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Comment letters on Proposed amendments to SAS No. 55.

American Institute of Certified Public Accountants. Auditing Standards Board

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Date: February 1, 2001
To: Auditing Standards Board
From: George H. Tucker, Chair, Technology Issues Task Force

The task force met on January 24 to discuss comments on the Exposure Draft of proposed amendments to SAS No. 55. Twenty-one letters were received. The majority (18) of those who commented on the ED support its issuance. The SEC believes the POB Panel recommendations should be incorporated in the proposed amendment. In addition, two other letters suggested that it may be preferable to issue the guidance as an interpretation or an Audit Guide.

Accompanying this letter are the following Word files, as well as an electronic file of each of the 21 comment letters (transmittal will occur in batches):

ComLetList.doc	List of the comment letters
ComLetSum2.doc	Summary of comments by paragraph (landscape)
EDSAS55mrk.doc	ED marked with changes to address comments

Please note that the comment summary has a column with the task force's proposed disposition of each comment. The task force agreed with many of the proposed changes. These have been reflected in the marked draft of the ED or will be addressed in the revisions to the Audit Guide on which the task force presently is working. The task force asks for your review and comment on the task force's proposed disposition not only of comments with which we agreed, but also those with which the task force disagreed.

Given the volume of comments, we believe our discussion with the ASB would be facilitated by considering the following overall themes:

- Scope of project. The task force noted that the following areas of comment raised questions about matters that we believe are beyond the scope of this project.
 - *Panel on Audit Effectiveness Recommendations.* The SEC comment letter (#19) made the following recommendation:

The Panel on Audit Effectiveness (the Panel) has recommendations on assessing inherent risk (paragraph 2.48 of the Panel's report) and assessing control risk (paragraph 2.77 of the Panel's report) that have not been addressed in this standard. We believe that the Panel's recommendations in this area are important and that these recommendations need to be incorporated into this amendment. Further, we do not believe it appropriate to defer action to the ASB's Risk Assessment and Linkage Task Forces.

- *Efficiency vs. effectiveness.* The SEC comment letter made the following recommendation:

Throughout the document the auditor is provided the opportunity to complete certain requirements if the result would be more efficient. As a policy matter, the auditors' decision-making process with respect to obtaining an understanding of the control environment or assessing risk should not be dictated by the efficiencies that would be created as a result.

- *Requirement to Perform Tests of Controls.* The SEC comment letter made the following recommendations:

The first sentence [of paragraph 68] states, "the auditor may need to perform tests of controls to determine whether internal controls are operating effectively and to support an assessment of control risk below the maximum." The words "may need to" should be changed to "should". Note that paragraph 66 states that auditors "should" perform tests of controls when the auditor assesses control risk below the maximum.

The last sentence [of paragraph 69] states, "Evidential matter obtained from tests of controls may be required to enable the auditor to audit the related financial statement assertions." The sentence should be revised to read "Evidential matter should be obtained from tests of controls to enable the auditor to audit the related financial statement assertions." This change is necessary for consistency with the wording in paragraph 66 and our comment above on paragraph 68.

- *Clarification of "placed in operation" vs. "operating effectiveness."* A number of comments were received about the apparent contradiction between the guidance in paragraph 28 that "The auditor is not required to obtain knowledge about operating effectiveness as part of the understanding of internal control necessary to plan the audit" and guidance in other paragraphs, including paragraphs 66-70 and paragraphs 85-87. See the various comments on paragraph 28, and also comment letter 4 on paragraphs 26 and 66.
- *Documentation requirements.* A number of comment letters (GAO, SEC, state agencies) support more extensive documentation requirements. See comments on paragraphs 6, 62, and 84.
- *Overall organization and clarity of standard.* A number of general comments were received on the complexity of the standard and its lack of a helpful summary.
- Guidance on using a specialist, qualifications of the specialist, and how this guidance relates to SAS No. 73. See comments on paragraphs 32 and 33.

- Definition and content of “general controls” and “application controls,” the applicability of these controls outside IT systems, and the appropriate level of detail in the guidance on these controls. See comments on paragraphs 44 and 45.
- Sufficiency of guidance on nonstandard journal entries. See comments on paragraphs 50 and 51 and related comment letter #8 on paragraph 48.

We look forward to receiving the Board’s input on going forward with this project.



January 19, 2001

File Ref. No. 4420

To the Technology Issues Task Force:

Here are the comment letters received to date on the AICPA Exposure Draft, *Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as Amended by Statement on Auditing Standards No. 78, Consideration of Internal in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55.*

Name/Affiliation **Location**

1. Lee Linker

North Carolina Office of the State Auditor North Carolina

2. George Lewis Lafayette, LA

3. Arthur A. Hayes

State of Tennessee

Department of Audit Nashville, TN

4. P. Gerard Sokolski

New York State Society of CPAs New York, NY

5. Stephen W. Head

ISACA Standards Board Rolling Meadows, IL

6. Vickie Rauser

State of Montana

Montana Legislative Audit Division Helena, MT

7. Candace Wright

PCPS Technical Issues Committee Jersey City, NJ

8. Arthur Andersen LLP Chicago, IL

9. Barbara J. Hinton

National State Auditors Association Topeka, KS

- 10. Janice Mueller
 - State of Wisconsin
 - Legislative Audit Bureau Madison, WI
- 11. Jeffrey Steinhoff
 - U. S. General Accounting Office Washington, DC
- 12. Jon A. Wise
 - Association of Government Accountants
 - Financial Management Standards Board Alexandria, VA
- 13. Walter J. Kucharski
 - Commonwealth of Virginia
 - Auditor of Public Accounts Richmond, VA
- 14. Thomas H. McTavish
 - State of Michigan
 - Office of the Auditor General Lansing, MI
- 15. Wayne Kolins
 - BDO Seidman, LLP New York, NY
- 16. Christopher P. Buse
 - State of Minnesota
 - Office of the Legislative Auditor St. Paul, MN
- 17. Deloitte & Touche LLP Wilton, CT
- 18. Debra Hopkins
 - Illinois CPA Society Chicago, IL
- 19. Lynn E. Turner
 - Securities and Exchange Commission Washington, DC
- 20. Grant Thornton LLP New York, NY
- 21. Ernst & Young LLP Cleveland, Ohio

22. John M Lacey
Calif. CPAs

If you have any questions, please call me at 212/596-6043.

Sincerely,

Julie Anne Dilley

Technical Manager

Audit and Attest Standards

Enclosures

AICPA KnowledgeNET



Comment Letter # 1

December 15, 2000

Jackie Walker
Audit and Attest Standards File 4420
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Greetings:

On behalf of the North Carolina Office of the State Auditor, I am pleased to provide these comments regarding the Auditing Standards Board's exposure draft of an amendment to Statement on Auditing Standards No. 55. In general, this office supports the proposed amendment. However, we feel that the standard could be improved by providing additional definitive guidance concerning the consideration of information technology in a financial statement audit. Our specific suggestions appear below.

Paragraphs 44 and 75 discuss information technology general controls and application controls. It is unclear which categories of general controls the auditor is expected to test in order to rely on application controls. Paragraph 44 lists data center operations controls and systems software acquisition and maintenance as categories of general controls which may impact the effectiveness of application controls. Paragraph 75 states that the effective operation of application controls depends on general controls which include program change controls and access controls. We suggest that an appendix be added to the standard which gives specific examples of application controls, general controls which must be tested in order to rely on application controls, and example tests of these controls. For example, what controls related to systems software does the auditor have to consider? If specific applications have built-in access controls, does the auditor also have to consider general access controls?

Paragraphs 45 and 78 discuss user controls that depend on computer-generated reports. In order to verify the reliability of the control, the auditor must determine that the report is complete and accurate. Paragraph 78 indicates that to avoid unwarranted reliance on the report, the auditor should test controls related to the completeness and accuracy of the report. However, the standard does not indicate that any direct tests of the report are necessary. Can the auditor solely rely on tests of controls to ensure the completeness and accuracy of the report? In the alternative, can the auditor solely rely on direct tests of the report?

Paragraph 48 contains a new provision that auditors should gain an understanding of the information system to understand "the nature of other events and conditions that may require recognition or disclosure." This provision is somewhat unclear. Perhaps examples could be added to enhance understandability.

Paragraphs 49, 62, and others discuss the impact when IT is used to initiate, record, process, and report transactions. It seems that the audit is impacted when IT is used to perform any one of these functions. Initiation of transactions by IT systems results in

special risks that may warrant additional discussion. The standard would be enhanced by adding definitive guidance for auditors when transactions are initiated by IT systems and separate guidance when transactions are only recorded, summarized, and reported using IT systems.

Paragraph 99 indicates that once the auditor determines that an automated control is effective, program change controls should be tested in subsequent audits to determine whether changes have been made which affect the functioning of the control. It is unclear whether it is acceptable to only test controls associated with program changes, or whether the auditor must also examine some or all of the actual program changes to make sure the effectiveness of the control has not been reduced.

We appreciate the opportunity to comment on this exposure draft. Should you have any questions about our comments, please contact me at (919) 807-7583.

Sincerely,

Lee Linker
Director of Research and Training
North Carolina Office of the State Auditor

FYI. Another comment letter.

Jackie Walker
Administrative Assistant
American Institute of CPAs
Professional Standards and Services Team - NY
Phone: 212-596-6033
Fax: 212-596-6064
E-mail: jwalker@aicpa.org

----- Forwarded by Jackie Walker/NY/AICPA on 12/20/00 11:17 AM -----

"George Lewis"
<GALEWIS@bplb.co
m>
12/19/00 09:58 AM

To:
cc:
Subject:
on SAS 55

jwalker@
Comment

Hi Jackie:

I think the ASB has done a good job in incorporating IT into SAS 55. They certainly point out the dangers that exist and that the auditor should consider when the client's records are so heavily dependent upon IT.

However, I feel that they have dropped the ball when there is no change in paragraph 84 (Old paragraph 57).

Paragraphs 63 through 71 do a good job of incorporating IT consideration into the control risk assessment. But then, paragraph 84 negates all of that information by sticking with the concept of only requiring the auditor to document that control risk is assessed at the maximum level and not requiring any explanation.

In order to make the document more effective, I think there needs to be a hook in paragraph 84 that forces an auditor that assesses control risk at max when IT is a major component of the financial reporting process to document a bridge that explains how he or she is going to handle this exposure.

Amendment No. 1 to the Yellow Book requires such documentation. As the proposed amendment to SAS 55 stands now, an auditor could have a system that is totally IT, assess control risk at max, simply document that assessment, and have no responsibility to show how, if at all, he or she is going to be able to find substantive information on which to develop an audit opinion. Too often, what people think are source documents may only be a screen reconfiguration of the same basic information incorporated in the IT system.

My proposal doesn't entail any additional audit procedures - just some documentation. And auditors performing audits under the Yellow Book are having to do the documentation already. Let's make the standards consistent when consistency makes sense.

George Lewis



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 741-3697
FAX (615) 532-2765

Comment Letter # 3

December 18, 2000

Jackie Walker,
Audit and Attest Standards
File Reference No. 4420
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Walker:

On behalf of the Department of Audit we would like to thank you for the opportunity to comment on the Exposure Draft, Amendment to Statement on Auditing Standards No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as Amended by Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*.

We agree in principle with the exposure draft and believe that the information technology amendments will provide much needed guidance to help auditors. The document was well written. We do, however, have two suggested improvements for the document. First, within paragraph 72, an interim testwork footnote reference to the applicable AICPA standard (AU or SAS) would be beneficial at the end of the sentence "...account balances or transaction classes at an **interim** date." Next, within paragraph 84, this exposure draft continues the guidance that auditors do not need to document the basis for assessing control risk at the maximum level. However, when performing an audit in accordance with *Government Auditing Standards*, the auditor is now required to document that conclusion (GAO 4.21.3). A footnote reference to this guidance would be beneficial.

Should you have questions or need clarification on any of our comments, please contact Gerry Boaz or me at (615) 741-3697.

Sincerely,

Arthur A. Hayes, Director
Division of State Audit

new york state society of

NYSSCPA

certified public accountants

530 fifth avenue, new york, ny 10036-
www.nysscpa.org

December 21, 2000

Jackie Walker
Audit and Attest Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

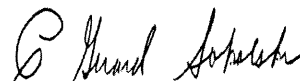
In re: File 4420

Dear Ms. Walker:

The New York State Society of Certified Public Accountants (NYSSCPA) thanks the AICPA Auditing Standards Board (ASB) for the opportunity to comment on the Proposed Statement on Auditing Standards: *Amendment to Statement on Auditing Standards No. 55, Consideration Of Internal Control in a Financial Statement Audit, As Amended By Statement on Auditing Standards No. 78, Consideration of Internal Control in A Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55.*

The NYSSCPA Auditing Standards and Procedures Committee requests that ASB consider the following comments and recommendations. If ASB would like additional discussion with the committee, please contact the committee chair, William Stocker, at (212) 503-8875 or NYSSCPA Staff, Robert Colson, at (212) 719-8350.

