

The Impact of Statements on Auditing Standards (SAS) 104-111, 112, 114 on Financial Statement Audits

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What We Will Cover

- Requirements of SAS No. 104-111, 112, 114
- How requirements relate to changes being made in future audits



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SAS No. 112, 114

- SAS No. 112: Communicating Internal Control Related Matters Identified in an Audit
- SAS No. 114: The Auditor's Communication With Those Charged with Governance
- Effective date = audits of periods ending on or after December 15, 2006



Essentially, SAS No. 112...

- Defines the terms *significant deficiencies* and *material weaknesses*
- Provides guidance on evaluating the severity of control deficiencies
- Requires the auditor to communicate, in writing, to management and *those charged with governance*



SAS No. 112

- *Those charged with governance*: the persons with responsibility for overseeing the strategic direction of the entity and the entity's financial reporting and disclosure process
- Recognizes that body to whom communication is made may take different forms
 - *Board of directors*
 - *Committee of management*
 - *Single owner*



Old Versus New

Old Definitions

New Definitions

SAS 60

Material weakness

SAS 112

Control deficiency

Reportable condition

Significant deficiency

Management letter
comment

Other matters related to
internal control

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 Design Deficiencies

- Inadequate design of internal control over the preparation of the financial statements being audited
- Inadequate design of internal control over a significant account or process
- Inadequate documentation of the components of internal control



Control Design Deficiencies

- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment
- Absent or inadequate segregation of duties within a significant account or process
- Absent or inadequate controls over the safeguarding of assets



Control Design Deficiencies

- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time



Control Design Deficiencies

- Employees or management who lack the qualifications and training to fulfill their assigned functions
- The absence of an internal process to report deficiencies in internal control to management on a timely basis



Operating Deficiencies

- Failure in the operation of effectively designed controls over a significant account or process; for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process
- Failure to perform reconciliations of significant accounts; for example, accounts receivable ledgers are not reconciled to the general ledger account in a timely or accurate manner



Operating Deficiencies

- Failure of controls designed to safeguard assets from loss, damage or misappropriation
- Management override of controls
- Failure of an application control caused by a deficiency in the design of the operation of an IT general control



SAS No. 112

- A **significant deficiency** is a control deficiency or combination of deficiencies, that would result in more than a *remote likelihood* that a significant misstatement of the entity's financial statements will not be prevented or detected.
- *The likelihood of an event is “more than remote” when it is at least possible.*



Significant Deficiencies

- Controls over the selection and application of accounting principles that are in conformity with GAAP; having sufficient client expertise in selecting and applying accounting principles is an aspect of such controls
- Anti-fraud programs and controls



Significant Deficiencies

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements



SAS No. 112

- A **material weakness** is a significant deficiency or combination of deficiencies, that would result in more than a remote likelihood that a *material misstatement* of the financial statements will not be prevented or detected.
- **Materiality:** The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed by the omission or misstatement.



Material Weaknesses

- Ineffective oversight by those charged with governance of the entity's financial reporting and internal control, or an ineffective overall governance structure
- 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



Material Weaknesses

- 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, which is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)



Evaluation Questions

- When determining whether control deficiency is significant, consider the following:
 - Is the likelihood that a misstatement of any magnitude could occur and not be detected by the client's controls considered remote?
 - Is the magnitude of a potential misstatement inconsequential or less than inconsequential to the financial statements?



Evaluation Questions

- 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 answer 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 *not* at least a significant deficiency?



Evaluation Questions

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



SAS No. 112

- Written communication required no later than 60 days following issuance of audit report (including deficiencies that were communicated in previous audits)
- Management may wish to, or be required to, prepare a written response to the auditor's communication
- Response may include a description of corrective actions



Evaluating the Design of Internal Control

- Understanding of internal control should enable you to:
 - Assess the risks of material misstatement of the financial statements, whether due to error or fraud
 - Design the nature, timing, and extent of further audit procedures
 - To do so, it must be determined that the control has been implemented (meaning that it exists and that the entity is using it)



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SAS No. 104-111

- SAS 104- *Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures (“Due Professional Care in the Performance of Work”)*
- SAS 105- *Amendment to Statement on Auditing Standards No 95., Generally Accepted Auditing Standards*
- SAS 106- *Audit Evidence*



SAS No. 104-111

- SAS 107- *Audit Risk and Materiality in Conducting an Audit*
- SAS 108- *Planning and Supervision*
- SAS 109- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*



