

Addressing Internal Control Related Matters Before They Become Critical

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Session Overview

Discuss management's role in addressing internal control matters ***before*** they become critical and reportable under the requirements of ***SAS 112 "Communicating Internal Control Matters Identified in the Audit"***

Session Overview

- Why today's governments are focused more than ever on internal controls and how they are using internal controls to drive organization accountability and excellence
- Management's role in building an effective internal control program that focuses on proactively identifying and dealing with internal control related matters
- The importance of linking internal controls to risk
- Identifying and classifying internal control weaknesses using the new definitions
- Overcoming significant deficiencies and material weaknesses
- Real life examples of how governments are enhancing their control consciousness and minimizing critical control deficiencies

**WHY TODAY'S GOVERNMENTS ARE FOCUSED
MORE THAN EVER ON INTERNAL CONTROLS**

AND

**HOW THEY ARE USING INTERNAL CONTROLS TO
DRIVE ORGANIZATION ACCOUNTABILITY AND
EXCELLENCE**

Governments are Focused More Than Ever on Controls

- The Sarbanes-Oxley Act has changed significantly the way Congress and the business community thinks about governance and internal controls
- It's the new definition of "Good Business Practice"
- Bond Analysts, Rating Agencies, and Underwriters are beginning to ask for better governance and stronger internal controls
- The federal government has mandated SOX like expectations through OMB Circular A-123 Appendix A
- State, and Local governments are beginning to look at applying some aspects of SOX to governmental entities
- Board members for governmental entities across the country are asking for better governance and controls

Key Provisions of SOX Relevant to Government

- **Stronger Corporate Governance**
 - Code of Conduct
 - Ethics and Fraud Awareness Programs
 - Conflicts of Interest and Improper Influence Rules
 - Active Audit Committee and Strong Audit Oversight
- **Enhanced Financial Management**
 - Adoption of a Controls Framework
 - Management taking ownership for the establishment and operating effectiveness of controls
 - Routine evaluation and monitoring of control design and operating effectiveness
 - Annual assertion on the status of controls

OMB Circular A-123

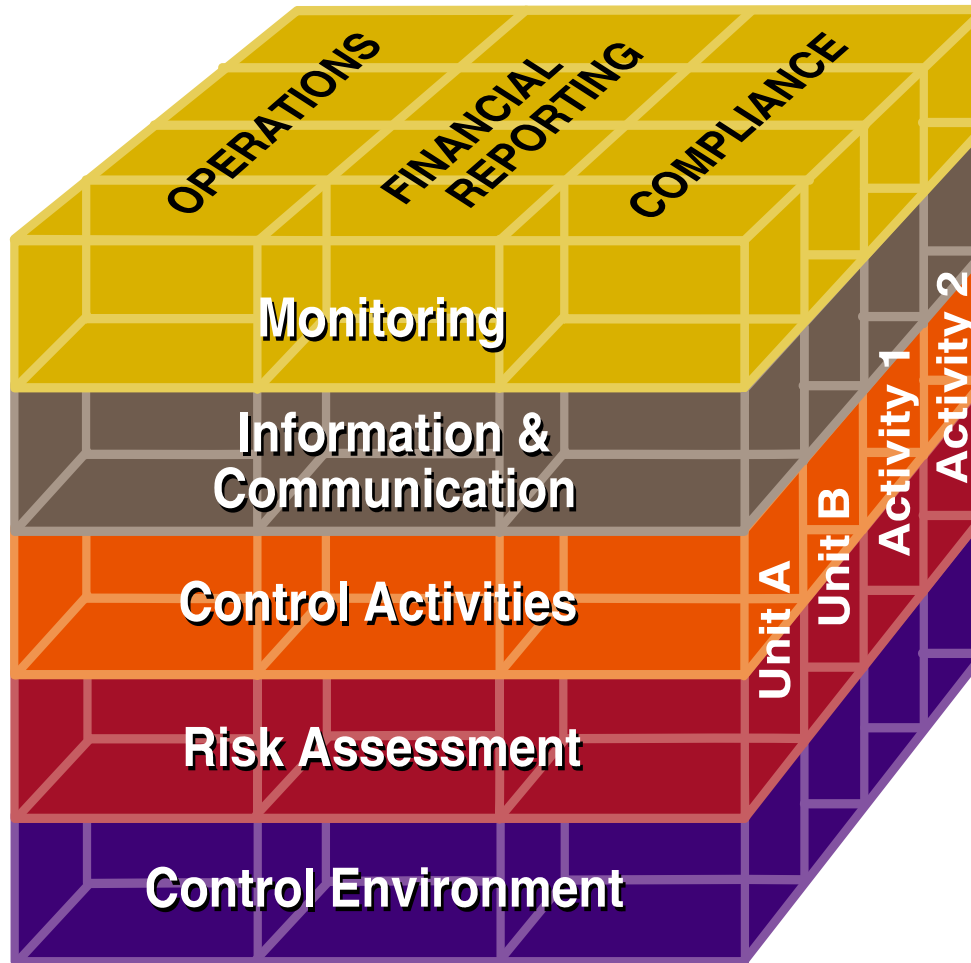
- Implementing guidance for Federal Managers Financial Integrity Act of 1982
- Defines management's responsibility for internal control
- Provides internal control standards (COSO)
- Specifies requirements for assessing the effectiveness of internal controls
- Requires assurances from agency head on the effectiveness of internal controls
- Requires reporting of material weaknesses and corrective actions
- New Appendix A – Controls over Financial Management – “FedSOX”

