

# An Overview of SAS 112 for Alternative Investment Funds: How does it Impact You?

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## Background

On May 25, 2006, the American Institute of Certified Public Accountants Auditing Standards Board issued Statement on Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (SAS 112). SAS 112 is effective for the audits of all nonpublic companies for periods ending on or after December 15, 2006. SAS 112 is applicable whenever an auditor expresses an opinion on financial statements.

SAS 112 provides guidance to auditors on evaluating and communicating matters related to an entity's internal control over financial reporting identified during an audit of financial statements. It requires that all control deficiencies defined as *significant deficiencies and material weaknesses* be communicated to management in writing within 60 days following release of the report. In addition to defining the terms "significant deficiency" and "material weakness," SAS 112 provides auditors guidance on how to evaluate the severity of any control deficiencies.

## Definitions

In order to fully comprehend the implications of SAS 112 and how it will affect an organization, it is important to understand the key terms and their definitions. SAS 112 defines a "control deficiency," "significant deficiency" and "material weakness" in determining whether a reportable condition exists. A control deficiency is considered a reportable condition if it meets the definition of a significant deficiency or a material weakness as explained below.

### Control Deficiency

SAS 112 defines the existence of a "control deficiency" as "when the *design or operation of a control does not allow management or employees*, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis."

SAS 112 further clarifies the difference between the *design* of the control and its *operation*: "A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met. A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively."

### Significant Deficiency

SAS 112 defines a "significant deficiency" as "a control deficiency or combination of control deficiencies that adversely affect the entity's

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."

### Material Weakness

A "material weakness" is defined by SAS 112 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."

A single control by itself can be considered a significant deficiency or a material weakness. A group of seemingly insignificant underperforming controls can be combined together to constitute a significant deficiency or a material weakness. The auditor is required to evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses, which are required to be reported.

## How Does SAS 112 Affect Alternative Investment Funds?

SAS 112 provides general examples of areas where control weaknesses and deficiencies will be considered at minimum a *significant deficiency* and potentially a material weakness, depending on the severity of the issue.

Some areas of focus of SAS 112 are as follows: Anti-fraud programs; processing of transactions; period-end financial reporting processes; and ineffective control environments.

Management of alternative investment funds must not only have an understanding of SAS 112, but must evaluate and test the control

environment to ensure accurate financial reporting. Things to consider: Is the fund's structure more complex? Have the organization's assets under management grown significantly? Have the strategies become more complex? Management has a responsibility to ensure the controls are effective and a process exists to monitor any deficiencies.

### Management's Responsibility: What You Should Do

Management must develop a thorough understanding of SAS 112 and should evaluate the controls over accounts that are significant to the fund's financial statements. Management should have a formal review process, which includes documentation of who reviewed the work of the fund administrator and when it was reviewed. In addition, it is management's responsibility to understand all issues and the subsequent resolution of discrepancies between the books and records of the administrator and those of management.

### Your Auditor's Responsibility: Evaluating Control Deficiencies as Part of the Audit

In assessing the impact of any control deficiencies, SAS 112 requires the auditor to consider the likelihood and the magnitude of the potential misstatement. The larger the impact, the more likely the control will be considered a significant deficiency or material weakness.

Factors that affect the magnitude of a misstatement include the following:

- The financial statement amounts
- The total number of transactions exposed to the deficiency
- The volume of activity in the account balance
- The class of transactions exposed to the deficiency in the current period or future periods

Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though such deficiencies might be individually insignificant.

When considering whether or not a significant deficiency or material weakness exists, the auditor is required to assess the mitigating effects of a compensating control that would limit the severity of a control deficiency and prevent it from rising to the level of a significant deficiency or material weakness. A control might not operate as designed, but there may be other mitigating controls that will reduce the risk of a material misstatement occurring. These controls may be used as part of the overall assessment of the control environment.

Following are a few of the issues which may affect an organization.

### Financial Reporting

Management should focus on financial reporting and potential audit adjustments. When drafting financial statements, the process should include a review by the chief financial officer or another member of senior management prior to review by the audit team. Management should review the financial statement balances as well as the notes to the financial statements, and needs to make a determination on the accuracy of the financial statement balances and the adequacy of the notes prior to the audit team's review.

### Top-Side Adjusting Journal Entries

The review process must include an examination of the top-side journal entries after the trial balance has been prepared and finalized. Management must have an understanding of the required adjusting journal entries prior to financial statement preparation. In addition, explanations of those adjustments should be documented by management and reviewed in a timely manner.

### Processing of Non-Routine Transactions

Many fund managers are comfortable with the internal controls over the daily processing of transactions. However, for non-routine transactions management must ensure that there is an effective process to identify the unusual items that are processed during a reporting period. An example includes a long/short fund and that enters into a credit default swap or invests in a new collateralized loan obligation or collateralized debt obligation structure.

### Use of an Administrator

Although many fund managers outsource some of their back-office accounting and operations function to a third-party administrator, it is important to recognize that the fund's management is still responsible for the accuracy of its books and records.

Management should have a formal review process, which includes documentation of who reviewed the work of the administrator and when it was reviewed. In addition, management is responsible for understanding all issues and the subsequent resolution of any discrepancies between the books and records of the administrator and those of management.

## Conclusion

There is no magic formula to determine whether a control deficiency exists that would be reported as a significant deficiency or a material weakness. The auditor will consider all the facts and circumstances in deriving a conclusion. It is management's responsibility to ensure that the appropriate checks and balances are in place and are operating effectively.

If you have any questions about SAS 112, please contact your local PricewaterhouseCoopers audit partner. ■

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