

SACUBO Fall 2008 Workshop  
Savannah, GA

## Learn to Beat Flying Monkeys!

### *The Impact of SAS 112 - Better or Worse than Advertised?*

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## Session Objectives

- What is a material weakness?
- Significant deficiency – what does it mean?
- “Look back” at the impact of this standard
  - Audit findings and recommendations
  - Accreditation
- The New Standard – SAS 115

## Current SAS 112 Definitions

A control deficiency with more than a remote likelihood that a misstatement:

- Is greater or equal to inconsequential = significant deficiency
- Is material = material weakness

## Effect of the SAS 112 Definitions

<b>Old Definitions</b>	<b>New Definitions</b>
Material Weakness	Material Weakness
Reportable Condition	Significant Deficiency
Management Letter Comment	Other Control Deficiency

## Significant Deficiencies

- Insufficient controls over, or expertise in, selecting and applying accounting principles in conformity with GAAP
- Insufficient antifraud programs & controls
- Inadequate controls over non-routine and non-systematic transactions
- Inadequate controls over the period-end financial reporting process

## Significant Deficiencies, Likely Material Weaknesses

Strong indicators of a material weakness in internal controls:

- Ineffective internal control over financial reporting
- Restatement of previously issued financial statements
- Audit adjustments to current financial statements
- Ineffective internal audit function

## Significant Deficiencies, Likely Material Weaknesses

- Ineffective regulatory compliance function
- Identification of fraud by senior management
- Failure by management to correct a previous significant deficiency
- An ineffective control environment with various control deficiencies

## Impact of the Standard

- Increase in material weaknesses?
- Increase in significant deficiencies?
- Effect of audit adjustments and prior period adjustments
- Types of findings
- Resolution of findings – auditor vs. client
- Confusion with Board members and management
- Effects on reaccreditation?

## Newest Development AICPA Issues SAS 115

- *Communicating Internal Control Related Matters Identified in an Audit*
- Conforms to Standards for Attestation Engagements (SSAAE)
- Aligns definitions to PCAOB and International Standards ED
- Supersedes SAS 112
- Effective for periods ending on or after December 15, 2009. Early implementation is permitted.

## SAS 115 Definition “Control Deficiency”

- *Deficiency* – 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 and correct misstatements on a timely basis
  - Material weakness
  - Significant deficiency

## Types of Deficiencies

- Deficiency in design
  - Control is missing
  - Not properly designed, so that if control operates as designed, the control objective would not be met
- Deficiency in operation
  - Control does not operate as designed
  - Person performing the control does not possess the authority or competence to the perform the control effectively

## Deficiencies in the Design of Controls

- Inadequate design over preparation of financial statements
- Inadequate design over a significant amount or process
- Inadequate documentation of internal control components

## Deficiencies in the Design of Controls

- Insufficient control consciousness
- Absent or inadequate segregation of duties
- Absent or inadequate controls over safeguarding of assets
- Inadequate design of IT general and application controls
- Employees or management who lack qualifications and training to fulfill assigned functions

## Deficiencies in the Design of Controls

- Employees or management who lack qualifications and training to fulfill assigned functions
- Inadequate design of monitoring controls to assess design and operating effectiveness of internal controls over time
- Absence of internal process to report internal control deficiencies to management timely

## Failures in the Operation Of Internal Control

- Failure in operation of effectively designed controls
- Failure on information and communication I/C component to provide complete and accurate output
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation

## Failures in the Operation Of Internal Control

- Failure to perform reconciliations
- Undue bias or lack of objectivity by those responsible for accounting decisions
- Misrepresentation by entity personnel to the auditor

## Failures in the Operation Of Internal Control

- Management override of controls
- Failure of an application control caused by a deficiency in the design or operation of an IT general control
- Observed deviation rate that exceeds the auditor's expected deviation in testing the operating effectiveness of a control

## SAS 115 Definition “Material Weakness”

- *Material Weakness* – deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected and corrected on a timely basis

## SAS 115 Definition “Significant Deficiency”

- *Significant Deficiency* – deficiency, or combination of deficiencies, in internal control that, in the auditor’s professional judgment, is less severe than a material weakness, yet important enough to merit attention by those charged with governance

## Effect of the SAS 115 Definitions

<b>Pre-112</b>	<b>SAS 112 &amp; 115</b>
Material Weakness	Material Weakness
Reportable Condition	Significant Deficiency
Management Letter Comment	Other Control Deficiency

## Severity of a Deficiency...

- Depends on:
  - The magnitude of the potential misstatement;  
and
  - Whether there is a reasonable possibility that the controls will fail to prevent, or detect and correct a misstatement.
- Does not depend on:
  - Whether a misstatement actually occurred.

## Factors that Affect the Magnitude of a Misstatement

- Financial statement amounts or total of transactions exposed to the deficiency
- Volume of activity in the account balance or class of transactions exposed to the deficiency

## Risk Factors

- Risk factors affect the possibility that a deficiency will result in a misstatement
  - Nature of accounts, transactions, disclosures, and assertions involved
  - Susceptibility of asset or liability to loss or fraud
  - Susceptibility, complexity, or extent of judgment
  - Interaction of control with other controls
  - Interaction among the deficiencies
  - Possible future consequences

## Compensating Controls

- Can limit the severity of a deficiency
- Can mitigate the effects, but does not eliminate the deficiency
- Auditor is not required to consider the effects of compensating controls when communicating significant deficiencies or material weaknesses, but if (s)he does:
  - Evaluate the design of compensating controls
  - Determine whether the compensating controls are implemented

QUESTIONS?