SAS No. 104-111

- SAS 110- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- SAS 111- *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*



Risk Assessment Standards

- Eight new statements on auditing standards (SASs) issued by Auditing Standards Board (ASB)
- Intended to provide better risk assessments and improved design of audit procedures to respond to the risk
- Effective date = audits of periods beginning on or after December 15, 2006



Risk Assessment Standards

- ASB's main objectives in developing SAS No. 104-111:
 - More in depth understanding of the entity and its environment, including its internal control
 - More rigorous assessment of the risks of where and how the financial statements could be materially misstated
 - Improved linkage between the auditor's assessed risks and the nature, timing and extent of audit procedures performed in response to those risks



SAS No. 104-111

- *Risk assessment* basically means stepping back before we begin and trying to figure out areas susceptible to higher risk
- By *higher risk*, we mean risks of material misstatements, either caused by fraud or error



SAS No. 104-111

Three steps:

- 1) Step back before doing anything and think about where material misstatements can occur
- 2) Design auditing procedures to be responsive to risks identified in step one
- 3) Evaluate findings and misstatements and loop them back to original planning





WHEN ACCOUNTANTS GET SCHIZOPHRENIA



SAS No. 104 (Professional Care in the Performance of Work)

■ Key Provisions

- Defines *reasonable assurance* as a “high level of assurance”



SAS No. 105 (Amendment to Statement on Auditing Standards-No. 95)

■ Key Provisions

- Expands the scope of the understanding that the auditor must obtain in the second standard of field work from “internal control” to “the entity and its environment including its internal control”
- Required understanding of the entity and its environment, including its internal control, is needed to assess risk of material misstatement of the financial statements



SAS No. 106 (Audit Evidence)

■ Key Provisions

- Defines *audit evidence* as “all the information used by the auditor in arriving at the conclusions on which the audit opinion is based”
- Defines *relevant* assertions as those assertions that have a meaningful bearing on whether the account is fairly stated
- *Assertions*: what management is saying, either explicitly or implicitly, about recognition, presentation, and disclosure information of financial statements



SAS No. 106 (Audit Evidence)

■ Key Provisions

- Inquiry alone is NOT sufficient to evaluate the design of internal control and to determine whether it has been implemented
- Recategorizes assertions by classes of transactions, account balances, and presentation and disclosure
- Identifies “risk assessment procedures” as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels



SAS No. 107 (Audit Risk and Materiality)

■ Key Provisions

- The auditor must consider audit risk when determining a materiality level for the financial statements taken as a whole
- Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*
- Separate assessed risks and the basis for those assessments should be documented
- Required to communicate all known and likely misstatements to management



SAS No. 108 (Planning and Supervision)

■ Key Concepts

- Overall audit strategy

- Audit plan

- Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit



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SAS No. 109 (Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement)

■ Key Concepts

- Describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control
- Audit team should discuss susceptibility of the entity's financial statements to material misstatement (“brainstorming session”)
- Directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented



SAS No. 109 (Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement)

■ Key Concepts

- Assess “the risk of material misstatement” and design and perform further audit procedures responsive to the assessed risk
- Auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels



SAS No. 110 (Performing Procedures in Response to Assessed Risks and Evaluating Audit Evidence Obtained)

■ Key Concepts

- Provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses
- Further audit procedures, which may include tests of controls or substantive procedures, should be responsive to the assessed risk of material misstatement at the relevant assertion level



SAS No. 111 (Audit Sampling)

■ Key Concepts

- Provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls



Applying the Audit Risk Model

- *Gather information about the entity and its environment, including internal control (aspects of client and its environment that allow risks to be identified and assessed)*
- *Understand the entity and its environment, including its internal control (should enable you to identify what could go wrong in specific relevant assertions related to each account balance, class of transactions, or disclosure)*



Applying the Audit Risk Model

- *Assess the risk of material misstatement*
- To assess risks,
 - Identify the risk of material misstatement
 - Describe the identified risks in terms of what can go wrong in specific assertions
 - Consider the significance and likelihood of material misstatement for each identified risk



Applying the Audit Risk Model

- *Design overall responses and further audit procedures*
 - Address risk of material misstatement at both financial statement and relevant assertion level
 - Financial statement risks may require an overall, audit-wide response
 - Assertion level risks should be considered when designing and performing audit procedures
 - Regardless of risks, substantive audit procedures must be performed on all relevant assertions to each material account balance, class of transaction, or disclosure

