The essence of Statement on Auditing Standard 114 is described in paragraph 5 of the pronouncement: "The auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process."

Statement on Auditing Standard 114:

The Auditor's Communication With Those Charged With Governance

by Michael A. Van Sertima

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Introduction

The auditing profession has been inundated with "new" auditing standards over the past couple of years, beginning with Statement on Auditing Standard (SAS) 103 on audit documentation and culminating with SAS 114. These auditing standards cover the overall audit process, beginning with planning the audit, accumulating audit evidence, documenting audit evidence, and ultimately reporting the results of the audit to those charged with management and governance. These standards, which represent an overhaul of the audit process, are the accounting profession's reaction following financial reporting scandals and audit failures in the last few years.

This article is on Statement on Auditing Standard 114, The Auditor's Communication With Those Charged With Governance, which requires auditors to communicate certain matters stemming from the financial statement audit; it continues the discussion presented by "Cutting to the Heart of SAS 112," on SAS 112, Communicating Internal Control Related Matters in an Audit published in the November 2007 issue of *Benefits & Compensation Digest*. Note that the reporting required under SAS 114 is in addition to that required by SAS 112.

Statement on Auditing Standard 114: The Au

SAS 114 draws a distinction between those charged with management and those charged with governance and requires the auditor to report to those charged with governance. The auditor deals with management constantly during the course of the audit and may lose sight of the need to communicate with those who have ultimate responsibility for the plan. The objective of SAS 114 is to ensure this does not happen.

SAS 114 replaces SAS 61, Communication With Audit Committees; the change in title is indicative of the increase in scope of the reporting audience. Public companies are required by law to have an audit committee. There is no such legal requirement applicable to nonpublic entities, including employee benefit plans. Additionally, since many employee benefit plans do not have an audit committee, the auditor did not previously have any communication responsibilities under SAS 61. SAS 114 has closed this "loophole" so auditors are now required to report to boards of trustees, administrative committees, etc. In other words, while SAS 61 was applicable only to those entities with an audit committee, SAS 114 applies to all entities.

One end result of compliance with SAS 114 is that those charged with governance will acquire a better understanding of the scope of the audit and the auditor's responsibilities. There are plan trustees and management who think that auditors test all transactions or that auditors are expected to find all fraud regardless of magnitude. In plans where there may be bookkeeping issues, it is also a common belief that the auditor is expected to "take care of" the bookkeeping. One other misconception is that the audit itself is a form of internal control. Plan trustees need to be aware the audit is separate and distinct from the plan's system of internal controls, and management (and ultimately the trustees) is responsible for implementing an effective system of internal controls.

There is an implication in SAS 114 that auditors need to be more effective in communicating to those charged with governance. The overriding requirement of SAS 114 is for auditors to communicate audit matters that are significant and relevant to those charged with ultimate responsibility for the financial reporting process. It is important to note that the auditor's responsibility under SAS 114 pertains only to the audit of the financial statement and does not extend to operational matters.

Effective two-way communication benefits the auditor in addition to those charged with governance. The more the interaction between the auditor and those charged with governance, the better the auditor's assessment of the plan's control environment. The *control environment* is the foundation of an effective system of internal controls.

Who Is Responsible for Governance?

Those charged with governance are responsible for overseeing the strategic direction of the plan. In a multiemployer plan, this would be the board of trustees, and in a corporate single employer plan, the administrative committee or its equivalent. In a case of a corporation or a charitable organization, it would be the board of directors or a similar group.

Audit Committees

If the auditor communicates with an audit committee or similar subgroup of those charged with governance, the auditor must consider whether this alone adequately meets the auditor's responsibility to communicate with those charged with governance. In addition, the auditor should:

- Have access to the audit committee as necessary.
- Meet periodically with the chair and other members of the audit committee.
- Meet with the audit committee without management present at least once a year.

Nature of Communication

The matters to be communicated under SAS 114 include the responsibilities of the auditor and the significant findings beyond those required under SAS 112.

