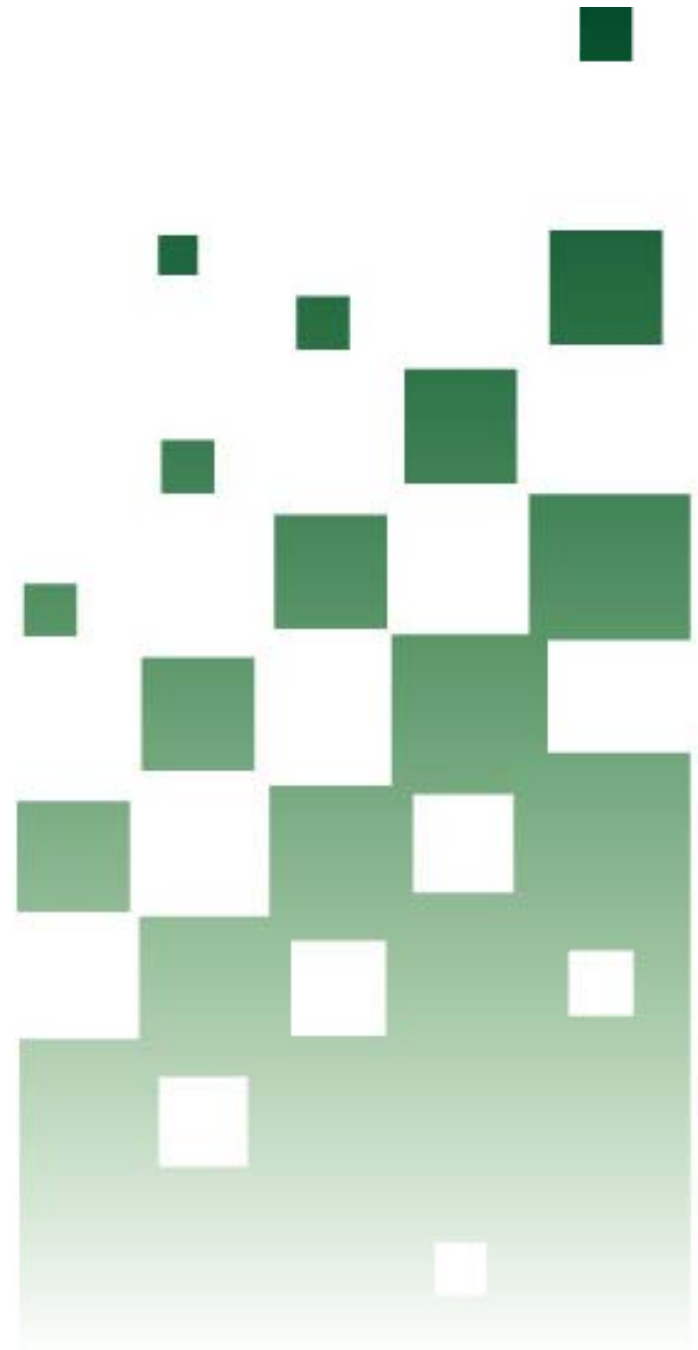


Understanding SAS 112

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Background

- ◆ *SAS No. 60 (AICPA) – now superseded*
 - *Title – “Communication of Internal Control Structure Related Matters Noted in an Audit”*
- ◆ *Sarbanes-Oxley Act of 2002*
- ◆ *AS No. 2 (PCAOB) – June 2004*
 - *Title – “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements”*
 - *Introduced the terminology now adopted by SAS No. 112*

Background

- ◆ *COSO definition of internal control*
 - *Effectiveness and efficiency of operations*
 - *Reliability of financial reporting*
 - *Compliance w/ applicable laws & regulations*
- ◆ *Reliability of financial reporting*

(Term relates to the preparation of reliable financial statements that are fairly presented in conformity with GAAP)

SAS No. 112 Overview

- ◆ *Objectives*
- ◆ *Definitions*
- ◆ *Auditing impacts*
- ◆ *Practical impacts*
- ◆ *Anecdotal information*

Objectives

Establishes standards that classify internal control “gaps” as

- ◆ *Control deficiencies*
- ◆ *Significant deficiencies*
- ◆ *Material weaknesses*

Objectives

Establishes standards for communicating internal control issues relating to

- ◆ *Integrity of financial reporting*
- ◆ *Compliance with applicable laws and regulations*

