PKF PERSPECTIVES

SAS NO. 112: FOCUS ON INTERNAL CONTROL

In the October 2006 issue of **PKF Perspectives**, we summarized the provisions of Statement on Auditing Standards (SAS) No. 112 ***Communicating Internal Control Related Matters Identified in an Audit***, issued by the American Institute of Certified Public Accountants, with effect for periods ending on or after December 15, 2006.

In a "nutshell", SAS No. 112 requires your auditor to:

- evaluate identified control deficiencies **(I.E., WHERE 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)** and determine whether those deficiencies - individually or in combination - are significant deficiencies or material weaknesses,

and

- communicate, in writing, no later than 60 days following the report release date, significant deficiencies and material weaknesses identified by them to client management and those charged with governance, including those identified significant deficiencies and material weaknesses previously communicated in prior audits which had not as yet been remediated.

In this issue of **PKF Perspectives**, we would like to share with you some of the examples offered in SAS No. 112 as circumstances that may be control deficiencies, significant deficiencies or material weaknesses.

Deficiencies in the Design of Controls

- Inadequate design of internal control over the preparation of the financial statements under audit.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, e.g., the "tone at the top" and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (as determined by the auditor as necessary for effective control over financial reporting).
- Inadequate design of information technology (IT): general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions (e.g., in an entity that prepares financial statements in accordance with generally accepted accounting principles, the person responsible for the accounting and reporting function lacks the skills and

knowledge to apply generally accepted accounting principles in recording the entity's financial transactions or preparing its financial statements).

- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's control over time.

- Absence of an internal process to report deficiencies in internal control to management on a timely basis.

Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process, e.g., the failure of a control such as dual authorization for significant disbursements within the purchasing process.

- Failure of the information and communication component of internal control to provide complete and accurate output due to deficiencies in timeliness, completeness, or accuracy, e.g., the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.

- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. ***This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness.***

- Failure to perform reconciliation of significant accounts, e.g., accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.

- Undue bias or lack of objectivity by those responsible for accounting decisions, e.g., consistent understatement of expenses or overstatement of allowances at the direction of management.

- Misrepresentation by client personnel to the auditor (potential indicator of fraud).

- Management override of controls.

- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

Conclusion

SAS No. 112 requires your auditor not only to evaluate failings in internal control that were uncovered during the audit, but also to evaluate likely deficiencies in internal control which may result in risks of material misstatement of the financial statements due to error or fraud. Clients are encouraged to review and strengthen, if necessary, key components of their financial internal controls, document them, and train their employees accordingly.

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PKF

Certified Public Accountants
A Professional Corporation
29 Broadway ✦ New York, NY 10006
Telephone: (212) 867-8000 ✦ Telefax: (212) 687-4346
www.pkfnewyork.com ✦ E-mail: info@pkfny.com

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