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

<table>
<thead>
<tr>
<th>Contractor</th>
<th>Subrecipient</th>
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<tbody>
<tr>
<td>1. Goods or Services are Normal Business Operations</td>
<td>1. Determines Eligibility of Recipients</td>
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<tr>
<td>2. Many Different Purchasers</td>
<td>2. Performance Measured Against Achievement of Objectives</td>
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<td>4. Ancillary to Operation of Federal Program</td>
<td>4. Subject to Compliance Requirements</td>
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<tr>
<td>5. Not Subject to Compliance Requirements</td>
<td>5. Uses Funds to Carry Out Program for a public purpose</td>
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## 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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