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## Audit Bulletin: Rule Changes Affecting 2006 Audits

As you may know, the Auditing Standards Board has been busy revising some of its core auditing standards recently for non-public entities. These standards impact the audit process, the communication of internal control matters to management, testing of internal control structures and a lot of other audit stuff! These changes will impact both management and the auditor.

Fortunately, some of the new standards are being implemented for year-end 2007 audits. This includes a "suite" of new risk assessment standards that incorporate many of the concepts in the current standards, but also create significant new requirements for auditors, particularly with respect to testing of internal controls. We'll have more on this in the future, but for now let's focus on what has been implemented for this year!

For year-end 2006 audits, there are two new important standards:

- I. Statement of Auditing Standard No. 103, Audit Documentation ("SAS 103")
- II. Statement of Auditing Standard No. 112, Communicating Internal Control Related Matters Identified in an Audit ("SAS 112").

I. The majority of the provisions of SAS 103 addresses how we as auditors conduct our audits and document audit procedures in the working papers. However, there is one provision that will be more visible and significant to the client. Historically, auditors have dated the audit opinion as of the date we completed audit fieldwork in our client's offices. Under SAS 103, the audit opinion cannot be dated any earlier than when our audit documentation is completed and reviewed, the financial statements have been drafted, and management has assumed responsibility for them (through the management representation letter). In practice, this means that to the extent wrap-up of your audit extends beyond the completion of audit fieldwork, we may need to return to the field, send updates for legal letters, or perform other procedures regarding subsequent events prior to releasing our financial statements. There can no longer be a significant gap in time between the opinion date and the date with which we provide you the final audited financial statements. For our insurance clients, one of the keys to eliminating the need for any additional work will be to make sure we get the actuarial report near the inception of our audit fieldwork.

II. SAS 112 calls for an increased focus on the identification; classification and reporting of internal control related matters. Some of the significant changes include:

1. The term reportable condition will no longer be used and will be replaced with the term significant deficiency. As a result, auditors will now make the following three observations in order of severity: 1) A deficiency<sup>1</sup> 2) a significant deficiency<sup>2</sup>, and 3) a material weakness<sup>2</sup>.
2. The definition of what should be considered a significant deficiency has expanded.
3. The auditor is required to communicate significant deficiencies and material weaknesses in writing to management and those charged with governance. Johnson Lambert has historically made these observations in writing as part of our standard communications so we believe the "in writing" requirement will not represent a significant change to our clients<sup>1</sup>.
4. Significant deficiencies<sup>1</sup> and material weaknesses<sup>2</sup> will need to be repeated each year until they are corrected.

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SAS 112 includes a listing of matters that typically are considered deficiencies, significant deficiencies, or material weaknesses, and we recommend you review the standard to understand these differences.

One of the most frequently discussed implications of SAS 112 is the reinforcement of the concept that it is management's responsibility to prepare the financial statements in accordance with GAAP (or SAP) and to assume ownership of the financial reporting. While the standard doesn't preclude the auditor from assisting management with preparation of the statements, the auditor must conclude that management is able to produce the financial statements in their entirety. We have historically taken liberty to draft the financial statements and notes. We intend to continue this service unless requested otherwise by management. To do this however, we now may request management to provide additional information not requested in prior years. This information must be presented in a form so that we can take that information, audit the information, and include it in the audited statements. The bottom line to all this is that we can continue to assist management in drafting financial statements, but we also must make sure that management retains ownership. In reviewing your financial reporting we ask that you consider the following:

- Do your financial statements include all required statements, including a statement of cash flow?
- Is management aware of all required note disclosures?
- Is information to create required note disclosures readily available?
- Does management take an active role in reviewing financial statements?
- Does management evaluate new FASB pronouncements for applicability?

The new standard is clear that if management does not have ownership of the financial reporting, the entity has a material weakness in control. We intend to work with management in implementing this new standard as well as the risk assessment standards in the coming months. We understand you may have questions on the implementation of these new standards and would be happy to meet with you to discuss further. We also recommend that management review Understanding SAS 112 and Evaluating Control Deficiencies, a "companion" document issued by the AICPA. This document provides clarification and working examples of what may or may not constitute a control deficiency, including examples related to management's role in preparing the audited financial statements.

Please know that our professional standards continue to allow us to provide advice, research materials, and make recommendations to assist management in performing its functions and making decisions. As a firm, we are committed to making the adjustment to this change in the auditing standards as smooth as possible for our clients.