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STATE AND LOCAL GOVERNMENT FINANCE DIVISION  
AND THE LOCAL GOVERNMENT COMMISSION

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**Memorandum # 2011-05**

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

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

**Subject: SAS No. 117, *Compliance Audits***

**Date: August 25, 2010**

To reflect changes in the compliance audit environment and incorporate the risk assessment standards in compliance audits, the Auditing Standards Board (ASB) has issued Statement on Auditing Standards (SAS) No. 117 *Compliance Audits*, which supersedes SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* and amends AU 801. SAS No. 117 was primarily developed in response to the National Single Audit Sampling Project conducted by the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. This project was essentially a study on the quality of audits performed under U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of State, Local Governments, and Non-Profit Organizations*. Among the recommendations of the study is that SAS No. 74 needs to be revised. The new standard is effective for compliance for fiscal periods ending on or after June 15, 2010 which is June 30, 2010 for most local governments and public authorizes in North Carolina.

SAS No. 117 is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with generally accepted auditing standards (GAAS), *Government Auditing Standards* (GAGAS), and when a governmental audit requirement requires an auditor to express an opinion on compliance. SAS No. 117 will apply to audits performed with OMB Circular A-133 and audits performed under the requirements of the *NC State Single Audit Implementation Act*.

This SAS addresses application of GAAS to a compliance audit. AU sections that are not applicable to a compliance audit are listed in Appendix A (page 9) of this memo. All other AU sections are applicable to a compliance audit. Some AU sections can be adapted and applied to a compliance audit with relative ease, for example by substituting the word "misstatement" with the word "noncompliance;" however other AU sections are more difficult to adapt and apply; additional modification is necessary. SAS No. 117 provides more specific guidance on how to adapt and apply certain AU sections to a compliance audit.

AU Sections often identify audit procedures and contain examples that are specific to a financial statement audit. The auditor is not expected to adapt or apply all such procedures to the compliance audit, only those that, in the auditor's professional judgment, are relevant and necessary to meet the objectives of the compliance audit.

## Auditor's Objectives

The auditor's objectives in a compliance audit are stated in SAS No. 117 as follows:

- a) Obtain sufficient appropriate audit evidence to form an opinion and report at the level specified in the governmental audit requirement on whether the unit of government complied in all material respects with the applicable compliance requirements; and
- b) Identify audit and reporting requirements specified in the governmental audit requirement that are supplementary to GAAS and *Government Auditing Standards*, if any, and perform procedures to address those requirements.

Management's responsibilities in a compliance audit are to identify the unit of government's federal and State programs and understand and comply with the compliance requirements. The auditor should determine which of those programs and compliance requirements to test in accordance with the governmental audit requirements.

## Definitions

For the purpose of adapting GAAS to a compliance audit, SAS No. 117 provides definitions for several terms that are specific to compliance audits. The list of terms is presented here, but only five are defined due to space limitations:

- Applicable compliance requirements
- Audit findings
- Audit risk of noncompliance
- Compliance audit
- Compliance requirements
- Deficiency in internal control over compliance
- Detection risk of noncompliance
- Governmental audit requirement
- *Governmental Auditing Standards*
- Government program
- Grantor
- Known questioned costs
- Likely questioned costs
- Material noncompliance
- Material weakness in internal control over compliance (Reasonable possible, Remote, Probable)
- Organization-wide audit
- Pass-through entity
- Program-specific audit
- Questioned costs
- Risk of material noncompliance (Inherent risk of noncompliance, Control risk of noncompliance)
- Significant deficiency in internal control over compliance

**Audit risk of noncompliance.** The risk that the auditor expresses an inappropriate audit opinion on the entity's compliance when material noncompliance exists. Audit risk of noncompliance is a function of the risks of material noncompliance and detection risk of noncompliance.

**Governmental audit requirement.** A government requirement established by law, regulation, rule, or provision of contracts or grant agreements requiring that an entity undergo an audit of its compliance with applicable compliance requirements related to one or more government programs that the entity administers.

**Detection risk of noncompliance.** The risk that procedures performed by the auditor to reduce audit risk of noncompliance to an acceptably low level will not detect noncompliance that exists that could be material, either individually or when aggregated, with other instances of noncompliance.

**Material noncompliance.** In the absence of a definition of material noncompliance in the governmental audit requirement, a failure to follow compliance requirements or a violation of prohibitions included in the applicable compliance requirements that results in noncompliance that is quantitatively or qualitatively material, either individually or when aggregated with other noncompliance, to the affected government program.