Responsibilities of the Auditor

The *auditor's responsibilities* under generally accepted auditing standards and an overview of the planned scope and timing of the audit are adequately covered

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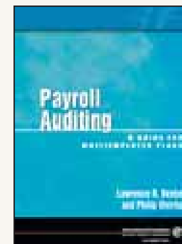

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Bonus Reading for Members

"Cutting to the Heart of SAS 112," November 2007, *Benefits & Compensation Digest* at www.ifebp.org/resources/periodicals.

by the engagement letter. Additionally, the auditor's responsibility is succinctly stated in the audit report, which clearly indicates the auditor is responsible for opining on the financial statements and that management, not the auditor, is responsible for the financial statements. This is the case even if the auditor assists in the preparation of, or prepares, the financial statements. The bottom line is that management cannot be absolved of its responsibility for the financial statements by having the financial statements prepared and/or audited by the auditor. An effective way of communicating the auditor's and management's responsibilities is to distribute the engagement letter to those charged with governance prior to the start of the audit and emphasize the following points by way of discussion.

The bottom line is that management cannot be absolved of its responsibility for the financial statements by having the financial statements prepared and/or audited by the auditor.

1. The auditor does not guarantee the accuracy of the financial statements; instead, the objective of an audit in accordance with generally accepted auditing standards is to provide reasonable (not absolute) assurance about whether the financial statements are free of material misstatements due to fraud or errors. *Reasonable assurance* is defined in the auditing standards as a high level of assurance and means there is still a risk that, after the audit is completed and an unqualified or clean opinion is rendered, there is still a slight chance of a material error or fraud in the financials.
2. *Materiality* means that, generally, the emphasis of audit procedures is on key items and transactions in the financial statements. That is, an audit is not designed to find immaterial misstatements. As a result, there is a chance that the financial statements contain *immaterial* misstatements after the audit is completed and an unqualified (clean) opinion is given.
3. As a result of (1) and (2) above, audit procedures and testing are not specifically designed to discover, say, a $10,000 theft of cash or other plan assets in a plan with $200M in assets. Such a loss of assets is clearly immaterial in the context of $200M in assets. However, if the auditor suspects fraud regardless of materiality, additional procedures should be performed. If fraud is discovered, auditing standards require the auditor to report it to the appropriate level of management and those charged with governance.
4. Management, not the auditor, is responsible for implementing a system of internal controls.
5. Management is responsible for the selection and application of accounting principles. The specific accounting principles followed by the plan are usually found in the first or second footnote disclosure to the financial statements and are referred to as *accounting policies.*
6. The audit is not a form of internal control.
7. The auditor is to provide an overview of the scope and timing of the audit, without compromising the effectiveness of audit. That is, the auditor does not indicate how samples are selected or what items will be tested. The overview should include the following components.
   a. Audit tests are performed on samples of transactions; that is, the auditor does not conduct a detailed examination of all transactions. As a consequence, the auditor will not find all misstatements in the financials.
   b. Types of audit evidence used—confirmations, inquiries of management, analytical procedures, etc.
   c. Anticipated start and completion dates of the audit, including the performance of interim procedures
   d. The auditor's response to significant risks of material misstatement
   e. The extent of reliance on internal audit, if the plan has internal auditors.
8. Other matters for the auditor:
   a. The individual or individual(s) in the governance structure to serve as a liaison with the auditor
   b. Areas of concern that those charged with governance would like to bring to the auditor's attention.

Significant Findings

Significant findings are to be reported from the audit regarding the financial reporting process, other than those required to be reported under SAS 112 (significant control deficiencies and material weaknesses) and in the management letter. Such findings include the following.