Using Controls to Drive Accountability and Excellence

- Entity Level Leading Practices
 - Passage of Statutory or Regulatory Control Expectations
 - Adoption of Entity-Wide Control Framework
 - Issuance of Internal Control Guidelines and Annual Reporting Requirements

- Agency Level Leading Practices
 - Establishing an Internal Controls Management Program
 - Updating Controls Documentation
 - Benchmarking Control Design Against Industry Best Practices
 - Using Control Self Assessment
 - Validating Control Effectiveness Through Independent Testing
 - Annually Attesting to or Certifying Adequacy of Control

COSO Framework



➤ **Most Widely Used SOX Framework**

➤ **Adopted as the Federal Internal Control Standard**

Purpose of an Internal Control Management Program

Establish a sustainable program for achieving and maintaining an effective system of internal control and accountability. An effective program ensures that

- Controls are adequately designed and meet industry best practices
- The nature, timing, and extent of controls are linked to the level of risk within the business process
- Technology is leveraged through the implementation of an automated controls repository and tracking system
- Design and effectiveness of controls will be routinely monitored through periodic review and evaluation
- Deficiencies are identified, discussed with management, and remediated proactively.
- Accountability of controls resides with process owners
- The appropriate framework exists to support the required assertion and certification requirements

**MANAGEMENT'S ROLE IN BUILDING AN
EFFECTIVE INTERNAL CONTROL PROGRAM THAT
FOCUSES ON PROACTIVELY IDENTIFYING AND
DEALING WITH INTERNAL CONTROL RELATED
MATTERS**

Management's Role in the Internal Control Program

- Determine the Desired Level of Control Consciousness for the Organization
- Create a Statute or Regulation to Set Expectations
 - Adopt a Control Framework
 - Define the Basics of Who, What ,When and How
 - Build in Sustainability
- Establish Guidelines to Support Implementation
- Communicate Effectively to All Levels of the Organization
- Routinely Monitor Program Activities and Results
- Hold Your People Accountable for Adherence to the Program

