SAS 112 Project at Penn:

Documenting and Enhancing Internal Controls, One Business Process at a Time

What is SAS 112?

A “SAS” is a Statement on Auditing Standards. SAS’s are issued by the American Institute of Certified Public Accountants (AICPA) to provide guidance to external auditors on auditing and issuing opinions on an entity’s financial statements. The University’s external auditor is PriceWaterhouseCoopers (PwC).

What Does SAS 112 Do?

SAS 112 is titled: Communicating Internal Control Related Matters Identified in an Audit

The Public Company Accounting Oversight Board (PCAOB) oversees the external auditors of public companies and establishes standards to which the auditors of public companies must adhere. The PCAOB standards apply only to the financial statement audits of public companies. However, SAS 112 adopts the PCAOB’s standards and definitions for the external auditor’s control reviews and control reporting so that they are applicable to all entities, including non-profit entities such as Penn.

PwC evaluates the University’s internal controls over financial reporting on an annual basis as part of the financial statement audit. Essentially, SAS 112 provides guidance to PwC regarding which internal control related matters identified during the audit must be reported in writing to management and those charged with governance (the Board of Trustees).

SAS 112 is effective for audits of financial statements for periods ending on or after December 15, 2006 (i.e., Penn’s FY2007).

What Are Internal Controls?

To fully grasp the nature and objectives of SAS 112, it is helpful to understand the definition of internal control adopted in SAS 112. This definition was originally set forth by the Committee of Sponsoring Organizations (COSO).

Internal control is a process, affected by the board of trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations

For SAS 112 purposes, reliability of financial reporting refers to generating monthly financial statements that are accurate and complete. Effective and efficient operations ensure that the University can continuously progress toward its mission with limited setbacks. Compliance with applicable laws and regulations will help the University avoid fines, penalties, unrecorded liabilities, and reputational damage.
What Sort of Internal Controls Does SAS 112 Address?

While all areas listed above are crucial to University operations, SAS 112 is primarily concerned with the University’s internal controls over financial reporting. The financial statements should provide a clear picture of the entity’s current financial position and performance over time. The integrity of financial reporting is vital because both internal and external users rely on the financial statements to inform their decisions related to University business. SAS 112 aims to communicate to management and the Board of Trustees problems with internal controls that could adversely affect the reliability of financial statements.

Who is Responsible for Internal Controls at Penn?

The short answer is “Everyone.”

University Financial Policy 2701 states, “The University Comptroller, as Chief Accounting Officer, has the fiduciary responsibility for the accounting records of the University and the ultimate responsibility for the adequacy and effectiveness of the overall system of internal control.” However, “in order to meet these responsibilities within the University’s decentralized operating environment, the responsibility for a variety of controls must be delegated to the various operating entities of the University.”

In order to formalize our business cycles, establishing ownership for the key processes is essential to maintain well controlled and efficient processes. The initial process under review for SAS 112 will be the Procure-to-Pay (P2P) process with Business Services/Purchasing Services as the Process Owners. As we move further in the SAS 112 Initiative Process Ownership will be established for the remaining key processes in our business cycle.

Ultimately, all areas of business administration throughout the school, centers, and central administrative units are responsible for establishing, maintaining and promoting effective business practices and effective internal controls. The decentralized nature of the University and the sheer volume of transactions it generates prevent central administrative units such as Accounting and Purchasing from being able to approve all transactions; indeed, these employees have neither the time nor the first-hand business knowledge to do so. As a result, the business administrators and other financial personnel in the schools have principal responsibility for executing internal controls (such as reviews, approvals, reconciliations, and monitoring) over financial operations and individual transactions. If business is conducted in a well controlled environment, where internal controls are implemented, functioning, and monitored, it will result in reliable financial reporting.

What are the Provisions for SAS 112?

SAS 112 – “Communicating Internal Control Related Matters Identified in an Audit”

SAS 112 establishes standards, responsibilities, and guidance for the external auditors (PwC) for evaluating controls over financial reporting during the year-end financial statement audit. During their engagement to audit financial statements, external auditors may identify issues related to internal control over financial reporting. SAS 112 states that external auditors must classify these issues as one of the following 3 types of deficiencies:
Control Deficiency: Exists when the design of operation of a control does not allow management or employees, in the normal course of daily responsibilities, to prevent or detect misstatements on a timely basis. Two types of control deficiencies exist:

- Deficiency in design – a control necessary to meet a control objective is missing or an existing control is not properly designed so that even if it is operating as planned, the control objective is not met.
- Deficiency in operation – a properly designed control does not operate as designed or the person performing the control does not possess the authority or qualifications to perform the control effectively.

Significant Deficiency: A control deficiency or combination of control deficiencies that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted account principles such that there is more than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected.

Material Weakness: A significant deficiency or a 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.

SAS 112 requires the external auditors to communicate (in writing) significant deficiencies and material weaknesses to management and the Board of Trustees.