**Risk of material noncompliance.** The risk that material noncompliance exists prior to the audit. This consists of two components described as follows:

**Inherent risk of noncompliance.** The susceptibility of a compliance requirement to noncompliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance.

**Control risk of noncompliance.** The risk that noncompliance with a compliance requirement that could occur and that could be material, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the unit of entity's internal control over compliance

### **Adapting and Applying the AU Sections to a Compliance Audit**

SAS No. 117 discusses the requirements of adapting and applying GAAS to the compliance audit. A discussion of materiality and the risk assessment process follows.

Materiality: In a compliance audit, materiality levels are used for:

- Determining the nature and extent of risk assessment procedures
- Identify and assess the risks of material noncompliance
- Determine the nature, timing, and extent of further audit procedures
- Evaluate whether the unit of government complied with the applicable compliance requirements
- Report findings of noncompliance and other matters required to be reported by the governmental audit requirements

Generally, materiality is determined in relation to a government program taken as a whole. The governmental audit requirement may specify a different level of materiality. Grantors, who usually establish audit requirements, require that noncompliance that is material in relation to the compliance requirements identified in the OMB Circular A-133 *Compliance Supplements* be reported.

Perform Risk Assessment Procedures: The auditor should perform risk assessment procedures to gain an understanding of the applicable compliance requirements and the related internal controls over the compliance requirements for each program and compliance requirement selected for testing.

- The auditor should inquire of management whether there are findings and recommendations in reports or other written communications resulting from previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit.
- The auditor should obtain an understanding of the management's response to findings and recommendations, such as corrective actions, that could have a material effect on the compliance with applicable compliance requirements.
- The auditor should use the information obtained about the findings and recommendations to assess risk and determine nature, timing, and extent to which testing the implementation of corrective actions is applicable to the audit objectives.

The nature and extent of the risk assessment procedures the auditor performs may vary among local governments and public authorities and are influenced by factors such as:

- Newness and complexity the applicable compliance requirements
- The nature of the applicable compliance requirements
- Auditor's knowledge of the unit of government's internal control over compliance with the applicable compliance requirements obtained in previous audits or other professional engagements
- The services provided by the unit of government and how these services are affected by external factors
- The level of oversight by the grantor or pass-through entity
- How management addresses findings

Assessing Risks of Material Noncompliance: The auditor should assess the risks of material noncompliance whether due to fraud or error for each applicable compliance requirement. The auditor should consider whether any of those risks are pervasive and might affect multiple compliance requirements. Examples of situations in which risk of material noncompliance that is pervasive to the unit's noncompliance are when a unit of government is experiencing financial difficulty and for which there is increased risk that grant funds will be diverted for unauthorized purposes. Another example is a unit that has a history of poor recordkeeping for its governmental programs. The auditor should develop an overall response to any pervasive risks of material noncompliance that are identified.

In assessing risks of material noncompliance, several factors an auditor might consider are:

- Complexity of the applicable compliance requirements
- The susceptibility of applicable compliance requirements to noncompliance
- Length of time the unit of government has been subject to the applicable compliance requirements
- Auditor's observations about how the unit of government has complied with the applicable compliance requirements in prior years
- Potential effect on the unit of government of compliance with the applicable compliance requirements
- Degree of judgment involved in adhering to the compliance requirements
- Auditor's assessment of the risks of material misstatement in the financial statement audit

Performing Further Audit Procedures in Response to Assessed Risks: The auditor should design and perform further audit procedures in response to the assessed risks of material noncompliance.

The auditor should perform test of controls over compliance if:

- The auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirements.
- Substantive procedures alone do not provide sufficient appropriate audit evidence.
- Test of controls over compliance are required by the governmental audit requirement.

If any of the above conditions are met, the auditor should test the operating effectiveness of controls over each applicable compliance requirement to which the conditions apply in each compliance audit.

Risk assessment procedures, test of controls, and analytical procedures alone are not sufficient to address a risk of material noncompliance. The use of analytical procedures to gather substantive evidence is generally less effective in a compliance audit than it is in a financial statement audit. However, substantive analytical procedures may contribute some evidence when performed in addition to tests of transactions and other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence.

Further Audit Procedures should include tests of details and may include tests of transactions. These tests may be performed in the following areas:

- Grant and disbursements or expenditures
- Eligibility files
- Cost allocation plans
- Periodic reports filed with grantor agencies

An auditor may decide to use audit sampling to obtain sufficient appropriate audit evidence in a compliance audit. AU section A350, *Audit Sampling*, as well as the AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* contains guidance on sampling in the context of a compliance audit. AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, paragraphs .04-.06, provide guidance that may be adapted when developing an overall response to the risks of material noncompliance.

