



UNDERSTANDING SASs #112 and #104 to #111

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SOX is here to stay

- Sarbanes-Oxley Act
 - Portions now applicable to all entities (including governments and not-for-profits)-just different forms and shapes
 - Don't be surprised if more keeps coming
 - We may not like it or agree with it, but we do have to live with it, so here we go...

TEAMWORK



OVERVIEW OF SAS #112

■ SAS#112

- Renewed emphasis on financial statements and the internal controls over financial reporting
- New definitions that will likely result in more findings and management letter comments being put in writing as opposed to communicated orally
- Effective for periods ending December 31, 2006 and after

TEAMWORK



OVERVIEW OF SAS #112

■ SAS#112

- Renewed emphasis on financial statements and the internal controls over financial reporting
 - Material weakness or significant deficiency if internal staff, in the judgment of the external auditors, do not have the ability to understand (and therefore prepare) their own financial statements
 - The entity does not have to prepare the financial statements, but they do have to show they have the ability to prepare them by performing a “critical review”



OVERVIEW OF SAS #112

- SAS#112
 - “Critical review” is a GF&H term
 - Two primary areas for general improvement to get a “passing grade”
 - Government wide statements and GASB 34 adjustments
 - Notes/disclosure checklist

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SAS#112-Old Versus New

Old Definitions	New Definitions
Material weakness	Material weakness
Reportable condition	Significant deficiency
Management letter comment (under Yellow Book only)	Other matters related to internal control



SAS#112-Old Definitions

- ***Reportable conditions*** involve matters coming to the auditors attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, *could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.*
- A ***material weakness*** is a reportable condition in which the design or operation of one or more of the internal control components *does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected* within a timely period by employees in the normal course of performing their assigned functions.



SAS No. 112

- Conforms definitions of *control deficiency*, *significant deficiency*, and *material weakness* to those in PCAOB AS#2 . The term *significant deficiency* replaces the term *reportable condition*
- Requires written communication of significant deficiencies and material weaknesses to management and those charged with governance.
 - Should be communicated even if they were communicated in connection with previous audits

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SAS No. 112

- **A CONTROL DEFICIENCY** exists when the *design* or *operation* of a control does not allow management or employees, in the course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- Control deficiencies may involve one or more of the five interrelated components of internal control



SAS No. 112

- Control deficiencies may involve one or more of the five interrelated components of internal control
 - Control environment
 - Risk assessment
 - Control activities
 - Information and communication
 - Monitoring

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SAS No. 112

- A ***significant deficiency*** is a control deficiency, or combination of control deficiencies ... 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 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.



Remote Likelihood

- Remote likelihood has the same meaning as in FASB Statement No. 5
- Remote is defined such that the chance of the future events or events occurring is slight
- Therefore, the likelihood of an event is “more than remote” when it is at least possible
- Leaves a lot of room for professional judgment used by the auditors



More Than Inconsequential

- More than inconsequential describes the magnitude of potential misstatement that could occur as a result of a significant deficiency
- Misstatement is “inconsequential” if a reasonable person would conclude that it would clearly be immaterial to the financial statements
- In determining whether potential misstatement would be more than inconsequential, auditor should consider qualitative and quantitative factors
- A potential misstatement that is less than 20% of overall financial statement materiality may be inconsequential



Evaluating Deficiencies

- Provides guidance in evaluating:
 - Deviations in the design or operation of controls and whether those deviations constitute control deficiencies
 - The severity of control deficiencies
 - Based on nature, likelihood, and magnitude
 - Whether misstatements or potential misstatements are “more than inconsequential”
- Examples of factors that may affect the likelihood that a control could fail to prevent or detect a misstatement
 - Susceptibility to loss or fraud
 - Subjectivity and complexity of the amount involved
 - Cause and frequency of any known or detected exceptions related to the operating effectiveness of a control



Evaluating Deficiencies

- Several factors affect the magnitude of a misstatement that could result from a deficiency including the following:
 - F/S amounts or total of transactions exposed to the deficiency
 - Volume of activity in the account balance or class of transactions exposed to the deficiency
- Auditor should also evaluate compensating controls



Evaluating Deficiencies

- SAS identifies control deficiencies that ordinarily would be considered at least significant deficiencies-see handout
- Also identifies circumstances that should be regarded as at least a significant deficiency and a strong indicator of a material weakness-see handout
- After concluding on severity of deficiency (control deficiency, significant deficiency, material weakness), to consider whether “prudent individuals” having knowledge of facts and circumstances would come to same conclusion.