### Evaluation of Severity of Deficiencies

<table>
<thead>
<tr>
<th>Likelihood of Occurrence</th>
<th>Control Deficiency</th>
<th>Significant Deficiency</th>
<th>Material Weakness</th>
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<tr>
<td>Probable</td>
<td>Control Deficiency</td>
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<tr>
<td>Possible</td>
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<td>Significant Deficiency</td>
<td>Material Weakness</td>
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<td>Remote</td>
<td>Control Deficiency</td>
<td>Control Deficiency</td>
<td>Control Deficiency</td>
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<tr>
<td>Inconsequential</td>
<td>More than Inconsequential</td>
<td>Less than Material</td>
<td>Material</td>
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### Key:
- SAS 112 requires the external auditors (PwC) to communicate in writing significant deficiencies and material weaknesses to the University’s management and the Board of Trustees.

In evaluating the significance of a deficiency, the auditors will consider several factors such as:
- The financial statement amounts or total of transactions exposed to the deficiency.
- The volume of activity in the account balance or class of transaction exposed to the deficiency.

The external auditors will also assess any additional controls that may compensate for the deficiency.
To understand the practical application of these definitions, it is helpful to identify examples. Examples of control deficiencies include the following:

- Lack of timeliness of cash deposit and account reconciliation
- Lack of review and reconciliation of departmental expenditures
- Inadequate segregation of duties
- Failure to obtain/document approvals
- Ineffective oversight/monitoring
- Lack of controls over non-routine and non-systematic transactions

Depending on the likelihood of occurrence and the magnitude of impact on financial statements, these control deficiencies are potential significant deficiencies or material weaknesses. For instance, a significant deficiency or material weakness may be identified if the entity lacks methods or uses incorrect methods for recording material estimates (allowance for doubtful accounts, liabilities from lawsuits, etc.) reported in financial statements.

What are the Consequences of SAS 112?

SAS 112 “raises the bar” for internal controls compliance and documentation. Under SAS 112, external auditors can no longer use “inquiry and observation” to ensure that the University’s internal controls are well-designed and operating as planned. The University must effectively demonstrate to external auditors that an internal control framework has been established and is practiced at all levels in University business administration. To accomplish this, the University will (1) document the internal control elements in place for all business processes (purchasing, asset management, etc.) and (2) provide evidence (written approvals, reconciliations, etc.) that these internal controls are in place and being practiced throughout the University. Now more than ever, it is critical that the University continuously monitor the effectiveness of these controls, identify weaknesses and gaps, and implement changes and improvements as necessary.

Another notable outcome of SAS 112 is that it expands the issues that must be formally communicated to management and the Board of Trustees. Refer to the charts below.

<table>
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<tr>
<th>Old Definitions</th>
<th>New Definitions</th>
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<tr>
<td>Material Weakness</td>
<td>Material Weakness</td>
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<td>Reportable Condition</td>
<td>Significant Deficiency</td>
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<td>Management Comment</td>
<td>Other Matters Related to Internal Control</td>
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Key:
- Issues related to internal controls over financial reporting that must be communicated to management and the Board of Trustees. SAS 112 increases the items that should be reported.
What is the Significance of SAS 112 to the University?

The University must take action to ensure that no significant deficiencies or material weaknesses in controls over financial reporting exist. Reportable conditions may cause Penn to suffer the following consequences:

- Negative impact on research funding
- Negative impact on credit ratings
- Additional federal audits
- Reputational damage

In Penn’s decentralized environment, personnel at all levels are responsible for the establishment and operating effectiveness of internal controls. One of the most important goals of the University’s SAS 112 Project is to take measures to ensure that transactions comply with applicable policies before they are entered into and are recorded correctly the first time after being processed through control measures (approvals, reviews, etc.) in accordance with the financial policies of the University. Central administrative units such as Purchasing Services and Accounts Payable can perform only limited reviews of transactions on the back-end, but any issues noted are indicative of control deficiencies at the front end processes (Schools and Centers). With delegated authority to purchase products and services on behalf of the University, authorized approvers (BEN Buys PO Managers, Purchasing Card Transaction Approvers & TAC Holders) must identify and correct errors and ensure policy compliance before transactions are submitted for processing and final approval in the Schools and Centers or in Purchasing Services.

What are the Objectives of SAS 112 Projects at Penn?

- Establish process ownership for all key processes within the University business cycle.
- Perform a comprehensive assessment of the design and operating effectiveness of Penn’s current internal controls for each significant business process that affects financial reporting
- Improve the design and operating effectiveness of internal controls
- Document the University’s key financial and administrative internal controls
- Achieve more formalized/standardized business processes, as established by central administrative functions that include improved operating efficiency, sufficient, clearly-identified internal controls, and assignment of responsibilities for control activities Emphasize the importance of internal control in our decentralized environment
- Foster a business environment throughout schools, centers, and central administrative units that:
  - Appreciates the importance of internal controls, their role in effective and efficient operations, and ultimately their effect on our financial statements
  - Knows the University’s business processes and practices and the internal controls established therein
  - Proactively identifies and corrects control weaknesses and gaps
  - Ensures policy understanding and compliance
- Decrease the likelihood of significant deficiencies and material weaknesses in our internal controls over financial reporting