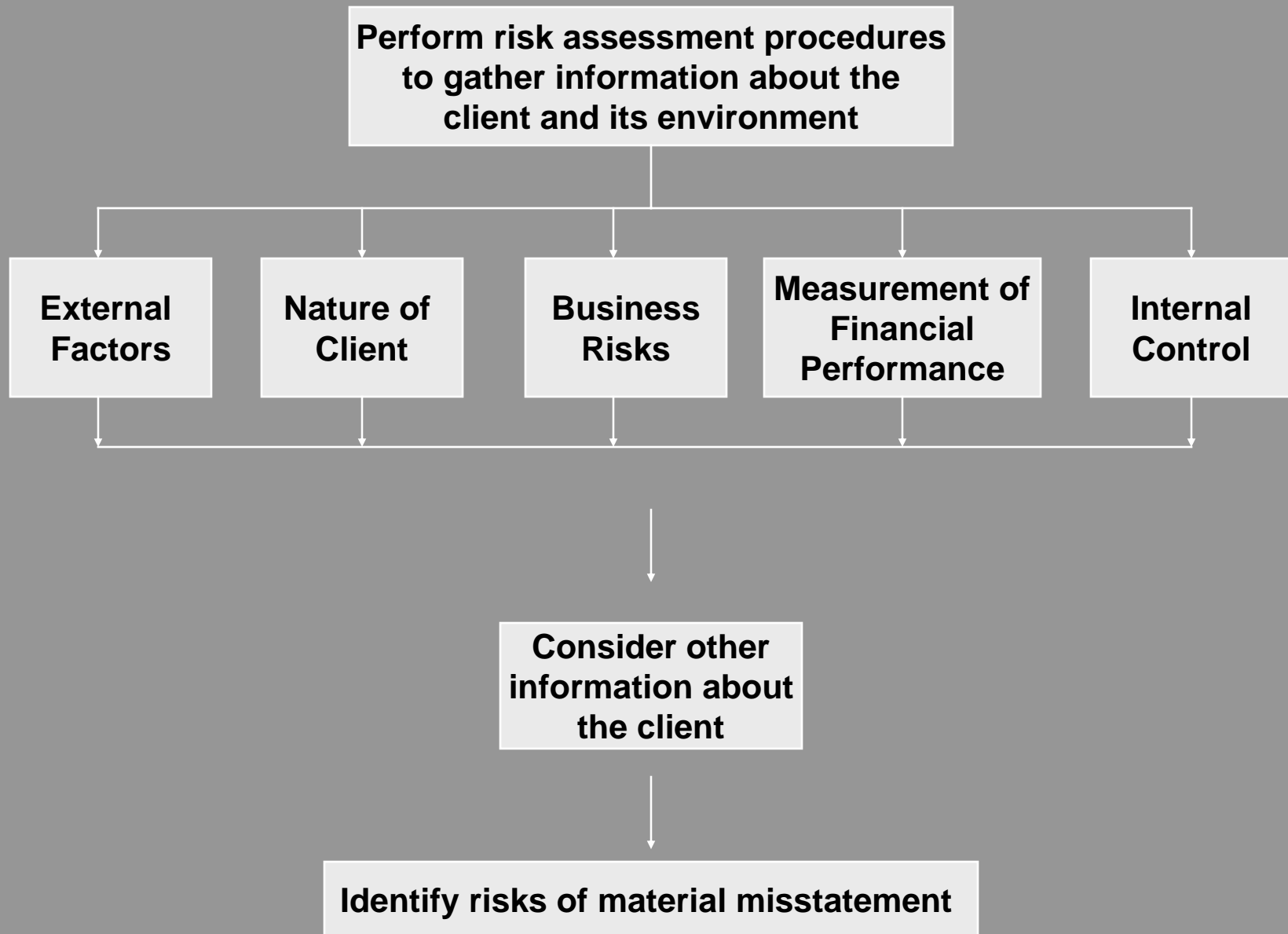


Fundamental Concepts

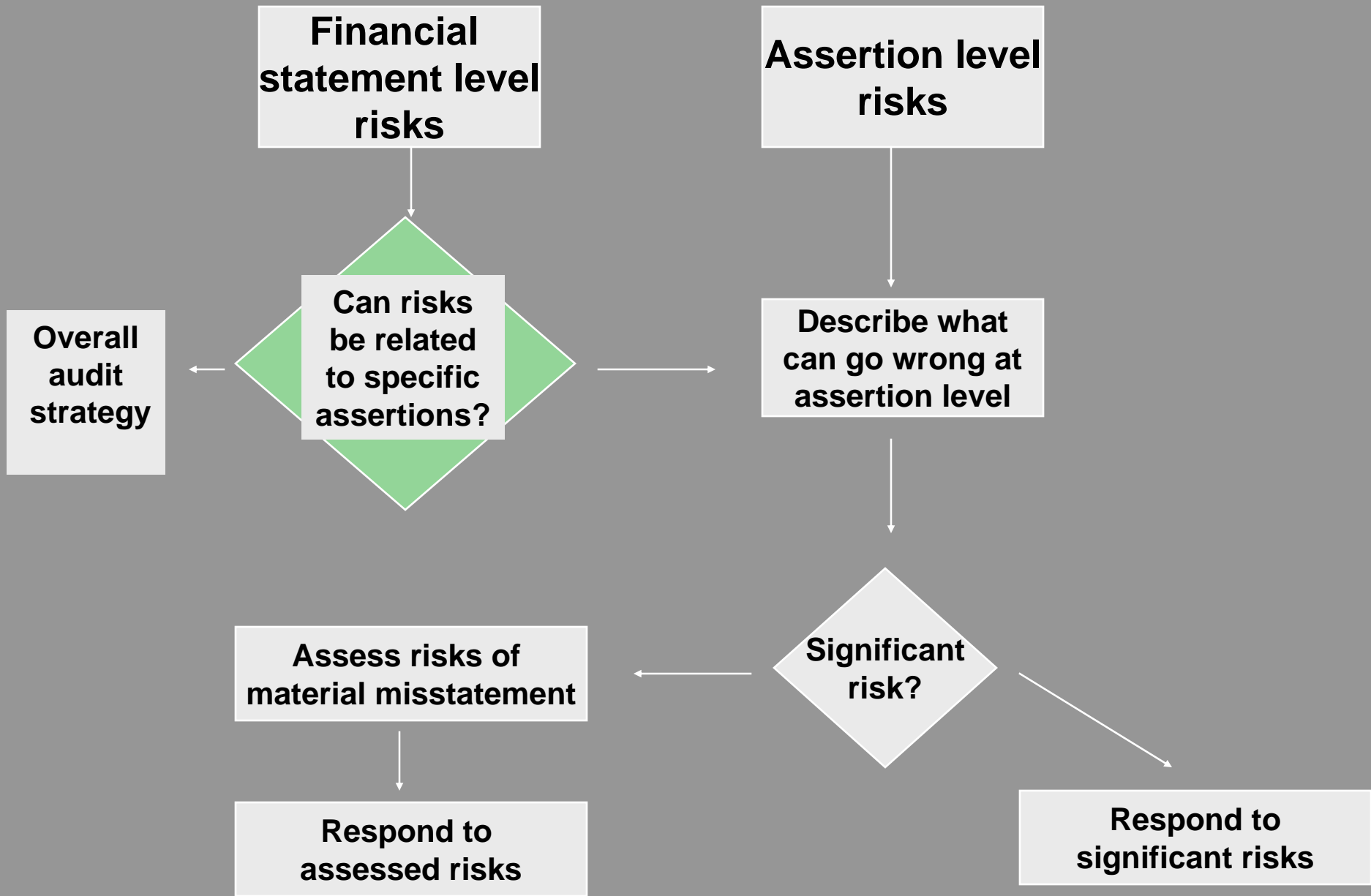
- The meaning of *reasonable assurance*
- Audit risk and the risk of material misstatement
- Materiality and misstatement
- Financial statement assertions
- Internal control
- Information technology
- Audit evidence



