

# SAS 112 internal controls readiness: a PwC perspective\*



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## I. Introduction

Since the enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes), auditing has become a more heavily regulated industry. Sarbanes created a new federal oversight body, the Public Company Accounting Oversight Board (PCAOB), to oversee auditors' examinations of public companies. The PCAOB and other stakeholders expect auditors to hold their audit clients to higher standards of accountability for internal controls and financial reporting in the post-Sarbanes environment.

In June 2004, the PCAOB issued its second auditing standard (AS2), *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. AS2 establishes requirements for auditing a public company's financial statements as well as management's assessment of the effectiveness of internal control over financial reporting. AS2 also establishes definitions for "significant deficiencies" and "material weaknesses" in internal controls. If auditors identify significant deficiencies and material weaknesses, they may conclude that they cannot obtain reasonable assurance about whether the public company has maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. In this case, the auditor may have to issue an adverse opinion, which would set several negative consequences in motion.

The American Institute of Certified Public Accountants (AICPA), the national professional organization for certified public accountants, issued its Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, in May 2006. SAS 112 substantially incorporates the PCAOB's definitions of significant deficiency and material weakness, making the definitions used for audits of nonpublic entities consistent with those in place for audits of public companies. Similarly, it is possible that the auditor would have to issue an adverse opinion without reasonable assurance about effective internal controls.

### What will change as a result of SAS 112?

We believe that the new definitions will lower the bar such that more control deficiencies will be considered severe. Also, the auditor must consider the "potential" magnitude of a control deficiency rather than the actual magnitude as well as the following questions:

- Does a control deficiency—or a combination of deficiencies—constitute a significant deficiency or a material weakness?
- Would prudent officials with knowledge of the facts and circumstances agree with the auditor's assessment?
- Are effective compensating or complementary controls in place?
- What is "material" to the financial statements from a quantitative and qualitative perspective?

In the first question, the requirement to consider a combination of deficiencies is new. In the last question, the requirement to consider materiality from both a quantitative and qualitative perspective is new. The auditor will have considerably less room for judgment as to the severity of a control deficiency under SAS 112.

In the second question, the auditor must consider the particular facts and circumstances of each auditee and whether someone else would agree with the auditor's assessment. In the third question the auditor must consider compensating controls. These two questions require that the auditor gather more evidential matter and documentation than before to support his judgment.

Communicating internal control matters is also an important component of SAS 112. When auditors identify internal control deficiencies, they must report them to trustees, granting agencies, and other stakeholders. As a result of SAS 112, more control deficiencies will be communicated to external and internal stakeholders in a more public manner.

In summary, under SAS 112:

- More control deficiencies will likely be considered significant and/or material and will be communicated more broadly to stakeholders
- The auditor has less judgment and will require more evidence and documentation from management to support his conclusions about the effectiveness of internal controls

SAS 112 is effective for financial periods ending on or after December 15, 2006—that would be fiscal 2007 for most not-for-profit organizations.

## II. What should you do to prepare for the implementation of SAS 112?

Obtaining a complete understanding of SAS 112 and formulating a detailed action plan are the best way to:

- Reduce the extent to which your institution's control environment is characterized as weaker than has previously been communicated, which might cast a less than favourable light on management.

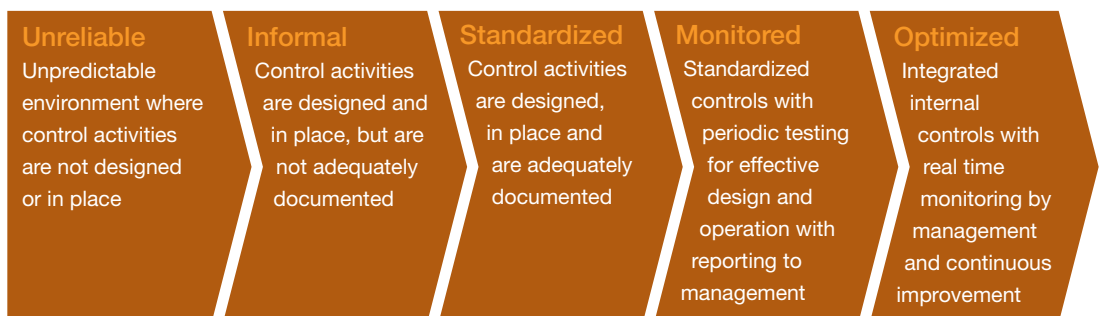
If the external auditor has been substantiating account balances rather than relying on internal controls, then the controls might not have been rigorously tested in prior audits. Without preparation and review of internal controls this year, you won't know what the external auditor might find when SAS 112 becomes effective next year.

- Manage the expectations of internal constituents, including nonfinancial management, faculty and governing board members, as well as key external stakeholders, such as donors, insurers, accreditors and rating agencies.

For example, consider federal sponsors. If the auditor identifies control deficiencies at your institution and reports them to federal sponsors, as the auditor might be required to do, how would your sponsors react?

