

**Questions from GAQC Conference Call
The Impact of SAS 112 on Governmental Financial Statement Audits
January 4, 2007**

Preparing Financial Statements

Q1. During a recent AICPA Webcast, a panelist indicated that if the auditor prepared the financial statements this must be reported as a material weakness in internal control. Under what circumstances can an auditor prepare the financial statements for a client and not have to report a material weakness?

A1. A variety of situations might exist at a client for whom the auditor is asked to prepare the financial statements. In analyzing these situations, it is important to consider:

- The effectiveness of the entity's internal control apart from what the auditor does or is being asked to do.
- Why the auditor is being asked to perform certain task such as preparing adjusting entries, notes to the financial statements, or even the financial statements
- The ability of client personnel (staff accountant, bookkeeper, management) to understand and evaluate the work performed by the auditor

The following are examples of those situations and the applicable analysis.

Situation A: Client's Accountant is Capable of Preparing Financial Statements

The client's accountant is capable of preparing the financial statements. The auditor knows that the accountant is capable of preparing the financial statements because he/she prepared the financial statements last year and did a good job.

Iteration A1: The auditor is being asked to draft the financial statements this year because the client's accountant is busy installing a new computer system. Consequently, the client's accountant doesn't have enough time to carefully prepare the financial statements this year. The client's accountant submits an adjusted trial balance to the auditor along with the notes to the financial statements with indicators of where the notes should go and asks the auditor to complete the task of drafting the financial statements. The auditor drafts the financial statements using the accountant's materials and recommends no additional adjusting or correcting entries. After the auditor has drafted the financial statements, the accountant reviews the auditor-drafted financial statements for accuracy and traces everything back to the adjusted trial balance

Analysis of A1: The accountant has done 90% of the work required to prepare the financial statements. The accountant's adjusted trial balance and notes reflect all of the requirements of GAAP except for presenting them in the proper format. Based on the facts presented, there is no identified control deficiency.

Iteration A2: Assume the same scenario as described in Iteration A1 except the accountant does not have enough time to prepare year end closing entries (e.g. adjustments to depreciation based on client's depreciation schedules, year end payroll accruals based on client's payroll journal), draft the financial statements and the accompanying notes and asks the auditor to perform these tasks. After the auditor prepares all necessary year end adjustments and drafts the financial statements and footnotes, the accountant reviews all the auditor-prepared documents for accuracy and traces adjusting entries back to all source documents.

Analysis of A2: This situation, like many, will require professional judgment. Although the accountant is capable of doing all this work and seems to have controls in place to prevent and detect misstatements, it could be argued that the client does not take the closing process seriously. If preparing the financial statements is a low priority to this entity, it could be argued that this situation is an indicator of an ineffective control environment. Paragraph 19 of SAS 112 identifies the following as at least a significant deficiency and a strong indicator of a material weakness:

- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

Situation B: Client's Accountant is Not Capable of Preparing the Financial Statements

The client has a staff accountant who is able to accurately keep the books and records on the cash basis and to prepare an unadjusted trial balance but cannot compute the accruals or prepare the financial statements.

Iteration B: Because of the client's inability, the auditor computes all year end accruals which the client's accountant posts to the trial balance. The accountant is very careful and posts the accruals to the correct accounts. He thanks the auditor for providing him with the accruals and tells the auditor that he could not have prepared them himself. Using last year's adjusted trial balance and financial statements as a template, the staff accountant codes the accounts in the adjusted trial balance, combines the accounts with the same code, formats the financial statements and substitutes this year's numbers for last year's numbers. Finally he inserts the same notes that were included in last year's financial statements attaching them to the line items they were attached to last year. When he has completed the financial statements, he explains to the auditor how he prepared the financial statements and gives the financial statements to the auditor.

Analysis B The staff accountant is unable to either adjust the cash basis trial balance or evaluate the auditor's adjustments. Neither he nor anyone else within the client organization is capable of evaluating whether the financial statements are fairly presented in accordance with GAAP. As a result, the auditor has identified a control deficiency and evaluates the deficiency as a material weakness because the client has no controls which would prevent or detect material misstatements in the audited financial statements.

Q2. Is it your expectation that more significant deficiencies and material weaknesses will be communicated to smaller organizations that do not have qualified personnel to prepare GAAP financial statements?

A2. Yes, SAS 112 includes lists of items that should be considered at least significant deficiencies and those that are strong indicators of a material weakness, as well as an appendix that includes examples of situations that could be control deficiencies, significant deficiencies, or material weaknesses. These lists and examples provide more definitive information about these deficiencies that will help auditors in identifying control deficiencies that must be communicated.

Q3. Most CPA firms are drafting the financial statements and related footnotes for small clients, in many cases because they do not have staff capable of doing this. Does this automatically result in a significant deficiency or material weakness that is required to be reported under SAS 112?