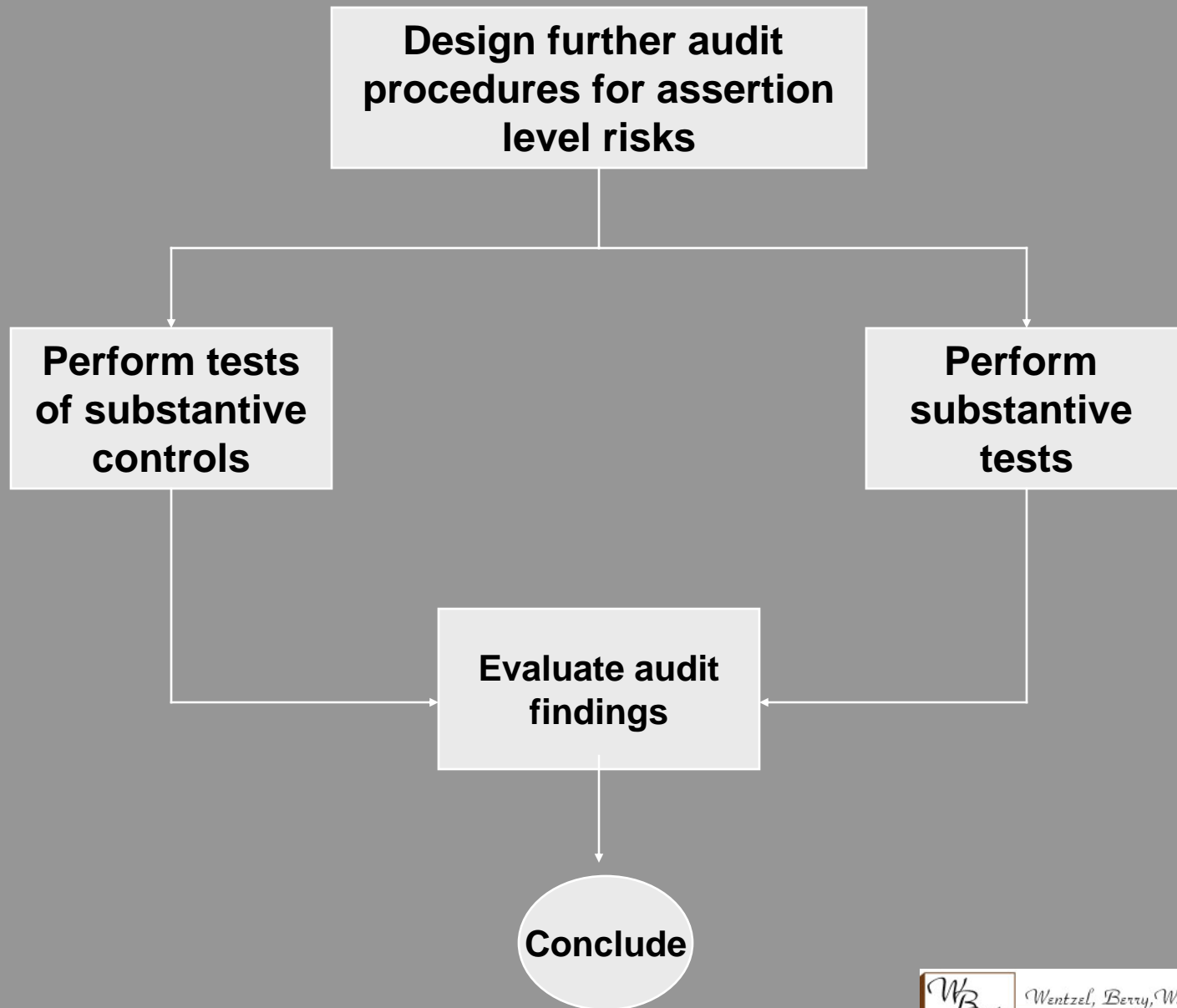
Summary of the Risk Assessment Process



Summary of the Risk Assessment Process



Summary of the Risk Assessment Process



Reasonable Assurance

- Key underlying concept in all aspects of auditing
- SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of assurance



Audit Risk and the Risk of Material Misstatement

- *Audit risk*- risk that financial statements are materially misstated and the auditor fails to detect such a misstatement
- Function of two components:
 - 1) *Risk of material misstatement (RMM)*- risk that account or disclosure item contains a material misstatement
 - 2) *Detection risk*- risk that you will not detect such misstatements in an account or disclosure item



Risk of Material Misstatement

- May reside at either the financial statement level or the assertion level
- Financial statement-level risks
 - Potentially affect many different assertions; for example, a lack of qualified personnel in financial reporting roles may affect different accounts and several assertions
- Assertion-level risks
 - Limited to a single assertion, such as valuation of inventory or the



Risks of Material Misstatement at the Assertion Level

- *Inherent risk*- susceptibility of an assertion to a material misstatement, assuming that there are no controls



Risks of Material Misstatement at the Assertion Level

- *Control Risk (CR)*- risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the client's internal control
- It's a function of the effectiveness of design and operation of the client's internal control.