Sincerely,



P. Gerard Sokolski
President

new york state society of

NYSSCPA

certified public accountants

530 fifth avenue, new york, ny 10036-5101
www.nysscpa.org

**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

COMMENTS ON

PROPOSED STATEMENT ON AUDITING STANDARDS

**AMENDMENT TO STATEMENT AUDITING STANDARDS NO. 55,
CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL
STATEMENT AUDIT, AS AMENDED BY STATEMENT NO. 78,
CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL
STATEMENT AUDIT: AN AMENDMENT TO STATEMENT ON
AUDITING STANDARDS NO. 55**

File 4420

December 14, 2000

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Robert H. Colson

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on Proposed Statement on Auditing Standards Amendment to Statement on Auditing Standards No. 55, *Consideration Of Internal Control in a Financial Statement Audit, As Amended By Statement on Auditing Standards No. 78, Consideration of Internal Control in A Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*

File 4420

December 14, 2000

The New York State Society of Certified Public Accountants (NYSSCPA) thanks the AICPA Auditing Standards Board (ASB) for the opportunity to comment on the Proposed Statement on Auditing Standards: *Amendment to Statement on Auditing Standards No. 55, Consideration Of Internal Control in a Financial Statement Audit, As Amended By Statement on Auditing Standards No. 78, Consideration of Internal Control in A Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*. The NYSSCPA Auditing Standards and Procedures Committee requests that ASB consider the following comments and recommendations. If ASB would like additional discussion with the committee, please contact the committee chair, William Stocker, at (212) 503-8875 or NYSSCPA Staff, Robert Colson, at (212) 719-8350.

This exposure draft (ED) is a welcome update to SAS 55, incorporating portions of the original Audit Guide that should have been in SAS 55. We believe that adoption of most of the ED's proposed amendments would enhance the state of audit practice. However, we detail changes in the following comments that would improve the effectiveness of the final standard.

Specific Comments

¶19. The existence of IT does not necessarily provide benefits of effectiveness and efficiency for an entity's internal control. The introductory sentence should be modified to read:

"It **may** provides benefits of effectiveness and efficiency for an entity's internal control because it **may** enables an entity to –..."

¶ 28. The last sentence of this paragraph would only be true if the auditor had already decided to not rely on internal controls and to set control risk at the maximum. In this case, the auditor's consideration and documentation of internal control is being performed solely to comply with GAAS and adds no evidence to support the audit opinion. Without knowledge of the operating effectiveness, the auditor has no basis to rely on internal control and therefore must rely on substantive tests. In today's business environments most accounting systems are highly automated and the auditor often performs substantive testing based on evidence obtained from computer or screen printouts. Lacking the knowledge of the effectiveness of internal controls, the auditor

may be unaware that such evidence may not be credible and, therefore, that the conclusions drawn from the substantive tests based on such evidence may be erroneous.

We recommend that the he last sentence of ¶ 28 be amended to read:

“Unless the auditor has already decided to assess control risk at the maximum, the auditor should obtain knowledge about the operating effectiveness as part of the understanding of internal control necessary to plan substantive tests. The auditor should also be aware that for some entities the use of IT may be so integral to the financial reporting system that if the auditor fails to obtain an understanding of the operating effectiveness of internal control he or she may fail to recognize that audit evidence collected through substantive tests may not be sufficient to support the audit opinion.”

¶33. This paragraph highlights the major weak link in the evaluation of IT systems: namely, the requirement that the auditor has sufficient IT skills to communicate the audit objectives, etc. to the IT specialist. The IT specialist must be a trained auditor to properly evaluate IT’s impact on the audit.

¶44. This paragraph includes the definition of general controls rather than treating it in an audit guide (AG) or an Auditing Position Statement (APS). We applaud both the change and the placement of the definition in the standard itself.

However, the discussion in the last three sentences gives examples for the transaction objectives of validity, proper authorization, and completeness of recording and processing. The first example given is edit checks of input data. Edit checking routines were often designed into legacy software, but they are generally not available or implemented in current systems. Current systems use look-up tables to validate input, so the effectiveness of the control relates to the general controls over access and change management for the program and look-up table. Numerical sequence checks and exception reports were also common controls in legacy systems and are generally not present in today’ systems. Modern systems also rely on access controls for proper authorization of transactions, reconciliation, and analytical procedures to control completeness.

Consequently, we suggest that the last sentence in this paragraph be rewritten as follows:

“Examples in earlier legacy systems included edit checks of input data, numerical sequence checks, and manual follow-up of exception reports. These controls may not be present in newer systems which instead may rely on general controls over access to look-up tables and change management, and manual controls such as reconciliation, and analytical procedures.”

¶45. This paragraph discusses user controls. The AG placed very heavy reliance on user controls without adequately addressing the accuracy of the information, produced by an IT system, which was the basis for the user controls. This paragraph corrects this shortcoming. We are very pleased that the ED has addressed this issue positively and hope that the final standard reflects the language proposed in the ED.

¶ 48. As written in the exposure draft, the bulleted list omits one of the single most important sets of information an auditor needs to know to understand an IT accounting system—the directories, data file names, and field names where the accounting records are stored. Although this information would be essential for testing operating effectiveness, the fact that a client could not provide this information would cast doubts on management’s competence to control IT.

We recommend adding the following bullet to the list in ¶ 48:

“The names of the directories, folders, and libraries where accounting data files are stored, data files, field names, field formats, and key fields that relate the data files to each other.”

¶50. This paragraph makes an unfortunate assumption in the third sentence that automated processes and controls in IT systems reduce the risk of inadvertent error. Although we agree that such processes may reduce the risk of some inadvertent manual errors, we are also sensitive that they may introduce alternative sources of inadvertent errors that may not result in an overall reduced risk. Therefore, we suggest amending this statement to:

“The automated processes and controls in such system **may** reduce the risk...”

¶66. The last sentence of the paragraph discusses performing tests of controls to determine the effectiveness of the design of controls. However, auditors make an evaluation of the effectiveness of the design of controls when they perform the procedures to obtain an understanding of the internal control system during the planning phase of the audit. Tests of controls are performed subsequently to evaluate the effectiveness of their operation. We suggest that the sentence be revised by eliminating the words “both ... design and.”

In a related concern, please consider addressing this issue in ¶26 with the addition of appropriate wording to that paragraph:

“In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan an audit by performing procedures to understand the design of controls relevant to an audit of financial statements, **the effectiveness of their design**, and whether they have been placed in operation.”

¶ 70. As written in the exposure draft, this paragraph omits from the bulleted list the important example of business-to-business (B2B) and business-to-consumer (B2C) e-commerce conducted over the Internet. Both have experienced exponential growth in the past several years. While B2C sales growth has slowed, Internet B2B sales growth is expected to continue. Some sources predict that almost all B2B transactions will be

conducted over the Internet within the next five years. We recommend that the following bullet should be added to the list in ¶ 70:

“An entity that conducts business-to-business (B2B) or business-to-consumer (B2C) transactions in which customers initiate orders through a browser over the Internet to a web server and for which no physical documentation of the order, fulfillment, or settlement may exist.”

¶ 101. As written in the exposure draft, we disagree with striking out the last sentence of this paragraph because it identifies a very good audit test that addresses unauthorized changes to account records perpetrated by IT personnel that might have resulted in past misappropriations of assets or financial frauds. Striking out this test procedure could have the unintended result that this important audit procedure is removed from audit programs and, hence, not performed by auditors. We recommend that the last sentence in ¶101 should not be stricken out, but should be amended to read:

“Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observations with inquiries of entity personnel and inspection of documentation about the operation of such controls at other times, **including the frequency and circumstances under which programmers may have access to the executable accounting programs and data files and may inspect documentation of past instances when programmers attempted to access these files to determine how such attempts were prevented or detected.**”

Comment Letter # 5

January 5, 2001

Ms. Julie Anne Dilley
Technical Manager
Audit and Attest Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Dilley:

This letter is sent on behalf of the Standards Board of the Information Systems Audit and Control Association (ISACA).

The ISACA Standards Board appreciates the opportunity to comment on the exposure draft of the proposed Statement on Auditing Standards (SAS) titled *Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as Amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55.*

Any changes in AICPA guidance are of particular interest to ISACA, as an important segment of our membership is composed of AICPA members.

We have considered the proposed SAS, issued by the AICPA as an exposure draft in November 2000, and we are pleased to state that we support the guidance contained within the proposed SAS, and have no other comments other than to urge you to keep up the good work. Your work contributes significant added value to the profession, and in this regard, we appreciate and congratulate the efforts of the AICPA Auditing Standards Board and the Technology Issues Task Force.

Thank you again for allowing us to provide our comments on the proposed SAS. If the ISACA Standards Board can provide further assistance, please feel free to contact me.

Sincerely,

Stephen W. Head, CPA, CITP,
CISA, CMA, CFE, CPCU, CISSP, CBCP
Chair
ISACA Standards Board
Tel. 704-522-2647

"Rauser, Vickie"
<vrauser@state.mt.us>
s>

12/22/00 10:27 AM

To: "Jackie Walker (E-mail)" <jwalker@aicpa.org>

cc:

Subject: Proposed Statement on Auditing Standards - Amendment to SAS 55, As Amended by SAS 78 (File 4420).

Jackie Walker
Audit and Attest Standards, File 4420
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Montana Legislative Audit Division staff members have read the proposed statement on auditing standards, "Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55."

We are in support of the proposed amendments, which clearly articulate internal control matters that auditors should already have been considering. This articulation should mitigate any tendencies to audit around systems regardless of the propriety of those decisions. We believe the proposed guidance also adequately addresses considerations related to entities of every size.

We appreciate the opportunity to participate in this due process. Should you have questions, please contact me via e-mail, vrauser@state.mt.us <mailto:vrauser@state.mt.us> , or phone, 406.444.3122.

Sincerely,

Vickie Rauser
Audit Manager

January 5, 2000

Comment Letter # 7

Ms. Jackie Walker
Audit and Attest Standards, File No.4420
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: ED Proposed Statement on Auditing Standards (SAS): *Amendment to SAS No. 55, Consideration of Internal Control in a Financial Statement Audit*

Dear Ms. Walker:

One of the objectives that the Council of the American Institute of Certified Public Accountants established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective.

TIC has reviewed the above referenced exposure draft (ED) and is providing the following comments for your consideration.

General Comments

TIC applauds the Auditing Standards Board for bringing information technology (IT) issues into the internal control standard. We believe it will heighten awareness for small-and-medium sized firms about the need to consider IT as it relates to internal controls.

Overall, however, TIC found the document difficult to read and absorb due to deficiencies in the Summary, paragraphs 3 through 5, and the use of repetitive phrases that were carried forward from SAS No. 55 (e.g., "The auditor should obtain" in paragraphs 36, 40, 43, 48, and 55). We found that the use of this phrase, and others like it, on a repetitive basis, led to confusion about whether the standard was introducing a new item for consideration or repeating something that had been mentioned earlier in the document.

Specific Comments

Suggested Revisions to Summary Paragraphs. As mentioned in our general comments above, TIC believes paragraphs 3 – 5 of the Summary require revision. Specifically, the control reliance approach and the substantive testing approach should be discussed in separate paragraphs of the summary. Currently, both concepts are intertwined within paragraph 3.

We recommend that paragraph 3 focus only on the assessment of control risk when the auditor plans to assess control risk below the maximum. Paragraph 4 would then become part of paragraph 3.

Ms. Jackie Walker
AICPA
January 5, 2001
Page two

A separate paragraph would then discuss the alternative substantive testing approach (i.e., planned assessment of control risk at the maximum level) and alert the auditor that substantive tests alone may not reduce detection risk to a sufficiently low level. The standard should mention that the level of technology used by the client could be one reason why reliance on substantive testing may not be sufficient for some audits.

The draft SAS includes the following caution for auditors using the substantive approach:

In addition, the auditor may determine that it is not practical or possible to restrict **detection risk** to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of **control risk**. [pars. 3 and 66, emphasis added]

We recommend that the Summary repeat the definitions of “control risk” and “detection risk” in a footnote (or cross-reference to AU 312.27[b] and [c], respectively) to set the stage for the discussion to follow and enhance comprehension of the material. A sentence should also be added to the Summary to remind auditors about the correlation between control risk and detection risk (paragraph 107) so that auditors would understand the importance of the required testing and the linkage between the two types of risk.

We also believe that the third sentence in paragraph 3 needs to be revised to avoid misunderstanding. It implies that sufficient evidence will always exist to support a reduced assessed level of control risk. We believe editorial changes to this sentence are necessary to clarify that obtaining sufficient evidential matter of control effectiveness is a pre-condition to reducing the assessed level of control risk. Without the evidence of control effectiveness, control risk remains high.

Additional Guidance: The standard would be more useful to practitioners that audit small and mid-sized entities if it included the following additional guidance presented in a concise format that is easy to find within the standard:

- All of the knowledge “the auditor should obtain.” This would be a summary of required procedures categorized by the type of audit approach taken and would include minimum internal control procedures applicable to all audits, along with guidelines that indicate the need for more extensive procedures.
- A process flow diagram for the consideration of internal control and risk in a financial statement audit that indicates the order in which procedures should be performed and the logic behind the approaches available.

Ms. Jackie Walker
AICPA
January 5, 2001
Page three

- Summary of documentation requirements. This appendix should summarize the requirements contained in paragraph 62 relating to understanding internal control and paragraph 84 relating to the assessed level of control risk.

Two or more of the above items could be included in one or more appendices, as appropriate, that would be referred to in the Summary.

The additional guidance recommended above is necessary due to the length of the standard and all of the various, complex concepts that are discussed in the document. Without helpful summaries, practitioners will have difficulty understanding and implementing this standard.

Amendments to AICPA audit guide: The AICPA Audit Guide, *Consideration of Internal Control In A Financial Statement Audit*, should be amended to incorporate the changes proposed by this ED.

Definitions: The ED should clearly define the term “emerging technologies” used in paragraph 32 and also provide examples to assist small- and medium-sized practitioners in understanding when an IT specialist may be needed when emerging technology is present.

Nonstandard Entries: The first sentence of paragraph 51 of the ED should read “nonstandard, nonrecurring” to conform to the last sentence.

