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Comment letters on on the exposure draft, "Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control - Integrated Framework Report."

American Institute of Certified Public Accountants. Auditing Standards Board

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EXHIBIT V

**LISTING OF AND
COPIES OF THE
COMMENT LETTERS
RECEIVED ON THE
AMENDMENT TO
REFLECT THE
COSO REPORT**

**ASB MEETING
AUGUST 1-3**

COMMENT LETTERS 1 - 27

EXHIBIT V

July 13, 1995

File Ref. Nos. 1120
4289

To the Auditing Standards Board:

Here are the comment letters received to date on the exposure draft, "Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the *Internal Control -- Integrated Framework Report*."

Name/Affiliation	Location	Page
1. Jack Birkholz, CPA	Cupertino, CA	4
2. Edward O'Reilly New Hampshire Society of Certified Public Accountants	Bedford, NH	5
3. Abe Akresh American University	Washington, DC	8
4. Daniel G. Kyle, CPA, CFE Office of Legislative Auditor	Baton Rouge, LA	9
5. P. Daniel Hurley, Jr. Massachusetts Society of Certified Public Accountants, Inc.	Boston, MA	10
6. David B. Marion, Partner Smith Marion & Co.	Redlands, CA	11
7. Henry W. Farnum, Chairman Pennsylvania Institute of Certified Public Accountants	Philadelphia, PA	12
8. Thomas H. McTavish, CPA Auditor General Office of the Auditor General	Lansing, MI	14
9. Claude L. Vickers State Auditor State of Georgia	Atlanta, GA	17

Name/Affiliation	Location	Page
10. Auditing Standards and Procedures Committee New York Society of Certified Public Accountants	New York, NY	18
11. Charles L. Lester, CPA Auditor General State of Florida	Tallahassee, FL	20
12. Management Accounting Practices Committee Institute of Management Accountants	Montvale, NJ	24
13. Accounting Principles and Auditing Standards Committee Florida Institute of Certified Public Accountants	Miami, FL	25
14. Financial Management Standards Committee Association of Government Accountants	Alexandria, VA	26
15. William G. Bishop III, CIA President Institute of Internal Auditors	Altamonte Springs, FL	29
16. Curtis C. Verschoor DePaul University	Chicago, IL	31
17. Lucinda V. Upton Governmental Training Solutions	Lexington, KY	35
18. Accounting and Auditing Standards Committee Louisiana Society of CPA's	Shreveport, LA	36
19. Coopers & Lybrand L.L.P.	New York, NY	38
20. Deloitte & Touche LLP	Wilton, CT	40
21. Margaret Kelly, CPA State Auditor of Missouri	Jefferson City, Missouri	43
22. Ernst & Young, LLP	Cleveland, OH	63
23. KPMG Peat Marwick LLP	New York, NY	67

Name/Affiliation	Location	Page
24. Price Waterhouse LLP	New York, NY	76
25. Arthur Andersen LLP	Chicago, IL	78
26. Anthony J. Verdecchia President National State Auditors Association	Lexington, KY	85
27. Robert O. Dale, Chair PCPS Technical Issues Committee	New York, NY	88

If you have any questions, please call me at 212/596-6028.

Sincerely,



J. Eric Nicely
Practice Fellow
Auditing Standards Division

Attachments

Disk: Travel
File: SAS55com.lst

EXPOSURE DRAFT

FILE 4289

PROPOSED STATEMENT ON AUDITING STANDARDS AND STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

AMENDMENTS TO STATEMENTS ON AUDITING STANDARDS AND STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS TO INCORPORATE THE *INTERNAL CONTROL - INTEGRATED FRAMEWORK* REPORT

JACK L. BIRKHOLZ, CPA
CONSULTANT
GOVERNMENTAL AUDITING

Name and Affiliation:

RETIRED

Comments:

(408) 257-7721

21381 MILFORD DRIVE
CUPERTINO, CA 95014

At ¶25 is the statement that the auditor should obtain knowledge about whether policies or procedures have been placed in operation and that they are being used. However, this statement does not require the auditor to obtain knowledge about operating effectiveness.

