

# SAS 112: Are You Ready?

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## Introduction

A longstanding point of view in the governance space is that boards of directors are required to provide the guidance and oversight necessary to hold management accountable for an effective system of internal control. Executive directors (EDs) have ultimate responsibility and ownership for the system of internal control. The ED, more than anyone else, sets the proper “tone at the top” by providing leadership and direction to other members of management. Directors of finance and administration are charged with putting the appropriate financial controls in place.

External financial statement auditors are required to evaluate all internal control deficiencies they find during the course of their work, and report to the audit committee (or other designated governing body) any deficiencies deemed to be significant or a material weakness under the new Statement on Auditing Standard (SAS) 112.

The question is, are you ready for SAS 112?

Before you answer, consider the following:

- In addition to SAS 112, the Auditing Standards Board (ASB) issued SAS 104 through SAS 111, effective for audits of financial statements for periods beginning on or after December 15, 2006. These standards are referred to collectively as “Risk Assessment Standards.” They require the auditor to:
  1. Obtain a more in-depth understanding of the organization being audited, including its internal controls;
  2. Conduct a more rigorous assessment of risks of material misstatement in the financial statements;
  3. Link the understanding obtained in No. 1 above and the risk assessment in No. 2 above to the auditor’s determination of the nature, timing and extent of audit procedures.

In complying with the new Risk Assessment Standards, auditors may ask questions they have not asked previously, look at areas they have not examined before or audit areas differently than they have in the past. While they are not charged with finding internal control deficiencies, the reality is that there is an increased likelihood they will find control deficiencies now that they are obligated to evaluate whether they exist and consider them for reporting.

- Audit firms with public company clients already have altered their audit approaches in order to meet the requirements of the Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2 (AS2), which now has been superseded by Auditing Standard No. 5 (AS5). AS2 requires an assessment of internal controls, which means the audit firms have trained their professionals to design and execute procedures to identify and evaluate control deficiencies, and report them to the appropriate governing body. Auditors may view the issuance of the Risk Assessment Standards and SAS 112 as a convergence that allows – or even requires – them to audit both public and nonpublic clients the same way. This may increase the likelihood that auditors could perform more work to evaluate whether internal control deficiencies exist. In this respect, it is interesting that both the Securities and Exchange Commission (SEC) and PCAOB have clarified in their recent releases that the purpose of an audit of internal control over financial reporting (ICFR) is to search for material weaknesses – not significant deficiencies.

- Nonprofits typically lack written policies and procedures documenting the components of internal control, have inadequate segregation of duties, have inadequate design of information technology (IT) controls, and struggle to hire personnel with the qualifications and training to fulfill their assigned functions. Each one of these issues is included in an appendix to SAS 112 that provides examples of circumstances that may be control deficiencies, significant deficiencies or material weaknesses.

Add it all up, and you have the recipe for a possible sea change in how auditors may approach the audit of nonprofits and private companies alike.

## Overview of SAS 112

In 2006, the ASB issued SAS 112 to be effective for audits of the financial statements of organizations that do not issue public securities (“nonissuers”) for periods ending on or after December 15, 2006. This standard:

1. Defines the term “significant deficiency,” which replaces the term “reportable condition” and broadens the term “material weakness”;
2. Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements;
3. Requires the auditor to communicate in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in the audit.

While auditors are not required to perform procedures to identify deficiencies in internal controls as required under AS2 for public companies filing with the SEC, SAS 112 is still important to nonissuer organizations subject to an external audit. This is because the new risk assessment standards have increased the likelihood auditors will identify deficiencies that must be evaluated to determine their severity. As noted earlier, this standard could lead to more work by auditors.

## Definitions

Under SAS 112, the term “significant deficiency” replaces the term “reportable condition.” Also, the term “material weakness” is broadened. These new definitions are now at a sufficiently low threshold that more deficiencies could require reporting to management and those charged with governance responsibilities. SAS 112 defines the terms “control deficiency,” “significant deficiency” and “material weakness” in the same way as AS2, which is important to note since AS2 was just superseded by AS5. SAS 112 defines these terms as follows:

- 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 GAAP 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.”*

Auditors of public companies have been complying with AS2 for more than three years, and during this time, these companies have made a significant investment in identifying, evaluating and remediating control deficiencies. This investment, in addition to the cost of compliance with the Sarbanes-Oxley Act of 2002, prompted the SEC and the PCAOB to reexamine the regulations and standards instituted in response to Sarbanes-Oxley.

