

Peer Review Guidance for SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*

The objective of SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, is to provide new definitions and guidance to assist auditors in better communicating internal control deficiencies. In addition, SAS No. 112 heightens the auditor's awareness that his/her clients are ultimately responsible for their system of internal control and financial statements and, therefore, must weigh and manage the associated risks. SAS No. 112 is effective for all financial statement audits for periods on or after December 15, 2006. For audits that have period end dates prior to December 15, 2006, the peer reviewer should apply SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, requirements.

While auditors are not required to search out or have procedures in place to identify deficiencies in internal control, auditors are required to "...evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses" according to the AICPA's "Communicating Internal Control." In other words, when an auditor "trips across" an internal control deficiency in the course of an audit, the auditor then must evaluate the control deficiency to determine whether it's a significant deficiency or material weakness.

SAS No. 112 has two unconditional requirements:

- The auditor must evaluate identified control deficiencies and then determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses. (There are new definitions of significant deficiencies and material weaknesses from those defined in SAS No. 60)
- The auditor must communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

SAS No. 112 defines control deficiencies, significant deficiencies and material weaknesses in the following manner:

Control Deficiency - 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.

Significant Deficiency - 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 generally accepted accounting principles 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 by the entity's internal control.

Material Weakness - 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 by the entity's internal control.

Note: The definition of significant deficiency above is different than the definition/criteria used in determining significant deficiencies in peer review.

Below is a chart to assist peer reviewers in evaluating the various situations that may be encountered during a peer review of audits that have period end dates subsequent to December 15, 2006 where SAS No. 112 would be applicable.

Situation

SAS 112 Guidance

Peer Review Guidance

<p>Auditor did not have specific procedures in place to identify control deficiencies.</p>	<p>The auditor is not required to search out or have procedures in place to identify control deficiencies.</p> <p>Note: The auditor is required to obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation.</p>	<p>No MFC - having specific procedures in place to identify control deficiencies is not a requirement of SAS No. 112.</p> <p>However, if the auditor has failed to obtain an understanding of internal control sufficient to plan the audit, an MFC related to that matter would be warranted</p>
<p>Auditor identified control deficiencies and determined that those deficiencies, individually or in combination, represent a significant deficiency or material weakness.</p>	<p>The requirements of SAS No. 112 are met providing the auditor communicates the identified deficiency or weakness in writing to management and those charged with governance no later than 60 days following the report release date.</p>	<p>No MFC if a written, timely communication¹ was made to management and those charged with governance.</p> <p>MFC if the auditor fails to communicate the deficiency and/or weakness in writing to management and those charged with governance no later than 60 days following the report release date.</p> <p>REPORT/LOC: If the matter described in the MFC is pervasive, consideration should be given to including the matter in the LOC or report. The auditor should use judgment in evaluating the significance of the failure to communicate and, generally, the peer reviewer should respect the auditor's professional judgment. If, however, the failure to communicate included audits conducted under Generally Accepted Government Auditing Standards (the Yellow Book), or included clients with operating</p>

		audit committees, the engagement could be deemed to be substandard. In circumstances where an engagement is not conducted under the Yellow Book and/or there is no operating audit committee, generally the engagement would not be deemed substandard if this was the only deficiency noted.
Auditor identified control deficiencies and did not evaluate whether they were a significant deficiency or a material weakness.	SAS No. 112 requires the auditor to evaluate the identified control deficiencies to determine whether these deficiencies, individually or in combination, are significant deficiencies or a material weakness.	MFC since the auditor identified the control deficiencies but did not evaluate whether they were a significant deficiency or material weakness. NOTE: See preceding guidance in evaluating if a substandard engagement exists and the related impact on the report or LOC.
Auditor identified control deficiencies and upon evaluation, determined that they were not a significant deficiency or material weakness. The control deficiencies were not communicated to management or those charged with governance.	SAS No. 112 requires the auditor to evaluate the identified control deficiencies to determine whether these deficiencies, individually or in combination, are significant deficiencies or a material weakness. If control deficiencies are evaluated and determined not to be a significant deficiency or material weakness, SAS No. 112 does not require the control deficiencies to be communicated with management or those charged with governance.	NO MFC since SAS No. 112 requires the auditor to evaluate the identified control deficiencies to determine whether these deficiencies, individually or in combination, are significant deficiencies or a material weakness. Since the control deficiencies were evaluated and determined not to be a significant deficiency or a material weakness, they are not required to be communicated to management or those charged with governance.
Auditor identified control deficiencies and upon	N/A	This should be handled as a disagreement in the same

