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- Type your question
- Click on Submit

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SAS 112: Communicating Internal Control Related Matters Identified in an Audit

June 22, 2006
Agenda

I. Overview of SAS 112
II. GAO and OMB Implications
III. Issues and Practical Guidance
IV. Institutional Impact
V. Integration with Other Initiatives
VI. Q&A
I. Overview of SAS 112
SAS 112

- Issued May 25th as Communicating Internal Control Related Matters Identified in an Audit
- Effective for periods ending on or after 12/15/06
- Supersedes SAS 60
- Makes definitions consistent with PCAOB’s 2nd auditing standard (AS2), An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements
- Focus is on “potential” exposure (versus actual exposure)
Three Categories of Control Deficiencies

1. 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.

2. 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.

3. 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.
Auditor Considerations

- 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?
Examples of Control Deficiencies

• At least significant deficiencies:
  – Controls over accounting principles in conformity with GAAP
  – Antifraud programs and controls
  – Controls over non-routine and non-systematic transactions
  – Controls over period-end financial reporting process
Examples of Control Deficiencies, continued

Strong Indicators of Material Weakness

- Ineffective: 1) oversight by governing board, 2) internal audit or risk management function, 3) compliance function in highly regulated industries, or, 4) control environment
- 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
Specific Auditor Communications

- Auditor must communicate control deficiencies noted by auditor during course of audit in writing
- Communications made to management and “those charged with governance”
- Should communicate by report release date but must do so no later than 60 days following the report release date
- Interim communications do not have to be written
- Auditor may communicate orally or in writing other matters of potential benefit to client
Key Point

• The new SAS is effective for June 30, 2007 audits.

SAS 112 “lowers the control bar,” increasing the likelihood that control deficiencies will be categorized as significant.
II. GAO and OMB Implications
Government Auditing Standards 2006 Revision

• Exposure Draft of 2006 Revision of Government Auditing Standards was released by GAO on June 7, 2006.

• Updates the definitions and terminology for internal control deficiencies to achieve consistency with SAS 112 and PCAOB approach.
Government Auditing Standards 2006 Revision, continued

• Incorporates the new definitions into the auditor’s traditional internal control reporting responsibilities under Government Auditing Standards

• This revision will likely impact the number and type of internal control weaknesses reported in Yellow Book audits.
Internal Control Deficiencies

• For all financial audits, auditors should report deficiencies in internal control considered to be significant deficiencies, including material weaknesses.

• Auditors should include all material weaknesses and other significant deficiencies in the auditor’s report on internal control.
• Auditors should communicate deficiencies that are not significant deficiencies or material weaknesses separately in a management letter, unless clearly inconsequential.

(Exposure Draft, 2006 Revision, paragraphs 5.15 & 5.18)
In addition to qualitative considerations, auditors evaluate the following when concluding about the significance of a deficiency in internal control:

– the likelihood that a deficiency, or combination of deficiencies, could result in a misstatement of an account balance or disclosure, and

– the magnitude of the potential misstatement resulting from the deficiency or deficiencies.

(Exposure Draft, 2006 Revision, paragraph 5.14)
<table>
<thead>
<tr>
<th>Old Definitions</th>
<th>New Definitions</th>
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<tbody>
<tr>
<td>Material weakness <em>(GAGAS paragraph 5.14 and AU 325.15)</em></td>
<td>Material weakness <em>(SAS 112, Paragraph 6)</em></td>
</tr>
<tr>
<td>Reportable condition <em>(GAGAS paragraph 5.13 and AU 325.02)</em></td>
<td>Significant deficiency <em>(SAS 112, Paragraph 6)</em></td>
</tr>
<tr>
<td>Management letter comment <em>(GAGAS paragraph 5.16)</em></td>
<td>Other matters related to internal control <em>(SAS 112, Paragraph 24)</em></td>
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Impact and Practical Issues

• The application of the new definitions will likely impact the number and type of internal control weaknesses reported in Yellow Book audits.

• The new definitions and impact will likely impact the risk criteria for major programs under OMB A-133.
Impact and Practical Issues, continued

• The internal control deficiency definitions may be further clarified in the future by the standards-setters.
• GAO has specifically requested comments on these matters.
• Business managers/CFO’s should take certain actions before the new definitions become effective.
Contact Information

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franzelj@gao.gov  202-512-9471

The Yellow Book is available on GAO’s website at: www.gao.gov/
For technical assistance, contact us at: yellowbook@gao.gov
III. Issues and Practical Guidance
Changing Environment

- Continuing momentum of Sarbanes into the private and non-profit sectors
- Reduced materiality thresholds (expectation of regulators)
- Decreasing tolerance for errors
- Changing expectations of stakeholders
- Audit methodology changes – focus on the Single-audit approach (an integrated audit process)
- Re-emphasis of testing for “effective operating controls”
Impact of SAS 112

Anticipate:

– A greater number of significant deficiencies and material weaknesses than reported in the past
  Absent preventative measures prior to adoption

– Increased disclosure / reporting of deficiencies to:
  (1) trustees, (2) federal sponsors, (3) possibly to 3rd party creditors, (4) donors, (5) accrediting agencies, (6) rating agencies, and (7) insurers
Issues Specific to Higher Education

- Decentralized structure
- Resource-constrained finance organizations
- Over-reliance on manual processes
- Level of “informal controls” (and lack of process documentation)
- Reliance on complex spreadsheets
- Questions around the effectiveness of IT general computer controls
- Over-reliance on your auditor / lack of internal expertise
- Recurring errors identified as part of the audit process
- Difficulty in the “annual close” process (financial close process)
- Federally sponsored research and student financial aid - GAO / OMB
Practical Guidance

How Should You Respond?