THE IMPORTANCE OF LINKING INTERNAL CONTROLS TO RISK

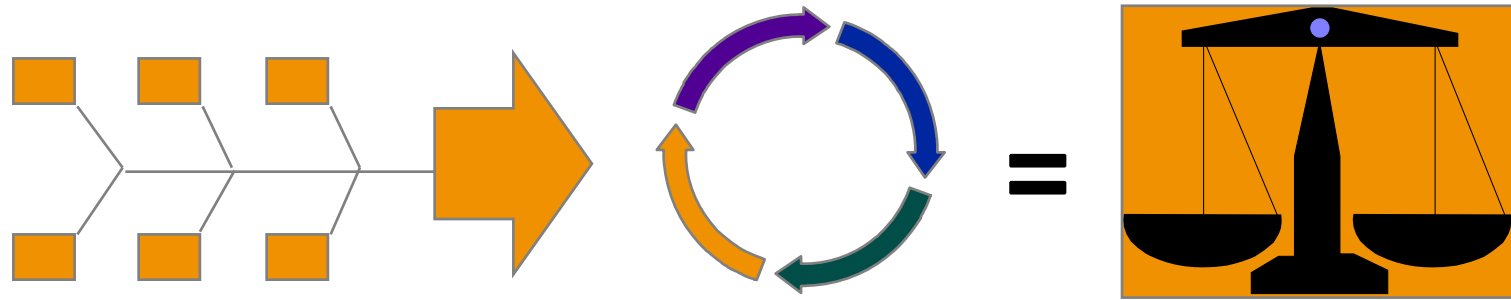
What is Risk?

Risk is “Any Event that can Adversely Affect the Achievement of Your Objectives” — COSO

- Risk is a significant event or series of events or conditions that can negatively affect the achievement of your objectives
- Risk can also occur as a result of the choices and decisions made by the organization

