

Understanding SAS 70 Reports on Internal Control

Agenda

- Internal Control Reporting: A Focus on SAS 70
- Trends affecting internal control reporting
- Discussion points for Mutual Fund Directors with management
- Key Risks/SAS 70 coverage/sample control objectives
 - Investment Advisor
 - Transfer Agent
 - Fund Accounting
 - Custody
 - Pricing
 - Information Technology
- SAS 70 vs. Compliance Reporting

What is a SAS 70 Report?

- SAS 70 is an acronym for American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards (SAS) 70, titled “Reports on the Processing of Transactions by Service Organizations.” SAS 70 defines the professional standards used by a service auditor to assess the internal controls of a service organization and issue a service auditor’s report. Examples of service organizations include: investment advisors, fund accounting, transfer agent, custodian, trust companies, application service providers, etc.
- SAS 70 is an internationally recognized auditing reporting standard used to communicate to other organizations who are receiving a service from a vendor, that the vendor’s internal controls over financial reporting are reasonable and effective.
- A SAS 70 is management’s document describing the overall control environment including control objectives and the specific controls they have put in place to meet them.

Types of SAS 70 Reports Issued

Type I Report

- Provides a description of controls that may be relevant to a user organization
- Controls as of a specific date
- Concludes on whether controls, as of specified date, are placed in operation and suitably designed to achieve specified control objectives
- *These reports provide little assurance and/or value and are typically only issued as a “step” towards a Type II report*

Type II Report

- Type I coverage, plus:
 - Provides description of tests of controls and results
 - Controls tested for operating effectiveness over a period of time (6 months +)
 - Concludes on whether controls tested were operating effectively during specified period

Form and Content of a SAS 70 Report

SAS 70 reports have the following two primary sections:

- Description of controls section (Type I and II reports)
 - Description of control environment, including management controls and practices (e.g., compliance, legal) typically using COSO
 - Organizational structure
- Key business process narratives
 - Information technology systems and controls narratives
- Control objectives, control activities and tests of operating effectiveness
 - Control objectives that management wants to achieve
 - Specific controls in place to achieve the control objectives
 - User controls (controls the user organizations need to have in place)
 - Tests of controls and results of tests (provided by Independent Accountants) (Type II report only)

Form and Content of a SAS 70 Report

SAS 70 reports can also include the following section (optional)

- Other information provided by service organization
 - Additional information which a service organization may desire to include in the report, which are not included within the scope of the audit opinion (e.g., business continuity/disaster recovery planning, etc.)

User Organization Benefits

SAS 70 offers many benefits to user organizations and user auditors; the following are a few examples:

- Provides an independent assessment of the service provider's internal controls over financial reporting
- Reduces controls testing required at the service provider for each fund audit when timing and scope align with the fund's requirements
- Provides an overview of the service provider's control environment, including COSO components
- Summarizes significant changes to the control environment

Trends Affecting Internal Control Reporting

The demand for Internal Control reports, including SAS 70, is increasing due to the following:

- Increased regulatory focus on internal controls
 - Sarbanes 404/302
 - 40 Act: Rule 38a-1
 - IA Act: Rule 206(4)-7
- Increase in country specific regulatory requirements related to internal control
- Increased focus on fiduciary responsibility by corporate and fund boards
- International institutional investors are requesting assurance over controls in the investment advisory operations for US investment advisors

Discussion Points for MF Directors with Management

Scope/timing of SAS 70

- Confirm with management that areas covered align with activities outsourced to third party
- Verify report is a Type II SAS 70 and tests of operating effectiveness were performed
- Confirm that management has validated period covered and identified gap between end of testing and FYE of user organization to determine if update testing is required

