

Internal controls readiness: why you need to act today*

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I. Introduction

Auditing has become *more* of a regulated industry after the enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes). Organizations have greater financial reporting and control responsibilities, and stakeholders expect auditors to hold their audit clients to a higher standard of accountability for financial reporting and compliance controls as well as operating and financial reporting transparency.

Sarbanes created a new federal oversight body, the Public Company Accounting Oversight Board (PCAOB), to oversee auditors' examinations of public companies. In June 2004, the PCAOB issued its second auditing standard (AS2), *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. AS2 establishes requirements for auditing a public company's financial statements as well as management's assessment of the effectiveness of internal control over financial reporting. AS2 establishes definitions for significant deficiencies and material weaknesses in internal controls. If the auditor identifies such deficiencies and weaknesses, the auditor may conclude that it cannot obtain reasonable assurance about whether the public company has maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. If the presence of material weaknesses is identified, the auditor may have to issue an adverse opinion, which would set several negative consequences in motion.

Consistency is one of the principles of auditing, accounting and financial reporting. Partly because of this principle, the American Institute of Certified Public Accountants (AICPA), the national professional organization for certified public accountants, proposed an amendment to its Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. The amended SAS would incorporate the PCAOB's definitions of significant deficiency and material weakness, making the definitions used for audits of nonpublic entities consistent with those already in place for audits of public companies. In addition, under the revised SAS:

- The auditor would be required to consider the "potential" magnitude of error of a control deficiency. (Currently, the auditor considers the *actual* amount of error rather than the *potential* magnitude.)
- The auditor has less room for judgment as to the severity of a control deficiency. In addition, the model is quantitatively focused, thus, lessening the subjectivity.

We believe that the revised standard will have an impact on the audits of not-for-profit colleges, universities, healthcare entities and other types of not-for-profit organizations. This Point-of-View explores the coming changes and provides advice on how institutions should prepare for the SAS revision, which is expected to become effective for audits of financial periods ending on or after December 15, 2006—that would be the fiscal year ending in mid-2007 for most colleges, universities and other not-for-profit organizations. There is still discussion taking place regarding the effective date being delayed.

The objectives of this Point-of-View are to assist institutional presidents, controllers, financial officers, and governing boards understand:

- The issues that the amended SAS will raise;
- Why they are important; and
- What they should be doing about it.

II. The focus on internal controls

Sarbanes emphasizes that management is responsible for internal controls. Under Section 404 of Sarbanes (which applies to public companies but not to not-for-profit organizations), management is required to certify that its financial reporting controls are working as intended and operating effectively for the time period under review. As mentioned on the previous page, the company's independent auditor opines on both management's assessment of internal controls and the effectiveness of financial reporting controls, as well as the financial statements taken as a whole. As a result of these requirements, independent auditors are integrating their audits of internal controls with their audits of financial statements by designing tests that simultaneously satisfy both internal control and financial statement audit objectives.

The integration of the internal controls testing with the financial statement audit has led to other changes in the ways that audits are conducted and results reported. In the past, external auditors could choose to rely more heavily on tests of internal controls or they could substantiate account balances by testing transactions at a detailed level. Under Sarbanes, auditors must specifically *focus* and opine on the effectiveness of financial reporting.

Audits of educational institutions and not-for-profit organizations have historically focused more on substantiation of account balances rather than on testing of internal controls, other than for grant compliance audits. Under the proposed SAS amendment, the pendulum would swing away from substantive testing of account balances and toward greater reliance on internal controls for institutions of higher education and not-for-profit organizations. The basic audit is not changing, but the "bar" used to report control issues is being lowered. In addition, the changes to the definitions in the revised SAS (e.g., significant deficiency and material weakness) would result in more control deficiencies being considered severe and being reported in external reports. Lastly, the type of evidential matter and documentation that management must retain to support operating effectiveness of the control would be held to a higher standard.

Despite the fact that the revised SAS is an auditing standard, its effects will be felt equally by organizations and auditors. *Why will it impact organizations under audit?* If the auditor identifies an internal control issue, it must be reported to trustees, granting agencies and other regulators under *new definitions* and *in a more public manner* than before and, as a result, control deficiencies could be exposed to greater scrutiny by stakeholders.