In June 2007, the PCAOB adopted AS5 to supersede AS2. With AS5, the Board sought, among other objectives, to focus the auditor on the most important matters and eliminate unnecessary auditing. AS5 redefined the terms “significant deficiency” and “material weakness,” aligning them with the SEC’s releases in order to raise the severity and probability thresholds to a level more in line with a top-down, risk-based approach to controls evaluation.

In AS5, the new definition for material weakness has two important changes compared to the one in SAS 112:

1. A material weakness is no longer “a *significant* deficiency, or a combination of *significant* deficiencies.” It is simply “a deficiency, or combination of deficiencies.” This is intended to make it easier to evaluate deficiencies because they do not have to qualify first as significant deficiencies. Furthermore, the revised definition sends a clear signal to the auditor not to plan the audit to identify significant deficiencies, which was a concern under AS2.
2. The probability threshold for being considered a material weakness has been raised from “*more than a remote likelihood*” to a “*reasonable possibility*.” In Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, paragraph 3 refers to the terms *probable*, *reasonably possible* and *remote*. *Remote* is defined when the chance of a future event(s) occurring is slight, whereas *reasonably possible* is defined when the chance of the future event(s) occurring is more than remote, but less than likely. By definition, *reasonably possible* also includes *probable*. As you can see from these definitions, this change is designed to focus the evaluator on higher risk areas.

In AS5, the definition for significant deficiency was changed considerably and now is “a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.” This definition basically focuses on escalation and does not incorporate a probability threshold. The bottom line is that it is about identifying matters worthy of management’s and the audit committee’s attention. Although it is included in AS5, this definition has been proposed and exposed for public comment by the SEC and, depending on the comments received by the Commission, could be revised again.

The message we can draw from these changes is clear: Management and auditors need to focus their line of sight on whether there is at least a reasonable possibility of a material misstatement in the financial statements. The use of the “more than a remote likelihood” threshold in the definitions of significant deficiency and material weakness led some companies and auditors to concern themselves with hypothetical situations that either had not occurred or were not likely to occur. This was never the intent of the SEC or the PCAOB. The focus on severity for a significant deficiency enables management to exercise judgment. When control deficiencies surface during the assessment process, management should eliminate consideration of deficiencies where the potential impact is not significant enough to warrant attention. The only remaining question is whether, combined with other deficiencies, the identified deficiency warrants attention.

We understand that the ASB plans to update the definitions of significant deficiency and material weakness. We hope those plans will result in convergence with AS5. In the meantime, in the audits of financial statements of nonissuers, auditors will continue to apply the SAS 112 definitions, even though the PCAOB has revised the definitions to focus auditors on applying a risk-based approach.

## Evaluation of Control Deficiencies

SAS 112 provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements. This guidance is in line with AS2, and there were no changes in AS5 that would lead us to believe this guidance would be revised. The primary focus on the evaluation of control deficiencies is the *potential* for misstatement, not whether a misstatement actually has occurred. The evaluation is based on the likelihood and magnitude of misstatement.

There are a number of qualitative factors that may affect the likelihood that a control or combination of controls could fail to prevent or detect misstatement. Those factors include, among other things, the nature of the accounts involved, the susceptibility to loss or fraud, and the subjectivity and complexity of the underlying processes affecting the account. There are also a number of factors that affect the magnitude of misstatement, including the size of the financial statement account, the total number of transactions exposed to the deficiency and the volume of activity in the account balance.

While it is important to evaluate the impact of an individual deficiency, it should not be done in isolation. Other deficiencies impacting the same financial reporting account or disclosure also should be considered along with mitigating effects of compensating controls. Compensating controls limit the severity of a control deficiency. For example, compensating controls for process-level authorization or processing control deficiencies include account reconciliations and budget-to-actual variance analyses because those controls may detect misstatements when executed properly. When that happens, appropriate adjustments can be made. Thus, these compensating controls reduce the risk of material misstatements.

The key to evaluating control deficiencies is the context of financial reporting assertions. The objective is to provide reasonable assurance that the financial statements are not materially misstated. This objective includes providing reasonable assurance that assets actually exist and are bona fide, and also that reported revenue and expense transactions are complete and accurate. In other words, everything that should be included is, and anything that shouldn't be isn't. The organization has the rights to the resources included, and all obligations are presented. What is presented are actual obligations of the organization. All amounts are properly valued and measured, and all necessary disclosures are presented in accordance with generally accepted accounting principles.

These and other financial reporting assertions are important because they are the focal point. While there may be an upstream preventive control that fails, there also may be a downstream detective control that mitigates the risk of failing to achieve one or more financial reporting assertions. This consideration has to be factored into the deficiency evaluation, as it directs the focus on the assertion and the key controls that provide reasonable assurance that the assertion has been met.

