



NATHAN WECHSLER & COMPANY

PROFESSIONAL ASSOCIATION

CERTIFIED PUBLIC ACCOUNTANTS

“...committed to providing personal attention and adding value to entrepreneurial clients who share a passion for excellence, integrity and community enrichment.”

Statement on Auditing Standard No. 112

Communicating Internal Control Related Matters Identified in an Audit

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PRESENTATION OUTLINE

- History
- Important Definitions
- Evaluating Control Deficiencies – flowchart
- Examples – evaluating control deficiencies
- Examples – SAS 112 reporting
- Tips to limit SAS 112 letter comments
- On the horizon

HISTORY

- Sarbanes Oxley Act of 2002
- PCAOB Auditing standard No. 2 “An audit of internal control over financial reporting performed in conjunction with an audit of financial statements” – applied to public companies only
- Statement on Auditing Standard No. 112 (SAS 112) issued by AICPA in May 2006 – superseded SAS No. 60
- Effective for audits of financial statements ending on or after December 15, 2006
- Two primary changes:
 - New definitions of significant deficiencies and material weaknesses – less room for auditor judgment
 - Requires written communication of significant deficiencies and material weaknesses

IMPORTANT DEFINITIONS

Control Deficiency

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

- *Deficiency in **design** – exists when a control necessary to meet the control objective is missing or an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met (walkthroughs & control checklists)*
- *Deficiency in **operation** – exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.*

IMPORTANT DEFINITIONS

Significant Deficiency

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 GAAP such that there is more than remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential (*magnitude*) will not be prevented or detected.

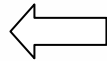
Material Weakness

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement (*magnitude*) of the financial statements will not be prevented or detected.

EVALUATING CONTROL DEFICIENCIES

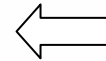
REMOTE

Small



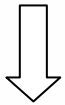
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Medium



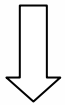
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MORE THAN
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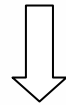
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Control
Deficiencies

MORE THAN
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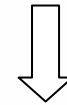
Medium



Significant
Deficiencies

MORE THAN
REMOTE

Large



Material
Weaknesses

-----Communicated in writing-----

Remote, More than Remote = refers to Likelihood
Small, Medium, Large = refers to Magnitude

EVALUATING CONTROL DEFICIENCIES

Likelihood *(Remote or More than Remote)*

- Nature of accounts and disclosures
(ex. related party transactions)
- Susceptibility of assets or liabilities to loss or fraud
(ex. cash, inventory)
- Subjectivity or complexity of accounts and extent of judgment necessary
(ex. bad debt allowances)

Magnitude *(Small, Medium or Large)*

- Financial statement amounts exposed to deficiency
- Volume of activity exposed to the deficiency

EXAMPLE #1 - Lack of Segregation of Duties

Background:

One person is in charge of accounting and reporting functions which indicates lack of segregation of duties and is therefore a *control deficiency*. In order to assess the severity of the control deficiency you must consider complementary, redundant or compensating controls.

EXAMPLE #1 - Lack of Segregation of Duties

Additional facts:

- Board Member (BM) signs all checks & reviews all supporting doc's
- The signed checks are returned to the client to be mailed
- The bank sends the bank statement directly to the BM, who reviews the bank statement and returned checks
- Bank statement is given to the client for reconciliation

Conclusion:

These compensating controls are effective in preventing or detecting an unauthorized disbursement, making the likelihood of a misstatement remote. Therefore this is only a control deficiency, NOT a significant deficiency or material weakness (*written communication is not required*).

EXAMPLE #1 - Lack of Segregation of Duties

Alternate facts:

- If the BM does not review bank statements you may determine that the compensating controls are not effective and would result in a **Material Weakness** (*more than remote likelihood & magnitude could be large*).
- If BM reviews only returned checks over certain dollar amount you may determine that the control is effective in preventing or detecting a *material misstatement* of cash and would result in a **Significant Deficiency or Control Deficiency** (*more than remote likelihood & magnitude less than material/large*).