Discussion Points for MF Directors with Management

Testing/exception analysis

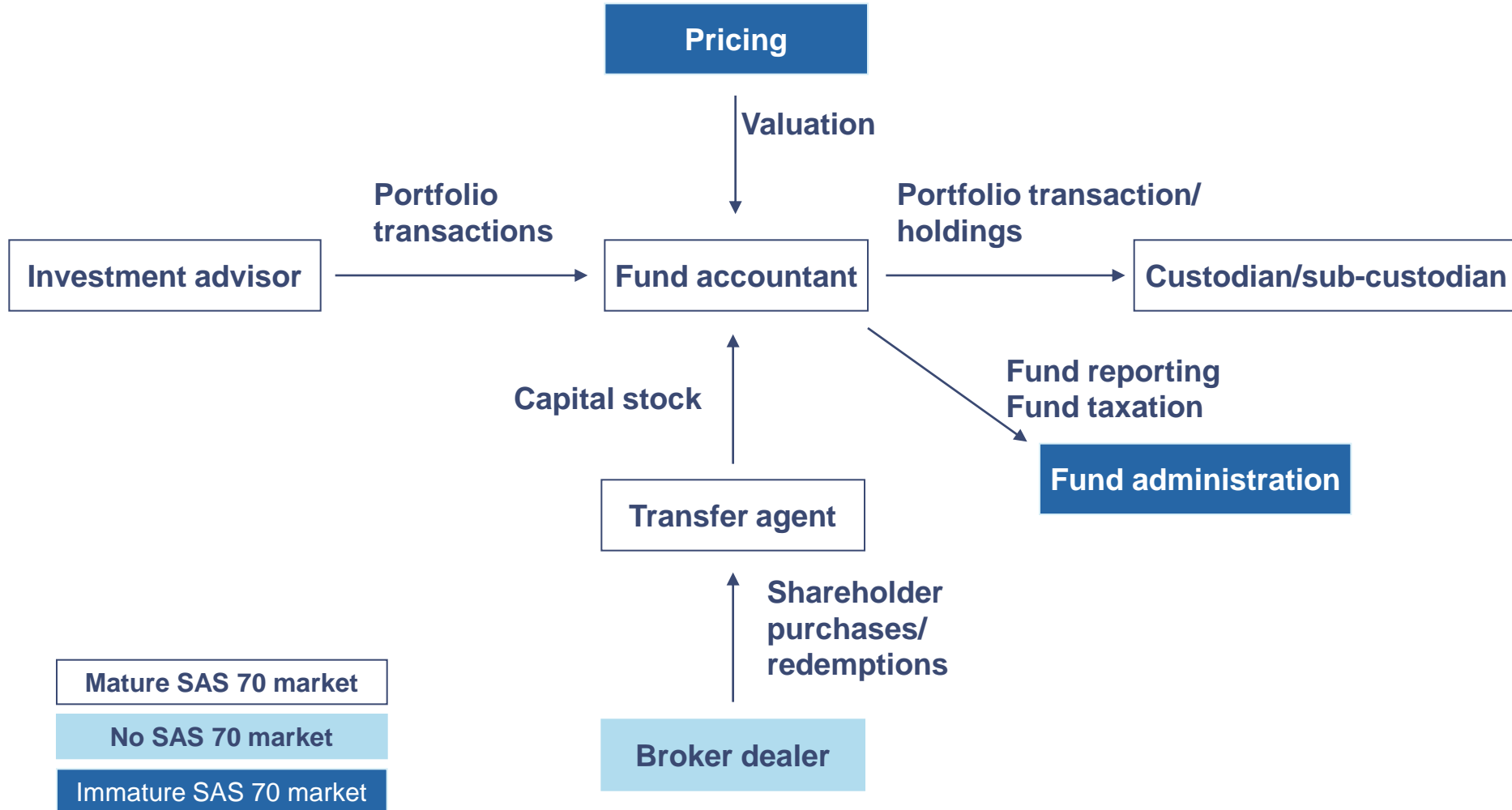
- Verify that management has assessed level of testing particularly related to key controls of user organization
- Determine if opinion is qualified or unqualified. There are a few reasons a report may be qualified:
 - The controls supporting an objective are not suitably designed or not placed in operation
 - The controls supporting an objective are not operating effectively (Type II only)
 - Sufficient evidence is not available to determine if a control is supporting the objective
 - The descriptions provided by the service organization do not fairly represent in all material respects the relevant aspects of service organization's controls

Discussion Points for MF Directors with Management

Testing/exception analysis (cont.)

- Confirm that management has reviewed detailed test exceptions to determine the impact specific to the user organization
- Determine if exceptions present risk to user organization and if additional testing is necessary or was performed. Additional procedures may include:
 - Discussions with user organization personnel who would be aware of any changes at the service organization
 - Review of current documentation and correspondence provided by the service organization
 - Discussions with service organization personnel or the service auditor
 - Performance of testing

SAS 70 in the Mutual Fund Industry



Investment Advisor – Key Risks

- Portfolio activity not in compliance with prospectus, contract or Investment Management Agreement
- Trades are not allocated according to company policy
- Securities are not properly valued
- Fees and expenses are not accurately calculated
- Trading activity is not properly processed nor accurately, completely or timely recorded in the accounting records
- Income and corporate actions (events in the life cycle of the security) are not accurately and completely processed nor properly reflected in the accounting records

Investment Advisor – SAS 70 Areas of Coverage

Internal controls covered by SAS 70

- Transactions comply with prospectus, contract or Investment Management Agreement
- Trade allocation
- Security valuation

