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Auditor of State

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TO: All Auditees
Independent Public Accountants

FROM: Mary Taylor, CPA
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SUBJECT: Statement on Auditing Standards No. 112 Requires Auditors to Report More Control Deficiencies

Background and Overview

The Auditor of State and contracted Independent Public Accountants (IPAs) follow professional auditing standards the American Institute of Certified Public Accountants (AICPA) issues, as well as the Comptroller General of the United States' *Government Auditing Standards*.¹ The AICPA issued Statement on Auditing Standards No. 112 (SAS 112), effective for financial reporting periods ending on or after December 15, 2006. SAS 112 lowered the threshold for reporting internal control² deficiencies.

This lower threshold means that some control deficiencies we previously reported only in management letters will now appear in the report on controls and compliance *Government Auditing Standards* requires. This report is part of the publicly released audit.

Summary of SAS 112

The new statement introduces the term *control deficiency*, which exists when the design or operation of a control does not allow management or employees to prevent or detect financial statement misstatements on a timely basis. SAS 112 requires auditors to determine whether control deficiencies they identify are *significant deficiencies* or *material weaknesses*, which SAS 112 defines as:

- *Significant Deficiency*: 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 the applicable accounting basis

¹ The 2007 revision to *Government Auditing Standards* and a June 26 revision to OMB Circular A-133 both adopted SAS 112.

² *Internal controls* are accounting procedures management uses to prevent or detect misstatements to financial data.

- Resulting in a *more than a remote likelihood* that auditee management would fail to prevent or detect:
 - A *more than inconsequential* financial statement misstatement
 - Note that *more than a remote likelihood* and *more than inconsequential* are relatively low thresholds.
- **Material Weakness:** 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.

Based on these definitions, SAS 112 essentially lowers the threshold for reporting control deficiencies identified during the audit. SAS 112 also eliminated the old term *reportable condition*, with the understanding that such a deficiency would now be either a significant deficiency or a material weakness.

To demonstrate how SAS 112 lowers the threshold for reporting control deficiencies, the following chart depicts the old definitions versus the new SAS 112 definitions for identified weaknesses in internal control.

Old Definitions	New Definitions
Material weakness	Material weakness
Reportable condition	Significant deficiency
Management letter comment (under Yellow Book only)	Other matters related to internal control - Deficiencies

As depicted in the chart, the items noted in the right-hand column are lower than those in the left-hand column. This illustrates that items which we might previously have reported in the management letter (which is not part of the publicly released audit) now require inclusion in the report on internal controls and compliance *Government Auditing Standards* requires.

Therefore, audit reports on financial statements done in accordance with *Government Auditing Standards* will likely include more comments on internal control deficiencies than in the past. The Auditor of State recommends that clients educate their governing boards on the effects of SAS 112. More importantly, clients should use this opportunity to evaluate and improve their internal controls over financial reporting.

Questions and Comments

If you have any accounting or auditing related questions regarding this Bulletin, please contact the AOS Accounting and Auditing Support Group at (800) 282-0370.



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