Control Exposure

Risk – Established Controls = Exposure

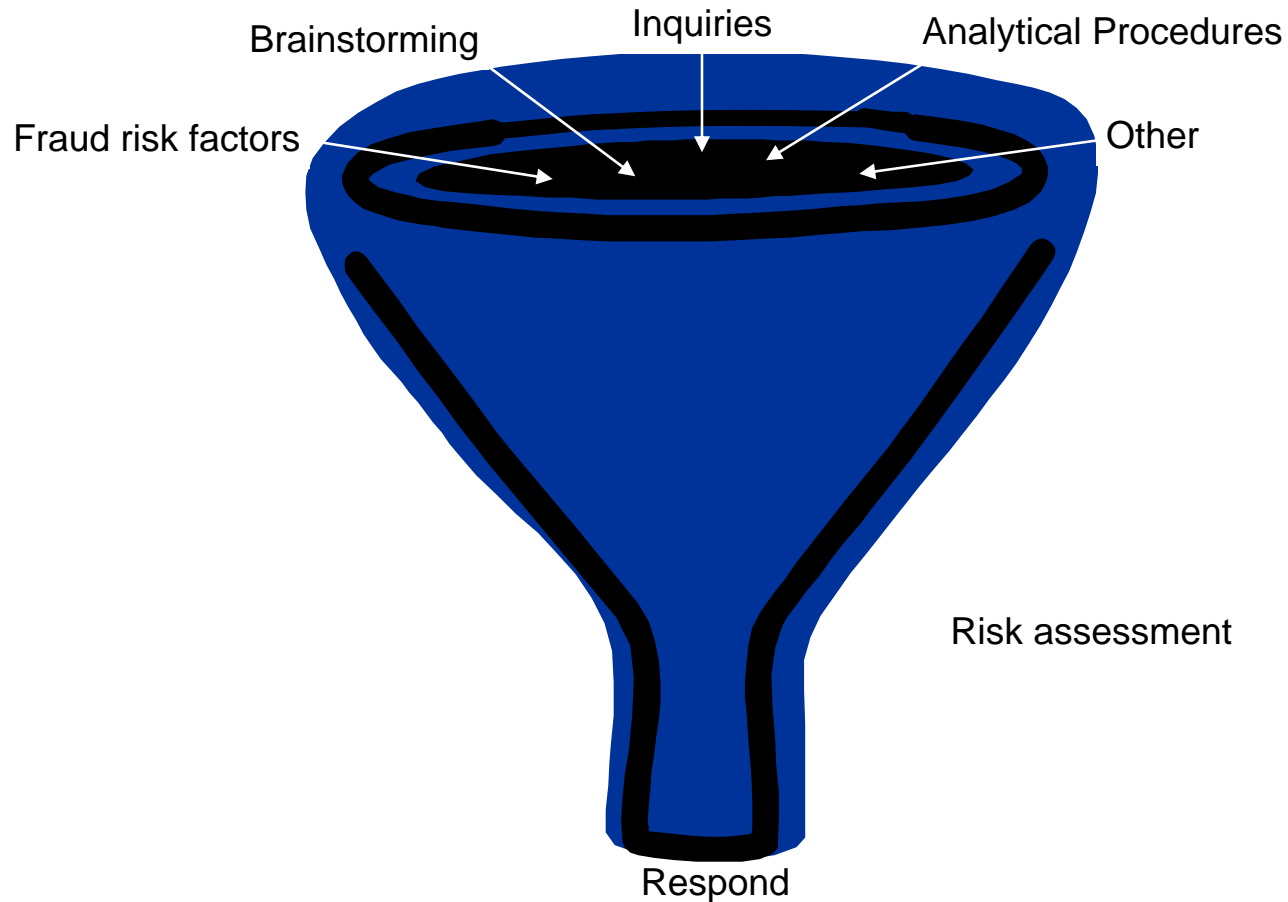


Risks that are Inherent in the Organization

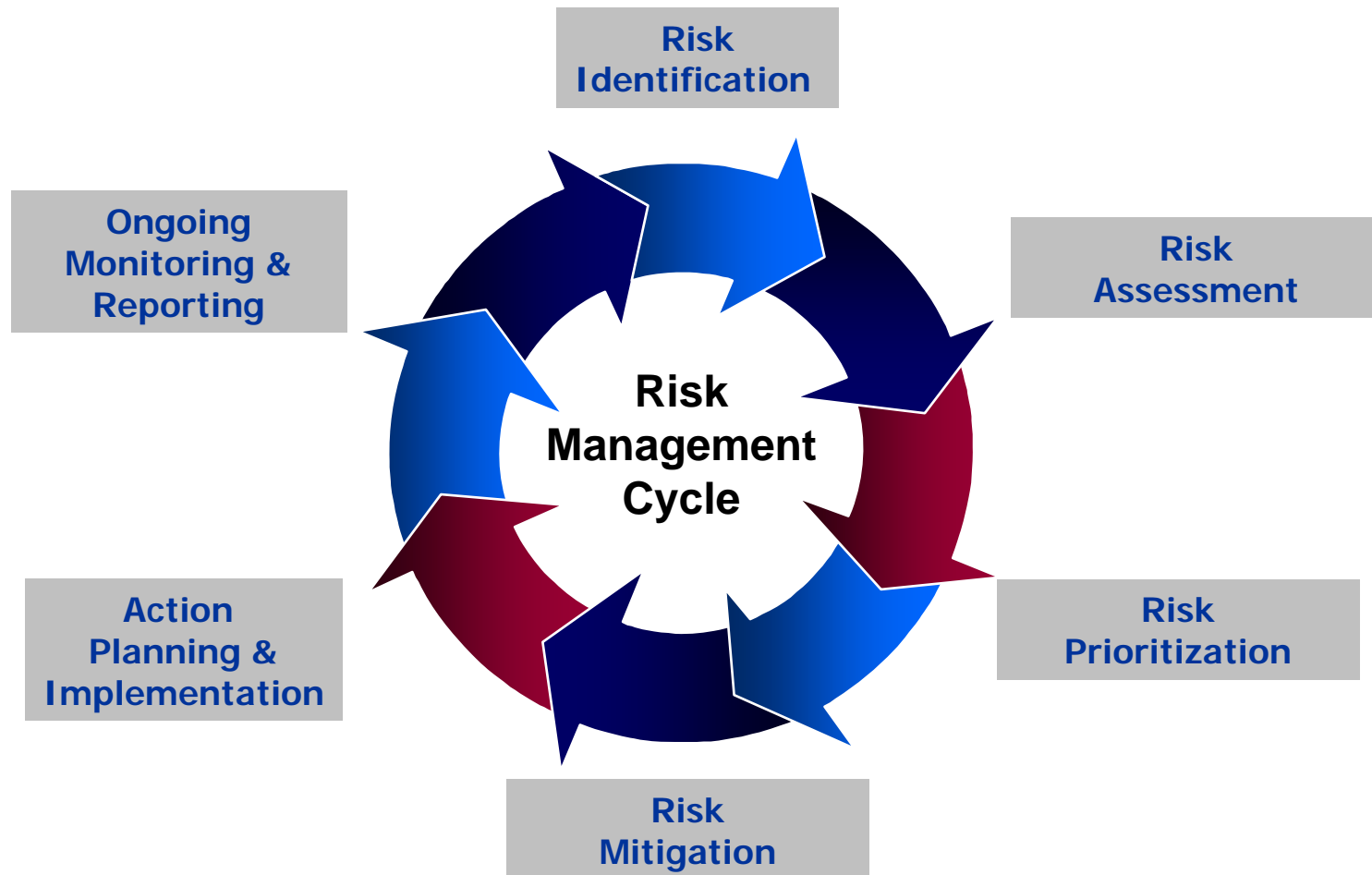
Mitigated by Internal Controls

Equals “Acceptable” Exposure

Process for Identifying and Assessing Risk



Basic Risk Management Cycle



What are the key threats and opportunities that might affect my business?



Risk Identification

What is the likelihood of a risk event and what would be the impact? How does the potential impact relate to our risk tolerance or risk appetite? What's my organization's total risk exposure?



Risk Assessment

What are the most critical risk issues that demand our immediate attention? How do they relate to our business strategy? What are our options?



Risk Prioritization

Do we avoid, transfer or retain the risk? Can we control or manage it better? Can we safely hedge risks in order to pursue growth opportunities? What are the costs vs. benefits?



Risk Mitigation

What's the best course of action? When and who's accountable? How will we know that our mitigating actions are effective? What's the linkage to our business plan?