A3. There is nothing that the auditor does or does not do that results in an “automatic” control deficiency. What the auditor does is totally independent of the client’s system of internal control. What is important is whether the client’s system of internal control prevents or detects material misstatements.

Q4. You say auditors are not allowed to perform control functions. For clients that are not capable of drafting financial statements or reviewing them in such a way to catch material errors (including missing material disclosures), wouldn’t the auditor’s drafting of those financial statements be performing a control function?

A4. No. The auditor’s drafting of the financial statements is part of the audit service, not part of the client’s system of internal control. The client is still responsible for their financial statements. If the auditor was considered part of the entity’s internal control, the auditor would be auditing his or her own work and therefore could not be independent.

Q5. Would you care to comment on the position of CCH that if a unit of government can accurately keep their books and records on the cash basis, and the auditor then computes and makes all of the year end accrual adjustments, and prepares the GAAP-based financial statements, there is not necessarily a material weakness in internal controls?

A5. An entity’s system of internal control over financial reporting should include controls over the prevention, detection and correction of misstatements in the audited financial statements. If an entity/government has not designed controls to prevent or detect misstatements in their audited accrual basis financial statements, then they have a control deficiency that must be evaluated if identified by the auditor.

Q6. Many small governments that are required to prepare GAAP financial statements may be capable of maintaining their detailed books and records in order to produce accurate fund basis financial statements, but have not received training to learn how to prepare the government-wide financial statements that GASB 34 requires. How does scenario affect your analysis?

A6. It doesn’t. The fund financial statements are not being audited. What’s important are the controls designed and placed in operations pertinent to the audited financial statements.

Audit Adjustments and Controls

Q7. In reading the definition of significant deficiency and material weakness, it seems that if the auditor discovers material audit adjustments during the audit there is one or more material weaknesses. True?

A7. If the auditor discovers a material misstatement and proposes an audit adjustment, then obviously, the client’s system of internal control did not prevent or detect the misstatement.

Accordingly, the auditor would have identified a control deficiency that must be evaluated. Since the amount was already determined to be material, the only remaining question is whether the likelihood is more than remote. If so, then by definition there is a material weakness.

Q8. Regarding audit adjustments, consider the following situation. A client knows there are significant audit issues that need to be addressed in the financial records but does not make adjustments for those issues until he can discuss them with the auditor as to an appropriate final resolution during the audit. Once discussed, a significant audit adjustment is then proposed by the auditor and accepted by the company. Would this result in the reporting of a material weakness?

A8. The fact that a client is aware that there is a financial statement matter that requires attention or clarification indicates that the preparer is sufficiently knowledgeable about accounting standards to know when he or she needs additional information and how to get that information. That awareness and follow up is one element of effective internal control over financial reporting

Meaning of Timely Basis

Q9. Can you define “timely basis” in the control deficiency definition?

A9. Timely basis means that the misstatement is prevented or detected in advance of when the financial statements are issued. The misstatement should not be in the financial statements.

Reporting

Q10. Can the auditor still justify issuing a clean audit opinion on the financial statements if the client has significant deficiencies or material weaknesses?

A10. Yes. The role of the auditor is to obtain a sufficient understanding of the entity’s internal control sufficient to plan and conduct his or her audit. When there are material weaknesses, the auditor responds to those control risks by adjusting the nature, timing and extent of audit procedures.

Other Questions

Q11. How will the recent issuance of proposed changes to AS 2 by the PCAOB affect SAS 112?

A11. The ASB will evaluate SAS 112 once a new PCAOB standard is issued.

Q12. What resources are available to help an auditor better understand SAS 112 and how it should be applied in practice?

A12. The AICPA has issued a risk alert entitled, *Understanding SAS No 112 and Evaluating Control Deficiencies - A Companion to SAS No. 112.*

Q13. Does SAS 112 apply to an audit of an entity that follows an other comprehensive basis of accounting (e.g., regulatory basis, cash basis, or modified cash) instead of GAAP?

A13. Yes. Footnote 1 of SAS 112 states: "Reference to generally accepted accounting principles includes, where applicable, a comprehensive basis of accounting other than generally accepted accounting principles, as that term is defined in paragraph 4 of Statement on Auditing Standards (SAS) No. 62, *Special Reports*, as amended."

Q14. Regarding the understanding of controls that must be performed related to third party service providers, if an entity uses another CPA firm to prepare financial statements, is the auditor required to document any controls regarding the third party CPA firm financial statement preparation?

A14. GAAS has always required that the auditor have an understanding of internal control sufficient to plan the audit. If the client has significant and material controls that are outsourced to outside service providers, then the auditor should be aware of those controls and use that knowledge to plan the nature, timing and extent of audit procedures.