### **Supplementary Audit Requirements**

The auditor should determine whether the governmental audit requirements have specified requirements that are supplementary to GAAS and GAGAS. Examples of supplementary audit requirements are the requirements in OMB Circular A-133 for the auditor to perform specified procedures to identify major programs and follow-up on prior audit findings and perform procedures to assess the reasonableness of the summary schedule of prior audit findings.

In instances where audit guidance conflicts with current GAAS or GAGAS, the auditor should comply with the most recent applicable GAAS and GAGAS standards instead of conflicting guidance. When there is conflicting guidance, the auditor may decide to consult with the governmental agency responsible for establishing audit guidance or that provides the funding.

## **Written Representation**

The auditor should request from management written representations that are tailored to the unit of government and the governmental audit requirement. These representatives should include:

- Acknowledging management's responsibility for understanding and complying with the compliance requirements
- Acknowledging management's responsibility for establishing and maintaining controls that provide reasonable assurance that the unit of government administers government programs in accordance with the compliance requirements
- Stating that management has identified and disclosed to the auditor all of its government programs and related activities subject to the governmental audit requirement
- Stating that management has made available to the auditor all contracts and grant agreements, including amendments, if any, and any other correspondence relevant to the programs and related activities subject to the governmental audit requirement
- Stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements or stating that there was no such noncompliance
- Stating whether management believes that the unit of government has complied with the applicable compliance requirements (except for noncompliance it has disclosed to the auditor)
- Stating that management has made available to the auditor all documentation related to compliance with the applicable compliance requirements
- Identifying management's interpretation of any applicable compliance requirements that are subject to varying interpretations
- Stating that management has disclosed to the auditor any communications from grantors and pass-through entities concerning possible noncompliance with the applicable compliance requirements, including communications received from the end of the period covered by the compliance audit to the date of the auditor's report
- Stating that management has disclosed to the auditor the findings received and related corrective actions taken for previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit, including findings received and corrective actions taken from the end of the period covered by the compliance audit to the date of the auditor's report
- Stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements subsequent to the period covered by the auditor's report or stating that there were no such known instances; and

- Stating that management is responsible for taking corrective action on audit findings of the compliance audit.

### **Subsequent Events**

The auditor has no obligation to perform any audit procedures related to the unit of government's compliance during the period subsequent to the period covered by the auditor's report. However, the auditor should perform subsequent events procedures related to compliance during the period covered in the audit report up to the date of the auditor's report. The nature and extent should take into account the auditor's risk assessment and should include, but not be limited to, inquiring of management about and considering the following:

- Relevant internal auditors' reports issued in subsequent period
- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Reports from grantors and pass-through entities on the unit of government's noncompliance that were issued during the subsequent period
- Information about the unit of government's noncompliance obtained through other professional engagements performed for that unit of government.

If the auditor becomes aware of noncompliance in the period subsequent to the period covered by the auditor's report that disclosure is needed to prevent it from being misleading, the auditor needs to discuss this with management and the governing board. The auditor should include an explanatory paragraph in the report describing the nature of the noncompliance. An example of a subsequent event is a discovery of a noncompliance of such magnitude that it caused the grantor to stop funding the program.

### **Sufficiency and Appropriateness of Audit Evidence**

The auditor should evaluate the sufficiency and appropriateness of the audit evidence obtained in order to form an opinion, at the level specified by the governmental audit requirements. The auditor may consider the following factors:

- The frequency and the nature of the noncompliance identified
- The adequacy of the unit of government's system for monitoring compliance and the possible effect of any noncompliance
- Whether identified noncompliance resulted in likely questioned costs that are material to the government program

The auditor should evaluate likely questioned costs, not just known questioned costs, as well as other material noncompliance that, by its nature may not result in questioned costs.

### **Reporting**

Depending on the governmental audit requirements, the auditor may report on compliance only or may also be required to report on internal control over compliance. The auditor is not necessarily required to issue a combined report but may issue two separate reports, one on the compliance and one on internal control over compliance. If there is not a specific governmental requirement

to report on internal control over compliance, the auditor should provide written communication of significant deficiencies and material weaknesses in internal control over compliance to the governing board and management.

A sample illustrative combined report on compliance and internal control over compliance encompassing the required elements of SAS No. 117 can be found in Exhibit A of SAS No.117. The AICPA has updated their opinions and sample reports. They can be found at Governmental Audit Quality Center:

<http://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx>. The LGC 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,” “Audit and Reporting Resources,” “Single Audit Resources,” and finally “Sample Reports and Documents.”

