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ABSTRACT

In 2006 the Accounting Standards Board issued a Statement of Auditing Standards (SAS) # 112 that was closely related to internal control matters. This new regulation affects both profit and non-profit business. The purpose of this paper is to analyze how SAS #112 specifically affects internal control and audit in private clubs.

Introduction

Corporate scandals that took place in the past several years such as Enron and WorldCom led congress to pass federal legislation to curb such actions. The legislation is known as the Sarbanes-Oxley Act (SOX) of 2002 (Ho and Oddo, 2007).

The Public Company Accounting Oversight Board (PCAOB) was created due to SOX regulations. The main objective of this board is to supervise and regulate audits of publicly traded companies and provide the public and investors with fair and trustworthy reports. PCAOB introduced auditing standard # 2 (An Audit of Internal Control Over Financial Statements). It is intended to bring accounting issues to the attention of managers' responsible for internal control issues and audit responsibility. The goal is to find internal control issues, correct and communicate them to the public.

Despite the fact that SOX focused strictly on public companies, there were some provisions of the act that private and non profitable companies found beneficial (Savich, 2006). The Accounting Standards Board (ASB) originally issued a Statement of Auditing Standards

(SAS) # 60 (Communication of Internal Control Related Matters Noted in an Audit) that was superseded by SAS #112 (Communicating Internal Control Related Matters Identified in an Audit). SAS #112 became applicable for audits of financial statements for periods ending on or after December 15, 2006. This regulation became applicable when an auditor expressed an opinion on a business entity's financial matters. SAS #112, in contrast with SOX, is applicable to both commercial and not-for-profit business.

Section 501 (c) (7) of the Internal Revenue Code defines certain criteria that should be met by a company in order to achieve and maintain state exempt status. For a club the five criteria are: (a) the organization must be a club, (b) the organization must be organized for pleasure, recreation, or other non-profitable purposes, (c) substantially, all club activities must be for pleasurable, recreational or non-profitable purposes, (d) no part of the net earnings of a company may inure to the benefit of any private shareholder/member. The majority of clubs are very careful in maintaining a non-profit entity status and strictly monitor activities that may jeopardize a tax-exempt status.

In the United States, clubs have become a significant segment of the hospitality industry that deliver a variety of social activities to its members all over the country. Today, the United States of America has approximately 14,000 private clubs, including both country and city clubs (Walker, 2004). According to Gustafson and Redman (2000), 67% of clubs are considered non-profit and are eligible for federal and state income tax exemption. Recently, all of those clubs became affected by SAS #112. Weiner (2003) states that today the non-profit industry, the same as the for-profit industry, can lack accurate financial reporting, provide inappropriate financial packages and mishandle funds.

Brief Overview of SAS # 112

A primary focus of the standard is to identify control deficiencies, evaluate and communicate them in a proper format. Control deficiencies are supposed to be evaluated under Generally Accepted Auditing Standards (GAAS) that were established in the U.S. long before SAS #112 was issued. Control deficiencies are supposed to be evaluated based on two main parameters*: likelihood* and *magnitude,* which is a relatively standard audit approach. In this context, likelihood means the possibility that misstatements may occur. Magnitude means to what degree and to what extent misstatements have occurred. SAS #112 identifies three main levels of control deficiencies*:* a) the simple control deficiency, b) the significant deficiency and c) a material weakness.

The simple control deficiency takes place when employees or management due to reasons in design and operation of a company, simply can't detect or prevent misstatements within a reasonable time frame. *The significant deficiency* is either one control deficiency or a combination of control deficiencies that affect the company's ability to initiate, authorize, record, process and report financial data in the financial statements. *A material weakness* (the most severe form of deficiency) according to SAS #112 is defined 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."

SAS #112 no longer uses the term "reportable conditions" and replaced it with the terms, "significant deficiency" and "material weakness". Originally, in SAS #60 a reportable condition had to be communicated to management but not necessarily in writing. In the new standard, significant deficiency as well as material weakness must be communicated to management in writing. In the private club industry, an example of likelihood (probability of occurrence) in

terms of control deficiency is the lack of a clear policy on how golf carts should be rented from a golf cart barn; or a situation when such a policy exists but no one in the club uses it.

Magnitude can be divided into three main groups: a) inconsequential, b) more than inconsequential but less than material and c) material. According to SAS #112, factors that can affect the magnitude of misstatements and can result in deficiency include: a) amounts of financial statements and total amounts to transactions exposed to the deficiency b) volume of activity related to an account or class of transaction exposed to the deficiency. Example of magnitude for the private club industry can be exposition to deficiency revenue recognition related to the golf pro shop.

How does SAS #112 affect the private club industry?

Ge and McWay (2005) found that firms that are younger and growing more rapidly are more likely to report material weakness. However, those firms that have material weaknesses take only 1.28% of the total market value of S&P 500 firms together (Bryan and Lilien, 2005). Private clubs may still be considered relatively small hospitality businesses in comparison with large hotel and restaurant chains. Audit techniques of private clubs do not vary significantly from the audit techniques used for other organizations, regulated by GAAS and have also met the requirements of the General Accepted Accounting Principles (GAAP). Auditors perform assessments of the same balance sheet items as they do in other industries. Those items include, but are not limited to cash, receivables, inventories, equipment, payables, capital leases and some other significant items.

