

Audit and Compliance Issues For Board & Audit Committee Members

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Today's Agenda

1. Which audit?
2. Internal controls
3. Audit v. compliance
4. Key matters to discuss with your auditors



PART 1

Which Audit?



Audit Functions

- External Auditors/Service Providers
 - Financial statement audit
 - Single Audit Act (NPOs and State/Local Gov't agencies)
 - Special purpose audits – with opinion
 - Special purpose audits – AUP
 - Compliance/financial audits by funding sources
 - Investigations
- Internal Auditor
 - Various assurance and consulting activities
- Compliance
 - Ongoing auditing and monitoring activities



Auditor Responsibilities

- Issue an opinion on whether the financial statements are fairly presented in all material respects
- Applies to the basic statements and all notes
 - Are the financial statements accurate?
 - Are they complete?
 - Do they conform to GAAP (or IFRS)



Applicability of Single Audit Act

- State, local government, Indian tribe, institution of higher education (IHE), or nonprofit organization
- \$750,000 or More in Expenditures of Federal Awards (increased from \$500,000 for years ending after 12/26/14)
 - Federal Financial Assistance
 - Cost-Reimbursement Contracts
- U.S.-Based Entities Only
- Direct or Indirect Receipt
 - Pass-through entities



Contractor or Subrecipient

- | | |
|--|---|
| <ol style="list-style-type: none"> 1. Goods or Services are Normal Business Operations 2. Many Different Purchasers 3. Competitive Environment 4. Ancillary to Operation of Federal Program 5. Not Subject to Compliance Requirements | <ol style="list-style-type: none"> 1. Determines Eligibility of Recipients 2. Performance Measured Against Achievement of Objectives 3. Programmatic Decision Making 4. Subject to Compliance Requirements 5. Uses Funds to Carry Out Program for a public purpose |
|--|---|



Objectives of a Single Audit

- Financial Statements Fairly Presented in Accordance with GAAP
- Internal Controls Which Provide Reasonable Assurance that Auditee is in Compliance with Applicable Laws, Regulations & Award Provisions
- The Auditee has Complied with Laws, Regulations & Award Provisions That Have Direct and Material Effect on:
 - Financial Statements (Yellow Book/GAGAS)
 - Each Major Program (Single Audit)



Auditor Responsibilities – Public Companies

- An additional report attesting to the accuracy of management’s report on internal controls (SOX section 404)
 - Whether management has identified any material weaknesses in internal controls over financial reporting



PART 2

Internal Controls



Internal Controls

- Processes designed to achieve organizational objectives in three areas:
 - Operational effectiveness
 - Financial and nonfinancial reporting
 - Compliance with laws, regulations and policies



Internal Control Responsibilities

Management

- Establish internal controls designed to achieve all three objectives
- Monitor internal controls
- Identify, report and remediate deficiencies
- Communicate deficiencies with auditors

Auditor

- Gain understanding of internal control over financial reporting
- Risk assessment – impact on financial statements
- Limited testing of internal controls (404, government audits)
- Report significant deficiencies and material weaknesses to A.C.



Key Auditor Steps Relating to I.C.

- Conduct a risk assessment
 - How could FS be materially misstated as a result of error or fraud
- ➔ • Discuss with audit committee
- Gain an understanding of internal controls
 - Only IC over financial reporting
- Based on the understanding of internal controls, and other information gathered, design audit procedures to achieve the audit objectives
- ➔ • No requirement to test internal controls, unless 404 or Single Audit
- Communicate planned audit scope and key procedures to audit committee before audit commences
- Communicate significant deficiencies and material weaknesses in internal controls at end of audit



PART 3

Fraud and Compliance Risks



Compliance Risks

- Auditor responsibilities involving compliance risks are driven primarily by two factors
 - Fraud
 - Illegal acts



Management's Responsibilities

- Part of the “new” (2013) COSO internal control framework considered by auditors requires that management perform a fraud risk assessment
- Audit committee:
 - Inquire of management about and discuss this fraud risk assessment
 - How was it performed?
 - What were the most material inherent fraud risks identified?
 - Were any fraud risks identified with higher than acceptable residual risks?
 - If so, what remediation actions are being taken?