NOT covered by SAS 70

- Best execution
- Soft dollars
- Investment Company Act Rule 2a-7 (Money Market Funds)
- Investment discipline (e.g., “growth” vs. “value”)

Investment Advisor SAS 70 Sample Control Objectives

Controls provide reasonable assurance that:

- Investment guidelines and restrictions are reasonably established
- Amendments to client investment restrictions are authorized and accurately processed
- Account opening, closing and maintenance activities are authorized and completed accurately and timely
- Client contribution and redemption activity is authorized, processed and recorded accurately, completely and timely
- Portfolio security purchase and sale transactions are authorized, and executed timely and accurately
- Securities transactions and portfolio holdings are monitored for compliance with client guidelines and restrictions
- Cost of securities purchased and the proceeds of securities sold are accurately allocated among client accounts in accordance with company policy

Investment Advisor SAS 70 Sample Control Objectives

Controls provide reasonable assurance that:

- Transactions are completed and accurately recorded and settled in a timely manner
- Securities are valued using current prices obtained from sources authorized by the customer
- Investment income is accurately recorded in the proper period
- Corporate actions are identified, processed, and recorded accurately and timely
- Investment management fees and other account expenses are accurately calculated and recorded
- Client statements and reports are produced in a complete and accurate manner and delivered to clients on a timely basis
- Investment performance is calculated in accordance with company and client guidelines

Transfer Agent – Key Risks

- New accounts do not undergo proper know your customer routines
- Shareholder transaction activity is unauthorized or is not processed completely, accurately and timely
- Dividend transactions are not processed completely, accurately and timely
- Commissions and loads are inaccurately processed

Note: A “17ad-13” report is not an equivalent “substitute” for a transfer agent SAS 70

Transfer Agent – SAS 70 Areas of Coverage

Internal controls covered by SAS 70

- Daily monetary and non-monetary transaction processing
- As-of transactions and adjustments
- Late trading (cutoff)
- Cash reconciliations

NOT covered by SAS 70

- Redemption fees (Rule 22c-2)
- Market timing
- Anti-money laundering

Transfer Agent SAS 70 Sample Control Objectives

Controls provide reasonable assurance that:

- Transactions and adjustments, including as-of transactions, are authorized, processed accurately and timely, and valued at proper dollar and share amounts
- Dividend and distribution rates are authorized, and dividend and distribution amounts are accurately and timely calculated and recorded
- Tax withholdings are properly calculated, recorded and remitted
- Shareholder account maintenance transactions are properly authorized, and accurately and timely recorded
- The master security file, the detail security holder file, and the authorized share total records are accurately maintained
- Money movement is authorized and processed completely, accurately and timely
- Bank accounts are reconciled and exceptions are identified, researched and resolved in a timely manner

Fund Accounting – Key Risks

- Portfolio transactions are not properly authorized or are not processed completely, accurately and timely
- Securities are not accurately valued
- Investment income is not completely or accurately calculated
- Corporate actions are not processed completely, accurately or timely
- Expenses are not accurately calculated
- Capital stock activity is not complete and accurate
- Dividend distribution and dividend amounts are not accurately calculated
- Net asset values are not accurately calculated

Fund Accounting – SAS 70 Areas of Coverage

Internal controls covered by SAS 70

- Portfolio Transaction Authorization, Accuracy, Timeliness
- Security Valuation
- Investment Income
- Corporate Actions
- Expenses
- Dividends
- Net Asset Value

NOT covered by SAS 70

- Expense monitoring, budgeting and accrual analysis (typically)
- NAV error correction procedures
- Fair valuation
- Off-line securities processing (eg. complex derivatives)
- Compliance monitoring, including 1933 Act and 1940 Act requirements
- Fund mergers/liquidations/conversions
- Financial statement preparation (typically)
- Taxes

Fund Accounting SAS 70 Sample Control Objectives

Controls provide reasonable assurance that:

- Security reference file information is setup and maintained completely and accurately
- Portfolio transactions and related cash transactions are authorized, and processed and settled accurately and timely
- Portfolio securities are valued completely and accurately using prices from authorized sources
- Investment income is completely, accurately and timely calculated, and recorded
- Corporate actions are identified and processed completely, accurately and timely
- Expenses are accurately calculated and recorded in accordance with the authorized instructions
- Capital stock activity and related cash settlements are recorded completely, accurately and timely
- Dividend distribution rates are authorized and dividend amounts are timely and accurately calculated and recorded
- Net asset value is accurately calculated