<p>evaluation, determined that they were not a significant deficiency or material weakness. During the peer review, the team captain determines that the identified control deficiencies are a significant deficiency which should have been communicated in writing.</p>		<p>manner as other disagreements between reviewer and firm. The team captain, and if possible the reviewed firm, should contact the AICPA technical hotline or AICPA Audit and Attest staff for additional guidance. The team captain may also need to consult with the technical reviewer and committee chair.</p>
<p>During an audit procedure, the auditor determined a control deficiency was a significant deficiency or material weakness. The auditor orally communicated the identified deficiency as soon as it was identified to management and those charged with governance.</p>	<p>SAS No. 112 allows the auditor the ability to orally communicate identified deficiencies or weakness provided that the auditor issues a written communication no later than 60 days following the report release date.</p>	<p>No MFC if a written, timely communication¹ was made to management and those charged with governance.</p> <p>MFC if the auditor failed to communicate the deficiency and/or weakness in writing to management and those charged with governance no later than 60 days following the report release date.</p> <p>NOTE: See preceding guidance in evaluating if a substandard engagement exists and the related impact on the report or LOC.</p>
<p>The client has effective internal controls in place over fixed assets. However, as a convenience for the client, the auditor develops journal entries for fixed asset depreciation and recommends client's posting to its general ledger. Client recomputes selected auditor calculations to verify accuracy.</p>	<p>Nothing in SAS No.112 precludes the auditor from performing this service.</p>	<p>No MFC since the client has effective internal control procedures in place over fixed assets and the client's review of the auditor's proposed journal entry included the recomputation of selected auditor calculations to satisfy the auditor's computations were properly made.</p>
<p>Auditor prepares FASB 109 disclosure and provides necessary journal entries for posting by client. Client has a level of understanding such that the auditor meets AICPA</p>	<p>Since the client does not have the ability to fully understand the disclosure and detect a misstatement, the auditor has appropriately detected a control deficiency. The control</p>	<p>No MFC if the auditor evaluates the control deficiency and determines that a significant deficiency or material weakness exists and a written, timely communication¹ was made to</p>

<p>Ethics independence requirements but the auditor determines the client does not have the ability to independently prepare the correct entries. Therefore the auditor has determined that a control deficiency exists.</p>	<p>deficiency must be evaluated to determine if it was a significant deficiency or a material weakness.</p>	<p>management and those charged with governance no later than 60 days following the report release date.</p> <p>No MFC if the auditor evaluates the control deficiency and determines that a significant deficiency or material weakness does not exist and thus no communication was made to management or those charged with governance.</p> <p>MFC if the auditor (1) did not determine whether the deficiency was significant or constituted a material weakness; or (2) determined the deficiency was significant or constituted a material weakness and failed to provide written communication to management and to those charged with governance no later than 60 days following the report release date.</p> <p>NOTE: See preceding guidance in evaluating if a substandard engagement exists and the related impact on the report or LOC.</p>
<p>During interim fieldwork and before the client’s year end date, the auditor identifies a control deficiency and determines it is a material weakness. The auditor provides a written communication in a letter to management and those charged with governance.</p>	<p>SAS No. 112 does not distinguish how the written communication is to be done. It does specify that it must be provided no later than 60 days following the report release date.</p>	<p>No MFC since the written communication¹ was provided no later than 60 days following the report release date.</p>
<p>The auditor does not identify any control deficiencies during the audit. The auditor</p>	<p>SAS No. 112 indicates that the auditor should not issue a written communication stating</p>	<p>MFC should be issued if the auditor provided written communications that no</p>

<p>provides written communication to the client indicating that significant deficiencies were not identified during the audit.</p>	<p>that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.</p> <p>NOTE: A client may ask the auditor to issue a communication indicating that no material weaknesses were identified during the audit of the financial statements for the client to submit to governmental authorities.</p>	<p>significant deficiencies were identified.</p> <p>REPORT/LOC: If the matter described in the MFC is pervasive, consideration should be given to including the matter in the LOC or report. The auditor should use judgment in evaluating the significance of the departure from professional standards.</p>
<p>Auditor drafts the financial statements, including footnote disclosures. However, the auditor determines the client does not have the ability, either internally or through the use of a qualified outside party, to independently prepare or review financial statements and related footnote disclosures. As such, there are no controls in place to prevent and detect misstatements in this area. Therefore, the auditor has determined that a control deficiency exists.</p>	<p>The control deficiency must be evaluated to determine if it is a significant deficiency or a material weakness. SAS No. 112 provides that ineffective oversight of the entity's financial reporting and internal control by those charged with governance should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control. Therefore, the auditor should have communicated this deficiency to management and those charged with governance no later than 60 days following the report release date.</p> <p>Note: Generally, no control deficiency would exist where the client possesses or acquires, from a source other than the audit firm, a level of understanding necessary to prepare the financial statements and related footnotes and reviews the financial statements and related footnotes in sufficient detail to assume</p>	<p>No MFC if a written, timely communication¹ was made to management and those charged with governance.</p> <p>MFC if the auditor failed to provide written communication to management and to those charged with governance no later than 60 days following the report release date.</p> <p>NOTE: See preceding guidance in evaluating if a substandard engagement exists and the related impact on the report or LOC.</p>

	responsibility and prevent and detect misstatements.	
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¹ The written communication should:

- State that the purpose of the audit was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control over financial reporting.
- State that the auditor is not expressing an opinion on the effectiveness of internal control.
- Include the definition of the terms significant deficiency and, where relevant, material weakness.
- Identify the matters that are considered to be significant deficiencies and, if applicable, those that are considered to be material weaknesses.
- State that the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.