Reliance on Computer-Generated Data: In Paragraph 56, the ED states, “Management may rely on automated controls to ensure that computer-generated data are correct and may not perform procedures to confirm the data’s accuracy.” If the auditor is to rely on computer-generated data, then TIC believes it would be beneficial for the ED to provide guidance on when auditors need to do additional tests. The ED should provide examples to make auditors aware of what types of situations may occur that would indicate additional testing may be necessary (e.g., the need to test an aged accounts receivable trial balance if management uses the data to estimate the allowance for bad debts and does not test the accuracy of the data.)

Miscellaneous Readability Concern: To improve the flow and understanding of the ED, we suggest that the contents of paragraph 70 be moved to follow paragraph 66, which introduces the concept of performing tests of controls to assess control risk below the maximum for certain assertions. Paragraph 70 contains practical examples of when the tests may be appropriate. Providing the examples immediately after introducing the concept may enhance auditors’ understanding of subsequent paragraphs.

Ms. Jackie Walker
AICPA
January 5, 2000
Page four

We appreciate the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Candace Wright, Chair
PCPS Technical Issues Committee

cc: PCPS Technical Issues Committee

Comment Letter # 8

| Following is an electronic version of the letter we are sending to you
today |
| via Federal Express:
|

Ms. Jackie Walker
Audit and Attest Standards
File 4420
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

January 5, 2001

Dear Ms. Walker:

We appreciate this opportunity to comment on the proposed Amendment to Statement on Auditing Standards (SAS) No. 55, Consideration of Internal Control in a Financial Statement Audit as amended by SAS No. 78.

Information technology (IT) has permeated almost every aspect of the way in which contemporary business is carried on nationally and internationally. The pervasive impact of IT on business processes and internal controls has made it imperative that auditors consider IT in their evaluation of internal controls and assessment of control risk. Therefore, the contemplated amendment to SAS No. 55 (and SAS No. 78), if enacted, should have a significant impact on the way audits are conducted in the future.

We support the issuance of the final standard. We have the following suggestions that we believe will further improve the document.

"What It Does" Section

Item No. 5 under "What It Does" on page five highlights the importance of understanding how entries are initiated and recorded and the importance of what controls have been placed in operation to ensure the accuracy and validity of journal entries. In view of the increasing frequency of financial statement re-statements that have occurred as a result of consolidation practices that do not conform to GAAP, the specific issue of "consolidating journal entries" should be given greater attention in the text of the statement. We suggest modifying the last point in paragraph 48 to read as follows:

"The financial reporting process used to prepare the entity's financial statements including the preparation of journal entries (including nonstandard journal entries and consolidating journal entries), significant accounting estimates and disclosures."

Evidential Matter from Other Procedures

The last sentence of Item No. 3 under the Summary caption on page seven refers to "procedures that were not specifically planned as tests of controls but that nevertheless provide evidential matter about the design and operation of the controls." Examples of such procedures would help bring this statement into focus. We suggest that the following point be added as examples of other procedures to gain or gather evidential matter.

"Examples of such procedures would include analytical review procedures in the planning phase of the audit and substantive tests. For instance, examination of subsequent collections on accounts receivable may indirectly support the effectiveness of credit granting policies, or noting the absence of old inventory during a physical inventory observation may indirectly support the effectiveness of monitoring inventory turnover and the determination of provisions for inventory obsolescence."

On page 17, paragraph 44, the first sentence states that "Depending on the extent of an entity's use of IT, the auditor may need to obtain an understanding of how IT affects control activities that are relevant to planning the audit." Paragraph 26 states "In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and whether they have been placed in operation." In an environment that is awash with technology, it seems that this introductory sentence needs to be more forceful. We suggest that the first sentence should be modified in the following manner:

"The auditor should obtain an understanding of how IT affects control activities that are relevant to planning an audit."

On page 24, under Performing Tests of Controls, Paragraph 79, in the first sentence, which addresses the possibility of being able to "...reduce the extent of testing of an automated control since the computer will perform the control the same way each time." Some guidance as to the "timing" and the "extent" to which procedures may be reduced, including examples, is warranted to guard against the possibility that a subjective interpretation may lead some practitioners to reduce audit procedures to unacceptably low levels. We would recommend adding the following as the last sentence in that paragraph:

"In addition, specific tests of automated controls could be performed throughout the year by examining just a few items periodically (e.g., quarterly). The scope of testing could be limited to those risk controls, which if not in place, could result in errors that exceed tolerable error."

We would be pleased to discuss our comments with you or your staff at your convenience. If you have any questions, please contact Dorsey Baskin at 312-931-2238.

Very truly yours,

Arthur Andersen LLP

LRW

National State Auditors Association

January 5, 2001

OFFICERS AND EXECUTIVE COMMITTEE

President
BARBARA J. HINTON
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800 S.W. Jackson
Topeka, KS 66612-2212

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State Auditor
Utah

Comment Letter # 9

Jackie Walker
Audit and Attest Standards, File 4420
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Walker:

On behalf of the National State Auditors Association (NSAA), we appreciate the opportunity to respond to the exposure draft (ED) entitled, Amendment to Statement on Auditing Standards No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*.

Given the pervasiveness of information technology (IT) in today's environment, we believe a revision to the audit standards is needed and we generally support the proposed changes in this ED. We are especially pleased to see guidance in the area of "paperless" or near paperless systems and their effect upon the auditor's determination of audit risk. Paragraphs 65 through 70 of the ED provide needed guidance on the types of factors that should be considered when determining if tests of controls are necessary to restrict audit risk to an acceptable level. These paragraphs make it clear that when significant portions of the underlying data are initiated, recorded, and processed using IT, control testing may be the only method for reducing control risk and therefore, reducing audit risk to an acceptable level.

While we generally support the ED, we have identified in an attachment to this letter, various areas of concern and suggested improvements. Additionally, we believe it is very important for the AICPA to develop training courses and practice aids to accompany the release of this Statement. The rapid advance of IT has radically changed the financial reporting process and the internal control process needed to ensure accurate and reliable financial reports has also changed radically. New audit approaches and methodologies are required to examine financial statements produced in this new environment. It is important that audit practitioners have instruction and practice tools that permit them to effectively use new techniques required in this changing environment.

We appreciate the efforts of the AICPA and the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact Kinney Poynter, NSAA Deputy Director, at (606) 276-1147 or me at (785) 296-3792.

Sincerely,



Barbara J. Hinton
Legislative Post Auditor, Kansas
President, NSAA

National State Auditors Association
AICPA ED Amending SAS Nos. 55 and SAS 78

Paragraph:	Comment:
General	<p>References are made to manual and automated processes throughout the ED. However, the ED does not discuss automation that is embedded in the auditee's processes. Auditors should be alerted to these situations because they must be careful not to evaluate these embedded automated processes as manual processes based on the availability of what may appear to be manually prepared source documentation.</p> <p>It is not uncommon for auditors to continue to attempt to audit around a system based on documents that are produced from a system. The ED should provide additional clarification on manual versus automated processes in order to alert the auditor regarding these issues and help ensure consistency in the application of this Statement.</p>
3	<p>We suggest revising the last sentence to read, "Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding, tests addressing simultaneously both control issues and substantive issues, or from procedures that were not specifically planned as tests of controls but that nevertheless provide evidential matter about the design and operation of the controls." An example of the last item would also be helpful.</p>
6	<p>Consider adding an additional sentence to read, "The auditor must clearly document all relevant factors used in developing the audit approach and to evidence the auditor's consideration of internal controls in a financial statement audit."</p>
16	<p>We have two concerns with footnote 4, at the bottom of page 11. First, the footnote erroneously implies that the title of SAS No. 70 is merely "Service Organizations." Second, the footnote omits any reference to SAS No. 88, <i>Service Organizations and Reporting on Consistency</i>, which amended SAS No. 70 to include language and concepts from SAS Nos. 55 and 78. Therefore, to remedy these deficiencies, we suggest that the Board revise footnote 4 to read "See SAS No. 70, as amended by SAS No. 88, related to service organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), for guidance if an entity obtains services that are part of its information system from another organization." Similar references, such as footnote 7 on page 18 of the ED, may also require revision.</p>
20	<p>Because some systems could simultaneously incorrectly process data and consistently process inaccurate data, we suggest that the Board expand the first bullet slightly to read, "Overreliance on information produced by IT systems that are incorrectly processing data, consistently processing inaccurate data, or both." Also, consider adding an additional bullet, "Inadequate disaster recovery preparation that may result in an inability to continue as a going concern."</p> <p>Further, add the following language at the end of the bullets, "In addressing internal controls that include IT systems risk, the auditor must apply appropriate IT audit procedures or explain why these procedures are not required. For example, the auditor may decide not to examine systems authorization in an environment that provides sufficient manual compensating controls that are considered as part of the audit approach. The auditor should be alert for certain IT systems risks that are difficult to mitigate regardless of the level of substantive testing and/or compensating control evaluation and testing."</p>
31	<p>Paragraph 31 states that, "IT also presents risks, such as the risk that incorrect changes to the programs performing the calculations could result in consistently performing those</p>

Paragraph:	Comment:
	calculations incorrectly.” We believe that incorrect changes to the data used in the calculations, which would be controlled through access controls, could also result in incorrect results. A statement addressing this risk should be added to the paragraph.
32	<p>We believe two additional bullet items should be added to the list of factors in determining if the use of an IT specialist is needed:</p> <ol style="list-style-type: none"> 1. the extent to which the entity’s IT operations are performed by a service organization (i.e., subject to a SAS 70 audit) 2. the type of security the entity has implemented over the system <p>Also, we believe after an auditor considers the factors listed in this paragraph, it may be determined that an IT specialist is needed, but only to provide guidance or training to a non-specialized auditor who would be then be responsible for documenting the system and performing tests of controls. This paragraph should provide for the option to use an IT specialist in the role of a consultant to an audit team after considering the factors provided.</p>
40	An example of “certain financial instrument transactions” would be helpful if added to the final Statement.
42	Two additional control activities that should be considered are access controls and data back-up controls.
44-45, 75	<p>Discussions about application controls in paragraphs 44, 45 and 75 should include a discussion that application controls are only effective if general controls are in place and operating effectively. The guidance should clearly state that if general controls are poor or nonexistent, a test of application controls would be pointless in most instances.</p> <p>Further, it is unclear which categories of general controls the auditor is expected to test in order to rely on application controls. Paragraph 44 lists data center operations controls and systems software acquisition and maintenance as categories of general controls which may impact the effectiveness of application controls. Paragraph 75 states that the effective operation of application controls depends on general controls which include program change controls and access controls. We suggest that an appendix be added to the standard which gives specific examples of application controls, general controls which must be tested in order to rely on application controls, and example tests of these controls. For example, what controls related to systems software does the auditor have to consider? If specific applications have built-in access controls, does the auditor also have to consider general access controls?</p> <p>Lastly, we suggest three additional items be added to the list of general controls:</p> <ol style="list-style-type: none"> 1. backup and recovery 2. separation of duties 3. production and data control
44, 99	Paragraphs 75 and 99 list “program change” as a general control, but paragraph 44 does not. For purposes of clarity and consistency, “program change” should be listed as an example of a general control in paragraph 44.
45, 78	Paragraphs 45 and 78 discuss user controls that depend on computer-generated reports. In order to verify the reliability of the control, the auditor must determine that the report is complete and accurate. Paragraph 78 indicates that to avoid unwarranted reliance on the report, the auditor should test controls related to the completeness and accuracy of the report. However, the standard does not indicate that any direct tests of the report are necessary. Can the auditor solely rely on tests of controls to ensure the completeness and accuracy of the report? In the alternative, can the auditor solely rely on direct tests of the

Paragraph:	Comment:
	report?
48	This paragraph contains a new provision that auditors should gain an understanding of the information system to understand “the nature of other events and conditions that may require recognition or disclosure.” This provision is somewhat unclear. An example should be added to enhance understandability.
57	The last sentence reads, “However, these conditions may not affect the auditor’s assessment of control risk.” Because this is a conclusion, based on less desirable circumstances that are frequently apparent in small and midsized entities, we suggest that the Board revise this sentence slightly to read, “However, these conditions may not adversely affect the auditor’s assessment of control risk.”
66	Consider including a cross reference to paragraph 70. Paragraph 70 provides examples for the discussion in paragraph 66.
72	Within paragraph 72, an interim testwork footnote reference to the applicable AICPA standard (AU or SAS) would be beneficial at the end of the fourth sentence “...account balances or transaction classes at an interim date.”
77	In regards to monitoring, the guidance in the first sentence implies that the tests of controls are only concerned with <i>by whom</i> the control was monitored. In practice, we believe that tests of controls should also be concerned with how the control was monitored and the consistency with which it was monitored during the audit period. Therefore, we suggest that the Board expand the first sentence to read, “Tests of controls directed toward the operating effectiveness of a control are concerned with how the control was applied and monitored, the consistency with which it was applied and monitored during the audit period, and by whom it was applied or monitored.”
84	<p>This paragraph requires, for financial statement assertions where control risk is assessed at the maximum level, the auditor to document his conclusion that control risk is at the maximum level. However, the auditor does not have to document the basis for that conclusion. We are disappointed that the AICPA has chosen not to follow the lead of GAO’s <i>Government Auditing Standards</i> (Amendment No. 1, May 1999) regarding the need to <u>document</u> the basis for an auditor assessing control risk at the maximum level for assertions significantly dependent upon computerized information systems. The AICPA has chosen not to require auditors to document the reasons why test of controls would not be effective and how the planned audit procedures will reduce audit risk to an acceptable level.</p> <p>This appears to be contrary to the guidance offered in the rest of the ED and contrary to sound auditing practice. If an auditor decides to assess control risk at the maximum level and rely upon substantive testing alone to reduce audit risk on an assertion where a significant amount of information is electronically initiated, recorded, and processed, the auditor appears to be following an approach contrary to the guidance offered in the ED. Yet the auditor is not required to document the rationale for the decision.</p> <p>It would seem prudent for the AICPA to follow the lead of GAO and require additional documentation for decisions that seem counter to the guidance contained in the ED. Therefore, we propose that the AICPA require auditors that intend to rely upon substantive testing alone for reducing audit risk on assertions where a significant portion of the information is initiated, recorded, and processed electronically, to document their decisions in the same manner as required by GAO.</p> <p>At a minimum, the ED should add a footnote referencing this requirement in governmental where <i>Government Auditing Standards</i> are used.</p>
Appendix 15	To properly recognize that communication can also frequently be made electronically, we suggest that the Board expand the second sentence in paragraph 15 to read,

Paragraph:	Comment:
	"Communication also can be made electronically, orally, and through the actions of management."