Custody – Key Risks

- Transactions are not properly authorized or are not processed completely, accurately and timely
- Securities are not accurately valued
- Investment income is not completely or accurately calculated
- Corporate actions are not identified or processed completely, accurately or timely
- Physical securities do not exist
- Security positions of sub-custodian do not accurately reflect records of custodian
- Settlement results are not accurately or completely reported
- Securities lent and/or borrowed are not properly recorded
- Appropriate securities lending collateral / risk management do not exist to manage the risk of default

Custody – SAS 70 Areas of Coverage

Internal controls covered by SAS 70

- Trade/Cash completeness, accuracy and authorization
- Investment income
- Corporate actions
- Security valuation
- Reconciliations with depositories and sub-custodians
- Securities lending
- Safekeeping of assets
- Trade settlement

NOT covered by SAS 70

- Rule 17f-2 under the 1940 Act which deals with auditor's procedures applied to self-custody situations

Custody SAS 70 Sample Control Objectives

Controls provide reasonable assurance that:

- Accounts are setup completely and accurately
- Trades related cash transactions are authorized, recorded, settled, and reported accurately and timely in accordance with the client agreement
- Investment income is collected and recorded accurately and timely
- Corporate actions are identified, processed, settled and recorded accurately and timely
- The market values of securities are calculated based on prices obtained from authorized sources
- Lender and borrower participation in lending programs is authorized

Custody SAS 70 Sample Control Objectives

Controls provide reasonable assurance that:

- Loan initiation, processing, maintenance and termination are recorded completely, accurately and timely
- Securities loans are adequately collateralized and collateral is accurately and timely recorded
- Security lending income is accurately calculated and distributed accurately and timely
- Securities in physical possession are safeguarded from loss, misappropriation and unauthorized use
- Records accurately reflect security positions held by third parties (e.g., sub-custodians)
- Sub-custodians are authorized and performance standards are monitored on a periodic basis

Pricing – Key Risks

- Security prices are not calculated completely or accurately
- Security prices are not delivered within agreed upon timeframes
- Stale prices are not identified
- Conditions that require fair value pricing are not identified

Pricing – SAS 70 Areas of Coverage

Internal controls covered by SAS 70

- New accounts
- Market data
- Price evaluations

Pricing SAS 70 Sample Control Objectives

Controls provide reasonable assurance that:

- New accounts and account changes are authorized and processed accurately and completely
- Market data is received from authorized external sources and data is complete, accurate and received in a timely manner
- Price evaluations are generated accurately, completely, and in a timely manner
- Price evaluations, descriptive data, and market values are distributed to customers completely and in a timely manner

Information Technology – Key Risks

- Unauthorized personnel have access to systems, applications or data
- Unauthorized personnel have physical access to computer equipment and storage media
- Unauthorized changes are made to systems or applications
- Unauthorized processing is performed
- Production problems are not identified or resolved
- System and application data is not backed up and archived for restoration
- Data transmissions between the user organizations and service organization are not complete, accurate or secure

Information Technology – SAS 70 Areas of Coverage

Internal controls covered by SAS 70

- Access to systems and applications
- Physical security
- Job scheduling
- Problem management
- Application, database, operating system changes
- Data transmissions
- System conversions

Not covered by SAS 70

- Disaster recovery planning/business continuity planning
- Confidentiality of data

Information Technology Sample Control Objectives

The following information technology control objectives would be included to support a service organization's SAS 70

Controls provide reasonable assurance that:

- Changes to applications, operating systems and system software are authorized, tested, approved, implemented and documented
- Physical access to computer equipment and storage media is restricted to authorized personnel based on job responsibilities
- Logical access to operating systems, software, and applications is restricted to authorized individuals based on job responsibilities
- Processing is appropriately authorized and scheduled and deviations from scheduled processing are identified and resolved
- System and application data is regularly backed up and archived data is available for restoration in the event of processing errors and/or unexpected interruptions
- Data transmissions between the service organization and its user organization are complete, accurate and secure

Compliance Reporting

Emergence of examination-level attestation engagements with a focus on internal controls over compliance.

Key Differences:	SAS 70 Reports	Compliance Reports
Governing AICPA Professional Guidance:	SAS 70	Attestation Section 101 (AICPA Auditing Standards Board currently considering the issuance of a SOP)
Subject Covered:	Service provider's internal control over financial reporting	Service provider's specified compliance control objectives and related controls
Intended to be used by:	User's management and auditors and boards of directors	Chief Compliance Officers, management, boards of directors, and independent auditors of service providers and users
Contents:	Type II reports contain a description of controls and related control objectives, as well as tests of controls and results of tests performed by the independent auditor.	A description of the service provider's specified compliance control objectives and related controls