
**Auditing Standards No. 102 – 114:
A Client Update on Recently Issued Auditing
Standards**

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Since the enactment of the Sarbanes-Oxley Act of 2002 (SOX), auditing has become a more heavily regulated industry. Even though SOX primarily impacted public companies, there has been a significant “trickle down” effect for all organizations both large and small resulting in major changes in auditing standards.

The AICPA has issued a number of **Statements on Auditing Standards (SAS)** with effective dates as early as audits with years ending December 31, 2006.

SAS Statement	Effective Date
SAS No. 102 - <i>Defining Professional Requirements in Statements on Auditing Standards</i>	Effective upon issuance
SAS No. 103 - <i>Audit Documentation</i>	Periods ending on or after December 15, 2006
SAS No. 104 – SAS No. 111 - <i>Risk Assessment Standards</i>	Periods beginning on or after December 15, 2006
SAS No. 112 - <i>Communicating Internal Control Related Matters Identified in an Audit</i>	Periods ending on or after December 15, 2006
SAS No. 113 - <i>Omnibus 2006</i>	Periods beginning on or after December 15, 2006
SAS No. 114 - <i>The Auditor's Communication With Those Charged With Governance</i>	Periods beginning on or after December 15, 2006

This document communicates in detail SAS No. 112 and SAS No. 103, which are effective for the current audit year and provides basic detail of the standards with later implementation dates that we believe may have a significant impact on the audit approach and to your organization. Information on all standards can be obtained through the **American Institute of Certified Public Accounts (AICPA)** at www.aicpa.org.



Current Year SAS:

Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*. This new SAS is effective for audits of periods ending on or after December 15, 2006. SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. The Government Accountability Office has also adopted the provisions of SAS No. 112 in its recent proposed revisions of Government Auditing Standards (the “Yellow Book”). In most cases, SAS No. 112 will require us to gather more evidential documentation regarding internal control deficiencies and to include additional findings in the audit report/management letter.

Some highlights of SAS No. 112:

- Requires the auditor to communicate control deficiencies that are significant deficiencies or material weaknesses in internal control. New definitions for significant deficiencies and material weaknesses are included.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are at least significant deficiencies, as well as indicators that control deficiencies should be regarded as at least a significant

deficiency and a strong indicator of a material weakness.

- Requires the auditor to communicate in writing significant deficiencies and material weaknesses identified in the audit to management and those charged with governance.
- Indicates that the communication must be in writing and is best made by the report release date, but should be made no later than 60 days following the report release date.

SAS No. 112 Impact on Audit Clients

Auditors will be expected to focus on “what could go wrong” in addition to “what did go wrong.” **This is a huge shift in audit focus.**

Most auditing experts agree that this new standard will result in more control deficiencies reported as significant deficiencies or material weaknesses. Therefore, most audits will require additional procedures and time related to selected internal control areas. The AICPA has speculated that these additional procedures could increase audit costs as much as 15-20%.

Application of this new standard significantly lowers the threshold of what are considered reportable conditions, significant deficiencies and material weaknesses. This could likely result in reporting significant deficiencies in internal controls over the financial statement preparation/closing process, information technology controls, segregation of duties, and the use of complex spreadsheets used to track financial information. **There is a possibility that conditions in the internal control structure not previously considered reportable could rise to a significant deficiency or material weakness and would be included in the findings and questioned costs section of the annual audit report and/or the annual management letter.**

SAS No. 112 VLS Recommendation

We recommend that our clients and their accounting service providers, if applicable, take an initial step of strengthening internal controls in place over those areas considered to be high risk. This would include the following:

- Implement internal controls over the financial statement closing and preparation process. Ensure all closing entries are made prior to the

audit and journal entries are appropriately documented and reflect evidence of appropriate approvals and review. Regardless of whether the organization prepares the financial statements or the auditor assists in this process, the organization must establish controls to prevent or detect material misstatements in the financial statements and the notes to the financial statements. Ensure that the organization has an individual who possesses suitable skills, knowledge, and/or experience to review the financial statements and notes, including the conversion from cash or modified accrual basis to full accrual basis when applicable. This is a possible area where many organizations are currently vulnerable.