State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

JANICE MUELLER
STATE AUDITOR

22 E. MIFFLIN ST., STE. 500
MADISON, WISCONSIN 53703
(608)266-2818
Fax(608) 267-0410
Leg.Audit.Info@legis.state.wi.us

December 13, 2000

Ms. Jackie Walker
Audit and Attest Standards
File 4420, AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Walker:

Thank you for the opportunity to respond to the AICPA Exposure Draft, *Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as Amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*. We agree that the development of information technology (IT) has changed the manner in which transactions are initiated, recorded, processed, and reported and that auditors should consider the effect of IT on internal control and control risk. However, we do offer three technical suggestions to improve the document as discussed below.

- Paragraph 31 states that IT presents risks, including the risk that incorrect changes to programs performing calculations could result in consistently performing those calculations incorrectly. We feel that incorrect changes to the data used in the calculations, which would be controlled through access controls, could also result in incorrect results. We suggest that a statement addressing this risk be added to the paragraph.
- Paragraph 32 discusses factors to consider in determining whether an IT specialist is needed on an audit team. We suggest that after an auditor considers the factors listed in this paragraph it may be determined that an IT specialist is needed, but only to provide guidance or training to a non-specialized auditor who would be then be responsible for documenting the system and performing tests of controls. We suggest that this paragraph provide for the option to use an IT specialist in the role of a consultant to an audit team after considering the factors provided.

Ms. Jackie Walker
Page 2
December 13, 2000

- Paragraph 44 discusses general IT controls. We believe that three general controls, including backup and recovery, separation of duties, and production and data control are missing from the listing. These three areas of controls also relate to many applications and aid in the effective functioning of IT systems. Additionally, controls over a data center and network operations are not general IT controls, but are different platforms for which an auditor would review applicable general IT controls. We suggest changing the third sentence of the paragraph so that it reads "General controls commonly include controls over data center and network operations, including system software acquisition and maintenance, access security, backup and recovery, separation of duties, production and data control, and application system development and maintenance."

Again, thank you for the opportunity to respond. If you have any questions about our comments, feel free to contact Lisa Kasel at (608) 266-2818, who coordinated our response.

Sincerely,

Janice Mueller
State Auditor

JM/bm

GAO
United States General Accounting Office
Washington, DC 20548

December 22, 2000

Ms. Jackie Walker
Audit and Attest Standards
File 4420
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Walker:

This letter presents the U.S. General Accounting Office's (GAO) comments on the exposure draft Proposed Statement on Auditing Standards: Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as Amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55. The proposed amendment to SAS No. 55 represents a significant improvement over the existing standard by providing additional guidance, and we support its issuance. We do recommend, though, that the standard be further strengthened by including additional guidance for documenting key internal control decisions and testing of internal control.

We support the AICPA's efforts to incorporate additional guidance on the effects of information technology on the auditor's understanding of internal control and assessing control risk in planning a financial statement audit. Because of the increased use of information technology and the ways it affects an entity's internal control, the Comptroller General of the United States issued *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems* (GAO/A-GAGAS-1, May 1999). This amendment is applicable for financial statement audits conducted under generally accepted government auditing standards. Amendment No. 1 heightens auditors' awareness of the risks associated with auditing in the environment of computerized information systems that is pervasive today. It requires auditors to document their basis for assessing control risk at maximum and the planned audit procedures relating to that decision to help auditors avoid inadvertent and inappropriate reliance on computer-generated evidence in conducting substantive testing.

Assessing control risk at maximum is a key decision in planning a financial statement audit. As such, the subsequent decisions relating to the nature, timing, and extent of subsequent procedures in light of this assessment should be documented in the working

papers. We believe that the requirements of Amendment No. 1 are appropriate for financial statement audits under generally accepted auditing standards and recommend that you to incorporate similar requirements in Statement of Auditing Standards No. 55.

The proposed amendment to SAS No. 55 states "that, in some circumstances, auditors may need to perform tests of controls to perform an effective audit." We strongly support the concept of internal control testing, and we believe that SAS No. 55 should indicate that tests of controls are needed on most audits, not just some audits.

Since 1992, GAO's Financial Audit Manual has expanded the requirements for assessing internal control beyond current private-sector practices. The Office of Management and Budget audit requirements and the GAO Financial Audit Manual both require tests of internal control whenever auditors assess low control risk based on the design of controls. In amending SAS No. 55, we recommend that AICPA place additional emphasis on assessing and testing internal control by requiring tests of controls whenever auditors assess low control risk.

The exposure draft does not consider entitywide computer security and service continuity in the discussion of general computer controls. We recommend that in finalizing the amendments to SAS No. 55 these components be discussed since they represent areas commonly included in general controls.

We appreciate the opportunity to provide our comments on this exposure draft. Please call me at (202) 512-2600 if you have any questions.

Sincerely yours,

Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance

Comment Letter #12

December 28, 2000

Ms. Jackie Walker
Audit and Attest Standards (File 4420)
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Walker:

On behalf of the Association of Government Accountants (AGA), the Financial Management Standards Board (Board) appreciates the opportunity to provide comments on the exposure draft (ED) of a proposed Statement on Auditing Standards (SAS) entitled Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit as Amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: an Amendment to Statement on Auditing Standards No.55. The proposed Statement would provide guidance to auditors about the effect of information technology (IT) on internal control, and on the auditor's understanding of internal control and assessment of control risk.

The Board, comprised of 21 members with accounting and auditing backgrounds in federal, state, and local government, academia, and public accounting, reviews and responds to proposed standards and regulations of interest to AGA members. Local AGA chapters and, individual members are also encouraged to comment separately.

The Board supports the Auditing Standards Board's (ASB) desire to provide guidance to auditors about the effect of IT on internal control, including the auditor's understanding of internal control and assessment of control risk. We agree that entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. However, we believe that the alternative of assessing IT control risk at the maximum level and performing a substantive audit is becoming less tenable in the increasingly electronic environment for entities of all sizes. We believe that a substantive audit in an IT environment is usually not an effective approach and will become increasingly less effective in the future as entities' reliance on IT controls inevitably will expand. We believe that the ASB should revisit and reassess whether the ED inadvertently sends the wrong message about substantive audits in an IT environment and whether the proposed documentation requirements for such substantive audits are adequate. This letter describes the reasons for these beliefs and also provides other specific comments on the ED.

“Substantive Audit” Concerns

Paragraph 3, 18, 21, 22, 27, 31 and 32, among others, emphasize the nature of IT systems and the importance of performing tests of controls in an IT environment. Paragraph 3 states that "the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions." We agree with this statement and believe that there will be increasingly fewer cases in an IT environment when an auditor will be able to restrict detection risk to an acceptable level by performing only substantive auditing procedures. We believe that assessing control risk at the maximum in an IT environment and testing a few more, or even many more, transactions at year end with minimal or no reliance on controls in effect throughout the year creates problems for an auditor in expressing an opinion on the year-end balance sheet, much less the year-long accumulation of income statement amounts.

We realize that paragraphs 3, 5, and 65 caution auditors about the possible inappropriateness of assessing control risk at the maximum in an IT environment and performing a substantive audit. However, the guidance in paragraph 65 is that "the auditor needs to be satisfied that performing substantive tests alone would be effective in restricting detection risk to an acceptable level." As indicated above, we believe that such "satisfaction" would seldom be justifiable in an IT environment and that the guidance should so caution the auditor. We are also concerned that the following statement in the "Summary" on page 5 may mislead the auditor about the acceptability of a substantive audit in an IT environment: "The proposed SAS does not eliminate the alternative of assessing control risk at the maximum level and performing a substantive audit, if that is an effective approach." We believe that the message should be that such an approach "will seldom be effective," rather than the potential misinterpretation that "nothing has changed."

We are also concerned about the lack of documentation requirements when the auditor is "satisfied" that a substantive approach is appropriate. There are two somewhat related documentation requirements within the ED. Paragraph 71 states, in part, that "Assessing control risk at below the maximum level involves documenting the assessed level of control risk." Paragraph 84 states, in part, that "for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion." We are concerned that when the control risk is assessed at the maximum, the ED does not require the documentation of why performing substantive tests alone in an IT environment would be effective in restricting detection risk to an acceptable level.

Amendment No. 1 to *Government Auditing Standards* (1994 Version) entitled "Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems" addresses such documentation concerns. Amendment No. 1 created a new field work standard establishing the following additional internal control standard for financial statement audits conducted in accordance with *Government Auditing Standards*: "In planning the audit, auditors should document in the working papers (1) the basis for assessing control

risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, and (2) consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level." We believe that the ASB should consider requiring similar documentation requirements within this pronouncement.

"Internal Control" Terminology

Footnote 1 on page 7 states: "Internal control also may be referred to as internal control structure." As paragraph 7 indicates, internal control is considered to be a process. This alternative was originally provided for in SAS No. 78, which was issued in December 1995. Because most auditors have probably adopted the new language by now, we believe that the ASB should consider revising footnote 1 to read: "Because internal control is a process, the term internal control supersedes the previously used terms of internal control structure and system of internal control."

SAS 70 Reference

Footnote 4 on page 11 states, in part, "See SAS No. 70, Service Organizations (AICPA, Professional Standards, vol. 1, AU sec. 324)...." This footnote abbreviates the title and omits any reference to amending SAS Nos. 78 and 88, which are also cited for AU sec. 324. Therefore, we believe that footnote 4 should be revised to read: "See SAS No. 70, Reports on the Processing of Transactions by Service Organizations, as amended (AICPA, Professional Standards, vol. 1, AU sec. 324)...."

Operating Effectiveness on Internal Control

Paragraph 28 states, in part: "The auditor is not required to obtain knowledge about operating effectiveness as part of the understanding of internal control necessary to plan the audit." This statement appears contradictory or confusing with respect to paragraphs 68-70. These paragraphs describe circumstances when the auditor may need to obtain significant audit evidence, which may be available only in electronic form, through tests of controls. Paragraph 70 concludes: "it may not be possible for the auditor to design effective tests without obtaining evidence about the operating effectiveness of the automated controls." We believe that the ASB should modify the appropriate paragraph(s) to resolve this apparent contradiction or confusion.

Application Controls Dependence on General Controls

The Board believes that the guidance should clearly state that if the general controls are poor or nonexistent, tests of application controls would be ineffective. Therefore, we believe that paragraphs 44, 45, and 75 should include a discussion that application controls are only effective if general controls are in place and operating effectively.

Program Changes as a General Control

Paragraphs 75 and 99 identify program changes as a general control, but paragraph 44 does not. For clarity and consistency, we believe that program changes should be added to paragraph 44 as an example of a general control.

Title Improvement

Although the title of the ED aptly identifies the SASs that are being amended, it is quite lengthy and does not describe the subject of the proposed SAS. We suggest that the ASB consider adopting a shorter title that accurately describes the subject of the SAS, with a subtitle that describes the amended SASS.

Again, the Board appreciates the opportunity to provide comments on the ED. Should you have any questions, or desire further details on the Board's position, please contact me at (517) 334-8060, Ext. 500, or Jim Williams, the Board's facilitator for this project, at (216) 583-8276.

Sincerely,

Jon A. Wise, CPA, CGFM, Chair
AGA Financial Management Standards Board

cc: Mr. W. A. Broadus, Jr.
AGA National President

December 20, 2000

Jackie Walker
Audit and Attest Standards, File 4420
American Institute of Certified Public Accountants
1211 Avenue of Americas
New York, NY 10036-8775

Dear Ms. Walker:

The Auditor of Public Accounts for the Commonwealth of Virginia supports the provisions in the American Institute of Certified Public Accountants (AICPA) proposed exposure draft, Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as Amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55. We have no major concerns with the proposed exposure draft. However, we have several suggestions for improvements to the final document, which are summarized in the attached grid.

Our office appreciates the opportunity to participate in the AICPA's due process. Should you have questions concerning the response, please do not hesitate to contact us.

