

## Are Your Internal Controls Deficient?

A RECENT ASB STATEMENT ESTABLISHES STANDARDS AND PROVIDES GUIDANCE  
ON COMMUNICATING INTERNAL CONTROL MATTERS

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Following the Sarbanes-Oxley Act of 2002 and the creation of the PCAOB, there has been significant interest in management's responsibility for internal control and the auditor's responsibility for bringing certain internal control related matters to management's attention in a financial statement audit.

In any system of internal controls, a control deficiency exists

when the design or operation of a control does not allow management or employees to prevent or detect misstatements in a timely basis.

In May 2006, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 112, Communicating Internal Control Related Matters Identified in an Audit. SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. The statement is effective for audit periods ending after December 15, 2006 and may have an impact on your financial statement audit.

### **New Requirements**

SAS No. 112 has two unconditional requirements:

- The auditor must evaluate identified control deficiencies and determine whether those deficiencies are significant

deficiencies or material weaknesses.

- The auditor must communicate, in writing, significant deficiencies and material weaknesses.

A significant deficiency is a control deficiency, or combination or control deficiencies, that adversely affect 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.

Once an auditor has evaluated your organization's internal control deficiencies, they must determine which deficiencies rise to the level of a significant deficiency or a material weakness. Those control deficiencies that are evaluated to be significant deficiencies or material weaknesses are required to be communicated in writing to management and those charged with governance. The auditor must also communicate any significant deficiencies and material weaknesses that were already communicated to you in prior periods, even if you choose not to correct them.

### **What to Expect**

As a result of this requirement, you will probably see

an increase in the number of management letters issued compared to prior audits. While prior internal control related matters were communicated with management, the new standard requires that communication be sent to management and those charged with governance. In addition, although your organization's internal controls may be improving it may appear to other members of management as though these controls are weakening due to the requirement to issue the management letter yearly.

The definitions found in SAS No. 112 are fairly broad and as a result it is expected that many organizations will have control deficiencies that were never previously considered. Some examples include:

- If as part of your audit your auditor identifies a material misstatement that was not discovered by your staff, this is at least a significant deficiency. Based on the prior standard, this was not required to be communicated as an internal control matter.
- If your auditor has typically prepared your financial statements, they must now evaluate whether your staff is capable of preparing the financial statements, and related footnote disclosures, on their own or have the ability to carefully review and approve the statements.
- If your auditor maintains your organization's fixed asset ledger and computes book and tax depreciation, this may be a control deficiency. Because the auditor cannot be part of a client's internal controls, the controls that exist at your auditor's firm to perform the calculations cannot be taken into account in considering whether a control deficiency exists. Your auditor must determine whether your staff has the competency to perform the function and has just chosen to outsource this function. As long as your staff has the ability to review and take responsibility for the depreciation and related calculations, and possess the skills to prevent, detect, and correct potential misstatements, your auditor may determine that a control deficiency does not exist.

As with any change in auditing standards, you need to understand the new requirements and be able to discuss them with users of your financial statements. These changes will take additional time and may impact your audit fees. Your organization may want to examine its system of internal controls based on the new requirements and make any necessary modifications to reduce the number of significant deficiencies and material weaknesses.

In addition, you will want to communicate with other members of management and those charged with governance these new requirements and alert them that they may receive communication from the organization's auditors regarding internal controls. For many small organizations with a lack of segregation of duties, many of these control deficiencies are well-known but need to be communicated by your auditors for them to comply with SAS No. 112.

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