Certain issues must be communicated to management and those charged with governance

Communicating Results

- ◆ *Body to whom internal control matters are communicated may take different forms*
- ◆ *“Those charged with governance” refers to the body with responsibility for overseeing the strategic direction of the entity – along with the financial reporting and disclosure process*
- ◆ *Communicate significant deficiencies and material weaknesses within 60 days of report date*

Definitions

*Terminology conforms to PCAOB
Audit Standard No. 2 wording*

- ◆ *Control Deficiency*
- ◆ *Material Weakness*

*Replaces the term Reportable
Condition with Significant
Deficiency*

Definitions

*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*

Definitions

A deficiency in DESIGN exists when

- 1. A control necessary to meet the control objective is missing, or*
- 2. An existing control is not properly designed so that even if the control operates as designed, the control objective is not always met*

Definitions

A deficiency in OPERATION exists

- 1. When a properly designed control does not operate as designed, or*
- 2. When the person performing the control does not possess the necessary authority or qualifications to perform the control effectively*

Control Deficiencies

Examples:

- ◆ *Lack of controls over non-routine and non-systematic transactions*
- ◆ *Ineffective oversight of the entity's financial reporting and internal control by the governing body*
- ◆ *Restatement of previously issued financial statements*
- ◆ *Identification by the auditor of a material misstatement that was not initially identified by the entity's internal control, i.e., audit adjustments*
- ◆ *Failure by management , or the governing body, to assess the effect of a significant deficiency previously communicated to them and either correct it, or decide that it won't be corrected*

Definitions

A Significant Deficiency is a control deficiency (or a combination of control deficiencies) that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP 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.

Definitions

*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.*

Auditing Impacts

Auditors determine whether an internal control deficiency is a significant deficiency or material weakness based on the item's

- ◆ *Nature*
- ◆ *Likelihood*
- ◆ *Magnitude*

Auditing Impacts

“More than a remote likelihood” is defined in FASB Statement No. 5 – Accounting for Contingencies

- ◆ *Events are either probable, reasonably possible, or remote*
- ◆ *Remote means that the chance of the future event is slight*
- ◆ *Therefore, “more than a remote likelihood” means that the event is either reasonably possible or probable*

Auditing Impacts

“More than inconsequential” refers to the magnitude of potential misstatements that could occur as a result of a significant deficiency

- ◆ *Misstatement is inconsequential if a reasonable person would conclude item is clearly immaterial to the financial statements*
- ◆ *PwC guidance pegs “more than inconsequential” at a 1%-5% impact*

“Material” is a term that contemplates both quantitative and qualitative aspects, and is largely left to the judgment of the auditor

- ◆ *PwC guidance pegs “material” at a >5% impact*

Practical Impacts

- ◆ *Conducting the audit*
 - *Entrance conference expectations*
 - *Auditors are NOT performing an audit of internal controls*
- ◆ *Roles of auditor vs. client*
 - *Who finds the deficiencies?*
 - *Increased documentation by both sides*

Practical Impacts

- ◆ *Internal control awareness*
- ◆ *Likelihood of more reportable audit findings*
- ◆ *Correcting and following up on findings*
- ◆ *Understanding financial statements and their disclosures*

Internal Control Awareness

- ◆ *Properly designed accounting system*
- ◆ *Maintenance of source documents initiating transactions*
- ◆ *Anti-fraud controls*
- ◆ *Controls to ensure accurate and timely financial reporting*
- ◆ *Controls to ensure safeguarding of assets*

Likelihood of More Reportable Audit Findings

*SAS No. 112 has “lowered the bar” –
potential for misstatement*

*Significance of a control deficiency
dependent on potential for
misstatement, not whether a
misstatement actually occurred*

Correcting and Following Up on Findings

Impact on auditees

- ◆ *Amount of work required by management to correct and follow-up on reportable findings*

Impact on auditors

- ◆ *Requirement to gather more evidence and documentation to evaluate control deficiencies*
- ◆ *Must perform follow-up procedures on all previous findings*

Understanding Financial Statements and Their Disclosures

- ◆ *Entity must have necessary resources (professional personnel) to effectively apply GAAP in preparing its financial statements*
- ◆ *Governing body should have sufficient skills to understand the financial statements*
- ◆ *Auditors cannot be used as an integral part of the internal control system*