Sincerely,

Walter J. Kucharski
Auditor of Public Accounts

Comments on AICPA Propose Exposure Draft SAS No. 55 as amended by SAS No. 78

Paragraph Number	Comment
17	The paragraph would flow better if the highly complex example was followed by the example of the discrete system.
18	Next to last sentence should be changed as follows: "and to handling exceptions".
32	Another factor to be considered in the decision to have an IT specialist on the audit team is the type of security the entity has implemented over the system.
40	It would be helpful to include other examples.
42	Two other control activities that should be considered are access controls and data back-up controls.
58	Consider the following wording, "For example, same entities that use the Internet or sophisticated IT systems to conduct business <u>should</u> have internal control that is heavily dependent on IT. The example relates to all sizes of entities not just small and the word "may" could be misinterpreted. In this particular example you are more likely to have internal control dependent on IT than not.
62	Consider the following wording for the third sentence, "For example, documentation of the understanding of internal control of a <u>large entity with a complex IT system</u>"
66	Consider including a cross reference to paragraph 70. Paragraph 70 provides examples for the discussion in paragraph 66.
68	Consider rewording the last sentence as follows: "For example, the evidence, including related records , resulting from such functions performed by an entity's IT systems such as executing credit checks...."
84	Change wording in first sentence as follows: "In addition to the documenting documentation"

January 3, 2001

Ms. Jackie Walker
Audit and Attest Standards, File 4420
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Walker:

We have reviewed the AICPA Auditing Standards Board's (Board) Exposure Draft (ED) of a proposed Statement on Auditing Standards, entitled Amendment to Statement an Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as Amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit. An Amendment to Statement on Auditing Standards No. 55, and we agree in principle with the proposed guidance. We do, however, have the following thirteen comments for the Board's consideration in finalizing the document:

1. Paragraph 8, on Page 8 of the ED, begins "Internal control consists of five interrelated components, which are:" and then lists the five components in complete sentences. Because items a. through e. are complete sentences, rather than merely lists or bullets, we suggest that the Board delete the words "which are" so the beginning phrase in Paragraph 8 would read "Internal control consists of five interrelated components:"
2. The fourth sentence in Paragraph 14, on Page 10 of the ED, begins "For example, use of a lockbox system for collecting cash or computer access controls (for example, passwords) that limit access..." To eliminate the need for an example within an example, we suggest that the Board revise this sentence slightly to read "For example, use of a lockbox system for collecting cash or computer access controls, such as passwords, that limit access..."
3. Footnote 4, at the bottom of Page 11 of the ED, reads "See SAS No. 70, Service Organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), for guidance if an entity obtains services that are part of its information system from another organization." We have two concerns with this footnote as currently written. First, the footnote erroneously implies that the title of SAS No. 70 is merely "Service Organizations." Second, the footnote omits any reference to SAS No. 88, Service Organizations and Reporting on Consistency, which amended SAS No. 70 to include language and concepts from SAS Nos. 55 and 78. Therefore, to remedy these deficiencies, we suggest that the Board revise Footnote 4 to read "See SAS No. 70, as amended by SAS No. 88, related to service organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), for guidance if an entity obtains services that are part of its information system from another organization." Similar references, such as Footnote 7 on Page 18 of the ED, may also require revision.

4. Paragraph 20, on Page 12 of the ED, lists six specific bulleted risks that information technology (IT) systems pose to an entity's internal control. The first bullet is "Over reliance on information produced by IT systems that are incorrectly processing data or consistently processing inaccurate data." Because some systems could simultaneously incorrectly process data and consistently process inaccurate data, we suggest that the Board expand this bullet slightly to read "Overreliance on information produced by IT systems that are incorrectly processing data, consistently processing inaccurate data, or both."
5. The fifth sentence in Paragraph 22, on Pages 12 and 13, reads "For example, an entity's IT personnel may not completely understand how an IT system processes sales transactions, resulting in erroneously designing required changes to the system to process sales for a new line of products, or such changes may be correctly designed but misunderstood by individuals who translate the design into program code." This sentence is not only lengthy, but also difficult to understand. For clarity, we suggest that the Board revise this sentence into two separate sentences as: "For example, in some instances, an entity's IT personnel may not completely understand how an IT system processes sales transactions, resulting in erroneously designing required changes to the system to process sales for a new line of products. In other instances, such changes may be correctly designed but misunderstood by individuals who translate the design into program code."
6. In Paragraph 26, on Page 13 of the ED, the third bullet begins "When applicable, design tests of controls." For consistency within Paragraph 26, as well as with a similar reference in Paragraph 31, we suggest that the Board reverse the phrases in the third bullet to read, "Design tests of controls, when applicable."
7. The second sentence in Paragraph 30, on Page 14 of the ED, includes the phrase "...and the auditor's understanding of the industry in which the entity operates." Because we believe that the auditor must also understand the market in which the entity operates, and for consistency with Paragraph 25, we suggest that the Board expand this phrase slightly to read "...and the auditor's understanding of the market and industry in which the entity operates."
8. The third sentence in Paragraph 31, also on Page 14 of the ED, begins "However, the use of IT also presents risks, such as the risk that incorrect changes (for example, changes that are not properly authorized, incorrectly defined, or improperly made) to the programs..." To ensure that the parenthetical examples are parallel, we suggest that the Board revise this sentence slightly to read "However, the use of IT also presents risks, such as the risk that incorrect changes (for example, changes that are improperly authorized, incorrectly defined, or improperly made) to the programs..."
9. The second sentence in Paragraph 42, on Page 17 of the ED, states, "They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives." We had difficulty with the last phrase of this sentence. To improve the wording for the reader, we suggest that the Board revise the last portion of the second sentence to read "to address risks in order to achieve the entity's objectives."

10. The last sentence in Paragraph 57, on Page 20 of the ED, reads “However, these conditions may not affect the auditor's assessment of control risk.” Because this is a conclusion, based on less desirable circumstances that are frequently apparent in small and midsized entities, we suggest that the Board revise this sentence slightly to read “However, these conditions may not adversely affect the auditor's assessment of control risk.”
11. The first sentence in Paragraph 77, on Page 24 of the ED, states that "Tests of controls directed toward the operating effectiveness of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied or monitored." In regards to monitoring, this guidance implies that the tests of controls are only concerned with *by whom* the control was monitored. In practice, we believe that tests of controls should also be concerned with how the control was monitored and the consistency with which it was monitored during the audit period. Therefore, we suggest that the Board expand the first sentence to read “Tests of controls directed toward the operating effectiveness of a control are concerned with how the control was applied and monitored, the consistency with which it was applied and monitored during the audit period, and by whom it was applied or monitored.”
12. Paragraph 6 of the Appendix, on Page 32 of the ED, lists as bullets nine circumstances in which risks relevant to financial reporting can arise or change. The third bullet is “*New or revamped information systems.*” Significant and rapid changes in information systems can change the risk relating to internal control.” The fifth bullet is “*New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.” We believe these two circumstances are synonymous; for example, "significant and rapid changes in information systems” would result from 'incorporating new technologies into ... information systems.' Therefore, we suggest that the Board merge the third and fifth bullets in Paragraph 6 into one bullet in the final document.
13. Paragraph 15 of the Appendix, on Page 34 of the ED, states that “Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made orally and through the actions of management.” To properly recognize that communication can also frequently be made electronically, we suggest that the Board expand the second sentence in Paragraph 15 to read, “Communication also can be made electronically, orally, and through the actions of management.”

We appreciate the opportunity to comment on this Exposure Draft. Should you have any questions, or desire further details on our comments, please contact me or Jon A. Wise, C.P.A., Director of Professional Practice.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General



BDO Seidman, LLP
Accountants and Consultants

330 Madison Avenue
New York, NY 10017
Telephone (212) 885-8000
Fax: (212) 697-1299

Comment Letter # 15

January 9, 2001

Ms. Jackie Walker,
Audit and Attest Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: File 4420 – Proposed Statement on Auditing Standards, “Amendment to Statement on Auditing Standards No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as Amended by Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*”:

Dear Ms. Walker:

We appreciate this opportunity to respond to the Proposed Statement. We have the following comments:

Significant Points:

1. In paragraph 16, there is a list of bullet points that are considerations of the five components of internal control. However, the list does not take into account the existence of automated controls; it only makes a reference to generic systems. Most entities are replacing (or have replaced) manual controls with automated controls and the impact of these controls should be part of an auditor’s consideration of internal control. In addition, auditors should consider the relationship between manual and automated controls when they consider the five components of internal control. This requires the auditor to consider how the interplay of manual and automated controls impacts the overall control objectives contained in the five components. Accordingly, we suggest adding the following bullet points:
 - The extent to which automated controls are used to prevent and or detect errors in data used in the financial statements
 - The relationship between manual, automated and managerial controls in preventing and/or detecting material errors in data used to prepare in the financial statements
2. In paragraph 19, consider adding an additional bullet point that states:
 - Share data and applications across the organization and with its business partners

3. In paragraph 20, consider adding two additional bullet points that state:
 - Systems, especially those in larger entities, which are subject to multiple levels of controls (general, application and user) across multiple departments (e.g., the IT department and multiple user departments) that increase the number of points where control weaknesses could be introduced into the system
 - Unavailability of IT systems and associated controls and substitution of manual procedures and controls
4. While we agree with the context of paragraph 28, we believe the paragraph should be clarified. The auditor is not required to obtain knowledge about operating effectiveness as part of the understanding of internal control necessary when he or she does not plan to rely on controls. However, when an auditor intends to rely upon controls to reduce the level of substantive tests, then the auditor must test controls to determine if they can be relied upon. As a result, evidence about the operation of controls over a period of time (and hence, their operating effectiveness) will be gathered by this process. Making this change also would make the wording consistent with paragraph 66.
5. Paragraphs 30 and 31 are unclear. While these two paragraphs are designed to discuss the extent of information that an auditor should obtain about an entity's internal controls, they do not clearly lay out what the auditor should do. We recommend the following revision:

“In order to plan an audit, the auditor should have an understanding of the entity's internal controls. When determining how much information must be gathered to obtain this understanding, the auditor should consider the following: knowledge obtained from all relevant sources about the factors that could impact the entity (e.g., the industry, information from previous audits, internal audit reports); the types of potential misstatements that could impact the entity and the financial statements; the risk that such misstatements could exist; the internal (e.g., new IT systems, new management) and external (e.g., regulators, declining industry, new industry) risks impacting the entity; the complexity of the entity's operations; the complexity and sophistication of the IT systems in use and in development; the extent of use of and reliance on IT systems by the entity's management and employees, including their understanding of these systems and their experience in using them; the knowledge and experience of management (financial, operational, IT, etc.) and the entity's employees (and potentially its business partners); the nature and types of controls employed by the entity (and potentially its business partners), including manual and/or automated controls; and other factors that may be relevant to the entity and/or audit.

Based on these factors, the auditor should then determine the extent of the understanding of internal control that is required to plan the audit. The auditor should consider internal controls implemented in the entity's operations, financial, managerial and IT environments because it is the combined relationship between all of these types of controls that ultimately determines control risk.”

6. Footnote 6 should also include a reference to SAS No. 80. Consider revising this footnote to state: “These assertions are discussed in SAS No. 31, *Evidential Matter* and SAS No. 80 *Amendment to Statement on Auditing Standards No. 31, Evidential Matter* (AICPA, Professional Standards vol. 1, AU sec. 326).”
7. In paragraph 44, the 7th sentence, it is not clear how application controls ensure transaction validity -- they can help ensure accuracy and to some extent completeness. However, they may not, in certain circumstances, effectively address existence, which is a key component of validity (unless the applications are tied to external systems that allow for validation of data with third party sources). For example, an entity could enter into non-existent fraudulent transactions and the IT system would process them in an identical manner to valid transactions without knowing the difference between the two. Consider revising the sentence to eliminate the word valid. Also, consider removing the word “properly” from the phrase “properly authorized.”
8. In the section dealing with Information and Communication, consider adding the following:
 - In paragraph 49, a statement that addresses the relationship between the extent of the entity’s use of automated systems and the need for the auditors to determine whether they can rely on those controls, or must rely upon controls outside of the system.
 - In paragraph 49, a statement that in environments where automated controls are pervasive, the auditor should consider relying on these controls (and performing tests of controls to support that reliance) unless there is clear evidence of weaknesses that mitigate the effectiveness of automated controls, or it is more efficient to rely upon manual controls.
 - In paragraph 50, a statement that addresses the relationship between weaknesses in general controls and their impact on application controls and vice versa.
9. Paragraph 68, 2nd sentence. The term “validity” is used. However, automated controls alone may not be effective at ensuring the validity of data. Consider revising to say “over its accuracy, completeness and validity.”
10. Paragraph 70. The bullet list illustrates situations where reliance on automated controls may occur. However, auditors do not have to rely upon these controls if they so choose. If the auditor decides to rely upon controls outside of the IT system (especially in a highly automated environment) or to perform a substantive audit, he or she should consider the impact of that decision on audit risk and on the potential for inadvertent reliance on automated controls (the entity’s primary control processes). Accordingly, consider adding the following to paragraph 70 after the bullet points:

“If an auditor decides not to place reliance on automated controls in environments such as, or similar, to those illustrated above and decides to instead rely upon user controls outside the IT system or to perform an entirely substantive audit, the auditor should consider how the planned audit procedures will appropriately reduce the risk of errors or omissions in the financial statements to an acceptable level. The auditor should also consider performing tests on system generated reports to minimize the potential for inadvertent reliance on this information.”

11. Whenever an auditor decides to rely upon automated application controls, he or she should be required to assess general controls over change management prior to testing the controls upon which the auditor plans to rely. This reduces the risk that reliance would be placed on automated controls that are subject to weak general controls. Consider revising paragraph 79, 3rd sentence, to say:

- “Such tests **should ordinarily...**”

12. There is no discussion as to which IT general controls should be considered as part of the auditor’s understanding of the internal control framework. Whether the auditor places reliance on controls or performs an entirely substantive audit, he or she should document the IT controls over the delivery and support and acquisition and implementation (COBIT terms used to refer to security and systems development) of IT systems.

Consider revising the terminology used in this auditing standard to reflect the terminology contained within COBIT.

13. Consider providing guidance in an appendix to the Standard or in an implementation guide on how IT controls impact the entity’s internal controls. In particular, consider expanding the guidance on how general controls enhance controls over IT systems, systems access, changes and operations, but have little impact over data entered into the IT systems. Also provide more guidance on how application controls function as preventative and detective controls. Include in this discussion information on the relationship between general and application controls and the impact of weaknesses in one type of control (general/application) on the other type of control (application/general). This explanation would be particularly helpful for non-IT technical auditors.

14. Consider adding guidance on the limitations of automated controls and unwarranted reliance on them, in particular the risks that transactions could occur outside of the IT systems and not be recorded in those systems and, conversely, that data in the IT systems may not be valid.

