

How an Auditor Looks at Internal Control

NASCSP State CSBG Monitors Training

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Session Focus:

- Role & goal of independent audits
- Why auditors consider internal controls
- COSO framework
- System problems/implementation errors
- Testing controls & compliance
- Reports & findings

Quick Quiz?

1. What's the purpose of an independent audit of financial statements?
2. How is an A-133 audit different from a “standard” audit of financial statements?
3. Who can conduct independent audits and/or A-133 audits?

Independent Audits

- Board **engages CPA** to conduct independent audit
- **Management responsible** for preparing accurate financial statements
- **Auditor responsible** for **opinion** on extent to which readers can rely on the statements

Purpose of Independent Audit

Get **auditor's opinion** about whether the entity's financial statements **fairly present** the **financial position** and **results of activities** in accord with standards of US GAAP

Essential Requirements for Auditors

- Independence
- Professional competence
- Sufficient study & testing to form basis for opinion
- Work & communication in accord with Generally Accepted Auditing Standards

GAAS

- Generally Accepted Audit Standards
- Developed by AICPA
- Published in Statements on Auditing Standards (SAS)
- Significant changes since 2006

New Auditing Standards

- Require **more rigorous analysis of risks of misstatement** and design of audit procedures to test for significant risks
- Require **disclosure** to the board of material weaknesses and significant deficiencies

All Audits Require Auditor to:

- Understand the nature of the “business”
- Assess risks of misstatement & noncompliance
- Understand controls to address risks
- Test controls
- Analyze results of test
- Determine significance of problems

Yellow Book Audits

- Government Auditing Standards
<http://www.gao.gov/govaud/ybk01.htm>
- Guides audits of individual federal awards when A-133 not required
- Contains core requirements used for A-133 audits

A-133 Audits

- Required when combined federal expenditures of **\$500,000 or more** within the organization's fiscal year
- Described in Office of Management & Budget **Circular A-133**
- **Include** all standard independent audit procedures and reports
- Require **additional testing** and **reporting** on **compliance** with federal funds requirements

A-133 Audits- continued

- Include auditor's **opinion on compliance** with requirements of major federal programs
- Include **findings on compliance** and **questioned costs**

Key A-133 Resources

- **A-133 Compliance Supplement**
- **A-133 Compliance Supplement
Addendum June 30,2009 - ARRA**
- **A-133 2010 Compliance Supplement
August, 2010** *including new guidance on job creation*

Why Do Auditors Consider Internal Controls?

SAS 112 Requires Auditor to

- Assess organization's risks
- Understand controls
- Determine whether controls would be adequate if fully utilized
- Test whether the controls are working

Internal Controls

- **Systems**, policies & policies designed to prevent and detect errors and irregularities
- **Control environment**: organization - wide expectations around integrity & compliance

Internal Controls designed to:

- Reduce the risk of **improper actions**
- Increase the likelihood that **errors** or wrong acts will be **detected**
- Reduce the risk that error will go **uncorrected**

Controls Designed to Prevent

- **Misstatement:**
 - Financial statements do not fairly present financial condition
- **Misappropriation:**
 - Theft or misuse of the organization's assets
- **Non-Compliance:**

Reality

- No perfect controls
- Controls provide **reasonable assurance**, not absolute assurance
- **Cost/benefit analysis** essential in designing, implementing, & monitoring controls

Additional Requirements for A-133 Audits

Auditor must:

- Identify major federal programs
- Understand compliance requirements for major federal programs
- Identify risks of non-compliance
- Test controls to determine compliance

A-133 Requires Auditor to:

- Determine whether organization is a **high risk auditee**
- Determine whether the organization has received awards through **federal programs** that are deemed **high risk**
- **Tailor audit procedures & tests** to address the level of risk

A-133 Requires Auditor to obtain “low” control risk

- **“Low” control risk requires:**
 - Reliable controls
 - Controls operate effectively
- **Auditor gets to “low” control risk by:**
 - Documenting understanding of controls
 - Testing control design and implementation
 - Testing control effectiveness

A-133 Auditors Under Pressure

2007 GAO study of A-133 audits found:

- 48.6% of audits, which covered 92% of \$\$ audited, were deemed “acceptable”
- 16% deemed of “limited reliability”
- 35.5% of audits (covering only 4.8% of dollars) were deemed “unacceptable”

Internal Control Standards

- A-133 and standard audits rely on COSO
- COSO – Committee of Sponsoring Organizations created framework for establishing and evaluating internal controls
- www.coso.org/IC

COSO Framework

1. Control environment
2. Risk assessment
3. Control activities
4. Information & effective communication
5. Monitoring

Apply COSO Framework to:

- Operations
- Financial Reporting
- Compliance

Core Control Concepts

- Internal control is not one event, but a **series of actions** and **activities** that occur throughout an entity's operation on an ongoing basis
- **Integral part** of each **system** used to regulate & guide operations

Comprehensive Controls

- Highest levels of **management & governance**
- **Compliance** with law/regulation
- **Program** activities
- Operational **policies & procedures**
- Internal & external **reporting**

COSO Framework

1. Control environment
2. Risk assessment
3. Control activities
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COSO: Control Environment

Board oversight of controls

- Annual audit
- Audit committee/auditor communication
- CEO annual review
- Follow-up on audit/monitoring findings
- Review of monthly financial statements
- Awareness of most significant risks

COSO: Control Environment:

CEO & Management

- CEO/Management awareness of high risk areas
- Adequacy of resources for fiscal and program management
- Monthly analysis of financial statements
- Authority/responsibility for compliance clearly assigned