• First, educate your board and senior management
• Commence with a comprehensive risk assessment
• Accept / confront known “weaknesses
• Inventory your significant accounts, disclosures, as well as significant processes and cycles
• Develop project plan to prepare for SAS effective date, including verification that key controls are operating effectively
Practical Guidance – Areas of Focus

- **Account reconciliations** (timeliness of reconciliations, evidence of review, disposition of reconciling items)

- **Journal entries** (review and approval in accordance with your institutions’ policies and procedures; entry support)

- **Investments and Endowment Fund Management**
  - Effectiveness of monitoring controls over investments / alternative investments, including controls that address the valuation and existence financial statement assertions
    - Changes in investments / funds; vetting of new alternative investments
    - Ongoing monitoring of investments and related valuation (site visits, annual meetings, etc.)
    - Review and documentation of audited financial statements of alternative investments
    - Benchmarking and other monitoring controls (especially for alternative investments)
    - Reconciliation of information with custodian
Practical Guidance – Areas of Focus

• Investments and Endowment Fund Management, continued
  – Examination of account reconciliation activities, including evidence of review (segregation of duties)
  – Controls to ensure appropriate categorization of investment return
  – Reconciliation of endowment gifts with your institution’s Endowment and Development Offices

• Judgments, Estimates and Key Transactions
  – Formal documentation of accounting conclusions (qualitative and quantitative considerations, support for metrics utilized, and appropriate consideration of technical accounting guidance, as applicable)
  – Review and approval of accounting conclusions (segregation of duties)
Practical Guidance – Areas of Focus

• **Releases of restricted funds**
  - Assessment of how amounts are quantified for financial purposes (accuracy and completeness of transfers)
  - Monitoring controls over releases of restrictions
  - Adequacy of segregation of duties

• **Contributions Receivable / Revenue**
  - Reconciliation of contribution revenue recognized to supporting systems
  - Adequacy of evidence of contribution supporting accounting treatment

• **Information Technology Controls – focus in the following areas:**
  - Change management
  - Segregation of duties, restricted access
  - Security; Physical operations
Practical Guidance – Areas of Focus

• **Accounts Payable**
  – Effectiveness of controls to ensure proper “cutoff” of payables at period end

• **Financial statement preparation controls**
  – Review and approval of disclosure checklist
  – Reconciliation of financial statements and footnotes to books and records
  – Review and approval of cash flow reconciliation
  – Adequacy of segregation of duties related to each amount within the financial statements

• **Other Areas**
  – Key reports (controls to allow management to rely on key reports)
  – Spreadsheet controls
  – Cost capitalization (especially if you have significant capital projects)
IV. Institutional Impact
University of Notre Dame (ND)
University of Notre Dame (ND)

- $840 million operating budget
- $3.7 billion endowment
- 11,500 students
- 4 undergraduate colleges; Graduate School, Business School, Architecture, and Law School
- 10 major research institutes
- Rated among the top 25 institutions of higher learning in surveys conducted by *U.S. News and World Report*, *Princeton Review*, *Time*, *Kiplinger's*, and *Kaplan/Newsweek*.
Impact on a Larger Institution

<table>
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<tr>
<th>Impacted Audit Areas</th>
<th>University Response</th>
<th>Integration Opportunities</th>
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<tbody>
<tr>
<td><strong>Risk and Control Environment:</strong>&lt;br&gt;  - Research compliance/administration&lt;br&gt;  - Risk assessment process&lt;br&gt;  - Tax compliance&lt;br&gt;  - Fraud reviews&lt;br&gt;  - International operations&lt;br&gt;  - Retirement/post-retirement plans&lt;br&gt;  - IT systems (data integrity/security)&lt;br&gt;<strong>Financial Statement Control Activities:</strong>&lt;br&gt;  - Financial statement close&lt;br&gt;  - Investment valuations&lt;br&gt;  - Documentation/support of journal entries&lt;br&gt;  - Account reconciliations&lt;br&gt;  - Contract compliance&lt;br&gt;  - Identification/implementation of new accounting/reporting standards&lt;br&gt;  - Routine transaction processing&lt;br&gt;  - Cash receipts&lt;br&gt;  - Cash disbursements&lt;br&gt;  - Payroll</td>
<td><strong>Discuss impact on external audit</strong>&lt;br&gt;  - Inform and prepare units&lt;br&gt;  - Inform and prepare officers and board members&lt;br&gt;  - Assess stakeholder impact&lt;br&gt;  - Heighten awareness of control environment&lt;br&gt;  - Review and update policies and procedures&lt;br&gt;  - Simulate early adoption&lt;br&gt;  - Take corrective action as needed&lt;br&gt;  - Develop training for new and existing employees as needed&lt;br&gt;  - Systematically review internal controls going forward</td>
<td><strong>ERP and ancillary systems implementation and documentation</strong>&lt;br&gt;  - Consolidation of risk management activities&lt;br&gt;  - Central committee&lt;br&gt;  - ERP planning&lt;br&gt;  - Other committees&lt;br&gt;  - Tax compliance&lt;br&gt;  - Research compliance&lt;br&gt;  - IT Risk Assessment&lt;br&gt;  - PCI&lt;br&gt;  - Internal audit work plan&lt;br&gt;  - Response to NACUBO Advisory Report 2003-3&lt;br&gt;  - Establishment of collaborative risk identification and management mind-set</td>
</tr>
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Impact on Smaller Institutions
Considerations for Smaller Institutions