Minor Points

Paragraph	Sentence	Comment
3	2 nd	The phrase “restrict” detection risk should be “reduce”
Footnote 1		The term internal control framework should be used instead of internal control structure
7		Consider adding a fourth process, “detection and prevention of fraud.”
14	4 th	Replace the word “computer” with “information technology” or “information system.”
18	4 th	Remove the word “complex.” Simple IT systems have some elements of automated procedures that initiate, record, process and report transactions, whether they are “complex” or not.
19	5 th bullet	Consider revising to say: “Reduce the risk that controls will be circumvented, especially if controls over IT systems are effective at reducing control risk.”
21	1 st	Add “IT” to make the sentence read “... entity’s IT system.”
39	5 th bullet	Revise to state: “New/complex technology such as Enterprise Resource Planning systems and eCommerce systems”
42	2 nd bullet	Should it be “information” or “transaction”?
44	2 nd	Does the term “some” mean that other entities and auditors view control activities in other terms? If so, then where are these terms discussed? Consider revising to say “Entities and auditors typically view information system ...”
45	3 rd	Consider modifying to say “... such as reviews of data entered into the system , computer-produced ...”
57	3 rd	Most small entities have little or no descriptions of accounting procedures, etc., irrespective of management’s involvement in financial reporting. Consider revising to delete “with active management involvement in the financial reporting process.”
59	1 st	Consider replacing “provide sufficient knowledge of” with “obtain sufficient knowledge about.”
60	2 nd	Consider replacing “whether they have” with “whether controls have.”
68	1 st	Consider revising to say “tests of manual and/or automated controls.”
70	1 st bullet	Consider revising to say “the computer processes orders for goods based on predetermined rules with little or no user intervention. ”
70	2 nd bullet	Consider revising to say “An entity that provides products or services to customers (for example, some eCommerce companies , Internet service...)”.

Ms. Jackie Walker

Page 6

Paragraph	Sentence	Comment
75	1st	Consider revising “ indirectly related to all assertions ”

We would be pleased to discuss our views with you at your convenience. Please contact us if you would like to discuss our comments.

Very truly yours,

BDO Seidman, LLP

By s/ Wayne Kolins
Wayne Kolins
National Director of Assurance

Comment Letter # 16

December 22, 2000

Ms. Jackie Walker
Audit and Attest Standards
File 4420
AICPA
1211 Avenue of the Americas
New York, NY, 10036-8775

Dear Ms. Walker,

On behalf of the Minnesota Office of the Legislative Auditor, we would like to thank you for the opportunity to respond to the proposed amendment to SAS78.

It is our interpretation that the proposed amendments will have very little impact on current audit requirements. Instead, they simply define information technology concepts and discuss how those concepts might impact internal control. This is not new information to auditors. In fact, out of necessity, every auditor has already been forced to consider technological factors when assessing both inherent and control risk.

With this in mind, we encourage the AICPA to provide auditors with as much technology-related guidance as possible. However, our profession may be better served if this guidance were bound in a separate guide. This approach would make it easier to focus on the requirements that are embedded in our professional standards. A separate guide would also provide the AICPA with a forum to discuss technology concepts in greater detail and provide examples.

Once again, we thank you for the opportunity to comment on this exposure draft. Please feel free to contact me if you would like to discuss our comments in more detail. My business card is enclosed for your convenience.

Sincerely,

Christopher P. Buse, CPA, CIA, CISA
Informations Systems Audit Manager

Enclosure

cc: Kinney Poynter, Deputy Executive Director and NSAA Program Manager

January 5, 2001

Ms. Jackie Walker
Audit and Attest Standards
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: **File 4420**

Dear Ms. Walker:

We are pleased to comment on the Proposed Statement on Auditing Standards, *Amendment to Statement on Auditing Standards No. 55, "Consideration of Internal Control in a Financial Statement Audit," as Amended by Statement on Auditing Standards No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55."*

We fully support amending existing standards to provide guidance to auditors about the effect of information technology on internal control and on the auditor's understanding of internal control and assessment of control risk. However, we do have some overall recommendations and other comments for clarifying the language in the proposed standard, as described in the attachment to this letter. The attachment also contains several editorial comments for your consideration. Additions and deletions are in bold face italics and strikethrough, respectively.

Please contact Robert C. Steiner at (203) 761-3438 if you wish to discuss our comments.

Sincerely,

Attachment

COMMENTS

Overall Comments

We commend the Task Force for its thorough consideration of the changes needed to SAS No. 55 to provide guidance to auditors about the effects on internal control of an entity's use of information technology to initiate, record, process and report financial data. We offer the following overall comments for the Task Force's consideration.

First, the proposed standard introduces, in paragraph 2, the term "information technology"; however, the term is not defined within the standard. We believe the term is intended to be used in the generic sense to refer to the broad array of technology that may be used in originating, processing, storing and communicating information. The proposed standard also introduces, in paragraph 39, the term "information system"; that term is defined in paragraph 11 of the Appendix. We believe the term "information system" is intended to comprehend an *application* of information technology to perform a particular task or achieve a particular result.

We suggest that in order to clarify and differentiate the two terms, a definition of each be set forth early in the standard. This could be accomplished by adding a footnote (such as illustrated below) to paragraph 2 to define both information technology and information system.

Information technology encompasses automated means of **originating, processing**, storing, and ~~receiving~~ **communicating** information, and includes recording devices, telephones, **voice mail systems**, facsimile machines, computers **and related operating systems and software**, and other electronic devices. ~~Information technology is frequently used in information systems, although not all~~ **An entity's use of information technology may be extensive; however, the auditor is primarily interested in the entity's use of information technology to initiate, record, process and report financial data.** ~~and information systems are relevant to a financial statement audit.~~

An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. **Accordingly, the use of information technology may be very limited or absent in some information systems.**

In addition, we note that the term "information technology" (or "IT") is used throughout the proposed standard both on a stand-alone basis and as a modifier of the word "system" or "systems" (e.g., paragraphs 18, 22, 37, 44, 45 to cite just a few) in a context that suggests that what is being referred to is an application of information technology (i.e., an "information system"). The proposed standard, in other places, also uses the term "information system" in much the same context as the term "IT system." We believe that the clarity and usefulness of the proposed standard would be enhanced if a single term were used throughout the proposed standard and would prefer the use of the term "information system."

We recommend that the Task Force review the proposed standard for the use of the terms “IT system” and “information system” and adopt a single term to refer to applications of information technology that initiate, record, process and report transactions.

Other Comments

Paragraph 5

Paragraph 5 of the proposed standard states in part that “the auditor needs to be satisfied that performing substantive tests alone would be effective in restricting detection risk to an acceptable level.” We recommend that the following sentence be added to paragraph 5:

When evidence of an entity’s initiation, recording, or processing of financial data exists only in electronic form, the ability of the auditor to obtain the desired assurance from substantive tests alone would significantly diminish.

Paragraph 50

We believe the last sentence of paragraph 50 should offer insights as to how such statement affects the auditor. Accordingly, we propose revising that sentence to read as follows:

Furthermore, ***in planning the audit the auditor should be aware that*** there may be less visible evidence, or no evidence at all, of such intervention in IT systems.

Paragraph 61

For certain transaction classes, the internal control surrounding *related disclosures* may be a significant area. Accordingly, we believe that disclosures should also be encompassed in the auditor’s assessment of inherent risk and judgments about materiality. We recommend that paragraph 61 be revised as follows:

61. The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes, ***including related disclosures***, also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of internal control. ***However, the auditor may conclude that it is necessary to obtain an understanding of the internal control over the preparation and presentation of segment information.***

Paragraph 111

We believe that the section in the Appendix on “Monitoring” should also include consideration of the extent to which an entity’s monitoring activities rely on IT systems or on information produced by IT systems. In many entities, a significant portion of monitoring activities may rely on IT systems or information produced by IT systems.

Editorial Comments

Introduction/Summary

We recommend that the caption, “Summary,” preceding paragraph 2 be moved to precede paragraph 1 in the proposed standard.

Paragraph 4

We believe that the auditor either “desires to further reduce the assessed level of control risk” or “seeks a further reduction in the assessed level of control risk” but the auditor does not “desire to seek.” Accordingly, we recommend that following revisions to the first sentence of paragraph 4.

4. After obtaining the understanding and assessing control risk, the auditor may desire to ~~seek a further reduction in~~ the assessed level of control risk for certain assertions.

Paragraph 18

The concept of transactions being “initiated, recorded, processed and reported” is used extensively throughout the Exposure Draft, and paragraph 12 of the Appendix defines each term. We recommend that the first usage of the terms, which occurs in paragraph 18 be footnoted with a cross-reference to the definitions in the Appendix to increase the understandability of the standard. In addition, we recommend the following revisions to the first sentence of paragraph 18:

18. ~~The development of IT changed~~ **The use of IT changes** the fundamental manner in which transactions are initiated, recorded, processed, and reported^{FN}, from paper-based systems that rely primarily on manual controls to electronic systems using a combination of manual and automated controls.

^{FN} **Paragraph 12 of the Appendix in paragraph 111 defines initiation, recording, processing and reporting as used throughout this section.**

Paragraph 19

We recommend that the last bullet of paragraph 19 be revised as follows:

- Reduce the risk that controls will be circumvented, especially if **system or program change** controls ~~over IT system changes to the IT system~~ are effective.

Paragraphs 22 and 24

We believe the following changes improve the clarity of paragraphs 22 and 24:

22. Internal control, no matter how well designed and operated, can provide **to management and the board of directors** only reasonable assurance ~~to management and the board of directors of~~ 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 **such** as simple errors or mistakes. ~~Similarly,~~ In IT systems, errors may occur in designing, maintaining, or monitoring automated controls. For example, an entity's IT personnel may not completely understand how an IT system processes sales transactions;; **as a result,** ~~ing in~~ ~~erroneously designing required changes to~~ the system **developed** to process sales for a new line of products **may be erroneously designed**. ~~or such changes~~ **Similarly, the system** may be correctly designed but misunderstood by individuals who translate the design into program code. Errors may also occur in the use of information produced by IT. For example, IT systems may be designed to report transactions over a specified dollar limit for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.

24. ~~Another limiting factor is that~~ **Internal control is influenced by the quantitative and qualitative estimates and judgments made by management in evaluating the cost-benefit relationship of an entity's internal control.** ~~†The cost of an entity's internal control should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing internal control, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.~~

Paragraph 26

The following changes are recommended to improve the clarity of paragraph 26:

26. In all audits, the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit. **A sufficient understanding is obtained** by performing procedures to understand the design of controls relevant to an audit of financial statements, and **determining** whether they have been placed in operation. In planning the audit

Paragraphs 30 and 31

The following changes to paragraphs 30 and 31 are recommended to improve their clarity. Additionally, we believe the auditor's consideration with respect to the entity's reliance on manual controls should apply to both manual controls that are dependent on IT and those that are independent of IT.

30. In making a judgment about the understanding of internal control necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of tests of controls, when applicable, and substantive tests. Other sources of such knowledge include information from previous audits and the auditor's understanding of the industry in which the entity operates. The auditor also considers his or her assessment of inherent risk, judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including the extent to which the entity relies on manual controls ~~independent of the computer or~~ **and** on automated controls.

31. ~~This consideration also includes~~ **In making a judgment about the understanding of internal control necessary to plan the audit, the auditor should also consider** IT risks that could result in misstatements, and whether the entity has designed and placed in operation controls to prevent

or detect such misstatements. For example, if an entity uses IT to perform complex calculations, the entity receives the benefit of having the correct calculations consistently performed. However, the use of IT also presents risks, such as the risk that incorrect changes (for example, changes that are not properly authorized, incorrectly defined, or improperly ~~made~~ **implemented**) to the programs performing the calculations could result in consistently **incorrect** ~~performing these calculations incorrectly~~. In such cases, the auditor considers whether controls that prevent or detect incorrect changes to computer programs performing the calculations have been designed and placed in operation. As an entity's operations and systems become more complex and sophisticated, it becomes more likely that the auditor would need to increase his or her understanding of the internal control components to obtain the understanding necessary to design effective tests of controls, when applicable, and substantive tests.

Paragraph 32

Paragraph 32 refers to the specialist “designing and performing audit procedures.” It is not clear whether the specialist would be designing tests of controls or substantive tests, or both. Accordingly, we recommend that the first sentence of paragraph 32 be revised as follows:

The auditor should consider whether specialized skills are needed to determine the effect of computer processing on the audit, to understand the controls, or to design and perform ~~audits procedures~~ **tests of controls or substantive tests**.

Paragraphs 34 and 111

As the appendix in paragraph 111 is labeled “Appendix,” we believe that either the Appendix should be relabeled “Appendix A” to be consistent with the reference to it in paragraph 34, or paragraph 34 should be conformed to paragraph 111.

Paragraph 40

The intent of the last sentence in paragraph 40 is unclear. We recommend that the example of “risks . . . in certain financial instrument transactions” be expanded to identify the nature of the risks contemplated in the reference to “certain financial instrument transactions” or the specific financial instrument transactions contemplated.

40. The auditor should obtain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to financial reporting objectives and ~~decides about~~ **determines the actions to be taken** to address those risks. This knowledge might include understanding how management identifies risks, estimates the significance of the risks, assesses the likelihood of their occurrence, and relates them to financial reporting. The use of IT may be an important element in an entity's risk assessment process, including the identification and management of risks relevant to financial reporting. **For example, such as those in certain financial instrument transactions (describe the nature of the risks envisioned).**

Paragraph 44

We believe the following changes improve the clarity of paragraph 44:

44. ~~Depending on the extent of an entity's use of IT, T~~the auditor ~~may need to~~ **should** obtain an understanding of ~~how~~ **the extent to which** IT ~~may~~ affects control activities that are relevant to planning the audit. Some entities and auditors may view the information systems control activities in

terms of general controls and application controls. General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of IT systems. General controls commonly include controls over data center and network operations, system software acquisition and maintenance, access security, and application system development and maintenance. The continued effective functioning of application controls depends on general controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions are valid, properly authorized, and completely and accurately recorded and processed. Examples include edit checks of **data** input-data, numerical sequence checks, and manual follow-up of exception reports.

