

## **Sample of SAS No. 112 deficiencies**

SAS No. 112 cites examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses. The auditor should use this as a checklist for his audit.

### *Deficiencies in the Design of Controls*

- Inadequate design of internal control over the preparation of the financial statements being audited.
- 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, for example, 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 (this applies to controls that the auditor determines would be necessary for effective internal 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. For example, 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 internal control over time.
- The 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, for example, 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 because of deficiencies in timeliness, completeness, or

accuracy, for example, the failure to obtain timely and accurate consolidating information from remote locations this 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. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.
- Failure to perform reconciliations of significant accounts. For example, 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, for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an 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.

SAS No. 112 includes a list of deficiencies in the following areas which ordinarily qualify at least as significant deficiencies in internal control. Below are selections from that list:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.
- Antifraud programs and controls.
- Controls over nonroutine and nonsystematic transactions.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transactions totals in the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

SAS No. 112 includes a list of indicators of control deficiencies that should be regarded at least as significant deficiencies and as strong indicators of material weaknesses in internal control. Below are selections from that list:

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement, which includes misstatements due to error or fraud. It does not include restatements to reflect a change in accounting principle to comply with a new principle or a voluntary change from one generally accepted accounting principle to another.
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control. This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amount. Even though management subsequently corrects the misstatement, this is a strong indicator of a material weakness.
- Identification of fraud of any magnitude on the part of senior management.
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.