I submit that only through obtaining knowledge of the operating effectiveness will the auditor gain any degree of reliance upon the controls. To have controls in place and in operation means little, indeed, if the controls are not effective in attaining their objective.

In apparent conflict to ¶25, in Appendix A at ¶19 we speak of the "effectiveness" of physical controls concerning inventory under certain circumstances.

Other than for the above comments, I am in agreement with the draft. This is a very clearly written document. You are to be complimented.

Instructions for Response Form

This form may be used for comments or suggestions relating to any aspect of the exposure draft that is of concern to you. For convenience, the most significant points have been identified in the summary that accompanies this exposure draft. Return this response form to the address indicated on the reverse side by the comment date.

Mr. Paul L. Drahnak, Chairman
Accounting & Auditing Committee
NH Society of CPAs
3 Executive Park Drive
Bedford NH 03110

March 20, 1995

Dear Mr. Drahnak,

Please find enclosed to following items regarding the proposed statement on Auditing Standards & Statement on Standards for Attestation Engagements, and Amendments to Statements on Auditing Standards & Statements on Standards for Attestation Engagements to incorporate the Internal Control -- Integrated Framework.

Having read this exposure draft, it is my understanding that Statement on Auditing Standards (SAS) #55, consideration of the internal control structure in financial statement audits will be replaced by the committee of sponsoring organizations' publication on internal control framework.

Changes from three elements to five components, along with the language of control procedures to control activities of internal control structure may refine the approach to reporting objectives.

DELETE ELEMENTS:

The accounting system

ADD COMPONENTS:

Risk Assessment
Communication & Information
Monitoring

Components are applicable to every entity, however, considerations are made in the context of the entities:

- * Size
- * Organization & ownership characteristics
- * Nature of business
- * Complexity
- * Methods of processing data
- * Legal & regulatory requirements

Although refined and accepted, there remains a test of judgement in the components applicability to the entity.

The exposure draft goes on to briefly describe each component as follows:

Control Environment - Foundation, sets tone.

Risk Assessment - Identify, analyze and manage risks that effect entity objectives.

Control Activities - Physical controls, management directives are carried out.

Information &
Communication - Accounting system, clear understanding of individuals roles.

Monitoring - Quality of internal control performance over time.

Understanding the internal control structure and the control environment, especially an understanding of management and board of directors attitude, awareness and actions concerning the control environment is a burden on professional judgement and experience. This is very much different than a questionnaire regarding segregation of duties.

APPENDIX A.

Involves a greater detail of explanation concerning the five components.

i.e. Risk Management - The usual cost\benefit relationship. Managements decision to accept risk because of cost should always be a reasonable concern. Monitoring - Performance over time. Experience with entity is an important factor with any internal control structure.

PROPOSED CHANGE TO SSAE #2

Reporting on an entities internal control structure over financial reporting.

Change components for elements (language).
Most items consistent with SAS #55 except for footnote changes.

PROPOSED CHANGE TO SAS #70 AND #60

Reports on the processing of transactions by service organization and communication of internal control structure and related matters noted in an audit.

Again, as with SSAE #2, language changes are meant to be consistent with the new internal control -- integrated framework report, published by the committee of sponsoring organizations.

COMMENT

The second standard of fieldwork states that 'A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed'.

Experience and judgement in the assessment of the internal control structure of the entity is the strength and risk that auditors assume as they evaluate whether or not the controls can be reasonably relied upon.

This exposure draft explains very well the responsibilities, policies and procedures necessary to meet the reporting objectives. My general comment is that a continuing acceptance and use of 'Internal Control -- Integrated Framework Report' will be a useful guidance to auditors.

Deadline for invitation to comment, June 30, 1995	No Comment
Date of document for public inspection August 1, 1995	No Comment
Effective date of audits of financial Statements for accounting periods beginning January 1, 1997	No Comment

I would like to thank-you for this opportunity to comment as a member of the Accounting and Auditing Committee. Should you have any questions regarding anything in this correspondence, please call me at 627-2255.