Financial Statement Assertions

- Audits result in an opinion of financial statements taken as a whole.
- To reach this opinion, audit procedures must be directed at the more detailed, *assertion* level.



Financial Statement Assertions

- Assertions are management's implicit or explicit representations regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures

- Fall into 3 categories:
 - 1) Classes of transactions
 - 2) Account balances
 - 3) Presentation and disclosure



Financial Statement Assertions

- For example, by presenting the information “Cash....\$10,000” in the financial statements, management implies that:
 - The cash truly exists and company has the right to use it
 - The amount presented represents all the company’s cash
 - The amount presented is accurate



CATEGORIES OF ASSERTIONS

Description of Assertions

Assertions	Classes of Transactions & Events During the Period	Account Balances at the End of the Period	Presentation and Disclosure
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred and pertain to the entity.
Rights and obligations	----	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	----
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interest that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded properly.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	----	----
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	----	Financial information is appropriately presented and described and information in disclosure is expressed clearly.



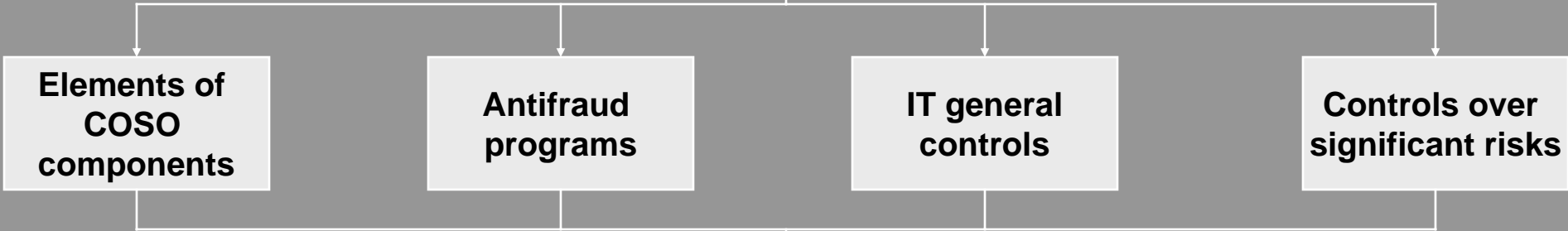
Internal Control

- Controls may be *pervasive* to the entity or *restricted* to an account or assertion
- Process effected by those charged with governance, management, and other personnel; designed to provide reasonable assurance about the achievement of the entity's objectives
- Entity's objectives fall into three categories:
 - 1) Financial reporting
 - 2) Operations
 - 3) Compliance with laws and regulations



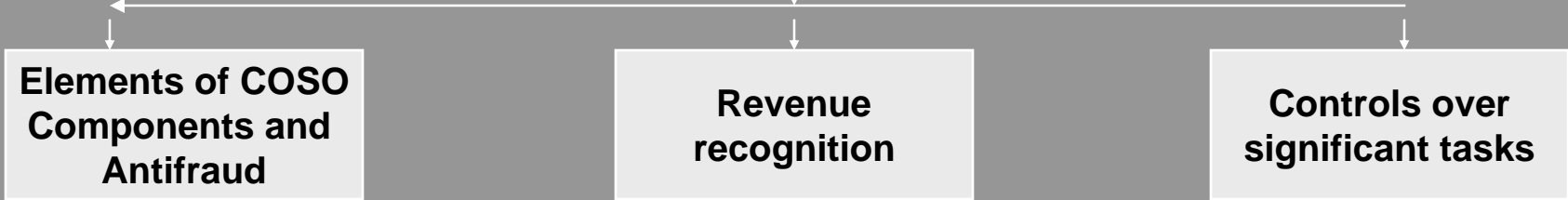
Process for Understanding Internal Control