- Scope and composition of financial position should make SAS 112 more manageable for smaller institutions
  - Less issue related to decentralization
  - Fewer IT systems (with lower level of complexity)
  - Lower level of federal awards
  - Less complex balance sheet
    - Fewer alternative investments and complex accruals
    - Lower level of “unique contributions”
    - Fewer complex accounting transactions / contracts
Considerations for Smaller Institutions

• However, size / nature of institution’s finance function creates risk -
  • Informal controls; lack of process documentation
  • Segregation of duties issues
  • Financial close process generally performed annually
  • Lower level of financial statement materiality
  • Over-reliance on complex spreadsheets
  • Greater degree of reliance on the external auditor
  • Lack of internal accounting expertise
Considerations for Smaller Institutions

SAS 112 implementation similarities – consistent preparation process for adoption

• Communication plan to Senior Management / Board
• Risk assessment process (“top down” approach)
• Identification of “Known Weaknesses”
• Scoping
• Development and implementation of project plan
Considerations for All Institutions

Key Take-Away Points -

• Engage in dialogue with Senior Management, Board and your auditor

• Critical to get “project plan” in place - - once behind, difficult to recover.

• Perform scoping / risk assessment as part of your 2006 audit (or sooner)

• Identify resource needs now - - if outsource, identify as soon as possible

• Ensure you are not “surprised” in 2007 by the reporting of control deficiencies; if deficiencies exist, you should be aware of them prior to the audit
V. Integration with Other Initiatives
Integrating SAS 112

- SAS 112 does not have to be a stand-alone project or one more thing to do for the auditors
- Integrate SAS 112 action plans with other initiatives
## Integration Examples

<table>
<thead>
<tr>
<th>Initiative</th>
<th>SAS 112</th>
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<tbody>
<tr>
<td>IT Systems (implement, upgrade, review)</td>
<td>Inadequate design of information technology (IT) general and application controls may be a significant deficiency or material weakness.</td>
</tr>
<tr>
<td>Enterprise Risk Management</td>
<td>An ineffective risk assessment function is at least a significant deficiency and a strong indicator of a material weakness at an entity for which such a function is important to the risk assessment component of internal control.</td>
</tr>
<tr>
<td>Implementation of Sarbanes-Oxley best practices (e.g., governance)</td>
<td>Ineffective oversight of financial reporting and internal control by those charged with governance is at least a significant deficiency and a strong indicator of material weakness.</td>
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## Integration Examples, continued

<table>
<thead>
<tr>
<th>Initiative</th>
<th>SAS 112</th>
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</thead>
<tbody>
<tr>
<td><strong>Compliance Program</strong></td>
<td>An ineffective regulatory compliance function is at least a significant deficiency and a strong indicator of a material weakness at an entity for which violations of laws and regulations could have a material effect on the reliability of financial reporting.</td>
</tr>
<tr>
<td><strong>Process Improvement (e.g., financial close)</strong></td>
<td>The financial closing process is particularly important under SAS 112. At least a significant deficiency and a strong indicator of a material weakness in internal control would be: 1) Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud, and 2) Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity’s internal control. This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)</td>
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</table>
## Integration Examples, continued

<table>
<thead>
<tr>
<th>Initiative</th>
<th>SAS 112</th>
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<tbody>
<tr>
<td>Internal Audit</td>
<td>An ineffective internal audit function is at least a significant deficiency and a strong indicator of a material weakness at an entity for which such a function is important to the monitoring component of internal control.</td>
</tr>
<tr>
<td>Anti-Fraud Program</td>
<td>The identification of fraud of any magnitude on the part of senior management is at least a significant deficiency and a strong indicator of a material weakness.</td>
</tr>
<tr>
<td>Outsource Functions (e.g., investment management)</td>
<td>An ineffective control environment is at least a significant deficiency and a strong indicator of a material weakness. Management is responsible for oversight over outsourced functions.</td>
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</table>
VI. Q&A
Thank You For Your Participation

Please complete our online evaluation