However, there are some specifics related to the private club business from the audit stand point in addition to a granted non-profit status in comparison with other hospitality establishments. In the general course of hospitality business, income is generated from sales,

such as hotel rooms, food and beverage and sales of cruises. Private clubs can receive thousands of dollars in dues at the beginning of the year. Clubs usually have a small amount of bad debt because members usually pay on time. Auditors will most likely pay a significant amount of attention to the procedure of receiving membership dues because a lack of proper recording will immediately indicate a risk related to magnitude due to the large volume of money that goes through the membership dues account. Ideally, clubs may want to have a guest's dues receivable clerk who will immediately stamp arriving checks with a stamp for deposit only. It is deemed an effective internal control tool.

According to the American Institute of Certified Public Accountants (AICPA) the four objectives of internal control applicable to a diverse pool of businesses are: a) Safeguard Assets, b) Check Accuracy and Reliability of Accounting Data, c) Promote Operational Efficiency and d) Encourage Adherence to Prescribed Managerial Policies (Schmidgall, 2006). SAS #112 indicates that it is managements' responsibility that their business has a properly designed internal control environment and auditors can no longer be a part of a company's internal control that was allowed by regulations before. As a result, private club managers and controllers have to have sufficient expertise in their field in order to be able to develop, implement and update (when necessary) an effective internal control system. Based on SAS #112, auditors may no longer be a part of the internal control of the organization. However, these days some board members do have such well recognized credentials as CPA or CFO and may provide assistance with improving an internal control system (Condon and Reilly, 2005). Board members are usually reasonably concerned with a possible increase in membership dues. Especially knowing that years ago there was a waiting list for people who wanted to join a private club but it switched to a waiting list of people who wanted to leave the club (Pellissier, 1993). A weakly

desired internal control system immediately becomes a red flag for an audit group in terms of the probability of existing high control risk. SAS #112 definitely puts serious stress on risk assessment from the auditor's point of view. The more time audits will have to spend evaluating risks of internal controls, the higher the cost of their services. The cost of audit for the majority of private clubs was increasing in 2006 versus 2005 and 2007, but those increases were not relatively significant. Some audit companies have already reported an increase of 15-40% in audit fees due to recent issues of new audit standards (Venegas, 2007).

How Can Clubs Become More Prepared for SAS #112 Launching?

Clubs have millions in assets and mismanagement of those assets due to weak internal control can be very costly. Financial operations and transactions usually start outside the accounting department. An effective internal control system may save significant amounts of money for the club. Companies that do not invest a proper amount of time and resources into their internal control matters can easily become the subject of control failures (Chan, 2006).

Auditors may develop an extensive list of questions related to different functions of different club departments. It especially makes sense for those audit companies that specialize in audit of private clubs. Not all questions from the list will be applicable to every club due to the multiple different procedures that can be unique to specific clubs. It may be necessary to determine if a particular question is applicable to a business matter of a particular club and if so, determine who is responsible for the supervision of the issue and what type of documentation is used to regulate the issue. Acknowledging that a particular internal control matter is in place will not necessarily bring about the conclusion that it is actually used effectively.

While evaluating internal control matters, a controller may not be the only person to give all answers about the control process. Other individuals who are employed by private clubs such

as the food and beverage director, chef and general manager should also be included in the process of answering those questions. A food and beverage director may not always know what a chef is doing specifically to ordering and how this process is established. A controller may have even less knowledge on this subject.

Private clubs, as many other small non-profit organizations, are in higher risk for issues related to the segregation of duties. A small private club may have only one accountant/controller who is fully responsible for signing and mailing checks. It is relatively common for small country clubs to leave the controller signed checks from the manager in case the controller will need them while the manager is not on duty. Both of the examples are cases of control deficiency.

SAS #104 (Due Professional Care in the Performance of Work) that was issued at the same time as SAS #112 clearly states that professionals who audit an organization should have expertise in the nature of its business. However, the new SAS #112 states that an authorized individual (usually managers or controllers) employed by the club, should sign an auditor report and state that they understand what it says. In case they fail to understand the content of the report, it is going to be interpreted as at least “significant deficiency.” It is also the job of a controller/manager to be able to explain to auditors how their entity functions, so that auditors can draw better conclusions about operations and be able to develop an effective audit plan.

Conclusions and Implications

SAS #112 is visibly going to affect the audit process for private clubs. A poorly designed internal control system can make an audit process longer, more challenging and significantly increase auditors’ fees. The new regulation puts much more responsibility on managers and controllers of private clubs to develop and implement an effective internal control system.

Despite the fact that SAS #112 prohibits auditors from being a part of the internal control, they can provide training to employees and educate them on internal control matters.

Professional networking, seminars, and on-line presentations are offered by such groups as hospitality financial technology professionals that have a large pool of members who are actually employed by private clubs. Some audit companies such as McGladrey & Pullen are one of the top companies that provide audit services to private clubs and offer free seminars on new audit standards to its clients.

Encouraging implementation of managerial policies can be a vital step in the improvement of internal control systems. However, those systems have to be effective and updated so employees will be able to accept them. Club managers may not expect to fix every internal control problem immediately. It may be a long and costly project and have to be done in segments. In the long-term, an efficient internal control system can save a club significant amounts of money.

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