EXAMPLE #2 – Lack of Client Expertise in Financial Accounting & Reporting

Background:

During the year under audit the organization acquired a new vehicle that cost \$50,000 – an amount material to the financial statements – and financed the purchase. The vehicle should be capitalized. The bookkeeper has recorded monthly cash payments for the vehicle but not the initial asset and liability.

EXAMPLE #2 - Lack of Client Expertise in Financial Accounting & Reporting

Discussion:

- Based on these facts we determine that there was a control deficiency that did not detect, prevent or correct the misstatements in the draft financial statements.
- Audit/auditor cannot be part of internal control and the organization did not have sufficient expertise or knowledge to properly record the transaction.

Conclusion:

- Because the audit caught this error, the likelihood that the financial statements would be misstated is more than remote and the magnitude is material (*large*) therefore = *Material Weakness*

EXAMPLE #2 - Lack of Client Expertise in Financial Accounting & Reporting

Alternative facts:

- The bookkeeper contacted the CPA for guidance on recording the transaction

Discussion:

- This demonstrates the client ability to detect a potential misstatement and the ability to gain the necessary competence

Conclusion:

- No control deficiency detected

EXAMPLE #3 - Lack of Client Expertise in Financial Accounting & Reporting

Background:

The organization has an accounting manager who requests that you assist in drafting the financial statements and notes to the financial statements. However, prior to signing the representation letter the accounting manager obtains the financial statement grouping schedules and documentation of amounts in the footnotes and reviews and approves these schedules. In addition, the accounting manager obtains a current disclosure checklist and reviews the answers to ensure accuracy and completeness. The financial statements are also read, revised and approved by the accounting manager and audit/finance committee.

EXAMPLE #3 - Lack of Client Expertise in Financial Accounting & Reporting

Discussion:

- Dependent upon competence and expertise of accounting manager
- If accounting staff and audit committee lack the necessary accounting expertise to detect a misstatement then that would result in a control deficiency to be evaluated.

Conclusion:

- If accounting staff do possess the necessary accounting expertise to prevent, detect and correct a potential misstatement in the financial statements or footnotes there would be *NO control deficiency*.

SAS 112 REPORTING

- Specifically addressed to management and audit committee
- Common SAS 112 comments:
 - Client expertise
 - Journal entry review/approval
 - Bank reconciliation process
 - Segregation of duties
 - Information Technologies
- Funding sources are coming around – now asking for “any other communication from independent auditors”
- Additional wording to emphasize this is a new reporting requirement
- Review examples

PUBLIC COMPANY STATISTICS - 2006

- 1,118 US and 90 foreign companies reported Material Weaknesses (8.8%) – one of every 12 companies with U.S.-listed securities
- 2,260 companies with U.S.-listed securities disclosed 6,046 material weaknesses in their internal controls over financial reporting
- Most weaknesses were pervasive and affected multiple accounting areas

TIPS TO LIMIT SAS 112 COMMENTS

- Review audit adjustments and unadjusted audit differences from prior years – some may indicate a control deficiency
- Review Management letter comments received in prior years
- Identify significant accounts and disclosures and document the related controls and processes related to them (design, operation, monitoring)
 - Cash reconciliations
 - Contributions
 - Temporarily restricted gifts and expenditures
- Educate your board – may be a good resource to improve controls
- Be proactive with your independent auditors

ON THE HORIZON

- New SAS's related to internal control – what to expect
 - Audit Organizer (handout)
 - Understanding Internal Control (handout)
- 403(b) changes
 - Final IRS 403(b) regulations (handout)
- 990 changes
 - Additional disclosure
 - Focus on related parties, compensation & private inurement
 - Entities should have Written Conflict of Interest Policy, Written Whistleblower Policy & Written Document Retention Policy in anticipation of new requirements
 - New e-postcard for small NPO's