BEHIND the NUMBERS
SAS 112: Internal Controls Take Center Stage
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SAS 112 is a new auditing rule that may disproportionately impact small and medium sized nonprofit organizations. This article will discuss what this new rule is, how it may impact your organization, and what you should do to prepare for it.

Statement on Auditing Standards 112, "Communicating Internal Control Related Matters Identified in an Audit," or SAS 112 for short, is one of a series of auditing rules issued by the Auditing Standards Board, a part of the AICPA (American Institute of Certified Public Accounting). This rule is effective for fiscal years ending on or after December 15, 2006. If your organization has a year-end audit after this date, then your auditors are required to follow this rule. SAS 112 applies to for-profits as well as nonprofits.

As the title of SAS 112 suggests, your auditors are now required to tell you about various internal control weaknesses or deficiencies that they identify while conducting your audit. In and of itself, this is reasonable — what director or board member would not want to know if there is a problem with their internal controls? This is also not entirely new, as auditors already customarily issue management letters in which they identify various issues that come to their attention. However, what is new about this rule is that the standard has been lowered in terms of what now is considered a problem, meaning things that may not have been problems in the past might now be considered a problem, and auditors are now *required* to note these problems in writing.

SAS 112 introduces three new definitions concerning internal control problems: "control deficiency", "significant deficiency", and "material weakness."

As per the Standard, "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 [in financial reports] on a timely basis." SAS 112 ¶5.

"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." SAS 112 ¶6.

"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." SAS 112 ¶6.

To understand the above definitions, think of these three internal control problems this way: a control deficiency is bad and should be remedied, but is unlikely to cause a significant problem.

A significant deficiency is a step worse than a control deficiency. It has a higher likelihood of leading to problems within the organization and causing more than inconsequential mistakes in the financial statements because the organization will not be able to prevent the mistakes, or find them once they exist.

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A material weakness is the worst type of internal control problem. Like the significant deficiency, it also has a higher likelihood of leading to problems, but the mistakes in the financial statements that it might cause would be material or significant.

Beyond the new definitions, SAS 112 requires your auditors, as part of each audit, to communicate to management and those charged with governance of your organization (i.e., the Board) *in writing* any significant deficiencies or material weakness in internal controls that they find. This communication will include internal control problems identified in previous years that have not yet been remedied. Even control deficiencies that have never resulted in a misstatement of your financial reports have to be reported if the auditors believe that there is more than a slight chance they will cause mistakes in your financial statements, and that the mistakes will be of a greater than inconsequential nature.

In effect, SAS 112 lowers the bar in terms of what will now be considered a control deficiency. As a result, organizations may find themselves being written up for things that their auditors have never previously considered to be a problem. Take for example the preparation of the year-end financial reports. Small to medium sized nonprofits likely have their auditors prepare the statements and footnotes. While SAS 112 does not preclude the auditors from continuing to do so, it does say that the auditors cannot be part of your system of internal controls. If the auditors conclude that your organization does not *have the ability and expertise* to have prepared the statements and footnotes themselves, or at least have the knowledge to have read the footnotes to determine whether they are accurate, then you have either a significant deficiency or a material weakness.

SAS 112 provides some examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses. The three examples below are some that small to medium sized nonprofits may face.

- *Failure to reconcile significant accounts*. For example, do all of your subsidiary ledgers such as accounts receivable and fixed assets agree with your general ledger? Are your bank accounts reconciled accurately and on a timely basis?
- *Absent or inadequate segregation of duties within a significant account or process*. For example, does your organization have adequate segregation of duties?
- *A lack of staff with the necessary skills and knowledge to prepare your financial statements in accordance with generally accepted accounting principles*. Can your staff prepare your year-end financial reports, including the footnotes?

If you answered ‘no’ to any of the questions posed above, you may have a control deficiency, significant deficiency, or material weakness.

Interestingly, SAS 112 requires your auditors to communicate significant deficiencies and material weaknesses even if “the existence of significant deficiencies and material weaknesses may already be known to management and may represent a conscious decision by management or those charged with governance to accept that degree of risk because of cost or other considerations.” SAS 112 ¶23.

SAS 112 impacts small to medium-size nonprofits disproportionately because in many states these organizations are required to have audits in order to register to solicit contributions, while for-profit organizations of similar size are not. In addition, small and medium-sized organizations often do not have the same capacity as large organizations to review and improve internal financial controls. As directed by SAS 112, this process is vital.

The impact of receiving a “SAS 112 letter” from your auditors is not yet known. Our firm, however, is predicting that some funding organizations, donors, and banks will start requesting them. This could have a potential negative impact on an organization’s fundraising.

Your organization should immediately begin to review your internal controls in light of the new SAS 112 requirements to see where you may have exposure. Consult your auditors to get their advice. Educate your board and your staff on the issues and of the importance of improving your internal controls. Fortunately, SAS 112 allows you to hire professional assistance.

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