

# Upside-down Thinking

## Arizona's First Year SAS 112 Experience from the Audit Side

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## SAS 112 in Arizona

We're following a common project cycle

- Plan
  - Arizona Experiment
- Implement
  - How-To-Report Decision – Related Risks and Quirks
- Evaluate
  - No change in number or types of findings
- Adjust as needed
  - SAS 112 Tool Modifications
  - Quality Control Process Revisions
  - Additional Trainings

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PLANNING

## Our Experiment

- Take all the financial statement audits issued in 2006
  - 23 audits – 1 qualified opinion
- Summarize all findings into their four “buckets”
  - Material weaknesses, reportable conditions, management letter items, Points for Discussion
- Re-categorize the findings under the new criteria of SAS No. 112
  - Material weaknesses, reportable conditions, management letter items, points for discussion

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PLANNING

## Our Experiment—Results

	Pre-SAS 112	Using SAS 112
■ Material weaknesses	3	32
▒ Reportable conditions/significant deficiencies	11	156
▓ Management letter items	65	78
■ Points for discussion	340	185

IMPLEMENTATION

## SAS 112 Implementation

Implementation Committee made two major decisions:

- We eliminated management letters.  
Yellow Book report would be our SAS 112 communication
- SAS 112 implementation would not be driven by the addition of more forms.  
We would give implementation guidance in a useful 'tool'

IMPLEMENTATION

## AZ Reports: Pre-SAS 112



Auditor's financial statement report



Additional Single Audit Reports- YB report bound inside




Management letters




Points for discussion

IMPLEMENTATION


## AZ Reports: Post-SAS 112




Auditor's financial statement report




Yellow Book report



Additional Single Audit Reports



No more management letters



Points for discussion (presented orally)

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EVALUATION

## Evaluation

After our first eight 2007 engagements have been issued, we found:

**No significant change in the number of reported findings after implementing SAS 112.**

## Identified Reasons

Not troublesome:

- Experiment presented the 'worst-case' scenario
- Clients got the message, emphasizing and allocating resources to improve internal control
- Current results are from clients that value financial reporting and internal control
- Insufficient information was gathered in the prior audit to fully evaluate findings

## Identified Reasons

Troublesome:

### Upside-down Thinking

- Presumption by staff that findings do not meet reporting requirements unless criteria indicate they should be reported.
- When judgment about a finding could go either way, staff elected to not report the finding.

## Identified Reasons

EVALUATION

Also Troublesome:

- “Magnitude” suggests a quantified evaluation – qualitative factors were under-evaluated and not considered FIRST
- Certain COSO slices are difficult to evaluate in SAS 112 terms
- Design deficiencies are difficult to evaluate
- Compensating controls mitigated significance without sufficient appropriate audit evidence
- Finding evaluations performed almost exclusively by auditors close to the audit


## AZ OAG SAS 112 Tool




ADJUSTMENTS

A Multiple Tab Workbook




- Table
- Definitions
- Materiality/Magnitude Meter
- Process
- Finding Index and Evaluation Spreadsheet
- A-133 Single Audit Guidance
- Examples
- Resources

## SAS 112 Table

SAS 112 Reporting Table 

		Magnitude of Possible Misstatement 			
		Qualitative Factors Must be Considered When Assessing Magnitude			
		No F/S Effect	Inconsequential 	More than Inconsequential	Material
ADJUSTMENTS	Likelihood of Misstatement	Not Possible	Not a Control Deficiency		
	Remote		Other Control Deficiency	Other Control Deficiency	Other Control Deficiency
	More than Remote		Other Control Deficiency	SIGNIFICANT DEFICIENCY 	MATERIAL WEAKNESS

## Related Definitions

ADJUSTMENTS	<p><b>Design Deficiency</b> </p> <p>A type of control deficiency for which a necessary control is missing or the control will not meet the objective even if performed as designed.</p>
	<p><b>Materiality</b></p> <p>Materiality refers to whether a misstatement is significant enough to change or influence the judgment of a reasonable person relying on the information. Materiality includes qualitative factors such as the nature of the item and the related surrounding circumstances as well as quantitative factors. <u>For a discussion of materiality, please see the Materiality Meter tab.</u></p>
	<p><b>Magnitude</b></p> <p>Magnitude refers to the significance of the possible misstatement and includes qualitative factors such as the nature of the misstatement and the surrounding circumstances. It includes actual noted misstatements and any other misstatement that could have occurred. When considering magnitude, it does not matter whether an actual misstatement was noted. What matters is the potential for misstatement. <u>When making magnitude determinations, please see the Materiality Meter tab.</u></p>
	<p><b>Inconsequential</b> </p> <p>Magnitude is inconsequential if a reasonable person would conclude that the possible misstatement (any actual misstatement plus potential undetected misstatements) would clearly be immaterial to the financial statements, qualitatively and quantitatively. <u>When determining whether an item is inconsequential, please see the Materiality Meter tab.</u></p>
	<p><b>Prudent Official</b> </p> <p>Although the term prudent official is not defined in the standard, the concept is that an auditor should step back and take an objective look at the severity of the deficiency like a regulator or a person from an oversight agency would do.</p>

ADJUSTMENTS

## The SAS 112 Process

Additions and Clarifications to the SAS 112 Process Outline:

- Government Auditing Standards 5.12  
Fixing the UPSIDE-DOWN THINKING
- Prudent Official Test

## Finding Index and Evaluator

ADJUSTMENTS

Affected Financial Statement Area				Compliance and Other Matters							Disposition											
LDR #	Audit Documentation Reference	Description	Prior Year Finding	Account Balance	Disclosure Requirement	Assertion	Internal Control Component	Non-Federal Compliance?	Fraud, Illegal Act, or Abuse?	Federal Compliance #?	CFDA Number	Compliance Requirements	Material Weaknesses	Significant Deficiency	Instance of Non-compliance	Material Weakness	Significant Deficiency	Other Matter	Verbal PFD	Date Discussed with Client	Pass	
Affected Financial Statement Area																						
		Account Balance		Disclosure Requirement		Assertion	Internal Control Component															
Disposition																						
Yellow Book Report																	Verbal Communication					
		Material Weakness		Significant Deficiency		Other Matter												Verbal PFD	Date Discussed with Client		Pass	

ADJUSTMENTS

## Materiality Meter

MATERIALITY (MAGNITUDE) METER

INCONSEQUENTIAL
MORE THAN INCONSEQUENTIAL
MATERIAL

**Inconsequential**

The magnitude of a control deficiency is inconsequential if a reasonable person would conclude that the misstatement would be clearly immaterial to the financial statements.

**More than Inconsequential**

The magnitude of a control deficiency is more than inconsequential if a reasonable person would not conclude that a misstatement was inconsequential.

**Material**

The magnitude of a control deficiency is material if the misstatement makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the misstatement.

To make these determinations, the auditor must consider any actual misstatement, the possibility of further undetected possible misstatements, and the effects of any other related control deficiencies.

**INFORMATION NEEDED TO HELP MAKE THESE DETERMINATIONS**

AAG-SLV 4.30 **Materiality** refers to whether a misstatement is significant enough to change or influence the judgment of a reasonable person relying on the information.

ADJUSTMENTS

## A-133 Single Audit Guidance

- Complete Summary of A-133 Finding Reporting
- Input on significance of findings from Inspectors General
- The \$400 Questioned Cost Hypothetical Scenario

## Summary

We haven't seen the expected increase in findings

We analyzed why and identified:

- Reasons that didn't need correction
- Reasons that did need correction

UPSIDE-DOWN THINKING

Corrections

AZ SAS 112 Tool modifications and training