 from the local government’s perspective, with particular emphasis on what smaller governments can expect as a result of implementation. Please refer to both memorandums for a complete discussion of SAS 112.

### **1070A Sample of SAS No. 112 deficiencies**

SAS No. 112 cites examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses. The auditor should use this as a checklist for his audit.

#### *Deficiencies in the Design of Controls*

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply generally accepted accounting principles in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

#### *Failures in the Operation of Internal Control*

- Failure in the operation of effectively designed controls over a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy, for example, the failure to obtain timely and accurate consolidating information from remote locations this needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a

significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

### **1070B-Sample illustration of SAS No. 112 reports**

SAS No. 112 provides illustrative communication that encompasses the requirements found in the standards. The requirements are not noted in this memorandum, but may be found in the SAS. It is not required that this form be used.

The following is an illustrative written communication encompassing the requirements in SAS 112 paragraph .25.

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies [*and other deficiencies that we consider to be material weaknesses*].

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 misstatements on a timely basis. A significant deficiency is 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. We consider the following deficiencies to be significant deficiencies in internal control:

*[Describe the significant deficiencies that were identified.]*

*[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 by the entity's internal control. We believe that the following deficiencies constitute material weaknesses.]*

*[Describe the material weaknesses that were identified.]*

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

A client may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements for the client to submit to governmental authorities. The following is an illustrative communication that may be used when the auditor has not identified any material weaknesses and

wishes, or has been requested, to advise management and those charged with governance that no material weaknesses were identified. \*\*

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our audit procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

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 misstatements on a timely basis. A significant deficiency is 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.

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 by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

If one or more significant deficiencies have been identified, the auditor may add the following sentence to the fourth paragraph of the communication:

However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [*date*].

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\*\* If an examination of internal control under AT section 501 was performed for the same period or "as of" date as the audit of the financial statements, the issuance of a report indicating that no material weaknesses had been identified during the audit of the financial statements would not be appropriate.