Paragraphs 59 and 62

To improve the clarity of paragraphs 59 and 62, the following changes are recommended:

59. In obtaining an understanding of controls that are relevant to audit planning, the auditor should perform procedures to **obtain** ~~provide~~ sufficient knowledge of the design of the relevant controls pertaining to each of the five internal control components and **determine** whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

62. The auditor should document the understanding of the entity's internal control components obtained to plan the audit. The form and extent of this documentation is influenced by the nature and complexity of the entity's controls. For example, documentation of the understanding of internal control of a complex IT system in which a large volume of transactions are electronically initiated, recorded, processed, and reported may include flowcharts, questionnaires, or decision tables. For a system making limited or no use of IT or for which few transactions are processed (for example, long-term debt), documentation in the form of a memorandum may be sufficient. Generally, the more complex **the entity's** internal control and the more extensive the procedures performed **by the auditor**, the more extensive the auditor's documentation should be.

Paragraph 67

We believe the last sentence of paragraph 67 was intended to be the fourth bullet of the paragraph rather than a separate sentence.

Paragraph 68

We believe that the two occurrences of the phrase “internal controls” in paragraph 68 should be replaced with “controls,” as illustrated below:

68. In circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, and reported, the auditor may need to perform tests of controls to determine whether ~~internal~~ controls are operating effectively and to support an assessment of control risk below the maximum. For such assertions, significant audit evidence may be available only in electronic form, in which case its competence usually depends on the effectiveness of ~~internal~~ controls over its validity and completeness. For example, the evidence, including related records, resulting from such functions performed by an entity’s IT systems as executing credit checks or matching purchase orders with shipping documents may be maintained only in electronic format.

Paragraph 70

We believe that the intent of paragraph 70 was to provide examples of situations in which substantive tests alone may not provide the auditor with sufficient evidential matter and that such paragraph was a follow-up to paragraph 69. However, we are concerned that the lead in is too general and may encompass other situations as well. Accordingly, we believe that the closing sentence should be expanded to clarify the intended relationship to paragraph 69. Additionally, we propose several editorial changes to incorporate the use of IT terminology in paragraph 70.

70. Examples of situations where the auditor may determine that he or she should perform tests of controls to gather evidential matter to use in assessing control risk include the following:

- An entity that conducts business using *an IT system in which the computer to* initiates orders for goods based on predetermined **decision** rules and *to* pays the related payables based on **system generated** ~~electronic~~ information ~~in transactions~~ regarding receipt of goods. No other documentation of orders or goods received is produced or maintained.
- An entity that provides electronic services to customers (for example, an Internet service provider or a telephone company) and uses computer applications to log services provided to users, initiate bills for the services, process the billing transactions, and automatically record such amounts in electronic accounting records that are used to produce the financial statements.

In such cases, it may not be possible for the auditor to design effective **substantive** tests without obtaining evidence about the operating effectiveness of the automated controls **because substantive tests alone may not provide the auditor with sufficient evidential matter as discussed in paragraph 69.**

Paragraph 72

We believe the first reference to the word “misstatement” in paragraph 72, should be plural, as follows:

The knowledge that an auditor gains from obtaining an understanding about internal control should be used to identify the types of potential misstatements that could occur in financial statement assertions, and to consider factors that affect the risk of material misstatement.

Paragraph 84

The third sentence of the paragraph appears to conflict with the first sentence concerning the documentation of the basis for the auditor’s conclusion about the assessed level of control risk. We recommend the following changes to resolve that apparent conflict:

84. In addition to the documentation of the understanding of internal control discussed in paragraph 62, the auditor should document ~~the basis for~~ his or her conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. ~~However, f~~For those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his or her conclusion that the effectiveness of the design and operation of controls supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control, and the nature of the entity's documentation of internal control.

Paragraph 111

We believe that there should be a clearer differentiation between the *New or revamped information systems* bullet point and the *New technology* bullet point in paragraph 6 of the Appendix and that the auditor’s consideration of production processes that impact information systems that initiate, record, process and report financial data. Accordingly, we propose the following changes to the *New technology* bullet point in paragraph 6 of the Appendix:

- *New technology*. Incorporating new technologies into production processes **that impact information systems**, or **into** information systems **themselves**, may change the risk associated with internal control.

To incorporate “information technology” into the definition of an information system and the concepts of SAS No. 82, we recommend that the following changes be made to the last bullet point in paragraphs 9 and 11 of the Appendix:

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:
- ...
 - *Information processing.* A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are general controls and application controls. General controls commonly include controls over data center and network operations, system software acquisition and maintenance, access security, and application system development and maintenance. These controls apply to mainframe, ~~miniframe~~ ~~minicomputer~~ and end-user environments, application controls apply to the processing of individual applications. These controls help ensure that transactions are valid, properly authorized, and completely and accurately recorded and processed.
 - ...
 - *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or ~~irregularities~~ **fraud** in the normal course of his or her duties.
11. An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. ***Accordingly, the use of information technology may be very limited or absent in some information systems.***

Footnotes 4-6, 8 and 10

Footnotes are used to provide cross-references to related discussions in other standards; however, the references used are to the original standards, which have been amended by other standards that are not recognized. In many cases, the topic that is referred to in the proposed standard was never part of the original standard cited. For example, we noted references to SAS Nos. 22, 31, 47, and 70; each of which were subsequently amended by later Statements on Auditing Standards. We recommend that references to the original standards be replaced by references to the corresponding AU sections in the codification.

Footnote 7

A reference is already made to SAS No. 70 in footnote 4; accordingly, we recommend that footnote 7 be deleted as repetitive. If not deleted, the inclusion of footnote 7 raises questions as to why SAS No. 70 is not referenced in other paragraphs.



January 10, 2001

Ms. Jackie Walker
Audit and Attest Standards, File 4420
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Walker:

The Committee on Audit and Assurance Services of the Illinois CPA Society ("Committee") is pleased to have the opportunity to comment on the exposure draft of the Proposed Statement on Auditing Standards (SAS) titled *Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit*, as amended by Statement No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*. The following comments and considerations represent the collective views of the members of the Committee. The organization and operating procedures of the Committee are reflected in the Appendix to this letter.

SUMMARY

We are in general support of the issuance of the proposed SAS, with suggested considerations. We must note, however, that it appears that this proposed SAS updates the previous SAS simply to now include information technology. This proposed SAS appears to raise no new specific guidance. As such, is this proposed SAS necessary as a new standard, or would information technology be better addressed as a specific audit guide topic and/or a supplemental auditing interpretation of consideration of internal control in a financial statement audit?

SPECIFIC CONSIDERATIONS

Operations and Compliance Objectives

New paragraph 13, last sentence may be enhanced with the addition of "unless that data is useful for analytical procedures."

Effects of IT on Internal Control

The listing of risks in new paragraph 20 may also include the risk of unauthorized 3rd party access to client information, ie. hackers, security issues, blackmail, etc.

Consideration of Internal Control in Planning the Audit

New paragraph 27 addresses considerations for both noncomplex and complex entities. Such distinctions are welcomed. Perhaps other such examples can be included throughout the SAS.

New paragraph 28 needs clarification. There now seems to be subtle changes in the meaning of *placed in operation* versus *operating effectively*. The time element is what is now being stressed. Perhaps the emphasis should be changed from a time element discussion to a discussion that understanding the controls and testing control effectiveness are two different steps. The discussion can then address whether or not an auditor must understand how the client is using the

SPECIFIC CONSIDERATIONS

(Continued)

Consideration of Internal Control in Planning the Audit (continued)

controls at a specific point in time or over a period of time. The discussion may then conclude with separately addressing the time element of point in time or period of time when performing tests of control for effectiveness. The emphasis of the entire discussion should be the auditor is not required to perform tests of controls to test for operating effectiveness to plan the audit.

Understanding of Internal Control Necessary to Plan the Audit

Should new paragraph 33 also include reference to the standard (SAS No. 73) for considerations when using the work of a specialist?

Consideration of Internal Control in Assessing Control Risk

In new paragraph 66, should inherent risk be brought into the discussion?

Identifying Controls

In new paragraph 72, the term "specific assertions" is introduced. This term should be defined and perhaps, if appropriate, illustrated with an example or two.

Concluding on the Assessed Level of Control Risk

Interestingly, new paragraph 82 does not address "specific assertions." (See new paragraph 72)

Timeliness of Evidential Matter

More guidance about testing controls at an interim date as discussed in new paragraph 100 would be helpful.

Sincerely,



Debra Hopkins
Chair, Audit and Assurance Services Committee
Illinois CPA Society

APPENDIX A

ILLINOIS CPA SOCIETY
AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATIONAL AND OPERATING PROCEDURES
2000 – 2001

The Audit and Assurance Services Committee of the Illinois CPA Society (the Committee) is composed of twenty technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to fifteen years. The Committee is a senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of auditing standards.

The Committee usually operates by assigning a subcommittee of its members to study and discuss fully exposure documents proposing additions to or revisions of auditing standards. The subcommittee ordinarily develops a proposed response which is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint.

Comment Letter # 19

January 12, 2000

Mr. James S. Gerson, Chair
C/O Auditing Standards Board
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Jim:

Enclosed please find a summary of the staff's comments related to the Exposure Draft on Proposed Amendments to Statement on Auditing Standards No. 55. The issues addressed in our comments are important to preserving the credibility of audited financial statements and should be addressed now, and not in the future. Should you have questions, I can be reached at (202) 942-4400.

Sincerely,

Lynn E. Turner
Chief Accountant

Cc: Jerry Sullivan
Public Oversight Board
George Tucker
Technology Issues Task Force, Chair
Julie Anne Dilley
Technical Manager- Audit and Attest Standards

**Exposure Draft of Proposed Amendment to SAS 55
SEC Comments**

**Paragraph
Reference**

Comment

Significant Comments That Require Action

- | | |
|----------------|--|
| General | The Panel on Audit Effectiveness (the Panel) has recommendations on assessing inherent risk (paragraph 2.48 of the Panel's report) and assessing control risk (paragraph 2.77 of the Panel's report) that have not been addressed in this standard. We believe that the Panel's recommendations in this area are important and that these recommendations need to be incorporated into this amendment. Further, we do not believe it appropriate to defer action to the ASB's Risk Assessment and Linkage Task Forces. |
| General | Throughout the document the auditor is provided the opportunity to complete certain requirements if the result would be more efficient. As a policy matter, the auditors' decision-making process with respect to obtaining an understanding of the control environment or assessing risk should not be dictated by the efficiencies that would be created as a result. |
| 51 | We believe that the discussion in this paragraph should be expanded and/or highlighted. Where financial frauds occur, we find that in many (if not most) cases non-standard entries are used by management to perpetrate the fraud. Further, the Panel's findings and recommendations with respect to non-standard entries documented in paragraphs 3.34 and 3.51 (in the Panel's report) have not been adequately addressed. We recommend that the standard be modified to provide appropriate consideration to this matter. For example, we believe that an auditor should be required to understand, document and test the process for recording non-standard transactions. |
| 62 | In paragraph 2.77 of its report, the Panel recommended that more specific guidance be provided for the "nature and extent of documentation needed, particularly to support the auditor's consideration of internal control in planning the audit and in assessing control risk." The guidance in paragraph 62 has not been modified to address the Panel's concern. |
| 84 | See above comment on audit documentation for paragraphs 62 and 84. In addition, paragraph 84 states, "(h)owever, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion." We disagree with this statement and believe that it contradicts the following Panel |

recommendations:

“2.48 No longer permit the auditor to default to assessing inherent risk at the maximum for efficiency or other reasons without considering what could go wrong in specific financial statement assertions.”

“2.77 Provide more specific guidance on the nature and extent of documentation needed, particularly to support the auditor’s consideration of internal control in planning the audit and in assessing control risk.”

- 68 The first sentence states, “the auditor may need to perform tests of controls to determine whether internal controls are operating effectively and to support an assessment of control risk below the maximum.” The words “may need to” should be changed to “should”. Note that paragraph 66 states that auditors “should” perform tests of controls when the auditor assesses control risk below the maximum.

Technical Recommendations

- 3 Consider modifying the last sentence in paragraph 3 by inserting “or subsequent to” between “concurrently with” and “obtaining the understanding.”
- 28 This paragraph discusses the distinction between a control that has been “placed in operation” and its “operating effectiveness.” The last sentence of the paragraph states, “The auditor is not required to obtain knowledge about operating effectiveness as part of the understanding of internal control necessary to plan the audit.” This sentence conflicts with paragraphs 85 to 87 which acknowledge that an understanding internal control and assessing control risk may be performed concurrently in an audit. Some procedures performed may achieve both objectives. These procedures may have the advantage of enabling the auditor to assess the substance, in addition to the form, of the control. We recommend that the last sentence be modified or another sentence be added that, at a minimum, references paragraphs 85-87.
- 44 Paragraph 44 introduces the notion of general controls in the context of IT systems. It does not discuss general controls outside of IT systems. Did the ASB intend for this notion to not apply to non-IT areas? If such controls are meant to address non-IT areas, then how do general controls reconcile to monitoring controls as discussed in paragraphs 53 to 56? Clarification of the general control concept is needed.
- 44 and 45 Paragraph 44 defines application controls within the context of IT systems. Application controls are defined as “processing of individual applications. These controls help ensure that transactions are valid, properly authorized,

and completely and accurately recorded and processed.” Paragraph 45 states that application controls may also be known as user controls when they are performed manually.

