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Auditor of State

AUDIT DIVISION ADVISORY MEMO 2010-02

To: Audit Division Staff, Office Managers, and IPA Firms

From: Accounting & Auditing Support Division

Date: February 10, 2010

Re: Auditor of State Guidance regarding adopting Statement of Auditing Standards No. 115, ***Communicating Internal Control Related Matters Identified in an Audit*** (SAS 115)

SAS 115 supersedes SAS 112, and is effective for financial statement periods ending on or after December 15, 2009. SAS 115 requires the AOS to amend the SAS 112 guidance we previously issued to our staff and to IPAs in ADAM 2007-07.

However, the AOS will retain much of the guidance from ADAM 2007-07, as described herein. (We will post ADAM 2007-07 to *IPA Resources* on the AOS' website so IPAs can compare these revisions to the guidance we will retain from the ADAM 2007-07.)

The following are the most significant considerations resulting from SAS 115:

- SAS 115 revised the definition of a *significant deficiency*.

- This revised definition requires wording changes in the report on compliance and internal controls *Government Auditing Standards* requires.

- We expect the federal Office of Management & Budget to conform Circular A-133 to SAS 115 within a few weeks. Until this guidance is available, auditors should continue to use the SAS 112 significant deficiency definition and reporting examples in A-133 reports on federal compliance and on internal controls.

The remainder of this ADAM discusses these implementation considerations in more detail.

New definition of *significant deficiency*
SAS 112 established quantitative criteria for auditors to differentiate "mere" deficiencies in internal control from significant deficiencies and from material weaknesses. SAS 115 omits the minimum quantitative threshold for determining significant deficiencies, and redefines significant deficiencies as follows:

> "A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance."

Revisions to ADAM 2007-07 (Parts 1 – 3)
While the new definition omits the quantitative minimum threshold from the *significant deficiency* definition (i.e. more than inconsequential / more than 20% of materiality), AOS will **retain** quantitative criteria for our staff because of the consistency we believe it has promoted in reporting these matters throughout the State.

Therefore, we are retaining the guidance from Parts 1 – 3 from ADAM 2007-07, with the exception of the following two bullet points:

- We are raising our "general" minimum threshold for measuring significant deficiencies from 20% to 40% of materiality. For example, we believe deficiencies at the lower end of this range resulting from intrafund classification errors normally do not affect financial statement users' judgments.

- However, to comply with SAS 115, staff must *also judge* whether deficiencies of less than 40% of materiality "merit attention by those charged with governance," and therefore require classification and reporting as *significant deficiencies*.

We discussed the above with the AICPA, and they do not believe it is inconsistent with SAS 115, if staff use judgment in their final assessment of whether a deficiency merits attention by those charged with governance.

The AOS will not object if IPA use other (i.e. more judgmental) criteria for determining significant deficiencies, consistent with the SAS 115 definition.

Also remember: SAS 115 still limits deficiencies in internal control to those potentially causing financial statement misstatements.

- For example, consistent with SAS 112, a failure to adequately safeguard assets is not a SAS 115 control deficiency ***if*** the entity has controls to reasonably assure the entity does not report missing assets on its balance sheet.
  - However, auditors should still report inadequate safeguarding controls in the management letter.
- For other examples of control deficiencies that are not SAS 115 control deficiencies, see Part 3 of ADAM 2007-07.

Material Weaknesses
SAS 115 did not substantively change the definition of a material weakness. Therefore, auditors should still use the guidance in ADAM 2007-07 (primarily in Part 1) in assessing whether a control deficiency is a material weakness.

GAGAS Report Revisions
The AICPA has issued example GAGAS reports with revised SAS 115 language. We will post our version of these examples to the *Audit Briefcase* for AOS staff and to *IPA Resources* on the AOS webpage for IPAs.

One other minor change: SAS 115 no longer defines material weaknesses as *significant deficiencies* resulting in a reasonable possibility of a material misstatement. This means GAGAS reports will no longer report material weaknesses in both the significant deficiency paragraph and in the material weakness paragraph. We will only report them in the material weakness paragraph.

A-133 Revisions (ADAM 2007-07, Part 4)
The AICPA recently announced they are working with OMB to adopt SAS 115 into the A-133 report on compliance and on internal controls. They expect to have example reports available "in the next several weeks." They will also amend Auditing Interpretation 9325.1 to redefine significant deficiencies related to federal compliance. We will e-mail our staff and IPAs when we post our example SAS 115 / A-133 report to the *Audit Briefcase* for AOS staff and to *IPA Resources* on the AOS webpage for IPAs.

If an auditor wishes to issue a single audit before the revised guidance is available, ¶ 91 of the AICPA's Risk Alert, *GAGAS and A-133 Developments -- 2009* advises auditors to continue using existing (i.e. SAS 112) A-133 reports on compliance and on internal control.

In other words, until the updated guidance / reports are available, you should continue to follow SAS 112 reporting examples and definitions when reporting single-audit significant deficiencies.

Communicating Significant Deficiencies and Material Weaknesses within 60 Days (ADAM 2007-07, Part 5)
SAS 115 did not change these communication requirements. Therefore, we are retaining the guidance in ADAM 2007-07, Part 5 regarding *Communication*.

Management Letters and Other Considerations (ADAM 2007-07, Part 6)
Part 6 from ADAM 2007-07 explained that we would likely report fewer control deficiencies in management letters, because SAS 112 might require auditors to classify and therefore report more control deficiencies as *significant deficiencies* than were reported under SAS 60.

Under this ADAM, our staff might not classify deficiencies potentially affecting 20% -- 40% of materiality as significant deficiencies. Therefore, we would report these deficiencies in the management letter or by "other methods the auditor deems appropriate." (Note that SAS 115, ¶ 21 states, "If other matters are communicated orally, the auditor should document the communication.")

2007 GAGAS 5.14 permits auditors to communicate *inconsequential* control deficiencies in a management letter or by other methods the auditor deems appropriate. Unless GAO amends GAGAS or informs us otherwise, we will assume auditors can report any control deficiency less than a significant deficiency in the management letter or by other methods. If subsequent GAGAS amendments contradict this assumption, we will inform you.

Finally, ADAM 2007-07 Part 6 includes a bullet stating that SAS 112 applies to basic financial statements and notes, but does not apply to unaudited required supplementary information, CAFR statistical tables, etc. Subsequent to issuing the ADAM, the AICPA suggested that while SAS 112 was not clear on this matter, a more conservative approach would be to deem this information as part of *financial reporting*, and therefore subject to reporting under SAS 112 if the auditor became aware of deficiencies.

Part 6 from ADAM 2007-07 is otherwise unaffected.