



The Power of Experience®

SAS No. 112

What you may not want to know, but need to know

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Introduction

SAS No. 112

- SAS No. 112 establishes standards and provides guidance on matters related to financial reporting (internal control).

Why Was it Introduced?

- The Sarbanes-Oxley Act of 2002 and the issuance of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2.
 - Generated interest in management's responsibility for internal control.
 - Auditor's responsibility for bringing certain internal control related matters to management's attention.
- The ASB believed there was a need to reconsider and clarify the internal control matters that auditors must communicate.

Introduction - continued

Disparity in standards between for-profit and not-for-profit entities:

- AICPA issued the Statement on Auditing Standards (SAS) 112 in May 2006.
- Effective for the 2007 fiscal year.

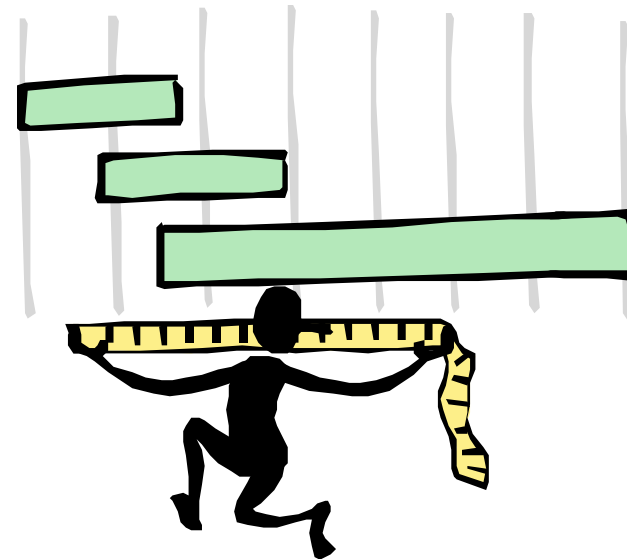
The goal was to make the standards for audits of not-for-profits consistent with those of public companies:

- To comply with federal, state and local laws, rules and regulations and University policies.
- To prevent fraud.
- To highlight positive and negative aspects of an entity.
- To alert management and other concerned parties of required courses of action.

Introduction - continued

What does SAS No. 112 do?

- In general, SAS No. 112 provides guidance to identify and evaluate control deficiencies during an audit.
- Highlights conditions that lead to communications with management and those charged with governance.



SAS 112 Overview

- Reflects several changes from the earlier SAS 60.
- Significant deficiencies and material weaknesses:
 - Must be communicated in writing to management and those charged with governance as part of each audit.
 - This communication includes significant deficiencies and material weaknesses that were communicated and have not yet been remediated.
- The term “reportable condition” is no longer used.
 - “Significant deficiency” and “material weakness” are used in place of “reportable condition.”



SAS 112 Overview - continued

- Potential control deficiencies must be carefully examined.
- A decision is made as to whether or not they are significant deficiencies or material weaknesses.
 - Link identified control deficiencies to actual or potential financial statement misstatements.
- The communication is best made by the report release date, but should be made no later than 60 days following the report release date.



Identifying Control Deficiencies

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.

Types

- A **deficiency in design** exists when:
 - A control necessary to meet the control objective is missing.
 - An existing control is not properly designed so that, even if it operates as designed, the control objective is not always met.
- A **deficiency in operation** exists when:
 - A properly designed control does not operate as designed.
 - The person performing the control does not possess the necessary authority or qualifications to perform the control effectively.



Auditor's Responsibility

When conducting an audit of historical financial statements, auditors are not required to perform procedures to identify control deficiencies. However, during an audit, they may become aware of deficiencies.

Auditors may identify control deficiencies at any point when:

- Obtaining an understanding of the entity's internal control.
- Assessing the risks of material misstatement of the financial statements due to error or fraud.
- Performing further audit procedures to respond to assessed risk.
- Communicating with management or others (for example, internal auditors or governmental authorities).



Evaluating Control Deficiencies

Definitions of Significant Deficiency and Material Weakness:

- **Significant Deficiency** - 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 (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.
- **Material Weakness** - It 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.

The significance of a deficiency in internal control **depends on the potential for misstatement** in the financial statements being audited, not just on whether a misstatement has actually occurred.

Factors to Consider

The factors to be considered when evaluating control deficiencies are:

- **Likelihood** - refers to the probability that a control, or combination of controls, could have failed to prevent or detect a misstatement in the financial statements being audited. If, in your professional judgment, it is at least reasonably possible that a misstatement could have occurred because of a missing control, or because of the failure of a control or combination of controls, then the likelihood is more than remote.
- **Magnitude** - refers to the extent of the misstatement that could have occurred, or that actually occurred, since misstatements can be both potential and actual.