Obtaining a complete understanding of the Standard and formulating a detailed action plan are the best way to:

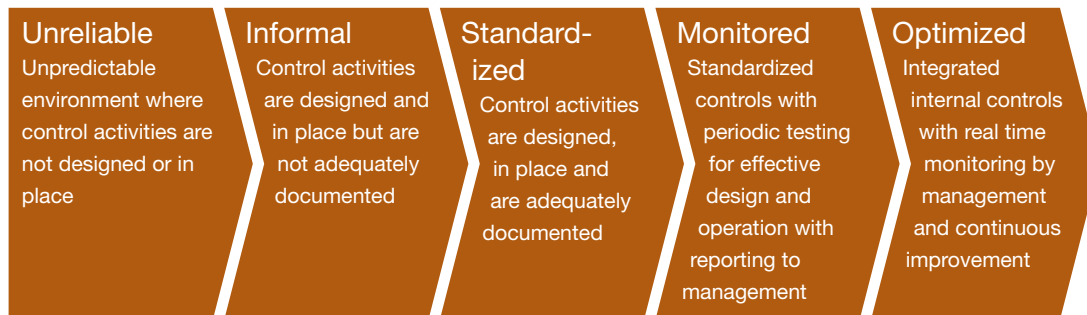
- Reduce the extent to which your institution's control environment is characterized as weaker than has previously been communicated;
- Manage expectations of internal constituents including nonfinancial management; faculty and the Board;

- Learn how key external stakeholders such as donors, insurers, accreditors and rating agencies will view your newly characterized control environment and begin to proactively manage their reactions; and
- Deal with the public perception and political consequences of information that casts a less than favorable light on your institution and its management.

You have an opportunity to affect the outcome for your organization. We outline an approach in the next section.

III. What should you do to prepare for the new internal control definitions?

Internal controls can be viewed in a maturity framework, which is depicted below. Many educational institutions can be characterized as having an informal maturity status.



Being characterized as informal would present several challenges for institutions. In order for auditors to document, test and rely upon controls, the internal controls should be more formalized and documented. In addition, we consider it in an institution's best interest to have a more formalized internal control environment and demonstrate that it is operating effectively, which will be viewed favorably by stakeholders. For example, documentation and operating effectiveness of controls would be much more important in the new environment. Moving to the right on the maturity framework would take on greater urgency.

Other concerns would include:

- You may not be able to take comfort that all key controls have been rigorously tested. If the auditor has relied on an approach of primarily substantiating account balances, all internal control deficiencies may not have been identified.
- Consider federally sponsored programs and public interest debt. If the auditor identifies control deficiencies at your institution and reports them to federal sponsors and bondholders (as the auditor might be required to do), how would they react?

Now is the time to attend to the deferred maintenance that may have accumulated in your control environment. Don't panic, however. Institutions are being pushed closer to a 404-like environment but there is no current indication that management would have to conduct an assessment of internal controls and that the auditor will have to attest to management's assessment. Those two elements are responsible for much of the expense and time devoted to Section 404.

Institutions might want to review the adjustments and unadjusted differences that their external auditor has proposed over the past three to five years. These adjustments might have a recurrent theme and might be considered at least "controls deficiencies" in the proposed new SAS. There are certain types of adjustments that are the result of the timing of the receipt of information rather than a control weakness, like the receipt of certain actuarial information. Segregation of those types of adjustments would be key as well.

The level of action you need to take depends on the nature and complexity of your institution as well as your comfort level. You won't be able to do everything at once. We outline several suggestions below.

A. Educate your board and senior management. The last thing you need is for your board and senior management to be surprised at a future audit committee meeting if your auditor brings significant deficiencies and material weaknesses to the committee's attention. Inform the board and senior management fully now and give them a chance to help you evaluate and improve controls.

B. Inventory the significant accounts, disclosures, and components as well as the processes and cycles (e.g., investments, contributions/fund-raising, sponsored research) **and subprocesses/subcycles** (e.g., financial closing process). What are the key activities that take place in your organization, and how would you assess their ranking using the maturity framework on the previous page?

C. Consider reviewing controls over three areas the first year, such as:

1. **Financial closing process:** What controls are in place over the financial statement closing process? Who reviews estimates? What documentation exists? Is the organization ready when auditors arrive? What types of adjustments take place as a result of the audit?

The financial closing process is key because material adjustments found by the auditors are likely to be considered significant deficiencies or material weaknesses in controls – even if the organization records them.

Consider developing a financial statement binder in which you collect the work papers that support the financial statements. Consider using a financial statement checklist for completeness over financial statement disclosures. In particular, include support for all amounts in the statement of cash flows (e.g., treatment of capital accruals, identification of noncash activities, treatment of restricted cash and cash overdrafts, proof of reclassification of amounts restricted for long-term investment). Also, include proof of the accuracy and completeness of "release of restrictions" transfer.

2. **Information technology (IT) controls over significant systems:** What IT controls are in place over significant systems, such as the financial reporting system, payroll, general ledger, and grant administration? Are the controls automated or manual? Are they documented? What controls exist over program security, program access, and program changes?

IT controls support the overall control structure of the organization and if there are weaknesses in the IT controls, there may be monitoring or mitigating controls at the process level so integrating findings during your review would be a good idea.

3. **Sponsored research (or payroll or general ledger):** What controls are in place? Are they manual or automated? Are there periodic reconciliations performed, and is there evidence of review and approval?