In this section, we outline an approach to accomplish these goals.

### Internal Control Maturity Framework



Internal controls can be viewed in a maturity framework, which is depicted in the diagram on the previous page. Many educational institutions can be characterized as informal. Under SAS 112, this might present challenges because controls must be documented in order for auditors to rely on them. Moving to the right on the maturity framework will take on greater urgency in the new environment.

The level of action you need to take depends on the nature and complexity of your institution as well as on your comfort level. We present several actions to consider below.

- A. **Educate your board.** You don't want board members to be surprised at a future board meeting if your auditor brings significant deficiencies and material weaknesses to their attention. Educate them now and give them a chance to help you evaluate and improve controls.
- B. **Inventory the significant accounts, disclosures, and components as well as the processes and cycles** (e.g., investments, contributions/fund-raising, sponsored research) and subprocesses/subcycles (e.g., financial closing process). What are the key activities that take place in your organization, and how would you assess the related controls using the maturity framework on the previous page?
- C. **Consider reviewing controls over three areas the first year, such as:**

**Financial closing process:** What controls are in place over the financial statement closing process? Who reviews estimates? What documentation exists? Is the organization audit-ready when the auditors arrive? What adjustments does the auditor propose as a result of the annual independent audit?

The financial closing process is key because material adjustments found by the auditors are likely to be considered significant deficiencies or material weaknesses in controls under SAS 112—even if the organization records them. Currently, the auditor does not communicate adjustments that have been booked.

To prepare for SAS 112, you might want to review the adjustments and unadjusted differences that the external auditor has proposed over the past three to five years. These adjustments might be considered at least “control deficiencies” in SAS 112. Certain adjustments relate to timing, but others may indicate a control deficiency. Group the adjustments in two categories, one for timing adjustments and the other for possible control deficiencies, and then evaluate them, particularly those in the second category.

Consider developing a financial statement binder. Collect the work papers that support the financial statements in this binder. Consider using a financial statement checklist for completeness over financial statement disclosures. Include support in the binder for amounts in the Statement of Cash Flows (e.g., treatment of capital accruals, identification of noncash activities, treatment of restricted cash and cash overdrafts, proof of reclassification of amounts restricted for long-term investment). Also, include proof of the accuracy and completeness of “release of restrictions” transfer.

**Information technology (IT) controls over significant systems:** What IT controls are in place over significant systems, such as the financial reporting system, payroll, general ledger, and grant administration? Are the controls automated or manual? Are they documented? What controls exist over program security, program access, and program changes?

IT controls support the overall control structure of the organization. Automated, well-functioning controls reduce the need for time-consuming and expensive manual intervention, but monitoring or mitigating controls at the process level might compensate for weaknesses in IT controls.

**Sponsored research (or payroll or general ledger):** What controls are in place? Are they manual or automated? Are periodic reconciliations performed? Is the review and approval evidenced?

For sponsored research, for example, review written policies and procedures for pre-award and post-award grants and contracts. Make sure that policies and procedures for high-risk areas (e.g., effort reporting, transfers, and subrecipient monitoring) are well documented.

**D. In the second year, consider reviewing controls over other areas, such as:**

**Contributions and fund-raising:** Make sure that policies for appropriately recognizing gifts for financial reporting purposes are in place. Consider the classification of gifts and the appropriateness of the cutoff at year-end.

**Endowment:** Points to consider include documenting: 1) the board's approval of endowment spending formulas, and 2) spending from endowments in accordance with donor restrictions and state laws. In addition, ensure proper allocation of yield and appreciation on a "by-fund" basis.

**Property, plant and equipment:** Document policies related to capitalization of expenditures. Evidence compliance with these policies. Also, document the accounting for capitalized interest and other borrowing-related activities, including derivatives.

**E. As you review the controls, consider the following questions:**

**How do you know your controls are effective?** What assurance do you have that staff are complying with policies and procedures? For example, does your institution have an internal audit function that tests transactions and processes periodically?

**Is there adequate segregation of duties?** Particularly for the financial closing process, consider segregation of duties. If you don't have enough staff to segregate duties adequately, establish monitoring or mitigating controls.

**Are spreadsheet controls in place for key management reports?** Most institutions rely heavily on spreadsheets for areas like endowment and pledges. Make sure that spreadsheets have appropriate version controls in place and consider providing password protection.

**What constitutes good documentation?** Begin with the basics. Is there a policy and procedure document for each major process/cycle? Has it been updated in the last few years? Are key controls documented? What about key assumptions and judgments? Are they documented?

Are the estimates that management has made about such areas as pension and postretirement obligations documented? Is the documentation adequate for significant reserves, such as uncollectible accounts receivable and pledges? Are journal entries appropriately documented? Do they evidence the appropriate approvals and review?