UNDERSTANDING AND PREPARING FINANCIAL STATEMENTS-WHY?

- So what are your choices when it comes to internal controls over financial reporting?
 - If already have ability, convince your auditors
 - Obtain ability through internal and external training over time
 - Accept the fact that there is going to be a material weakness or significant deficiency finding in the compliance section of your financial statements
 - Educate management and council/board
 - Get management and council/board to agree with you as to your course of action



UNDERSTANDING AND PREPARING FINANCIAL STATEMENTS-RESOURCES

- GFOA Blue Book
- PPC and similar entities
- Your own financial statements
- Your external auditors
- Training classes

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SAS #104-111

- Risk assessment standards
- Objective of the standards is to promote utilization of the audit risk model by requiring:
 - Greater understanding of the entity and its environment, including internal control
 - More rigorous assessment of the risks of material misstatement in financial statements
 - Better linkage between assessed risks and nature, timing and extent of audit procedures



SAS #104-111

- Effective for periods beginning after December 15, 2006 (December 31, 2007 period end and later)

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Audit Risk Model

- $AR = (CR \times IR) \times DR$
 $(CR \times IR) = RMM$
- AR=audit risk
- CR=control risk (controlled by entity)
- IR=inherent risk (controlled by entity)
- DR=detection risk (controlled by auditor)
- RMM=risk of material misstatement



Enterprise Risk Management

- Risk of material misstatement is one aspect of a larger entity-wide risk model:

Enterprise Risk Management Model

- See handouts on *COSO-internal controls and enterprise risk management*.

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Overview of Risk Assessment Standards

- ***Reasonable assurance*** now means a “high level of assurance” (SAS 104)
- ***The entity and its environment, including its internal control*** replaces “internal control” (SAS 105)
- ***Management’s assertions***-implicit or explicit assertions regarding the recognition, measurement, presentation and disclosure of information in the financial statements, notes, MD&A, etc. (SAS 106)



Management Assertion Overview

Management Assertion Framework

Classes of Transactions	Account Balances	Presentation and Disclosures
Occurrence	Existence	Occurrence and rights and obligations
Completeness	Rights and obligations	Completeness
Accuracy	Completeness	Classification and understandability
Cutoff	Valuation and allocation	Accuracy and valuation
Classification		