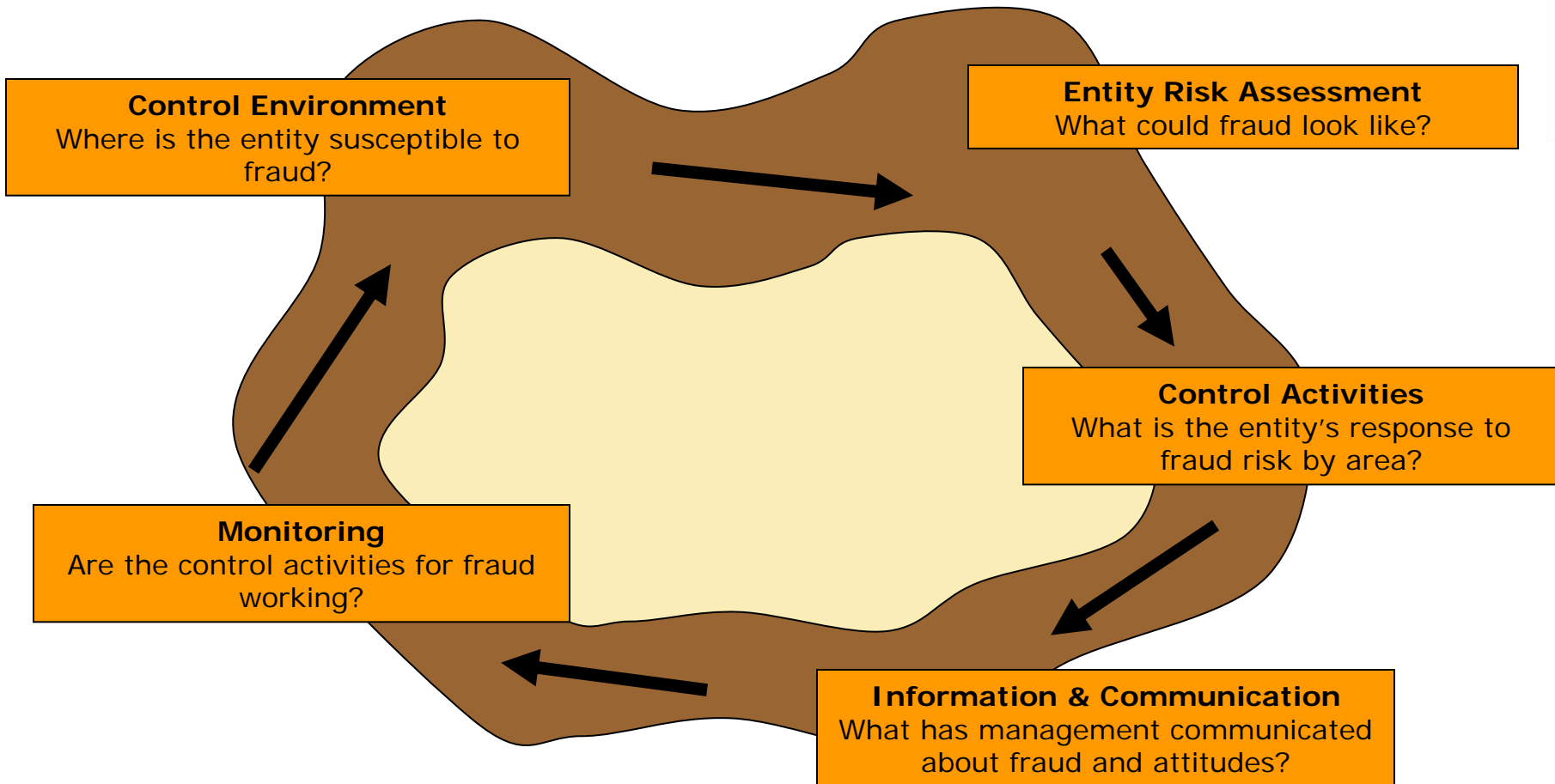
Action Planning

What information will be available to assure that we are operating within risk policies and limits? How can we assure that our organization is risk intelligent and risk aware?