The Magnitude Scale

The magnitude of a misstatement may be:

- ***Inconsequential*** - If a reasonable person would conclude that the misstatement, individually or in aggregated with other misstatements, would clearly be immaterial to the financial statements.
- ***More than inconsequential*** - If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.
- ***Material Weakness*** - If the misstatement would have been material to the financial statements, the control deficiency is a material weakness.



Evaluation Matrix

| Magnitude of Misstatement - real or potential | Likelihood of Misstatement | |
|--------------------------------------------------|----------------------------------------------------------------------------|----------------------------------------------------------------------------|
| | More Than Remote | Remote |
| Quantitatively or Qualitatively Material | Material Weakness | Control Deficiency But Not a Significant Deficiency or a Material Weakness |
| More Than Inconsequential But Less Than Material | Significant Deficiency But Not a Material Weakness | Control Deficiency But Not a Significant Deficiency or a Material Weakness |
| Inconsequential (i.e., Clearly Immaterial) | Control Deficiency But Not a Significant Deficiency or a Material Weakness | Control Deficiency But Not a Significant Deficiency or a Material Weakness |

The Prudent Official Test

When evaluating the significance of a deficiency, the last step in the evaluation is to conclude whether a prudent official, having knowledge of the same facts and circumstances, would agree with your classification of the deficiency.

- Would a prudent official be comfortable with your conclusion?
- If not, you should reconsider your evaluation looking through the skeptical lens of a prudent official.



Communication

All control deficiencies deemed as significant as well as material weaknesses must be communicated.

- Communicate in writing to management and those charged with governance.
- If significant deficiencies and material weaknesses were communicated in previous audits and those deficiencies have not yet been remediated, they must be communicated again.
- Communication should be issued no later than 60 days following the report release date.



Likelihood

Examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect a misstatement are:

- The nature of the financial statement accounts, disclosures, and assertions involved.
 - Suspense accounts and related party transactions involve greater risk.
- Susceptibility of the related assets or liability to loss or fraud.
- Subjectivity and complexity of the amount involved.
- Cause and frequency of any known or detected exceptions relating to the operating effectiveness of a control.
- Interaction or relationship of the control with other controls.
- Interaction of the control deficiency with other control deficiencies.
- Possible future consequences of the deficiency.

Magnitude

Factors that could affect the magnitude of a misstatement that could result in a deficiency in controls include:

- Financial statement amounts or total of transactions exposed to the deficiency.
- Volume of activity in the account balance or class of transactions exposed to the deficiency.



Control Deficiencies

Deficiencies in the design of controls may include the following:

- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization.
 - The tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.



Control Deficiencies - continued

- Absent or inadequate controls over the safeguarding of assets.
- Inadequate design of information technology (IT) general and application controls that prevent the system from providing complete and accurate information.
- Employees or management who lack the qualifications and training to fulfill their assigned functions.
- Inadequate design of monitoring controls used to assess the operating effectiveness of the entity's internal control.
- Absence of a process to report deficiencies in internal control to management on a timely basis.



Failures in Design

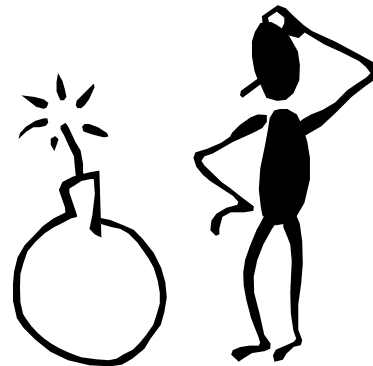
Failures in the operation of internal control may include the following:

- Failure in the operation of effectively designed controls over a significant account or process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation.
- Failure to perform reconciliations of significant accounts.
- Undue bias or lack of objectivity by those responsible for accounting decisions.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

Significant Deficiencies

Control deficiencies in the following areas are considered “significant,” at a minimum:

- Controls over the selection and application of accounting principles that are in conformity with GAAP.
- Antifraud programs and controls.
- Controls over non-routine and non-systematic transactions.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger.



Material Weaknesses

The following circumstances are an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight by those charged with governance of the entity's financial reporting and internal control, or an ineffective overall governance structure.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.
- Identification by the auditor of a material misstatement in the financial statements that was not initially identified by the entity's internal control.
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control.

Material Weaknesses - continued

- For complex entities in highly regulated industries, an ineffective regulatory compliance function.
- Identification of any fraud on the part of senior management.
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment.



Evaluation Questions

In evaluating the severity of a control deficiency, the first step is to ask whether the deficiency is at least a significant deficiency.

- Is the likelihood that a misstatement of any magnitude could occur and not be detected by the client's controls at least reasonably possible?
- Is the magnitude of a potential misstatement inconsequential or less than inconsequential to the financial statements?
- Are there complementary or redundant controls that were tested and evaluated that achieve the same control objective?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to inconsequential?