- Review processes and procedures to make sure that performance of duties are adequately segregated. If you don't have enough staff to segregate duties adequately, establish monitoring or mitigating controls. Mitigating controls must be appropriately documented and effective for the auditor to place reliance on the activity. Unsupported mitigating controls may be considered control deficiencies.

Auditors will be expected to focus on “what could go wrong” in addition to “what did go wrong.” This is a huge shift in audit focus.

- Ensure there are IT controls in place over significant computer systems. Identify which IT controls are in place over significant systems, such as the financial reporting system, payroll, general ledger, and grant administration.

- Assess your organization's responsibility for outside service organizations. Many organizations use external vendors to service financial activities. Keep in mind that management is still ultimately responsible. Ensure conversations with external vendors about service and performance are documented. Document how management monitors the control activities of outside service organizations.
- Analyze and catalog spreadsheets used for accounting purposes and determine the internal controls to be utilized for each level (type) of spreadsheet, including those received from third party service providers.

Statement on Auditing Standards (SAS) No. 103, Audit Documentation. This new SAS is effective for audits of periods ending on or after December 15, 2006 and changes and expands current documentation requirements.

Some highlights of SAS No. 103:

- Requires that the auditors' report be dated no earlier than the date on which the auditor obtained sufficient evidence to support the opinion. This includes not only review of audit documentation but also completion and/or review of financial statements and disclosures. This may extend testing for events occurring after field work which may result in additional procedures and time.
- Requires that oral explanations by a client in and of themselves do not represent sufficient audit evidence and may need to be corroborated by other audit evidence. Again this may result in additional procedures and time.

Subsequent Year SAS Impact on Audit Clients:

Statements on Auditing Standards (SAS) No. 104 - No. 111, *Risk Assessment Standards*. This suite of new standards is effective for audits of periods beginning on or after December 15, 2006 and may result in significant changes to a firm's audit methodology. The Auditing Standards Board (ASB) believes that the standards will improve the quality and effectiveness of audits.

Some highlights of SAS No. 104 – No. 111:

- Requires a more in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them. A greater emphasis will be placed on understanding the entity's risk assessment process. Additional time may need to be spent understanding the entity's objectives, strategies and related business risk in the overall assessment of risk of financial statement misstatement. In addition, similar to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, the audit team will be required to meet in a "brainstorming" session to discuss the risks of material misstatement.
- Requires a more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding and provides further guidance on determining materiality thresholds.
- Requires improved documentation between the assessed risks and the audit procedures to be performed in response to those risks. It is

anticipated that "generic" audit programs will no longer be appropriate and that additional time will be spent developing specific audit programs for each engagement.

- In line with SAS No. 103, inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

Statements on Auditing Standards (SAS) No. 114, *The Auditor's Communication With Those Charged With Governance*. This new standard is effective for audits of periods beginning on or after December 15, 2006 and superseded SAS No. 61, *Communication With Audit Committees*. The new SAS includes additional matters to be communicated to those charged with governance, provides guidance on determining the appropriate individuals to communicate matters to and provides additional guidance on the communication process. The Auditing Standards Board (ASB) believes the new standard will help meet increased expectations for auditors to communicate candidly with those charged with governance regarding significant findings and issues.

Some highlights of SAS No. 114:

- Requires the auditor to evaluate the adequacy of the two-way communication between the auditor and those charged with governance and establishes a requirement to document specific matters to be communicated.
- Adds requirements to communicate an overview of the planned scope and timing of the audit.
- Adds requirements to communicate representations the auditor is requesting from management.
- Provides additional guidance on the communication process, including the forms and timing of communication.

Conclusion

We recommend that our clients (and in certain cases accounting service companies) start to educate governing boards, related committees, bond insurers, banks, and regulatory agencies about these new audit standards and the possible impact on the organization.

VLS is dedicated to our clients and their success. We are also committed to professional standards and helping our clients understand new and significant changes in those standards. We hope that this update helps you to prepare for your upcoming audit(s).