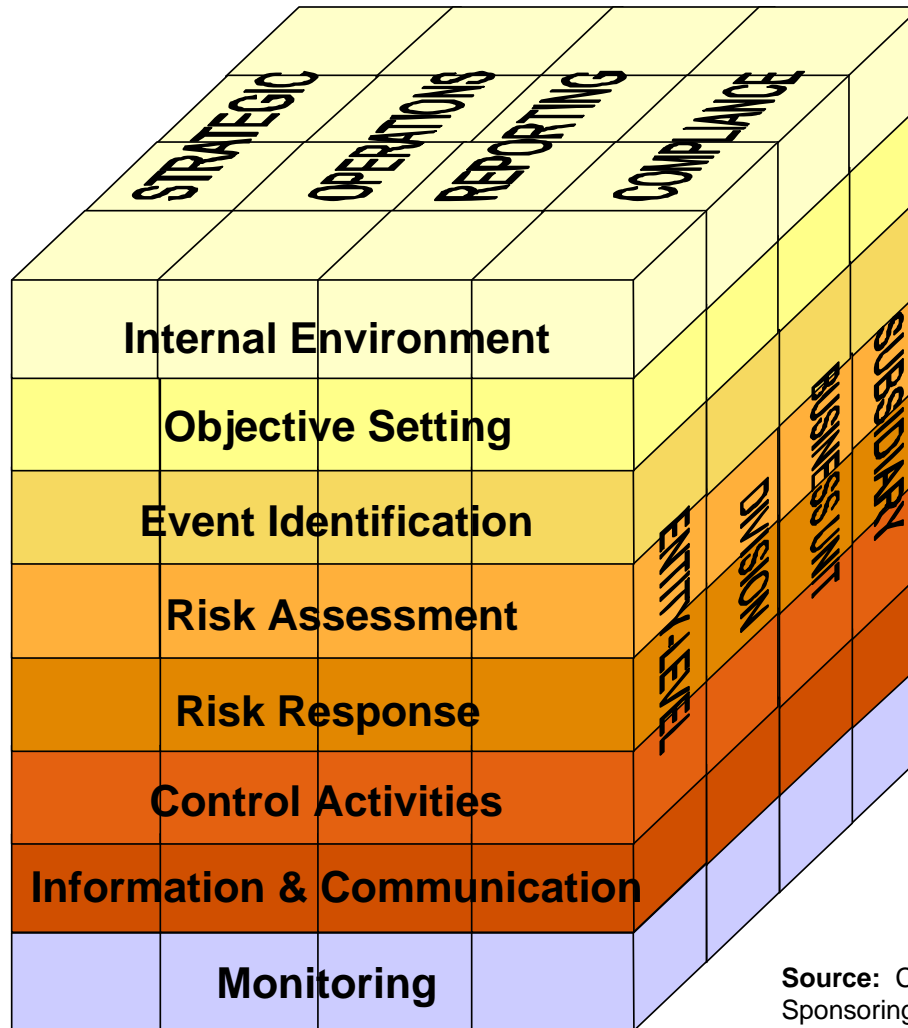


Ongoing Monitoring

Assessing Fraud Risks



COSO and Risk



Risk is “any event that can adversely affect the achievement of your objectives” — COSO

Source: COSO - The Committee of Sponsoring Organizations of the Treadway Commission, Enterprise Risk Management Framework (Exposure Draft), 2003.

The Importance of Linking Internal Control To Risk

- Many financial debacles, business failures and frauds can be linked to poor risk intelligence and weak internal controls
- Risks not controlled are risks not managed
- Internal controls should be directly linked to the organization's risks
- The more significant a risk is to the organization, the more control that should be placed around it
- Its management's responsibility to understand it's risk and to develop a system of internal controls to manage it
- It's the auditor's responsibility to understand managements actions in these areas and to design the audit to address the level of risk and control impacting the organization's financial reporting

**IDENTIFYING AND CLASSIFYING INTERNAL
CONTROL WEAKNESSES USING THE NEW
DEFINITIONS FROM SAS 112**

Overview of SAS 112

- *Communicating Internal Control Related matters Identified in an Audit.*
 - 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. It is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). In particular, it:
 - Defines the terms *significant deficiency* and *material weakness*.
 - Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements.
 - Requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

Overview of SAS 112

- Supersedes SAS 60
- Adopts PCAOB AS2 terminology
- Elimination of “reportable condition” terminology
- Conforming changes were made to AT 501, *reporting on an Entity’s Internal Control Over Financial Reporting*
- Effective for financial audits for periods ending on or after December 15, 2006

Control Deficiencies

- **A control deficiency exists when the design or operation of a control does not allow management or employees in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.**
 - A design deficiency exists when
 - A control necessary to meet a control objective is missing
 - An existing control is not properly designed so that even if the control operates as designed, the control objective is not always met
 - An deficiency in operation exists when
 - A properly designed control does not operate as designed or
 - When a person performing the control does not possess the authority or qualifications to perform the control effectively.
- A control deficiency may involve one ore more of the 5 internal control components

