Volume 1
Issue 1

IN CONTROL

APRIL 2007

DEPARTMENT OF ADMINISTRATIVE SERVICES
STATE CONTROLLER'S DIVISION

TRAINING OPPORTUNITY

Internal Controls over Financial Reporting

- **June 7, 2007**
- **1:30 to 4:30 p.m.**
- **L&I Bldg., CR 260**
- **3 CPE hours**

Who should attend:

- **Accounting managers and senior accountants**

To register, send an email to:
SCD.REGISTER@state.or.us

Be sure to include:

- **Class title and date in subject line**
- **Attendee name**
- **Agency name and address**
- **Phone number and email address**

For more details, see page 3

Inside this issue:

Something New

With the publication of this newsletter, the State Controller's Division introduces a new communication tool that will focus primarily on the subject of internal control. The format may change as the newsletter evolves. However, the goal will remain constant – to keep readers up to date on the latest trends, best practices, training opportunities and more in the area of internal control.

Internal control has received a lot of attention recently from the press and policy makers and, especially, in the business community where public companies have struggled to implement the compliance requirements contained in the **Sarbanes-Oxley Act (SOX) of 2002**. Enacted by Congress in response to Enron and other high-profile corporate failures, this legislation also sparked a revision of the internal control guidance aimed at large federal agencies, **Office of Management and Budget, Circular A-123**.

Circular A-123 has always required the large federal agencies to perform annual internal control assessments. The difference now is that documentation must be maintained not only of the controls in place, but also of the assessment process and methodologies used to support management's assertion on the effectiveness of its internal control system. In addition, A-123 requires heads of federal agencies to report their internal control findings, including disclosure of significant or material weaknesses, in a separate annual *assurance statement*.

How do these changes impact state and local governments? Will state and local governments soon face similar requirements imposed on them by federal authorities or other regulatory bodies? The fact is that pressure for stronger controls in government now is coming from another source.

Statement of Auditing Standards (SAS) No. 112–Communicating Internal Control Related Matters Identified in an Audit was issued in May 2006 by the Auditing Standards Board of the American Institute of Certified Public Accountants. This statement applies to state and local governments and is effective for the state of Oregon beginning with the financial statement audit of fiscal year ending June 30, 2007.

Internal Control Over Financial Reporting

It is important to note that *SAS No. 112* does not require state governments to perform an annual assessment of their internal controls. Its purpose, rather, is to provide guidance to auditors on communicating matters related to an entity's internal control over

Internal Control Over Financial Reporting (cont'd)

financial reporting identified in an audit of financial statements. In particular, this publication:

- Defines the terms ***significant deficiency*** and ***material weakness***.
- Provides guidance on evaluating the severity of identified control deficiencies.
- Requires the auditor to communicate, in writing, to management, significant deficiencies and material weaknesses identified in an audit.

SAS No. 112 defines a ***significant deficiency*** as a control deficiency, or combination of control deficiencies, that adversely affects an organizations ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A ***material weakness*** is defined as 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. *The significance of a control deficiency depends on the "potential" for a misstatement, not on whether a misstatement actually has occurred.*

SAS No. 112 provides examples of the factors an auditor should consider when evaluating the likelihood and magnitude of misstatement. The auditor also should evaluate the possible mitigating impacts of effective compensating controls that have been tested and evaluated as part of the financial statement audit. In the end, it is the auditor's responsibility to determine whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

According to *SAS No. 112*, deficiencies in the following areas would ordinarily be considered *at least* significant deficiencies:

- Controls over selection/application of accounting principles that are in conformity with generally accepted accounting principles. *Having sufficient expertise to select and apply accounting principles is an essential aspect of such controls.*
- Antifraud policies and controls.
- Controls over nonroutine and nonsystematic transactions.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transactions into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

Each of the following control deficiencies would be regarded as *at least* a significant deficiency and a *strong indicator* of a material weakness:

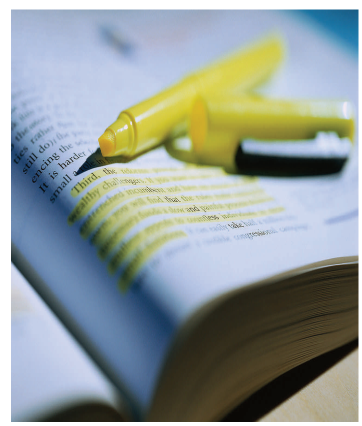
- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.
- A prior period adjustment to correct a material misstatement in previously issued financial statements, whether due to error or fraud.

Internal Control Over Financial Reporting (cont'd)

- Identification of misstatements for the period currently under audit that were not initially detected by the entity's system of internal control. This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of recorded amounts.
- An ineffective internal audit function or risk assessment function in those entities that are very large or highly complex for which such functions are important to the monitoring or risk assessment component of internal control.
- Ineffective regulatory compliance for complex entities for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.
- Identification of fraud of *any* magnitude on the part of senior management.
- Failure to assess the effect of a significant deficiency previously communicated to the entity and take steps to correct it.
- An ineffective control environment.

Although these conclusions are not automatic, a high hurdle has been set. As auditors gain experience in applying *SAS No. 112*, more guidance will become available. In the meantime, the State Controller's Division would like to begin a dialogue that emphasizes the benefits of a strong system of internal control – not because of a federal mandate or the issuance of a new auditing standard – but because it makes good business sense and because it protects the integrity of our financial reporting.

Training Opportunity



Internal Controls Over Financial Reporting

(for Accounting Managers and Senior Accountants)

June 7, 2007 — 1:30 to 4:30 p.m.

Labor & Industries Building - Room 260

This class will provide an overview of internal controls over financial reporting, introduce a set of self-assessment tools that agencies may use to improve their internal controls over financial reporting and then apply these tools to recent audit findings. The self-assessment tools focus on the following transaction cycles or processes:

- The financial close process
- Entity-level controls
- Expenditures and cash disbursements
- Revenues, cash receipts and accounts receivable
- Payroll processing

To register, send an email to: SCD.REGISTER@state.or.us. Be sure to include: (1) the class title and date in the subject line, (2) attendee name, (3) agency name and address, and (4) phone number and email address.

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Statewide Financial Services

155 Cottage Street NE

Salem, OR 97301

Phone: 503-378-3156

Fax: 503-378-3514

http://www.oregon.gov/DAS/SCD/index.shtml

Who Can You Call for Help?

The State Controller's Division reminds state agencies that it is always available to answer internal control questions. If you have an internal control problem or an audit finding and need help in resolving it, please contact:

Kathryn Ross
Statewide Financial Internal Control Officer
Kathryn.Ross@state.or.us
503-378-3156 x277

Internal control tools are on the Web!

http://www.oregon.gov/DAS/SCD/internal_controls.shtml