SAS 112 Communicating Internal Control Related Matters Identified in an Audit
Questions and Answers

When the auditors come to your agency this year, they will be auditing using a standard they first used in 2007. This standard, issued by the American Institute of Certified Public Accountants (AICPA), is Statement on Auditing Standards (SAS) 112 "Communicating Internal Control Related Matters Identified in an Audit" and applies to both financial and federal single audits. Because the standard is new and many are not familiar with it, this document is written to provide some basic information.

1. **Question:** What does SAS 112 do?
   Answer: The standard:
   - Defines three categories for internal control deficiencies an auditor may find during an audit of your agency. The categories are control deficiency, significant deficiency, and material weakness.
   - Gives guidance on determining how to categorize an internal control deficiency.
   - Requires the auditor to communicate significant deficiencies or material weaknesses in writing to management and "those charged with governance."

2. **Question:** How is this standard different from the standards already in place?
   Answer: This standard is different in two main ways.
   - It reduces the thresholds for significant deficiency and material weakness, meaning that a control deficiency reaches one of these critical levels more easily than in the past.
   - Once a control deficiency is considered a significant deficiency or material weakness, auditors must communicate that condition in writing as a finding. Previously, AICPA standards allowed these conditions to be communicated verbally or in a letter to the entity.

     That said, in Washington, the State Auditor's Office performs their audits in accordance with *Government Auditing Standards,* which requires significant deficiencies and material weaknesses to be reported as findings. Therefore, the issuance of SAS 112 did not affect their approach for reporting internal control deficiencies.

3. **Question:** When required to do so, how will the auditor communicate in writing?
   Answer: The written communication will be in the form of a finding included with the auditor's report on internal control related to financial reporting. This report is a required part of the Single Audit Report and is referenced in the state's Comprehensive Annual Financial Report (CAFR) opinion. Agency accountability reports will reference these findings; however, the findings will not be included in agency accountability reports.

4. **Question:** Who are management and "those charged with governance"?
   Answer: At the agency level, the agency head is considered "management" because that person has responsibility for the agency's financial statements and for designing, implementing and maintaining effective internal controls over financial reporting. For the state CAFR, the director of the Office of Financial Management (OFM) is considered "those charged with governance" because statute gives the director of OFM the responsibility of preparing and publishing the state's annual financial report. The Director has the role as defined in SAS 112 of "overseeing the financial reporting or disclosure process."

5. **Question:** Will SAS 112 result in more findings?
   Answer: The general consensus on a national level is that very likely SAS 112 will result in more findings. There are several reasons for this.
   - A condition reaches the level of significant deficiency or material weakness more easily and then must be reported as a finding.
   - Both material weaknesses and significant deficiencies from prior audits must be repeated as findings each year until they are resolved.
   - The standard is more prescriptive than former standards, which relied heavily on auditor judgment. It includes a list of conditions that are normally considered to be significant deficiencies. The standard also includes a second list of conditions that should be considered at least significant deficiencies and that are strong indicators of material weaknesses. The auditor has to have a reason to decide differently than the lists suggest. Therefore, the auditor may have less flexibility about what is called a finding.

6. **Question:** Can the auditors use their judgment when deciding whether a condition is a significant deficiency or material weakness?
   Answer: The general consensus on a national level is that SAS 112 does not preclude auditors from exercising professional judgment, and auditors around the country are working to interpret the standard. The Washington State Auditor's Office has put controls in place to ensure that their interpretation and exercise of judgment are consistent on their audits throughout the state.

7. **Question:** What are some examples of conditions that may be significant deficiencies or material weaknesses and therefore communicated in writing?
   Answer: Some examples include:
   - The auditee records a prior period adjustment to correct a major (material) misstatement in a financial statement line item, such as investments, capital assets or accounts payable.
   - The auditor finds a major error in federal expenditures claimed by the auditee.
   - The auditor sees a failure to record accurate information, as evidenced by major general ledger cleanup journal entries after year-end.
   - The auditor sees a failure to reconcile material general ledger balances with related subsidiary ledgers.
   - The auditee has prior findings that have not been resolved.
   - The auditor is aware of a failure to receive accurate timely information that is needed to prepare the financial statements.

8. **Question:** Will agencies be asked to satisfy additional reporting requirements and/or make additional certifications on internal control?
   Answer: Each agency head is already required to sign a financial disclosure certification during the fiscal year end closing process that includes multiple statements about their agency's internal controls, financial activity, and balances. Three of these statements from last year's certification are noted below.

   - We are responsible for establishing and maintaining effective internal control over financial reporting. Our agency's system of internal controls complies with the prescribed requirements as contained in Chapter 20 of SAAM.

- The transactions and adjustments submitted to the Agency Financial Reporting System (AFRS) for Fiscal Year 2007 accurately and completely reflect our agency's activity and ending account balances for each of the accounts listed below, in conformity with Generally Accepted Accounting Principles (GAAP) as outlined in the *State Administrative and Accounting Manual* (SAAM) and demonstrate legal compliance, where applicable.
- Capital assets, including infrastructure assets, are properly capitalized, reported, and, if applicable, depreciated. The state has satisfactory title to all owned assets and there are no liens or encumbrances on such assets nor has any asset been pledged. The balances shown for capital assets in the Agency Financial Reporting System (AFRS) reflect fairly our agency's capital assets on June 30, 2007, and these balances have been reconciled to assets $5,000 and over in our authorized capital asset subsidiary system.

Similar certifications are required for federal assistance reporting. All documentation supporting these certifications should be available to the auditor, and any exceptions to these certifications must be attached to the form submitted to OFM. In the future, there may be additional certification requirements. At this time we are not aware of any changes to the existing certification requirements, but if changes are necessary, we will bring them to your attention.

9. **Question:** How does SAS 112 impact the Single Audit?
Answer: Part of the Single Audit tests an agency's internal controls over compliance for federal programs as well as its compliance with federal regulations. On June 26, 2007, the U.S. Office of Management and Budget adopted the wording, definitions, and requirements found in SAS 112. This means the auditors are now required to report on inadequate internal controls and noncompliance in federal programs using the SAS 112 standards. Therefore, significant deficiencies and material weaknesses in internal controls and noncompliance related to federal assistance programs must be reported as findings.

10. **Question:** When was SAS 112 effective?
Answer: For both financial reporting and federal audits, SAS 112 was effective for audits of periods ending on or after December 15, 2006 - for the State of Washington, Fiscal Year 2007.

11. **Question:** Who can answer further questions on SAS 112?
Answer: Questions can be directed to the State Auditor's Office or to the OFM Accounting Consultant assigned to your agency. You can find your agency's OFM Accounting Consultant at:
http://www.ofm.wa.gov/accounting/swa/swacontacts.asp.