Significant Control Deficiency

- A significant deficiency is a control deficiency, or combination of control deficiencies that adversely affects the entity's ability to initiate, authorize, process, and report financial data reliably in accordance with GAAP and there is ***more than a remote likelihood that a misstatement*** of the entities financial statements that is ***more than inconsequential*** will not be prevented or detected

More than Inconsequential

- A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement either individually or in the aggregate would clearly be immaterial to the financial statements.
- ***If a reasonable person would not reach such a conclusion regarding a particular misstatement then the misstatement is “more than inconsequential”.***
- Both quantitative and qualitative factors should be considered when determining if a potential misstatement is more than inconsequential.

Material Weakness

- A material weakness is a significant deficiency or combination of significant deficiencies that result in ***more than a remote likelihood*** that a material misstatement of the financial statements will not be prevented or detected.

Evaluating Control Deficiencies

- “**All**” identified control deficiencies must be evaluated individually and in combination with other related deficiencies to determine if they are a significant deficiency or material weakness
- Likelihood and magnitude of the misstatement must be also be considered

Likelihood

- Likelihood may be impacted by:
 - Nature of the accounts
 - Susceptibility of the related asset or liability to loss or fraud
 - Subjectivity and complexity of the amount involved and the extent judgment is involved
 - Cause and frequency of any known or detected exceptions
 - The interaction or relationship to other controls
 - The interaction with other control deficiencies
 - Possible future consequences of the deficiency

Magnitude

- Magnitude may be impacted by:
 - Financial statement amounts or total of transactions exposed to the deficiency
 - The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected future periods

Indicators of Significant Deficiencies or Material Weaknesses

- Ineffective oversight of the entities financial reporting and internal control by those charged with governance
- Restatement of previously issued financial statements
- Identification by the auditor of a material misstatement in the financial statements in the period under audit not identified by the entity's internal controls
- An ineffective internal audit or risk assessment function
- An ineffective compliance function for heavily regulated entities
- Identification of fraud by senior management
- Failure to assess and remediate previous significant deficiencies or material weaknesses
- An ineffective control environment

SAS 112 Required Communications:

- Communicate all significant deficiencies and material weaknesses, in writing, to management and those charged with governance
 - Significant deficiencies and material weaknesses identified during the current year audit
 - Significant deficiencies and material weaknesses that were communicated from previous audits and have not yet been remediated
- Communicate significant deficiencies and material weaknesses regardless of management's decision to not take corrective action to remediate such deficiencies
- Report should be issued within 45 days of the issuance of our audit report on the financial statements

OVERCOMING SIGNIFICANT DEFICIENCIES AND MATERIAL WEAKNESSES

Overcoming Significant Deficiencies and Material Weaknesses

- Gain a thorough understanding of the issue and why it was determined to be significant deficiency or material weakness
- What was the specific control that failed?
- What type of control was it (preventative or detective)?
- Was the failure a design or operating effectiveness failure?
- What risk was the control supposed to be addressing?
- Understand the root cause of the failure
- Identify the key players

Overcoming Significant Deficiencies and Material Weaknesses

- Develop a corrective action plan to include who is to do what, when and how
- If a design failure - redesign the control
- If an operational effectiveness failure – hold your people accountable, re-communicate expectations, and re-train as necessary
- Monitor that corrective action is taking place as expected
- Validate corrective action has been completed through independent validation

**REAL LIFE EXAMPLES OF HOW GOVERNMENTS
ARE ENHANCING THEIR CONTROL
CONSCIOUSNESS AND MINIMIZING CRITICAL
CONTROL DEFICIENCIES.**

Real Life Examples of Governments Enhancing Internal Control

- The Federal Government takes the lead with OMB Circular A-123
- A number of state's are building internal control programs
- Local government is beginning to take notice
- Some organizations are doing it to prevent fraud and abuse
- Some organizations are doing it to drive efficiency and effectiveness

WHAT ARE YOU SEEING?

QUESTIONS?

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