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Reporting on an entity's internal control over financial reporting : an amendment to Statement on standards for attestation engagements no. 2 : (amends Statement on standards for attestation engagements, no. 1, AICPA professional standards, vol. 1, AT sec. 400.01,.12 through .18, .20, .26, and .27); Statement on standards for attestation engagements 6;

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American Institute of Certified Public Accountants

Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2

(Amends Statement on Standards for Attestation Engagements No. 2, AICPA, Professional Standards, vol. 1, AT sec. 400.01, .12 through .18, .20, .26, and .27.)

1. This amendment conforms the description of elements of an entity's internal control to the components of internal control contained in Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, Professional Standards, vol. 1, AU sec. 319), and *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). New language is shown in boldface italics. References hereinafter to SAS No. 55 are to the amendment to SAS No. 55 included in SAS No. 78. In addition, conforming changes will be made to substitute *components* for *elements* and *internal control* for *internal control structure*. The amendment is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter. Early application of the provisions of this Statement is permitted.

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of any part of this work should be mailed to Permissions Department, AICPA,
Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

[Footnote 3 to paragraph 1 will be amended as follows.]

³ A practitioner engaged to ~~provide assurances on~~ **examine** management's assertion about the effectiveness of an entity's internal control ~~structure other than over financial reporting (for example, controls over safeguarding of assets other than those described in paragraph 27c, or other operating controls or controls over compliance with laws and regulations)~~ **over operations or compliance with laws and regulations** should refer to the guidance in SSAE No. 1, *Attestation Standards* (AICPA, Professional Standards, vol. 1, AT sec. 100, "Attestation Standards"). **A practitioner engaged to perform agreed-upon procedures on management's assertion relating to an entity's internal control over operations or compliance with laws and regulations should refer to the guidance in SSAE No. 4, Agreed-Upon Procedures Engagements (AICPA, Professional Standards, vol. 1, AT sec. 600). In addition, the guidance in SSAE No. 3, Compliance Attestation (AICPA, Professional Standards, vol.1, AT sec. 500) may be helpful when performing an engagement relating to internal control over compliance with laws and regulations. Further,** ~~In addition,~~ the guidance in this Statement may be helpful in attestation engagements to report on management's assertion about internal controls over **operations or compliance with laws and regulations** ~~other than financial reporting.~~

[Paragraph 12 will be amended as follows.
Footnotes 7 through 21 will be renumbered.]

Elements Components of an Entity's Internal Control Structure

12. The ~~components~~ **elements** that constitute an entity's internal control ~~structure~~ are a function of the definition **and description** of an internal control ~~structure~~ selected by management **for the purpose of assessing its effectiveness**. For example, management may select the definition **and description** of an internal control ~~structure~~ contained in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, Professional Standards, vol. 1, AU sec. 319). Paragraphs 13 through 16 describe the elements that constitute an entity's internal control structure as defined in SAS No. 55. **based on the internal control framework set forth in Internal Control—Integrated Framework,⁷ published by the Committee of Sponsoring Organizations of the Treadway Commission.⁸ Internal Control—Integrated**

⁷ As noted in footnote 6, this report also contains control criteria.

⁸ This definition and description is consistent with the definition contained in SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, Professional Standards, vol. 1, AU sec. 319). However, AU sec. 319 is not intended to provide criteria for evaluating internal control effectiveness.

Framework describes an entity's internal control as consisting of five components control environment, risk assessment, control activities, information and communication, and monitoring. If management selects another definition **and description** of an internal control, ~~structure, the description of the elements contained in those paragraphs~~ **these components** may not be relevant.

*[Paragraphs 13 through 16 will be superseded.
Paragraph 17 will be replaced as follows.]*

13. Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty, and that breakdowns in internal control can occur because of such human failures as simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people or management override of internal control.

[Paragraph 18 will be amended as follows.]

~~18.~~ **14.** Custom, culture, and the corporate governance system may inhibit irregularities by management, but they are not **absolute** infallible deterrents. An effective control environment, too, may help mitigate the probability of such irregularities. For example, an effective board of directors, audit committee, and an internal audit function may constrain improper conduct by management. Alternatively, an ineffective control environment may negate the effectiveness of control policies and procedures within the accounting system and other control procedures **the other components**. For example, **when the presence of management incentives creates an environment that could result in material misstatement of financial statements, the effectiveness of control activities may be reduced.** ~~although an entity has good controls relating to the financial reporting process, a strong bias on the part of management to inflate reported earnings to maximize bonuses may result in financial statements that are materially misstated.~~ The effectiveness of an entity's internal control ~~structure~~ might also be adversely affected by such factors as a change in ownership or control, changes in management or other personnel, or developments in the entity's market or industry.

*[Paragraph 19 will be renumbered as paragraph 15.
Paragraph 20 will be amended as follows.]*

~~20.~~ **16.** Performing an examination of management's assertion about the effectiveness of an entity's internal control ~~structure~~ involves (a) planning the engagement, (b) obtaining an understanding of ~~the~~ internal control ~~structure~~, (c) ~~testing and~~ evaluating the design effectiveness of the

controls ~~internal control structure policies and procedures~~, (d) testing and evaluating the operating effectiveness of the **controls** ~~internal control structure policies and procedures~~, and (e) forming an opinion about whether management's assertion regarding the effectiveness of the entity's internal control is fairly stated, in all material respects, based on the control criteria.

[Paragraph 21 through 25 will be renumbered as paragraphs 17 through 21. Paragraph 26 will be replaced with the following.]

26. 22. To evaluate the design effectiveness of an entity's internal control, the practitioner should obtain an understanding of the controls within each component of internal control.¹⁰

¹⁰ *As discussed in paragraph 12, the components that constitute an entity's internal control are a function of the definition and description of internal control selected by management. Paragraph 12 lists the components the practitioner should understand if management decides to evaluate and report on the entity's internal control based on the definition of internal control in Internal Control—Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission. If management selects another definition, these components may not be relevant.*

*[Paragraph 27 will be superseded.
The remaining paragraphs will be renumbered.]*

This Statement entitled Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2 was adopted unanimously by the fifteen members of the board.

Auditing Standards Board (1995)

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