Identify relevant entity-level controls



Identify significant transactions and material accounts

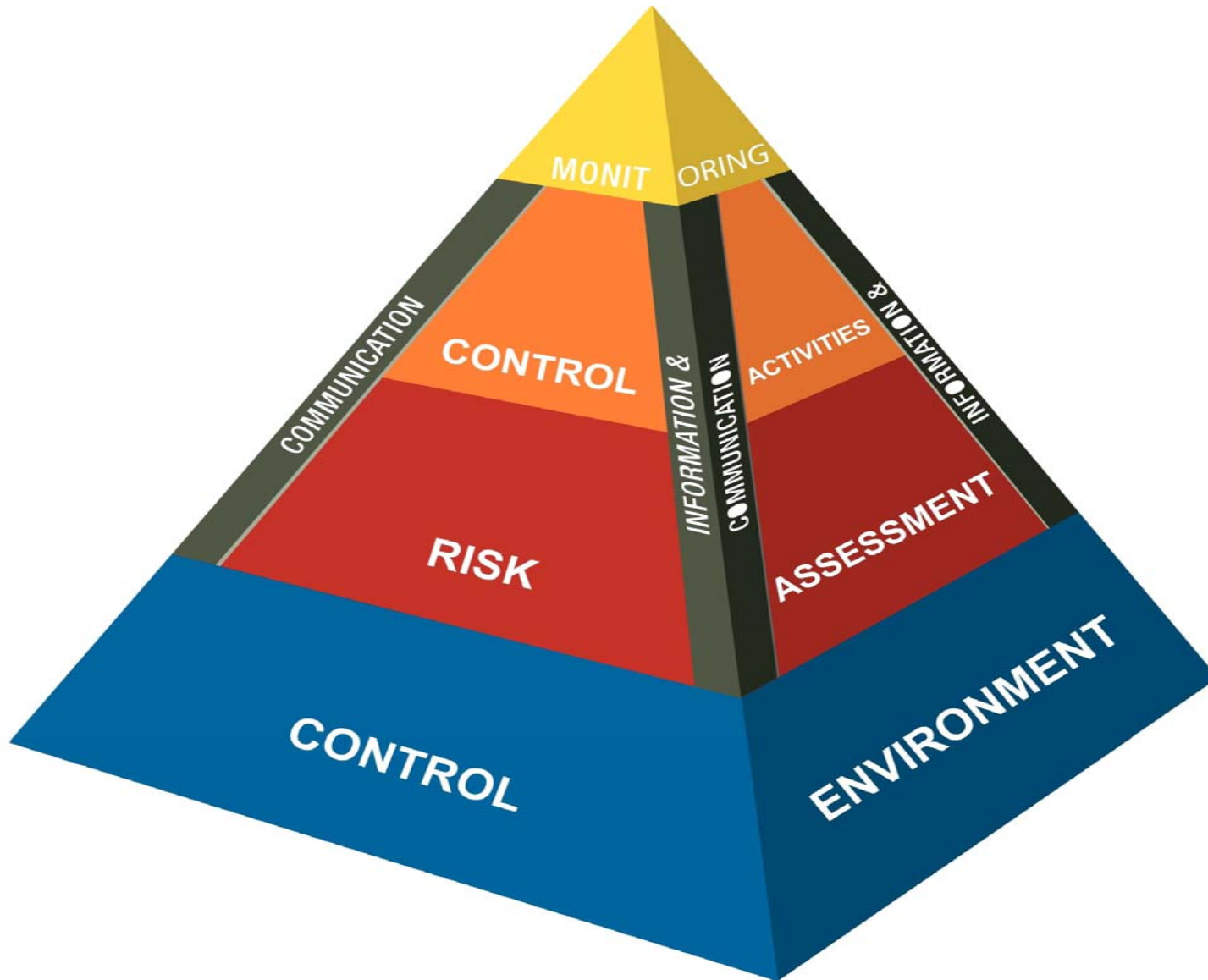
Identify relevant activity-level controls