Single Audit Implications

- ◆ *GAO revised their Government Auditing Standards (the “Yellow Book”) for 2007 to include these same definitions found in SAS No.112*
- ◆ *OMB Circular A-133 (the Single Audit) has also recently been amended via its annual “compliance supplement”, to adopt these same definitions*
- ◆ *Deficiencies not “significant” would go in management letter as “other matters”, unless clearly inconsequential*

What NACUBO is Hearing

- ◆ *Findings that require an adjustment*
 - *Why did it happen?*
 - *Are there compensating controls that mitigate the effects of a control deficiency?*
 - *If not, and the amount is material = material weakness; if not material = significant deficiency*

What NACUBO is Hearing

- ◆ *Prior to SAS #112, isolated or relatively minor findings resulted in verbal recommendations or ones not requiring a response*
- ◆ *Since SAS #112, if such findings are deemed “control deficiencies”, would fall into the Other Matters category and require written recommendation – single audit report*

What NACUBO is Hearing

- ◆ *If footnotes are NOT kept current, could result in a significant deficiency finding*
- ◆ *Process for communicating with management hasn't really changed – simply more formal*

What NACUBO is Hearing

PwC presentation at recent ACUA Annual Conference - Atlanta, GA

- ◆ *Most findings so far have been related to:*
 - *Financial statement closing process*
 - *IT controls*
 - *Audit adjustments (found by auditor indicating control deficiencies)*
 - *Gifts – restrictions, pledges*

What NACUBO is Hearing

PwC presentation at recent ACUA Annual Conference - Atlanta, GA

- ◆ *If control deficiency is found and fixed*
 - *If it was related to a key control relied upon by auditors for their opinion – significant deficiency*
 - *Control matters relate to the whole year, not just a point in time – lapses have to be reported*

What NACUBO is Hearing

University of Utah

- ◆ *State Auditors*
- ◆ *No material weaknesses*
- ◆ *4-5 significant deficiencies*
- ◆ *3-4 “other” matters (single audit)*

What NACUBO is Hearing

Arizona State University Foundation

- ◆ *Identified need for prior period adjustment (related to classification of endowment fund earnings) in order to “remediate a past weakness”*
- ◆ *Auditors reported issue as a “material weakness”*
- ◆ *ASUF formally disagreed with the finding in their response to the management letter*

What NACUBO is Hearing

University of Notre Dame

- ◆ *Tolerance level a lot lower*
- ◆ *More documentation required*
- ◆ *Issue with recording fair value of investments*
 - *Previously based on 12/31/06 data, updated for subsequent transactions (lagging effect)*
 - *Auditors considered difference to be material; now insist that data based on 6/30/07 valuations*

What NACUBO is Hearing

MIT

- ◆ *Before audit:*
 - *Cleaned up documentation and problem areas*
 - *Increased communication and questions with auditors*
- ◆ *During audit*
 - *Tolerance level a lot lower*
 - *More documentation required*
 - *Auditors found fixed asset adjustment*
 - *MIT responded*
 - *Auditors did not pursue*

What NACUBO is Hearing

UT System

- ◆ *Work is complete*
- ◆ *No SAS 112 classification as of 12/31/07*
 - *State auditors still thinking through the standard*
 - *Historically, any exception has been considered a reportable condition*
 - *Usually have one or two material weaknesses*
 - *Above weaknesses get lost in the 300+ report to the state*
 - *Many internal audit and state auditor reports in the state, so SAS 112 will get lost*

Single Audit Implications

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SAS 112 and Internal Controls in General

- ◆ NACUBO Industry Survey
 - 2007
 - 2004
- ◆ Assessment
- ◆ Audit committee
- ◆ Senior management assertions

SAS 112

NACUBO Industry Survey

- ◆ Control deficiencies
 - My guess – less than 3%
 - Actual _____
- ◆ Significant deficiencies
 - My guess – less than 1%
 - Actual _____
- ◆ Material weaknesses
 - My guess – less than 1%
 - Actual _____

SAS 112 and A-133 Audits NACUBO Survey

- ◆ Material weaknesses
 - My guess – less than 1%
 - Actual _____
- ◆ Significant deficiencies
 - My guess = reportable conditions
 - Actual _____
- ◆ General
 - Don't know yet
 - More time to complete audits

SAS No. 112

Resources:

- ◆ *NACUBO*
- ◆ *AICPA*

Questions?

Comments?