## Communication

SAS 112 requires the auditor to communicate in writing, to management and those charged with governance, the significant deficiencies and material weaknesses identified in an audit no later than 60 days following the report release date. The auditors may communicate findings earlier; however, they are not required to do so. Even if management or the governing body already knows about significant deficiencies or material weaknesses and has made a conscious decision to accept the risk, the auditors are required to communicate them in writing.

If no material weaknesses are found, management or the governing body still may ask the auditor to issue a communication indicating that no material weaknesses were identified. Management or the governing body also may prepare a written response to the auditor's communication, including corrective actions taken, plans to implement new controls, or a statement of why management believes the cost of addressing a significant deficiency or material weakness would exceed the benefits.

## How Management Can Prepare

Let's go back to the original question: Are you ready for SAS 112? If the answer is no, here are 10 things that management can do to prepare:

1. **Educate your audit and/or finance committee, as well as your board of directors.** This step is important because it will help set management expectations so that any forthcoming auditor communications are not a surprise.
2. **Conduct your own risk assessment.** Identify the financial statement line items, accounts and disclosures most susceptible to material misstatement and evaluate which financial reporting assertions are of most concern – completeness, existence/occurrence, valuation and measurement, rights and obligations, or presentation and disclosure. Then, identify the risks (including fraud) that could result in failure to achieve those assertions. Finally, identify the controls that prevent those risks from occurring, or detect them if they have been realized. Do not try to identify and document every control, just those that are most critical to reducing to an acceptable level the risk of a material misstatement. Some controls will be organizationwide or entity-level (e.g., the development of a budget and monthly budget-to-actual variance analysis), and some will be process specific, such as matching invoices to purchase orders.
3. **Meet with your external financial statement auditors to review the results of their risk assessment and understand their audit approach.** Compare the results of your risk assessment to theirs and ask them to explain the results if they have identified something as higher risk than you have. You may be able to provide them with information that they otherwise do not have access to that will help “rightsize” the audit.
4. **Determine the reporting standard your auditors plan to follow.** As was pointed out earlier, there are differences between the SAS 112 and AS5 definitions of material weakness and significant deficiency. Until the ASB resolves these differences, management of nonissuers should inquire of their auditors to ascertain the definition they plan to use when evaluating identified control deficiencies.
5. **Ask your auditors to communicate deficiencies early and often.** This will allow management the opportunity to provide the auditor with information on compensating controls that will assist in the evaluation of identified deficiencies.
6. **Improve your segregation of duties.** Most people trust those with whom they work, especially colleagues with seniority. They do not want to question the integrity of others, so they rely upon trust rather than sound business practices. This common situation opens the door to problems. The reality is that individual circumstances change, and employees may not demonstrate the desired judgment at all times. By ignoring segregation of duties, organizations leave themselves susceptible to errors and omissions – intentional or not. Clearly identify who (a) has custody of assets, (b) can make authorizations to deploy those assets, (c) keeps the records and (d) performs reconciliations. Ideally, these functions are addressed by separate individuals. If not, start eliminating the conflicts. In smaller organizations, it is difficult to remove all conflicts, so get creative. For example, have the treasurer of the board do the account reconciliations or separate custody from record keeping and reconciliation.

7. **Enforce your segregation of duties with controlled system access.** There is no point in separating custody, authorization, record keeping and reconciliation if one person has access to the system and can add and delete transactions at will. Avoid vesting incompatible functions into the hands of a single individual. Make sure your user roles and rights for key financial applications are consistent with the segregation of duties you are trying to achieve.
8. **Document your current accounting policies and procedures, and make them available to everyone.** It is amazing the control weaknesses that become apparent simply by writing down what is to be done and why. Policy clarification is easier said than done, so start with areas that pose the greatest risk of misstatement and work from there. For most organizations, this is the “close the books” process.
9. **Write management’s response.** Prepare a written response to the auditor’s communication of identified deficiencies. This document should include details about the corrective actions taken, the plans to implement new controls, or a statement of why management believes the cost of addressing a significant deficiency or material weakness would exceed the benefits. This is your opportunity to most directly address the auditor’s evaluation of deficiencies reported. It also is an effective way to engage your audit and/or finance committee and your board of directors in the dialogue around costs and benefits.
10. **Request a communication from your auditors if no material weaknesses were found.** It is important to understand any and all control issues identified by the auditors. The knowledge they obtain about the organization’s controls as a result of the financial statement audit, and about how those controls can be improved, is worth understanding. It can result in meaningful improvements to the organization’s processes and controls.

## About Protiviti

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