UNIVERSITY OF LOUISVILLE
It's Happening Here.

New Auditing Standards Impact the Conduct of the Annual Audit

In the last couple of years new auditing standards have been issued that affect the nature, timing and extent of audit procedures performed by the external auditors of annual financial statements. One of the new standards changes what and how results of the audit are reported. This document describes some of the requirements of this standard and how it will impact UofL.

I. What is "SAS 112" and why does it concern UofL?

In May 2006, 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*. The AICPA establishes auditing standards generally accepted in the United States that certified public accountants and government auditors must follow in conducting of audits of state and local governments and universities. SAS No. 112 establishes standards, responsibilities and guidance for independent auditors during a financial statement audit engagement for identifying and evaluating a client's internal control over financial reporting. This standard requires the auditor to report *in writing* to management and the Board of Trustees / Directors any control deficiencies found during the audit that are considered significant deficiencies and/or material weaknesses.

Specifically this SAS 112 does the following:

• Defines the terms *significant deficiency* and *material weakness.*

• Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements.

• Requires the independent auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

You may be familiar with the terms *reportable conditions* and *material weakness,* but the use of these terms has changed. While the SAS No. 112 keeps the term material weakness, it modifies the definition and introduces new definitions for the following terms:

• A *control deficiency* exists when the design, or operation of a control, does not allow management or its employees, in the normal course of performing their assigned functions, to prevent or detect misstatements of the financial statements on a timely basis.

• A *deficiency in design* exists when a control necessary to meet the control objective is missing, or the 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 or the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

• A *significant deficiency* is a control deficiency or a combination of control deficiencies that adversely affects the University'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 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.

II. New Definitions and Old Definitions – what is the impact?

Because of the standard's more stringent reporting definitions, the number and type of findings relating to internal control over financial reporting or significant deficiencies and/or material weaknesses may increase in the schedule of findings and recommendations or similar letter issued by the auditors as a result of the audit of your financial statements. SAS No. 112 establishes standards for auditors concerning communicating matters related to an entity's internal control. Throughout the audit community, SAS No. 112 will have a significant impact on the number of findings and how those findings are reported. In addition, the auditor will likely be required to gather more documentation and evidence to support those findings.

SAS No. 112 will affect every audit of Kentucky's public universities, whether conducted by the Office of the State Auditor or an independent CPA firm. Many government audits are also performed in accordance with *Government Auditing Standards* issued by the Government Accountability Office (GAO). The GAO has incorporated the same definitions for significant deficiency and material weakness as SAS No. 112 in its revised *Government Auditing Standard (2007).* The Office of Management and Budget is also working on incorporating these definitions into OMB Circular A-133, which contains the standards for conducting federal program compliance audits.

III. How does SAS 112 affect UofL?

The objective of this document is to provide some awareness of how SAS No. 112 will impact UofL. As already noted, we may see more internal control findings reported in the annual audit. Our external auditor must consider the "potential" magnitude of a control deficiency rather than the "known" magnitude and will evaluate them bearing in mind the following questions:

• Does the control deficiency or combination of deficiencies constitute a significant deficiency or a material weakness?

• Would prudent University officials with knowledge of the facts and circumstances agree with the auditor's assessment of the deficiency?

• Are there effective compensating or complementary controls in place?

• What is considered "material" to the financial statements from both a quantitative and qualitative perspective?

This standard, as well as other new auditing standards, will increase the emphasis placed on the need for adequate internal controls over financial reporting. This includes controls over the actual preparation of the annual financial statements, including all disclosures.

• Internal control awareness - Although internal control has always been a critical management function, the changes in audit reporting requirements underscore the importance management should place on designing and implementing an effective internal control system. The system should include among other things, a properly designed accounting system, maintenance of source documents initiating transactions, anti-fraud controls, controls to ensure accurate and timely financial reporting and controls to ensure safeguarding of the agency's assets. Also, those internal controls should document in a well-maintained policies and procedures.

• Likelihood of more reportable audit findings – "SAS No. 112 has lowered the bar" so that findings that may not have been previously reportable may now be considered reportable simply because there is the potential for misstatement. The SAS clarifies that the significance of a control deficiency is dependent on the *potential* for misstatement, not whether a misstatement actually occurred. Some items that would fall into these control deficiencies are:

• Lack of controls over non-routine and non-systematic transactions.