COSO: Risk Assessment

Risk Factors:

- Materiality of exposure – \$\$\$ at risk
- Complexity of compliance requirements
- Experience/lack of experience with program
- Weak control environment/lack of management expertise

COSO: Risk Assessment

More Risk Factors

- Financial pressure
- Failure to address previous findings
- Change in CFO

COSO: Control Activities

Control Activity Basics:

- Top level **review of accomplishments**
- **Comparison of actual to planned**, both \$\$\$ & activities
- HR management to employ **competent, high integrity staff**
- Info processing controls

COSO: Control Activities

More Control Basics

- Physical control of assets
- Segregation of duties
- Proper execution of transactions
- Accurate/timely recording
- Access restrictions & accountability
- Documentation of transactions & controls

COSO Framework

1. Control environment
2. Risk assessment
3. Control activities
4. Information & effective communication
5. Monitoring

COSO: Info & Communications

Key Elements

- Relevant, reliable, & timely access to programmatic & financial info for managers???
- Clarity regarding responsibility for monitoring info & authority to require change ???

COSO: *Monitoring*

Monitoring ???

- Is **responsibility** for periodic **testing of compliance** clearly assigned & adequate time available for timely testing?
- **Responsibility for follow-up** on prior findings clearly assigned with realistic timeline for resolution?

Auditor Analysis of Internal Controls

- Adequacy of design of control systems:
 - Control environment
 - Policies and procedures
 - Control activities
 - Info and communication
 - Internal monitoring

More Auditor Analysis

- Are controls working as designed?
- How **likely** is it that the controls have failed
 - To deter and or detect error or improper action
 - To result in correction of error
- How **significant** would the consequences be if the controls failed?

Key Changes Since 2006

- Auditors required to do **more rigorous analysis of risks of misstatement** and design audit procedures to test for significant risks
- **Must test of controls** even when controls are deemed inadequate

Test Controls through Sampling

- Auditors use sampling to **test internal controls & compliance**
- **Do not test every transaction**
- Design sample to **test significant transactions** & test a **statistically** large enough # of total transactions to **predict** the reliability of the controls

Sampling - continued

- **Expand sample** when initial tests reveal unacceptable rate of error
- Auditor evaluates potential significance of **errors or noncompliance with controls** to determine whether controls are effective

Auditor Conclusions

- Consider **adequacy of control design**
- Analyze results of testing to determine **effectiveness of controls**
- Determine the **significance** of control problems
- Communicate control conclusions

SAS No. 115
**Communicating Internal Control-Related
Matters
Identified in an Audit**

- Requires written communication of **material weaknesses** and **significant deficiencies** in controls
- Must continue to report weaknesses/deficiencies until they are corrected

Which sounds worse to you?

- **Material Weakness**
- or
- **Significant Deficiency**

Significant Deficiencies

- Replaces term “reportable condition”
- Exists when **design** or **operation** of a **control** does not allow management/staff to **prevent** or **detect misstatements** on a timely basis

Significant Control Deficiencies

- Inability to prepare F/S
- Inadequate segregation of duties
- No Safeguarding of assets
- Receives significant accounting services
- Lack of timely reconciliations
- Lack of expertise in accounting principles
- Employee fraud
- Qualification & training of staff
- No monitoring of controls

Material Weaknesses

- 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

Material Weaknesses

- Significant audit adjustments
- Not correcting internal control deficiencies
- Fraud by management
- Regulatory non-compliance
- Bias in accounting estimates
- Restatement of financial statements
- Deficiencies in IT controls
- Ineffective oversight of financial reporting

Recent Trends

- Increased reporting of **significant deficiencies** or **material weaknesses** in internal control
- Increased auditor concern about **independence** – reluctance to perform audits for clients lacking sufficient expertise to form independent judgments about proposed adjustments

A-133 Compliance Report

A-133 Auditor must issue:

*Report on **Compliance** with Requirements that Could Have a Direct and Material on each **Major Program** and on **Internal Control Over Compliance** in Accord with OMB Circular A-133*

A -133 Compliance Testing

- If **internal controls** are found to be **effective**, auditor uses **similar sized samples** sizes to **test compliance**
- If **controls** are found to be **not effective**, sample sizes need to be **significantly increased** to determine compliance

Key Federal Funds Compliance Issues

- Identification of compliance requirements
- Personal activity reporting to substantiate personnel related charges
- Sub-recipient monitoring
- Procurement
- Cash Management

Key Federal Compliance Controls - continued

- Allowable costs – including allocated costs
- Facilities & equipment controls

Common A-133 Compliance Issues

- Time and Effort / Personal Activity Reporting
- Davis-Bacon Act Compliance
- Inadequate sub-recipient monitoring
- Lack of compliance policies & procedures
- Financial statement audit adjustments

A-133 Compliance Findings

- CFDA number and title
- Federal award number and year
- Federal agency
- Name of pass-through entity
- Criteria – statutory / regulatory
- Condition found
- Questioned cost – how computed
- Information to provide prospective
- Cause / effect
- Recommendation

Your Use of Auditor Reports?

- Focus monitoring efforts
- Identify common issues/challenges among CAAs in your state
- Support training & technical assistance to address common issues
- Track CAA follow-through on addressing findings

Quiz Answers

1. Boards hire independent auditors to obtain their professional opinion about whether the financial statements fairly present the financial condition of the organization.
2. The A-133 audit results in a professional opinion about the organization's compliance with Federal funding requirements in addition to an opinion about whether the financial statements fairly present the financial condition.
3. States control licensure of CPAs, including establishing specific requirements for governmental auditing.