We believe the definition and discussion of application controls should be expanded so that it encompasses both automated and manual application controls. Further, the definition should include the objectives of application controls. For example, the definition may state “application controls are transaction-level procedures designed to ensure the integrity of the accounting records. They directly support the control objectives of accuracy, completeness, cutoff, existence; they can be either manual or automated in nature.” We also recommend the addition of several specific examples of both automated and manual application controls to supplement the definition.

53 to 56 Paragraphs 53 to 56 discuss the need for monitoring activities so that management ensures that internal controls are operating effectively. Further, auditors should obtain sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting. We recommend the addition of a discussion that helps the auditor distinguish between an application control (discussed in paragraphs 44 and 45) and a monitoring control.

56 Paragraph 56 states, “(m)anagement may rely on automated controls to ensure that computer-generated data are correct and may not perform procedures to confirm the data’s accuracy. In such a case, errors may exist in the information leading management to incorrect conclusions from its monitoring activities. The auditor considers the reliability of information used to monitor internal control . . .”

If the objective of monitoring controls is to provide assurance regarding the effectiveness of internal controls, this paragraph is, in fact, discussing a failure in monitoring activities (i.e., the monitoring activity failed to detect a breakdown in application controls over the underlying data). It also seems to imply that the auditor’s consideration of the reliability of the underlying information is a mitigating factor for the breakdown in the monitoring control. Effective monitoring controls by design should detect failures in underlying automated and manual controls. The auditor’s test of controls is not a mitigating factor. We are unclear as to the intent of paragraph 56 and recommend that the current wording be revised.

69 The last sentence states, “Evidential matter obtained from tests of controls may be required to enable the auditor to audit the related financial statement assertions.” The sentence should be revised to read “Evidential matter should be obtained from tests of controls to enable the auditor to audit the related financial statement assertions.” This change is necessary

for consistency with the wording in paragraph 66 and our comment above on paragraph 68.

Throughout the ED, we noted that the auditor is required to “understand” the controls or environment. Requirements related to documentation are outlined in paragraphs 62 and 84. Not-with-standing our previous comments on these sections, we believe that where the auditor is required to obtain an understanding, they should also be required to document that understanding. For example, we would propose adding a specific documentation requirement to paragraphs 40, 51, and 59.

- 10** Paragraph 10 indicates that an understanding is not required of all business units or functions. We recommend that clarification be added to identify situations where not obtaining an understanding would be permitted such as when the unit or function is clearly immaterial.
- 33** Consider expanding paragraph 33 to elaborate on the requirements of the audit team in reviewing and documenting the qualifications and work of the specialist. Additionally, the standard addresses the skills that are required of the auditor but does not address the skills required of the IT specialist. We recommend that requirements of the IT specialist be provided, ensuring requisite knowledge of the audit requirements and financial reporting process.
- 37** We believe that improper access as well as improper changes to the IT system should be addressed and discussed.
- 25 and 39** Consider adding a discussion of the impact of outside third party influences such as analyst and venture capital partners.
- 65 and 85** Consider incorporating a discussion and/or cross-references that would link the requirements of “assessment of control risk” to “the actual test of controls.”
- 75** Consider deleting the words “the need to identify” from the last sentence of this paragraph.
- 70 and 89** These paragraphs do not appear to be an integral part of the document. We recommend that consideration be given to deleting these paragraphs.

January 16, 2001

American Institute of Certified Public Accountants
Jackie Walker, Audit and Attest Standards
1211 Avenue of the Americas, 6th Floor
New York, N.Y. 10036-8775

Attn: ED Proposed SAS, Amendment to SAS 55

Ladies and Gentlemen:

Grant Thornton LLP is pleased to submit this comment letter to the Auditing Standards Board (ASB) with regard to the Exposure Draft, *Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as Amended by Statement on Auditing Standards No. 78, Consideration of Internal Control in A Financial Statement Audit: An Amendment of Statement on Auditing Standards No. 55.*

We support the issuance of a final standard and the ASB's effort to provide guidance to auditors about the effect of information technology on internal control and on the auditor's understanding of internal control and assessment of control risk. We believe that from the perspective of transaction processing the proposed amendments significantly achieve this objective.

However, we believe the amendments could be improved as follows:

- Address the importance of security over data maintained in master files and ERP tables by incorporating this into some of the examples. Errors introduced into such "standing data" typically results in greater consequences than those introduced through individual transactions.
- Clarify the link that security settings in applications, databases, and operating systems have on segregation of duties. Paragraphs 37 and 44 of the proposed SAS approach these concepts but include nothing specific to address how these concepts relate. Paragraphs 94 and 95 further confuse the issue since they are written as if segregation of duties is a manual process with no technology implications.

We appreciate this opportunity to comment. We would be pleased to discuss in further detail these comments and any other matters with respect to the Board's Exposure Draft. Please feel free to contact Keith Newton at (214) 561-2316.

Sincerely,

Grant Thornton LLP

January 5, 2001

Ms. Jackie Walker
Audit and Attest Standards, File 3733
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Proposed Statement on Auditing Standards (SAS)
Amendment to Statement on Auditing Standards No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*

Dear Ms. Walker:

Ernst & Young LLP supports the issuance of the above referenced proposed Statement on Auditing Standards. We believe that the exposure draft provides appropriate guidance to auditors on the effect of information technology (IT) on internal control, and strengthens existing standards regarding the auditor's need to understand all aspects of the information system (including IT processing and controls) in assessing control risk and planning the nature, timing, and extent of audit procedures.

We recognize that this project was well under way before the Panel on Audit Effectiveness (the Panel) issued its report. We also recognize that the Panel had several recommendations regarding internal control, risk assessments, and the resulting effect on audit procedures, and that this proposed Statement represents only an intermediate step in addressing those recommendations. Nevertheless, we are very pleased that the Board has followed the Panel's additional recommendation to give priority to completing the work of the Technology Issues Task Force, and believe that this proposed Statement should be issued as a significant interim step in that process. We also support the efforts of the other task forces formed by the Board to address other Panel recommendations, and welcome the opportunity to participate in deliberations that may lead to further revisions of or enhancements to existing auditing standards.

With respect to the specific content of the proposed Statement, we believe the guidance on the use of an IT specialist and guidance on review of non-standard and non-recurring journal entries could be improved as follows:

Auditor's Responsibilities When an IT Specialist is Used

We agree with the concept in paragraph 33 (consistent with AU section 311.10) regarding the auditor's responsibilities to properly plan and supervise the work of an IT specialist. However, the requirement that the auditor should have "sufficient IT skills" seems to imply a higher level of knowledge or experience in IT matters than the language used in AU 311.10 ("sufficient computer-related knowledge"). We suggest mirroring the language in AU 311.10, in which case the last sentence of paragraph 33 would read as follows:

"If the use of an IT specialist is planned, the auditor should have sufficient ~~IT skills~~ computer-related knowledge to communicate the audit objectives to the specialist; to evaluate whether the ~~specialist's~~ specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures as they relate to the nature, timing, and extent of other planned audit procedures."

Alternatively, paragraph 33 could simply provide a reference to AU 311 because paragraph 32 already requires the auditor to consider whether specialized skills or knowledge might be needed on the audit team. This alternative would be similar to the approach used in paragraphs 5 and 6 of SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

Understanding the Financial Reporting Process

Paragraphs 50 and 51 address the critical need to understand the entity's financial reporting system, and the need to understand the process for initiating and recording both standard, recurring entries and nonstandard, nonrecurring entries as well as controls that have been placed in operation to determine that such entries are authorized, complete, and correctly recorded. We recommend expanding this guidance by adding a reference to the need to understand all aspects of the financial reporting process, including any sub-systems that are not part of the normal general ledger or financial reporting system, and any controls in place to prevent or detect errors in the assembly of financial statement amounts after information has been automatically passed from the general ledger or financial reporting system (i.e., adjustments or reclassification entries made solely to prepare the financial statements).

We suggest modifying the first sentence of paragraph 50 to read as follows:

"In obtaining an understanding of the financial reporting process, the auditor considers the various procedures an entity uses to produce financial ~~reports~~ statements (including the use of any sub-systems that are not part of the normal general ledger or financial reporting system), and how misstatements may occur."

Further, we suggest modifying the last sentence of paragraph 51 to read as follows:

“The auditor should understand how both standard, recurring entries and nonstandard, nonrecurring entries (including adjustments or reclassifications made solely to prepare the financial statements) are initiated and recorded, and the controls that have been placed in operation to ~~ensure~~ determine that such entries are authorized, complete, and correctly recorded.”

The appendix to this letter includes certain additional editorial comments for improving the exposure draft.

We would be pleased to discuss our comments with members of the Auditing Standards Board or its staff.

Sincerely,

Ernst + Young LLP

Attachment (see below)

Reference on Exposure Draft	Comment
Page 14, paragraph 28	<p>We suggest moving the phrase, “whether manual or automated” to follow directly after the first usage of “control” in the third sentence.</p> <p>The third sentence of the paragraph would then read: “Operating effectiveness, on the other hand, is concerned with how the control <u>(whether manual or automated)</u> was applied, the consistency with which a control (whether manual or automated) <u>it</u> was applied, and by whom it was applied.”</p>
Page 17, paragraph 40	<p>We suggest modifying the last sentence to explain that the use of IT can help to identify and manage risks by providing timely information for management to use as part of the company’s risk assessment process.</p> <p>The last sentence would read: “The use of IT may be an important element in an entity’s risk assessment process, including <u>providing timely information to facilitate</u> the identification and management of risks relevant to financial reporting such as those in certain financial instrument transactions.”</p>
Page 19, paragraph 51	<p>We suggest substituting “financial statements and reports” for “financial reports” in the third sentence of the paragraph.</p> <p>The third sentence of the paragraph would then read: “However, when IT is used to maintain the general ledger and produce financial <u>statements and reports</u>, such entries may exist only in electronic form and may be more difficult to identify through physical inspection of printed documents.”</p>

Reference on Exposure Draft	Comment
Page 22, paragraph 68	<p>We suggest the word “such” in the last sentence be moved as follows:</p> <p>“For example, the evidence, including related records, resulting from such functions performed by an entity’s IT systems <u>such</u> as executing credit checks or matching purchase orders with shipping documents may be maintained only in electronic format.”</p>
Page 28, paragraph 101	<p>We suggest that the following be added to the end of the last sentence: “Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries of entity personnel and inspection of documentation about the operation of such controls at other times <u>during the audit period.</u>”</p>

July 30, 2001

Ms. Jackie Walker
Audit and Attest Standards, File 4420
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Reference: Proposed Statements on Auditing Standards – Amendment to Statement on Auditing Standards No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as Amended By Statement On Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*

Dear Ms. Walker:

The Accounting Principles and Auditing Standards Committee of the California Society of Certified Public Accountants (the Committee) has discussed the above-referenced exposure draft and has a comment on it.

The Committee is the senior technical committee of our state society. The Committee is composed of 40 members, of whom 12% are from national CPA firms, 54% are from local or regional firms, 23% are sole practitioners in public practice, 8% are in industry, and 3% are in academia.

On balance, the Committee feels that the proposed statement is a significant improvement to Statement on Auditing Standards No. 55. The Committee has the following comments which they believe will enhance the document.

The last sentence of paragraphs 15 reads, "Controls relevant to the audit are those individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions." The Committee questions the meaning of "likely" in this context. We suggest that wording more familiar to the profession such

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as “can reasonably be expected” be used or that a definition of what “likely” means in this context be added.

The Committee felt that paragraphs 19 and 20 were excellent additions to the proposed standard. Along these lines, the Committee noted that initial implementation of SAS 55 was delayed pending issuance of the audit guide *Consideration of the Internal Control Structure in a Financial Statement Audit*. The Committee suggests that 1) wherever possible, sections of the audit guide be integrated into the proposed statement and 2) that the remaining sections be incorporated as an appendix.

The third sentence of paragraph 62 reads “For example, documentation of the understanding of internal control of a large complex IT system in which a large volume of transactions are electronically initiated, recorded, processed, and reported may include flow charts, questionnaires or decision tables.” Our comments with respect to this sentence are:

- Large does not always equate to complex. There are now readily available off the shelf programs for PC application that are capable of performing complex applications.
- Transactions can be complex in nature yet the volume may be less than large.
- The wording seems to discourage the use of narratives.

We suggest that this sentence and those following it be reworded to recognize that complex systems can be large or small, and the form of documentation be it flow charts, questionnaires, decision tables or narratives be a matter of auditors judgment.

It was the Committee’s opinion that paragraph 66 could be enhanced by addition of examples of where an auditor planning to do substantive testing would be unable to reduce detection risk to an acceptable level without performing tests of controls.

The first two sentences of paragraph 72 read, “The knowledge that an auditor gains from obtaining an understanding about internal control should be used to identify the types of potential misstatement that could occur in financial statement assertions, and to consider factors that affect the risk of material misstatement. In assessing control risk, the auditor should identify the controls that are likely to prevent or detect material misstatement in specific assertions.” The Committee was concerned that this wording raised the bar by requiring the auditors to spend more time than he might otherwise matching assertions to controls when he ultimately would end up doing substantive testing. It was the feeling of the Committee that the emphasis here should be on identification of the absence of controls related to assertions so as to design substantive test procedures to compensate for the weaknesses.

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Thank you for the opportunity to comment on the proposed Amendment. Please let us know if you have any questions or require additional information.

Very truly yours,

John M. Lacey, Chair
Accounting Principles and Auditing Standards Committee