• Lack of controls over period-end financial reporting process.

• Ineffective oversight of the entity's financial reporting and internal control by the governing body.

• Restatement of previously issued financial statements.

• Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the University's internal control, i.e. audit adjustments.

• Failure by management, or the Board of Trustees, to assess the effect of a significant deficiency previously communicated to them and either correct it, or decide that it will not be corrected.

• Correcting and following up on findings - An increase in the number of reportable findings will have a direct correlation to the amount of work required by UofL's management to correct and follow-up on reportable findings. In turn, this will affect the amount of audit effort required by our auditors to follow-up on corrective action to the findings.

The audit process may take longer because:

• The auditor will be required to gather more evidence and documentation to evaluate whether or not findings are significant deficiencies or material weaknesses, and

• The auditor must perform follow-up procedures on all previous audit findings.

• Understanding financial statements and their disclosures - the financial statement closing process is also highly dependent on the skills, experience, training, and competency of the preparer(s) and approver(s). As such, if the entity does not have the necessary resources to effectively apply generally accepted accounting principles to recording the University's financial transactions or prepare its financial statements, then a likely material weakness exists. The key controls are the review and approval by the preparer's supervisor and the review and approval by Board of Trustees. As such, it is necessary for the governing body to have sufficient skills to read and understand the University's financial statements and their degree of precision.

IV. What can UofL do to deal with SAS 112?

How we consider the impact depends largely on the size and complexity of the University and its corporate affiliates. Clearly, the larger and more complex the organization the more likelihood of an audit finding. Preparing for the new SAS No. 112 environment involves the following steps:

• *Educate yourself* –

- o Learn the key components of strong internal controls.
- o Understand your financial statements and the required disclosures.
- o Build a resource network to assist you as questions arise.

• *Eliminate audit adjustments –*
- o Talk to the auditor about the nature of any prior year audit adjustments.
- o Identify and record all potential adjustments prior to the audit.
- o Maintain a file of issues and/or transactions occurring during the year that might have audit interests.

GAAP accounting implications.
- o Seek advice from the auditor, or others, regarding these items prior to the audit.
- o Consider the need to hire external assistance prior to the audit.

• *Educate your governing body –*
- o Don't let the Board of Trustees be blind-sided.
- o Educate them so that they might assist in evaluating and improving controls.

• *Inventory your system –*
o Identify significant accounts, disclosures, processes and cycles that are used by, or take place.

• *Prioritize –*
- o Do not try to fix or improve everything at once.
- o Consider making improvements over multiple years.
- o Identify the areas of greatest weakness and improve those first.

One of the best things you can do is to educate your staff; and in particular, the Board of Trustees on SAS No. 112. Notify your Board of the potential of more audit findings than they may have seen in the past. You don't want a surprise at a future board meeting when the audit is presented.

Review internal controls over significant financial accounts or programs and answering the following questions:
- Are controls in place over the preparation of financial reports?
- Does documentation exist to support the activity of the financial account/program?
- Are duties adequately segregated?
- Are information technology controls over significant computer systems in place?
- Are controls in place to ensure routine reconciliations are performed?
- Are controls in place to adequately track and safeguard capital assets?
- Are controls in place to monitor subrecipients of federal grant funds?
- Is there adequate communication between the University's management, internal and external auditors, and the Board or audit committee of the Board?

As you're reviewing these controls, you should consider whether you know if the controls are effective. For example, are reviews and approvals evident? Does an internal audit unit test processes? Or, is there another form of internal control monitoring? Have internal control findings been communicated previously?

Be prepared to respond positively to a significant deficiency or material weakness. Having an improvement plan and acting on it will put any deficiencies in a much more positive light. Above all, be realistic; internal control is an ongoing process. All improvements to your system will have a cost and if the cost of completely eliminating significant deficiencies is high, be prepared to accept it. If you can't afford to be perfect today, set a goal to improve over time.

V. For which financial statement audits is SAS 112 effective?

SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. For UofL, this means audits of the year-ended June 30, 2007 financial statements.