If you choose sponsored research, for example, you might review the written policies and procedures for preaward and post-award grants and contracts. You also might ensure that high-risk areas, such as effort reporting, transfers, and subrecipient monitoring, have well-documented procedures in place.

D. Consider reviewing controls over other areas in the second year, such as:

1. **Contributions and fund-raising:** You might want to ensure that there are policies in place related to appropriate recognition of gifts for financial reporting purposes, including the classification of such gifts and the appropriateness of the cutoff at year-end.
2. **Endowment:** Document the endowment spending formula in accordance with Board approval and spending from endowments in accordance with donor restrictions and state laws. Ensure proper allocation of yield and appreciation on a "by-fund" basis.
3. **Property, plant and equipment:** Ensure that policies related to capitalization of expenditures are documented and that evidence of compliance with such policies exists. In addition, document the accounting for capitalized interest and other borrowing-related activities, including derivatives.

E. Consider the following points as you review these areas:

- **How do you know your controls are effective?** What knowledge do you have of the effectiveness of your internal controls? Is there an internal audit function that tests transactions and processes throughout the organization? How do you know that your policies and procedures are being adhered to?
- **Is there adequate segregation of duties?** It is important to pay attention to segregation of duties, particularly for the financial close. If there are not enough staff to provide for appropriate segregation of duties, consider placing monitoring or mitigating controls in place.
- **Are spreadsheet controls in place for key management reports?** Most institutions rely heavily on spreadsheets for areas like endowment and pledges since IT systems are often not tailored to these areas. Ensure that spreadsheets and reports have appropriate version controls in place and consider establishing password protections.
- **What constitutes good documentation?** Begin with the basics. Is there a policy and procedure document(s) for the major processes/cycles in your organization? Has it been updated in the last few years? Are key controls documented? Are key assumptions and judgments documented? Are the estimates that management has made about such areas as pension and postretirement obligations documented? Does documentation exist about significant reserves, such as uncollectible accounts receivable and pledges?

Do the procedures accurately depict what happens on a daily basis? This step includes determining which accounts and disclosures will be evaluated in the scope of the institution's internal control documentation. It may be necessary to document the flow of transactions for significant accounts and disclosures to determine where material misstatements, due to error or fraud, could occur.

Make sure that journal entries are appropriately documented and that they have the necessary approvals and review. In particular, document unique or significant transactions.

- **What is the institution's responsibility for service organizations?** Many institutions use outside service organizations, such as student financial aid servicers and investment management firms. Management is ultimately responsible for outside servicers, so it might be necessary to obtain evidence about the effectiveness of the service organization's controls. Have you documented your conversations with your service providers about service levels and performance? How do you monitor the control activities of your outside service organizations?

It is a good idea to obtain service provider reports (i.e., SAS 70 reports) for student financial aid and investment servicers (if available). Make sure that they are reviewed, and that the responsibilities of the users are documented and cross-referenced to work done at the organization. Also make sure that the reviewer has evidenced his review.

- **Is there adequate communication and coordination among management, internal and external auditors, and audit committee?** Management must communicate all significant deficiencies and material weaknesses that it detects to the audit committee and the external auditor. The auditor must obtain representations from management (e.g., acknowledgement that management is responsible for internal controls).

III. What may the federal government do?

We have discussed how the proposed new AICPA auditing standard will affect financial statement audits of not-for-profit colleges, universities, healthcare entities and other types of not-for-profit organizations. What about *federal audits*?

The Government Accountability Office (GAO) is planning to expose for comment in calendar 2006 a revised "Yellow Book" that includes the same definitions for significant deficiencies and material weaknesses as are in the SAS. In addition, the Office of Management and Budget (OMB) is expected to make similar changes in its Circular No. A-133, *Audits of States, Local Governments and Non-Profit Organizations*.

Auditors must abide by Generally Accepted Government Auditing Standards (GAGAS) that are issued by the Comptroller General of the United States for A-133 audits. The auditor must audit certain major programs, especially those that are considered to be high-risk, and the auditor must report its findings (i.e., deficiencies) in the schedule of findings and questioned costs. As a result of the changes to GAGAS, auditors may have to report more control deficiencies to the federal government.

IV. Conclusion

The new definitions of significant deficiency and material weakness will lower the threshold for reportable control deficiencies, and will likely cause more deficiencies to rise to the level of significant deficiencies and material weaknesses, which must be reported in external financial statement audits. We believe that the most prudent course of action would be to take this opportunity to attend to the deferred maintenance in your control environment.

How much time do you have? The revised SAS is effective for audits of years ending on or after December 15, 2006—thus, in less than 15 months from the date of this paper for most colleges and universities. The open question is when the changes of the GAO, OMB, and other federal agencies will become effective.

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