



NORTH CAROLINA  
**DEPARTMENT OF STATE TREASURER**  
STATE AND LOCAL GOVERNMENT FINANCE DIVISION  
AND THE LOCAL GOVERNMENT COMMISSION

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**Memorandum # 2011-03**

**To:** Local Government Financial Officials and Their Independent Auditors

**From:** Sharon Edmundson, Director, Fiscal Management Section

**Subject:** Statement on Auditing Standards No. 115, *Communicating Internal Control Related Matters Identified in an Audit*

**Date:** July 21, 2010

The Auditing Standards Board (ASB) has issued Statement on Auditing Standards (SAS) No. 115 *Communicating Internal Control Related Matters Identified in an Audit* that supersedes SAS No. 112 of the same title. SAS No. 115 aligns definitions of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with that of the Public Company Accounting Oversight Board (PCAOB) Auditing Standards No. 5. The new standard is effective for audits of financial statements for periods ending on or after December 15, 2009, which is the fiscal year ended June 30, 2010 for most local governments and public authorities in North Carolina.

The U. S. Government Accounting Office has incorporated the definitions and requirements of SAS No. 115 in the *Governmental Auditing Standards (Interim Guidance on Reporting Deficiencies in Internal Control for GAGAS Financial Audits*, November 2008). OMB Circular A-133 also has adopted the definitions and requirements of SAS No. 115 (*Federal Register* 6/26/2007).

SAS No. 115 revises the definitions of a material weakness and a significant deficiency as follows:

- A ***material weakness*** is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.
- 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.

A material weakness under SAS No. 112 was triggered when there was "more than a remote" likelihood when applying the term as used in Financial Accounting Standards Board Statement (FASB) No. 5, *Accounting for Contingencies*. SAS No. 115 provides for a likelihood of "reasonable possibility" as used in FASB No. 5 and also includes "corrected on a timely basis." SAS No. 112 required a significant deficiency to be reported when there was "more than a remote" likelihood

of a “more than inconsequential misstatement.” SAS No. 115 provides merely that the deficiency be “less severe than a material weakness, yet important enough to merit attention by those charged with governance.”

SAS No. 115 does not provide a list of deficiencies that ordinarily would be considered at least significant deficiencies. The revised list of indicators of material weaknesses in internal control was reduced to the following:

- Indication of fraud, whether or not material, on the part of senior management
- Restatement of previously issued financial statements to correct a material misstatement due to error or fraud
- Identification of a material misstatement that would not have been detected by the entity’s internal control
- Ineffective oversight of the entity’s financial reporting and internal control by those charged with governance

Exhibit B of SAS No. 115 includes a list of examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses. Some examples presented include:

- Lack of segregation of duties
- Inadequately trained management of staff
- Lack of account reconciliations
- Inadequate design of controls over preparation of financial statements being audited

Whether the circumstances for a particular unit of government or public authority require a finding is based on the professional judgment of the auditor. However the State and Local Government Finance Division (SLGFD) staff occasionally believes it is necessary to require the auditor to issue a finding based on the experience our office has in our oversight of the unit. This may be based on our visits with the unit of government, any inability to timely submit interim information or account balances requested by our office, and / or explanation given for a late submission of the audit report.

Another area that has generated concern since the issuance of SAS No. 112 is the preparation of draft financial statements by the auditor. Performing this task does not violate the auditor’s independence provided that management assumes responsibility for the statements and designates a competent employee to oversee the service provided by the auditor. The mere presence of a designated employee is not a control. At issue are the control procedures performed to prevent, detect, and correct misstatements in the draft financial statements prepared by the auditor. The auditor should consider and document things such as:

- Does the staff have sufficient awareness of, or experience in, the applicable accounting principles and disclosure requirements used to prepare draft financial statements?
- Does the staff use disclosure checklists when reviewing the statements?
- Has the staff consulted with the auditor on recording unusual or complex transactions?

SAS No. 115 states that the existence of significant deficiencies or material weaknesses may already be known to management and it may represent a conscious decision by management or those charged with governance to accept the risk associated with the deficiencies due to costs or other considerations. Management is responsible for weighing the costs to be incurred with the

related benefits. Included in their considerations should be the impact of the deficiencies or weaknesses on the decision making process by potential and current grantors and creditors. The auditor is responsible for communicating any significant deficiency and material weakness that exists regardless of management's decision to implement controls.

If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness, the auditor should consider whether prudent officials, having the knowledge of the same facts and circumstances, would likely reach the same conclusion.

Management, or those charged with governance, may ask the auditor to issue a written communication indicating that no material weaknesses were identified during the audit that can then be submitted to governing authorities. Exhibit A provides written illustration of such a report. The auditor should not issue a written communication stating that no significant deficiencies were identified in the audit.

Nothing precludes the auditor from communicating to the governing board other matters related to the government's internal control, such as deficiencies that are not significant deficiencies or material weaknesses or items that would improve operational efficiency and effectiveness or otherwise improve internal control. If a SAS No. 115 report is not issued, the SLGFD staff will continue to require a statement that neither a report on internal controls (SAS No. 115 report) nor a management letter was issued when an audit was conducted under Generally Accepted Auditing Standards (GAAS) only.

It is the opinion of the SLGFD staff that if an audit is performed under *Government Auditing Standards*, it is redundant to issue a SAS No. 115 report since the definitions of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies are the same under both requirements. However, if both reports are issued, then they must both reflect the same significant deficiencies and/or material weaknesses.

SAS No. 115 allows for a written communication concerning internal controls to be issued no later than 60 days following the audit release date; however, it states that written communication is best made by the audit report release date. The SLGFD staff strongly recommends that if a SAS No. 115 report is issued, it should be issued no later than the audit report release date and should accompany the audit package submitted to the SLGFD.

Sample illustrative written communication encompassing the requirements of SAS No. 115 can be found in Exhibit A of the Statement. The AICPA has updated their opinions and sample reports. They can be found at the Governmental Audit Quality Center: <http://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx>. The SLGFD staff also has prepared sample reports that can be found on our web-site: [www.nctreasurer.com](http://www.nctreasurer.com). Select "State and Local Government", then "Audit and Reporting Resources." There is a bullet specifically on SAS No. 115 reporting.

Should you have any questions concerning this memorandum, please contact Jim Burke at (919) 807-2389 or via email at [james.burke@nctreasurer.com](mailto:james.burke@nctreasurer.com)