Very Truly Yours

Edward O'Reilly
Edward O'Reilly CPA

Date: April 17, 1995

Reply:

3

To: The SAS No. 55 Amendment Comment Letter

From: Eric Nicely

Subject: Comments of Abe Akresh, American University

Specific Comments

SAS No. 55

General -

Consider using the term *internal control* instead of *internal control structure*. Internal control would facilitate teaching.

SAS No. 60

F/N 3 on Pg. 26 -

Does not sound right. The footnote tries to define internal control structure when it really defines internal control.

Overall

Supports the issuance of the amendments.



LEGISLATIVE AUDITOR
STATE OF LOUISIANA
BATCH: FOUÛE, LOUISIANA 70804-9397

4

DANIEL G. KYLE, PH.D., CPA, CFE
LEGISLATIVE AUDITOR

1600 NORTH THIRD STREET
P.O. BOX 94397
TEL (504) 339-3800
FAX (504) 339-3870

April 19, 1995

Mr. J. Eric Nicely, Practice Fellow
Auditing Standards Division, File 4289
AICPA, 1211 Avenue of the Americas
New York, New York 10036-8775

Dear Mr. Nicely:

I have reviewed the division's exposure draft *Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control -- Integrated Framework Report*, dated February 23, 1995. I support the provisions of the exposure draft with the following suggestions.

We continually encounter working papers of auditors in which the auditor has failed to document his understanding of internal control structure or relate that understanding to the nature, timing, or extent of the audit tests applied as a part of the audit. We consider that documentation a very primary part of the audit. I urge the division to make it very clear within paragraphs (new) 24-28 that the auditor must document within the working papers the understanding and the relationship of the understanding to the tests applied as a part of a financial statement audit.

I appreciate the opportunity to comment on the exposure draft.

Sincerely,

Daniel G. Kyle, CPA, CFE
Legislative Auditor

DGK:GCA:db

xc: Mr. Kinney Poynter, CPA

coso

⑤

May 5, 1995

J. Eric Nicely, Practice Fellow
AICPA
Auditing Standards Division, File 4289
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Amendments to Statements on Auditing Standards and Statements on Standards
for Attestation Engagements to Incorporate the Internal Control - Integrated
Framework Report

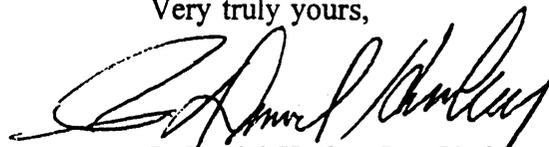
Dear Mr. Nicely:

The Accounting Principles and Auditing Procedures Committee is the senior technical committee of the Massachusetts Society of Certified Public Accountants. The committee consists of over thirty members who are affiliated with public accounting firms of various sizes from sole proprietor to international "big six" firms, as well as members in both industry and academia.

The Committee has reviewed and discussed the exposure draft of the proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagements noted above and is in substantial agreement with the general guidelines expressed in it, and has no further comments. This does not necessarily represent the positions taken by the organizations that employ the individual members of the Committee.

The Committee appreciates the opportunity to participate in your due process procedures and have our views considered.

Very truly yours,



P. Daniel Hurley Jr., Chairman
Accounting Principles and Auditing
Procedures Committee of the MSCPA



SMITH MARION & Co.
CERTIFIED PUBLIC ACCOUNTANTS

101 E. Redlands Blvd., Suite 298
Redlands, California 92373
Telephone (909) 793-0633
Facsimile (909) 792-3410

May 8, 1995

AICPA

J. Eric Nicely, Practice Fellow
Auditing Standards Division, File 4289
1211 Avenue of the Americas
New York, NY 10036-8775

**RE: EXPOSURE DRAFT - AMENDMENTS TO SAS AND SSAE to Incorporate the
Internal Control-Integrated Framework Report**

If *control* environment sets the tone of the organization, then a redundant use of the term *control* activities dilutes the importance of what constitutes the foundation of all other components.

I would like to suggest the term policies and procedures, which is a more universally understood term, be used in place of control activities. In the exposure draft, policies and procedures are used to define control activities.

At a minimum, however, the term *control* should be used only once and it seems appropriate to attach it to the organization's environment.

I am happy to see internal control being redefined to keep pace with the current environment.