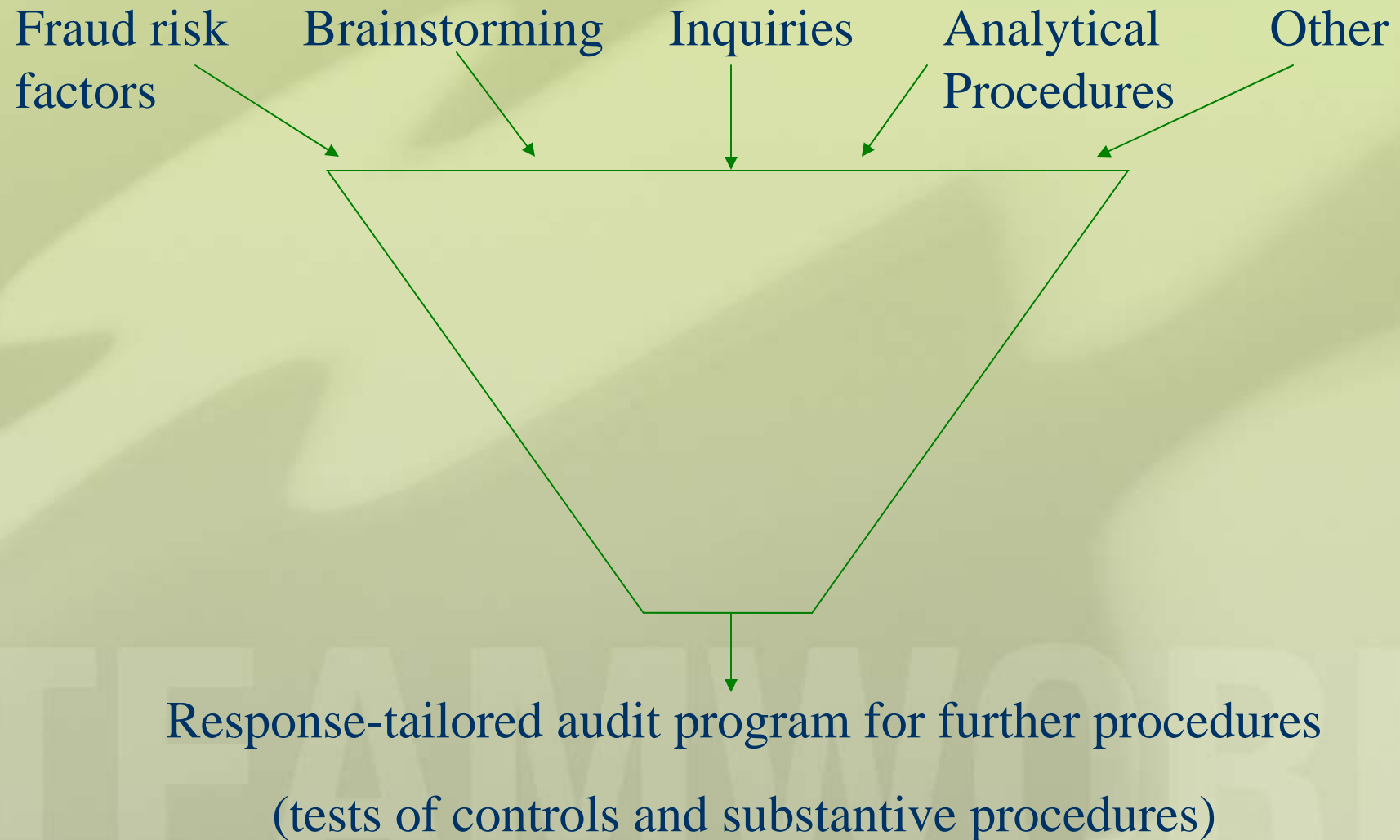


Overview of Risk Assessment Standards

- ***Audit risk*** must be considered at the financial statement level and the assertion level (SAS 107)
- ***Assessing risk***
 - the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing and extent of further audit procedures (SAS 109)
 - Continual process throughout the audit



Risk Assessment Overview





Overview of Risk Assessment Standards

- ***Sufficient understanding of internal controls*** includes (SAS 109):
 - Evaluating design of controls relevant to audit
 - Determine whether the controls have been implemented
 - Inquiry alone is NOT sufficient audit evidence to accomplish the two items above (no matter what the type or size of entity)

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Overview of Risk Assessment Standards

- A clear *linkage* must exist between audit risk assessment and the further audit procedures (SAS 110)
- A test of controls **MUST** be performed (SAS 110)
 - May be rotated (must test at least every 3 years)
 - If plan to rely on controls that mitigate significant risks, auditor must test those controls in period of audit (can't rotate)
 - Must update understanding annually
 - Must test changed controls if going to rely



SO WHAT?

- Expect communication from auditors of more material weaknesses and significant deficiencies (orally and in writing)
- Higher expectations at your entity regarding implementation of enterprise risk management (risk assessment program, anti-fraud program, etc.)
- Must have evidence that controls are in place (initials, dates, signatures, etc.)



SO WHAT?

- Significantly more expectations of external auditors
 - Moved from gaining understanding of internal controls to gaining understand of the entity and its environment, including internal controls, and testing implementation of those controls
 - More documentation of risk assessment and linkage to audit procedures
 - Significantly more time and fees (see GFOA article)