### **Documentation**

The auditor is not expected to prepare specific documentation of how the auditor adapted and applied each of the applicable AU sections to the objectives of a compliance audit. The documentation on the audit strategy, audit plan, and work performed cumulatively demonstrates this. The auditor should document all the following:

- Risks assessment procedures performed, including those obtaining an understanding of internal control over compliance
- The auditor’s responses to the assessed risks of material noncompliance, procedures performed to test compliance with applicable compliance requirements, and results of those procedures, including any test of controls over compliance
- Materiality levels and the basis on which they were determined
- How the auditor complied with specific governmental audit requirements that are supplementary to GAAS and GAGAS.

### **Reissuance of the Compliance Report**

If an auditor reissues the report, the reissued report should have an explanatory paragraph stating that the report is replacing the previously issued report, stating the reason for the reissuance, and describing any changes from the previously issued report. The date needs to be updated if any additional procedures were performed to obtain sufficient appropriate audit evidence for all governmental audit programs being reported on. However, if this audit evidence obtained applies only to some of the programs, there should be a dual date on the report. Reissuance of any auditor-prepared document required by the governmental audit requirement that is incorporated by reference into the auditor’s report, such as a schedule of findings and questioned costs, is considered to be a reissuance of the report.

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)

AU sections 100-300 and 500 generally can be adapted to the objectives of a compliance audit. However, with certain exceptions, AU sections 400, 600, 700, and 900 generally cannot be adapted, because these sections address auditor's report on financial statements and other topics not related to compliance.

<b>AU Sections in AICPA Professional Standards That Do Not Apply to Compliance Audits</b>	
AU section 110, <i>Responsibilities and Functions of the Independent Auditor</i> , Paragraph .01	AU section 420, <i>Consistency of Application of Generally Accepted Accounting Principles</i>
AU section 150, <i>Generally accepted Auditing Standards, Standards of reporting in paragraph .02</i>	AU section 431, <i>Adequacy of Disclosure in Financial Statements</i>
AU section 314, <i>Understanding the Entity and its Environments and Assessing the Risks of Material Misstatement</i> , Paragraphs .09, .44 - .45, .83 - .86, and .102	AU section 504, <i>Association With Financial Statements</i>
AU section 315, <i>Communications Between Predecessor and Successor Auditors</i> , Paragraphs .12 - .13 and .21 - .22	AU section 508, <i>Reports on Audited Financial Statements</i> , Paragraphs .05, .08 - .09, .11(b) – (h), .14 - .18, .27 - .28, .33 - .34, .38, .41 - .57, and .64 - .76
AU section 317, <i>Illegal Acts by Clients</i>	AU section 534, <i>Reporting on Financial Statements Prepared for Use in Other Countries</i>
AU section 318, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i> , Paragraphs .40 - .45, .52, .68 - .69, and the appendix	AU section 543, <i>Part of Audit Performed by Other Independent Auditors</i> , Paragraphs .14 and .16
AU section 324, <i>Service Organizations</i> , Paragraphs .22 - .60	AU section 544, <i>Lack of Conformity with Generally Accepted Accounting Principles</i>
AU section 326, <i>Audit Evidence</i> , Paragraphs .14 - .19	AU section 550, <i>Other Information in Documents Containing Audited Financial Statements</i>
AU section 328, <i>Auditing Fair Value Measurements and Disclosures</i>	AU section 551, <i>Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents</i>
AU section 330, <i>The Confirmation Process</i>	AU section 552, <i>Reporting on Condensed Financial Statements and Selected Financial Data</i>
AU section 331, <i>Inventories</i>	AU section 558, <i>Required Supplementary Information</i>
AU section 332, <i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i>	AU section 560, <i>Subsequent Events</i>
AU section 333, <i>Management Representations</i> , Paragraph .12	AU section 623, <i>Special Reports</i>
AU section 334, <i>Related Parties</i>	AU section 625, <i>Reports on the Application of Accounting Principles</i>
AU section 337, <i>Inquiry of Client's Lawyer Concerning Litigation, Claims, and Assessments</i>	AU section 634, <i>Letters for Underwriters and Certain Other Requesting Parties</i>
AU section 341, <i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i>	AU section 711, <i>Filings Under Federal Securities Statutes</i>
AU section 342, <i>Auditing Accounting Estimates</i>	AU section 722, <i>Interim Financial Information</i>
AU section 410, <i>Adherence to Generally Accepted Accounting Principles</i>	AU section 901, <i>Public Warehouses – Controls and Auditing Procedures for Goods Held</i>