



BEST PRACTICE

Mitigating the Negative Effects of Statement on Auditing Standards No. 112 (2007) (CAAFR)

Background. In May 2006, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit*. This new pronouncement significantly increases the likelihood that a government's independent auditors may be required to report either a *significant deficiency*¹ or a *material weakness*² in conjunction with the financial statement audit.

SAS No. 112 clarifies that it is *not* sufficient that the independent auditor determine that the financial statements under audit are, in fact, *fairly presented* in accordance with generally accepted accounting principles (GAAP). Generally accepted auditing standards (GAAS) also require that the financial statements be the product of a financial reporting system that offers reasonable assurance that management is able to produce financial statements that comply with GAAP.

Independent auditors often assist clients with the preparation of their financial statements. Such assistance poses no problem if it is provided merely a matter of convenience (i.e., management could produce the financial statements, but chooses not to). However, such assistance will constitute either a significant deficiency or a material weakness under SAS No. 112 if it is provided as a matter of necessity rather than of convenience (i.e., management does not have the skills needed to prepare GAAP financial statements).

If management does not possess the skills to prepare GAAP financial statements on its own, the government could always choose to engage the services of someone other than the independent auditor to provide the needed assistance. Because such contractors would work for management (unlike the *independent* auditors) they would qualify as part of the government's financial reporting system, thus avoiding an automatic finding of a significant deficiency or material weakness.

SAS No. 112 also makes it clear that material auditor-identified audit adjustments typically will require that a significant deficiency or material weakness be reported.

Recommendation. The GFOA recommends that governments take into account the following considerations in crafting a strategy for minimizing any potential negative effect resulting from the implementation of SAS No. 112.

- ***Be prepared to provide evidence that the government has a sound financial reporting system in place.*** GFOA recommends that a government establish and document a system of financial reporting that is sufficient to provide reasonable assurance that management is able to prepare financial statements in conformity with GAAP. Appropriate criteria for evaluating the adequacy of a government's financial reporting system can be found in *Internal Control: Integrated Framework*, published by the Council of

¹ "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."

² "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."

Sponsoring Organizations of the Treadway Commission (COSO).³ In particular, the financial reporting system should incorporate an anti-fraud program and controls, as well as ongoing internal audit/risk assessment activity commensurate with the size and complexity of the entity.

- ***Minimize the likelihood of material audit adjustments.*** Every practical step should be taken to minimize the possibility of material auditor-initiated audit adjustments. For example, a government should carefully review its cutoff procedures and the method it uses to uncover unrecorded liabilities at the end of the fiscal period (items found by the auditor rather than by management could result in a significant deficiency or material weakness being reported). Special care also should be taken to ensure the timely and effective implementation of new accounting standards.
- ***Review any financial statement preparation assistance provided by the independent auditors.*** If management chooses to make use of the services of the independent auditors in helping to prepare the financial statements as a matter of convenience, it should carefully document that a staff member with the requisite skills has reviewed all of the work performed by the auditor (e.g., by completing the GFOA financial reporting checklist or by using some similar review tool). If management does *not* have the skills necessary to prepare GAAP financial statements and desires the assistance of its independent auditors to help it do so, but without exposing itself to the risk of an automatic significant deficiency or material weakness, it may wish to consider obtaining the services of a consultant or some other outside party (e.g., retiree volunteer) to review the auditor's work on the government's behalf.

The GFOA does *not* recommend that governments engage the services of a second accounting firm to assist in preparing its financial statements solely to avoid having a significant deficiency or material weakness reported. It is by no means assured that the benefits of engaging a second firm would outweigh the costs. Moreover, a significant deficiency or material weakness might still be reported as the result of some other weakness in the financial reporting system (e.g., auditor-discovered audit adjustment), which could defeat the purpose of hiring the second firm.

If management decides that the costs of remedying a significant deficiency or material weakness in its financial reporting system cannot be justified by the benefits to be obtained, it should take care to alert the governing body as early as possible to explain its conclusion. In that case, governments subject to a Single Audit should explore the possibility of obtaining a waiver pursuant to paragraph 530c of U.S. Office of Management and Budget Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," so as not to jeopardize the audit's "low risk" status.

Approved by the GFOA's Executive Board, October 19, 2007.

³ The guidance offered in this report is discussed and applied specifically to local governments in the GFOA publication *Evaluating Internal Controls: A Local Manager's Guide*.