Auditor's Fraud Risk Assessment

- Material misstatements in the FS caused by one of two factors
 - Error
 - Fraud
- Types of fraud considered by auditors
 - Asset misappropriation – theft by employees, other insiders
 - Financial reporting/accounting fraud
- One type of fraud not considered by auditors:
 - Bribery and corruption - why?
 - Not a direct effect on the financial statements (unless asset misappropriation is also involved or certain other illegal acts involved – more on this later)



Ask the Auditor

- How did they perform their fraud risk assessment (i.e. what information they considered, who they spoke with, etc)?
- What were the results of the fraud risk assessment?
- What audit procedures they performed in response to their fraud risk assessment?



Illegal Acts

- Defined as violations of laws or government regulations
- Auditor must consider laws and regulations that have a direct and material effect on the financial statements
 - Responsibility is same as that for errors or fraud – design appropriate audit procedures based on risk assessment
- Examples of direct effect on financial statements:
 - Income taxes, Internal Revenue Code
 - Revenue-related laws, such as False Claims Act
- Laws with an indirect effect on FS include those in which a violation could result in a fine or penalty (e.g. FCPA, environmental, FLSA, etc)
 - The majority of compliance considerations



Single Audits

- For NPOs and State/Local government agencies being audited under the Single Audit Act (a.k.a. OMB Circular A-133), scope of compliance auditing is:
 - Limited to “major” federal programs (i.e. no compliance work is performed on non-major programs)
 - Limited to compliance requirements identified in the Compliance Supplement
 - Limited to compliance requirements that are material to the program (even if not material to the financial statements)
 - Primary recipient is responsible for compliance of its subrecipients



Detection of Illegal Acts

- No requirement to design audit procedures to detect violations of laws with indirect effect on financial statements
- Auditor must ask AC about possible illegal acts
- If information comes to auditor's attention concerning violations of laws that could have a material indirect effect, auditor must apply audit procedures to determine whether an illegal act occurred
- How does it come to auditor's attention:
 - Audit procedures applied to laws with direct effect
 - Disclosure by client (management or audit committee)
 - Awareness of regulatory investigations, enforcement proceedings, etc
 - Other audit procedures



If Possible Illegal Acts Are Detected

- Gain an understanding of the act sufficient to assess impact on the financial statements
- Discuss with management at least one level above those involved
 - If senior management might be involved, the implication is that the auditor should discuss with the audit committee
- If management does not provide sufficient information that no illegal act occurred, consult with client's legal counsel or other specialists and perform additional audit procedures



Financial Statement Effect

- Consider quantitative and qualitative aspects of materiality
- “An illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue”



Other Key Audit Steps

- Auditor must make inquiries of management regarding compliance with laws and regulations
- Auditor should also obtain written representations from management concerning the absence of violations or possible violations of laws whose effects should be considered for disclosure or as a basis for recording a loss contingency



What's it Mean for You?

- Ask the auditor:
 - Which laws and regulations have they identified as having direct and possibly material effects on the FS?
 - What are their planned audit procedures in connection with those risks?
 - What were the results of their discussion with management concerning compliance with laws and regulations, and how did that discussion impact their risk assessment and design of procedures?



Questions - Illegal Acts

- What procedures they performed in connection with laws and regulations that could have a direct effect on the financial statements, and the results of those procedures?
- Did they become aware of possible violations of laws that could have an indirect effect on the financial statements and, if so, what did they do about it?
- Did they encounter any difficulties in performing their audit procedures relating to illegal acts (or fraud)?
- Did they have any disagreements with management in connection with assessing whether illegal acts occurred?



Questions - Fraud

- What were the results of the procedures they performed in response to their fraud risk assessment?
- Did they need to modify any of their audit procedures as a result of new information that came to their attention during the audit?
 - Note – the auditor’s fraud risk assessment is expected to continue through to the end of the audit; It is not merely a planning step done before the audit commences.
- Did they discover any possible frauds?
- Did they identify any red flags of fraud that they looked into?



Conclusions

- The auditor’s primary role is to express an opinion on the financial statements
- Very little of their work is focused on compliance matters
- However, they do have specific areas of focus that are quite relevant to compliance, beyond compliance with GAAP
- There are numerous auditor communications responsibilities beyond those covered here
- The key is to understand the auditor’s compliance-related responsibilities and to know what questions to ask and discussions to have with the auditors



QUESTIONS ??

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