Process for Understanding Internal Control

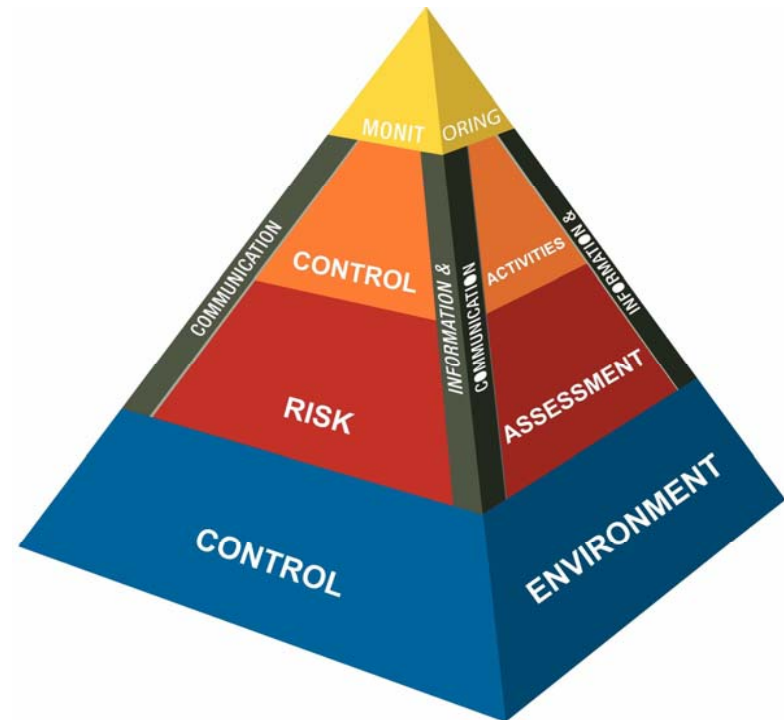


COSO Pyramid



COSO

- Control environment- sets tone of an organization; foundation for all other components, providing structure
- Risk assessment- identifies, analyzes & manages risks relevant to preparation of financial statements
- Information and communication- support the identification, capture, and exchange of information in a form and time frame enabling people to carry out their responsibilities
- Control activities- policies and procedures that help ensure that management directives are carried out
- Monitoring- a process that assesses the quality of internal control performance over time



Examples of Control Objectives

■ Control Environment

- Integrity and Ethical Values: sound integrity and ethical values, particularly of top management, are developed and set the standard for financial reporting
- Competency: do employees have necessary skills and knowledge to do their jobs?
- Importance of Board of Directors: the board of directors understands and exercises oversight responsibility related to financial reporting and related internal control



Examples of Control Objectives

■ Control Environment

- Philosophy and Operating Style: top management's attitudes about importance of entity's accounting systems and personnel
- Authority and Responsibility: evaluate whether people are doing the right jobs within financial reporting structure
- Governance: governance body may establish "whistle-blower policy" and a code of conduct; effective governance will insist on doing the right thing every time



Examples of Control Objectives

■ Control Environment

- Commitment to Financial Reporting Competencies: company retains individuals competent in financial reporting and related oversight roles
- Authority and Responsibility: management and employees are assigned appropriate levels of authority and responsibility to facilitate effective internal control over financial reporting



Examples of Control Objectives

■ Risk Assessment

- Risk Assessment: a process is designed and implemented that effectively identifies, analyzes and manages risks relevant to the preparation of the financial statements that are presented fairly in conformity with generally accepted accounting principles
- Assessment of Fraud Risk: the potential for material misstatement due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives



Examples of Control Objectives

■ Information Systems

- Information Needs: information is identified, captured and used at all levels of a company to support the achievement of financial reporting objectives
- Information Controls: information relevant to financial reporting is identified, captured, processed, and distributed within the parameters established by the company's control processes to support the achievement of financial reporting objectives



Examples of Control Objectives

■ Communication

- Management Communication: all personnel, particularly those in roles affecting financial reporting, receive a clear message from top management that both internal control over financial reporting and individual control responsibilities must be taken seriously
- Upstream Communication: company personnel have an effective and non retributive method to communicate significant information upstream in a company



Examples of Control Objectives

■ Control Activities

- Policies and procedures that help ensure that management directives are carried out
- Entity's response to either preventing misstatements or detecting them if they do occur
- Include authorization, segregation of duties, safeguarding, and asset accountability



Examples of Control Objectives

■ Monitoring

- Ongoing Monitoring: enable management to determine whether internal control over financial reporting is present and functioning to prevent or detect and correct material misstatements
- Separate Evaluations: evaluations of all five internal control components enable management to determine the effectiveness of internal control over financial reporting
- Reporting Deficiencies: internal control deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action, and to management and the board as appropriate



Control Operations

- Concept of the effective operation of controls is different from their design and implementation
- Operating effectiveness of controls involves the consideration of:
 - How controls were applied during the audit period
 - The consistency with which they were applied
 - By whom they were applied



Evaluating the Design of Internal Control

- Understanding of internal control should enable you to:
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 - Design the nature, timing, and extent of further audit procedures
 - To do so, it must be determined that the control has been implemented (meaning that it exists and that the entity is using it)



SAS No. 104-111 Inclusions

- States certain substantive procedures must be performed on all engagements, including:
 - Substantive tests for all relevant assertions related to each material class of transactions, account balance and disclosure regardless of the assessment of the risk of material misstatements
 - Agreeing the financial statements, including their accompanying notes, to the underlying accounting record
 - Examining material journal entries and other adjustments made during the course of preparing the financial statements