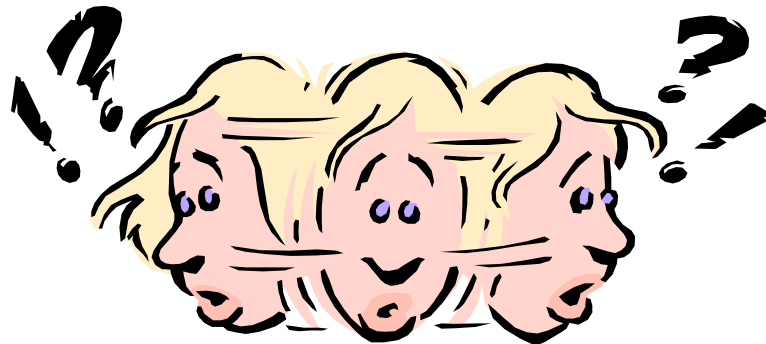
Evaluation Questions

- If the answers to these questions are all no, then the deficiency is at least a significant deficiency.
- If the answer to any question is yes, before concluding that the control deficiency is not at least a significant deficiency ask yourself:
 - Would prudent officials, having my knowledge of the facts and circumstances, agree with my conclusion that the deficiency is or is not at least a significant deficiency?

Evaluation Questions

The next step is to assess whether the deficiency is a material weakness. Some questions to ask yourself in making this determination include:

- Is the magnitude of the potential misstatement less than material to the financial statements?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to less than material but more than inconsequential?
- Does additional evaluation result in a judgment that the likelihood of a material misstatement of the financial statements is remote?



Evaluation Questions

- If the answers to these questions are all no, then the deficiency is a material weakness.
- If the answer to any question is yes, before concluding that the deficiency is not a material weakness, ask yourself:
 - Would prudent officials, having my knowledge of the facts and circumstances, agree with my conclusion that the deficiency is or is not a material weakness?



Example 1

Situation:

- Your client is a small nonprofit organization that has only one person in charge of the accounting and reporting functions.
- Through your understanding of controls over cash disbursements, you observe a lack of segregation of duties, which is a control deficiency.
- In assessing the severity of the control deficiency, you consider whether there are complementary, redundant, or compensating controls.

Example 1

Discussion:

- Your assessment would be based on the effectiveness of the compensating controls performed by the board members.
 - Compensating controls do not eliminate the deficiency but may mitigate its effects.
- If the board member does not perform a review of the bank statement and the returned checks, you might feel that the compensating control over disbursements is not effective in achieving the control objective and therefore, there is a material weakness.
- If the board member reviews only returned checks over a certain dollar amount, you might conclude that the compensating control is effective in preventing or detecting a material misstatement of cash and therefore, may be considered a significant deficiency since the magnitude of the reasonably possible misstatement is less than material but more than inconsequential.

Example 1

- However, if the board member examines the returned checks for the appropriate signature and alterations, you might conclude that the compensating control is effective in preventing or detecting an unauthorized disbursement, making the likelihood of a misstatement remote; therefore, this is only a control deficiency and not a significant deficiency or material weakness.

Example 2

Situation:

- Your client is a small not-for-profit organization that receives most donations by check from corporate donors.
- Some donations are made in cash.
 - Cash donations are not material to the financial statements.
- As a result of your understanding of internal control, you notice that there are no controls over cash receipts.
 - In planning your audit, you identify this as a fraud risk and you perform additional auditing procedures relative to cash receipts.
 - Through inquiry, you learn that someone may be stealing cash.
 - You notify management and as a result of performing certain audit tests you discover evidence that indicates an employee was pocketing cash and cash donations were not being recorded.

Example 2

Discussion:

- Your judgment is that the likelihood of a misstatement is more than remote, as the fraud has occurred.
- The magnitude of the potential financial misstatement resulting from this deficiency would be more than inconsequential but less than material, as total cash sales are less than material.
- Thus, this deficiency is at least a significant deficiency.
- However, because your client is a not-for-profit organization, because cash is a sensitive area, and because fraud is involved, you step back and try to look at this situation from a prudent official's perspective.
- Your judgment is that a prudent official would probably view an absence of controls over cash receipts as a material weakness.
 - Therefore, you conclude that this is a material weakness.

About Treasury Strategies, Inc.

Who We Are

Treasury Strategies, Inc. is the leading Treasury consulting firm working with corporations, financial institutions, and securities firms. Our experience and thought leadership in treasury management, liquidity, working capital management, and payments, combined with our comprehensive view of the market, rewards our clients with a unique perspective, unparalleled insights and actionable solutions.

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Questions????



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