1. Estimates in the financial statements. The significant estimates are typically for pension and health and welfare benefit obligations. The auditor should draw attention to the fact that an actuary provides these numbers, which are based on assumptions about future events, and that there is a degree of uncertainty involved.
2. The appropriateness of the accounting policies. Discussion of financial statements including the accounting policies adopted (specific applications of generally accepted accounting principles (GAAP) to the financial statements of the plan, for instance the methods used to recognize depreciation of fixed assets, amortization of leasehold improvements or the fair values of investments). As more and more plans seek to optimize investment returns and venture into alternative investments, the appropriateness of methods used to value such investments becomes an important matter for discussion.
3. Significant difficulties encountered during the audit include:
   a. Inadequate time to do the audit, for example, providing the books and records a mere two weeks before the Form 5500 is due to be filed
   b. Delays in management (or the third-party administrator) re-

sponding to audit requests. Receiving a reconciliation or a report from the plan administrator a day before the Form 5500 is due would fall into this category. Auditors are required to conduct procedures on significant pieces of information to ensure the representations contained therein are within the realms of reasonableness. In the event discrepancies are found, there needs to be adequate time to resolve them so that the plan's regulatory filings are done on time.

c. Above-normal effort incurred in obtaining sufficient appropriate audit evidence; that is, inadequate assistance by management in providing records, schedules and other information for the audit. Management should also intervene on behalf of the auditor to obtain documentation and information from third parties where difficulties are encountered. When significant scope limitations are not resolved, the auditor may have no choice but to render a qualified or adverse opinion in the audit report.

d. Unwillingness by management to provide information regarding how it intends to deal with the plan's ability to continue as a going concern. Health and welfare plans with spiraling benefit costs and contributions that have not kept pace come to mind.

4. Material corrected misstatements. Significant discrepancies discovered during the audit whether corrected by management or by the auditor (with management's approval) should be brought to the attention of those charged with governance.

Significant findings, if already communicated by management to those charged with governance, should nevertheless still be reported by the auditor.

Other matters should also be communicated.

- Representations from management, for example, all minutes of meetings pertaining to the audit, have been provided; there is no intention to merge or terminate the plan; there are no significant subsequent events (events occurring between the plan's year-end and the date of the audit report, such as the bankruptcy of a major contributing employer) that would require adjustment to, or disclosure in, the financial statements.
- Management's consultations with other accountants, for example, obtaining a second opinion about the application of an accounting standard ("opinion shopping"). When the auditor is aware of such consultations, the auditor should discuss his or her views of the subject matter of the consultation.

Timing of Communication

The communication with those charged with governance is a continuous process, the key guideline being timeliness. The time line of communication should begin with the auditor discussing the planning and scope of the audit, using the engagement letter as the basis.

Should difficulties be encountered in the audit, the auditor should bring these to the attention of those charged with governance so that timely corrective action can be taken.

At the conclusion of the audit, the auditor should discuss the audit report, the financial statements, including significant estimates and accounting policies, and the contents of the management representation letter.

Many multiemployer plans have quarterly board of trustees meetings, which provide ample opportunity not only to raise these matters with trustees, but also with plan professionals as appropriate—for instance, attorneys (litigation and collection matters and status of trust and plan documents where these are being modified); actuaries (actuarial valuation, status of plan funding and changes to benefits); plan administrator or third-party administrator (readiness of books and records for audit and changes in policies and procedures for processing financial and other data, in particular changes in information technology).

Form of Communication

The communication under SAS 114 may or may not be in writing. It could be oral if this is deemed adequate, formal as in writing a letter to the board, or informal, as in a PowerPoint presentation. The format of the communication should be guided by, among other things, the gravity of the findings reported; whether the matters have been resolved or already reported by management; the legal or regulatory ramifications; whether the auditor has frequent contact with those charged with governance, such as quarterly board of trustees meetings; and the expectations of the client. If the communication is oral, the auditor should document it, including client responses, in his or her work papers in accordance with SAS 103, Audit Documentation. A copy of the minutes of the meeting(s) should also be obtained. If the communication is in writing, the auditor should indicate it is intended only for those charged with governance and, as the case may be, management.

In conclusion, this author believes a discussion of the contents of the engagement letter, the client (management) representation letter, the audit report and the financial statements, including the footnote disclosures, will go a far way to cover many of the matters required to be communicated under SAS 114. B&C

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