Does the documentation accurately depict what happens on a daily basis? It may be necessary to document the flow of transactions for significant accounts and disclosures to determine where material misstatements, due to error or fraud, could occur. In particular, document unique or significant transactions.

**What is the institution's responsibility for outside service organizations?**

Many institutions use external vendors to service student financial aid or manage investments. Keep in mind that management is still ultimately responsible and consider: Are conversations with external vendors about service and performance documented? How does management monitor the control activities of outside service organizations?

Service organizations usually undergo an in-depth audit of their control activities. At the conclusion of the audit, the auditor issues an authoritative “SAS 70” report, which includes the auditor’s opinion on the organization’s control activities. The report goes to the organization’s customers and their auditors. Institutions should obtain and review SAS 70 reports for their external service organizations. Make sure that the review is documented.

**Is the level of communication among management, internal and external auditors, and the audit committee adequate?** Communication is a three-way street. Formal communication requirements have been established by the AICPA in its auditing standards.

Formal communications include the following: The auditor must obtain written representations from management acknowledging that management is responsible for internal controls. Management’s representations become part of the auditor’s evidential matter. The auditor must communicate its audit findings to management and the audit committee as well as deficiencies in internal controls and judgments about the quality of the institution’s accounting principles, policies, and estimates.

### III. What is the Federal Government’s response?

We have discussed how the proposed new AICPA auditing standard will affect the financial statement audits of not-for-profit colleges, universities, healthcare entities and other types of not-for-profit organizations. What about the federal audits of these organizations?

The Government Accountability Office (GAO) released an Exposure Draft of a revised “Yellow Book” on June 7, 2006 that includes the same definitions for significant deficiency and material weakness as SAS 112. The GAO anticipates the effective date of the revised Yellow Book will be for audits with December 31, 2006 year-ends, the same effective date as SAS 112. The Yellow Book, which gets its title from the bright yellow cover of the printed book, contains Generally Accepted Government Auditing Standards (GAGAS) that auditors must follow when performing audits of organizations (e.g., colleges and universities) that receive federal funding.

For example, auditors must follow GAGAS when performing Office of Management and Budget (OMB) Circular A-133 audits. The federal government requires an A-133 audit be performed on organizations that expend \$500,000 or more in federal funds annually. OMB is currently in the process of incorporating the definitions of significant deficiency and material weakness in its Circular No. A-133, *Audits of States, Local Governments and Non-Profit Organizations*, so that they correspond to the definitions in the Yellow Book as well as SAS 112.

Under A-133, the auditor audits certain major federally funded programs, especially those that are considered to be high-risk. The auditor reports findings (i.e., control deficiencies) in the schedule of findings and questioned costs. The application of the new definitions will likely impact the number and type of internal control weaknesses reported in Yellow Book audits. Also, the new definitions will likely impact the risk criteria for major programs under OMB A-133.

### IV. Conclusion

The new definitions of significant deficiency and material weakness will lower the threshold for reportable control deficiencies and are likely to cause more deficiencies to rise to the level of significant deficiencies and material weaknesses, which must be reported in external financial statement audits. We believe that the most prudent course of action would be to take this opportunity to attend to the deferred maintenance in your control environment. Time is rapidly passing, since SAS 112 becomes effective for December 31, 2006 year-end audits. Start preparing now.

# Appendix I

SAS 112 includes the following three important 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.

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.

A **material weakness** is a significant deficiency, or a 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.

The underlined words in the above definitions are important and SAS 112 provides guidance to the auditor:

- *"More than a remote likelihood"* is defined as it is in FASB Statement No. 5, *Accounting for Contingencies*. Events are either "probable," "reasonably possible," or "remote." Probable means that the future event is likely to occur. Reasonably possible means that the chance of the event occurring is more than remote but less than likely. 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.
- *"More than inconsequential"* and *"material"* refer to the chances that the financial statements will be misstated. These terms require that the auditor consider what is material to the financial statements from both a quantitative and qualitative perspective. Although the auditor has had to consider materiality all along, SAS 112 establishes firmer boundaries than have previously existed.

SAS 112 also provides examples of circumstances that should be considered as at least significant deficiencies and strong indicators of material weakness. If the following controls are not effective, the auditor should consider them to be *at least significant deficiencies*:

- Controls over accounting principles in conformity with GAAP
- Antifraud programs and controls
- Controls over nonroutine and nonsystematic transactions
- Controls over period-end financial reporting process

If the following are not effective, the auditor should consider them to be *strong indicators of material weakness*:

- Oversight by governing board
- Internal audit or risk management function
- Compliance function in highly regulated industries
- Control environment

In addition, if the following circumstances exist, the auditor should consider them to be *strong indicators of material weakness*:

- Restatement of prior year financial statements to reflect correction of material misstatement
- Auditor's identification of a material misstatement that was not caught by internal controls
- Identification of fraud
- Failure to assess the effect of a previously communicated significant deficiency and to either correct it or conclude that it will not be corrected

## About the authors

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