Sincerely,

David B. Marion, Partner
Smith Marion & Co.
Certified Public Accountants

DBM:scf



PENNSYLVANIA INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
Peer Review Division

AICPA Peer Review Program
American Institute of Certified Public Accountants

1608 Walnut Street
Third Floor
Philadelphia, PA 19103-5457
(215) 735-2635
(800) 776-2721
(PA Only)
FAX (215) 735-3694

April 30, 1995

Administered in
Pennsylvania, Delaware and
U.S. Virgin Islands by the
Pennsylvania Institute of
Certified Public Accountants

J. Eric Nicely, Practice Fellow
Auditing Standards Division
American Institute of CPAs -
File Reference No. 4289
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Nicely:

The Pennsylvania Institute of CPAs ("PICPA") appreciates the opportunity to comment on the Exposure Draft ("ED") of Proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagement - Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control - Integrated Framework Report. This letter was prepared by the PICPA's Accounting and Auditing Procedures Committee ("the Committee") and represents, except where indicated, the consensus of the Committee, which is not necessarily the view of any individual member.

We commend the Board and the AICPA for its efforts to integrate the Internal Control - Integrated Framework Report into the auditing and attestation standards; however, we believe that additional implementation guidance should be made available prior to the date on which the amendments to the auditing and attestation standards become effective.

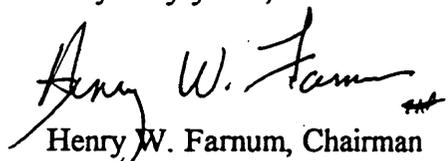
Implementation Guidance

The Committee strongly encourages the AICPA to modify the Audit Guide, "Consideration of the Internal Control Structure in a Financial Statement Audit", to provide practical guidance regarding how amended SAS No. 55 and the Internal Control - Integrated Framework might be applied by auditors in various situations, particularly to audits of financial statements of small and midsized entities. Further, the Committee believes the amendments to this Audit Guide should be issued in final form sufficiently in advance of the effective date of the amendments to SAS No. 55 to afford auditors ample time to consider the guidance when implementing the amendments to SAS No. 55.

J. Eric Nicely
April 30, 1995
Page 2

We appreciate your consideration of our comments. We are available to discuss any of these comments with the Committee or the technical staff of the AICPA at your convenience.

Very truly yours,

A handwritten signature in cursive script that reads "Henry W. Farnum". The signature is written in black ink and includes a small flourish at the end.

Henry W. Farnum, Chairman
Accounting and Auditing
Procedures Committee



OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 324-3130
FAX (517) 324-3079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

May 23, 1995

Mr. J. Eric Nicely
Practice Fellow, Auditing Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Mr. Nicely:

We have reviewed the Exposure Draft of the proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagements (File 4289), entitled Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the *Internal Control--Integrated Framework Report*, and agree in principle with the proposed guidance. We do, however, have the following three comments for consideration by the Auditing Standards Board (Board).

Effective Date

In reviewing the Exposure Draft, we noted that the four proposed changes contained different effective dates. The proposed change to Statement on Auditing Standards (SAS) No. 55 would be effective for audits for periods beginning on or after January 1, 1997, with earlier application permissible; the proposed change to Statement on Standards for Attestation Engagements (SSAE) No. 2 would be effective for an examination when management's assertion is as of December 15, 1996, with earlier application encouraged; and, the proposed changes to SAS Nos. 60 and 70 would be effective for audits for periods beginning after January 1, 1997, with no mention of earlier application. If the Board intends to issue an omnibus SAS and a separate SSAE, one common effective date would greatly simplify the implementation process for the reader. Also, because the Exposure Draft summary states that the Board itself "...believes the COSO report rapidly is becoming a widely accepted framework for sound internal control among U.S. organizations and its acceptance and use will continue to grow..." we see no reason to delay the effective date of the proposed changes to audits for periods beginning on or after January 1, 1997. Therefore, we strongly suggest that the Board provide an earlier common effective date (such as for audits for periods beginning on or after January 1, 1996 and for examinations when management's assertion is as of December 31, 1996) for all amendments in the final Statements and encourage even earlier application.

Management's Definition of Internal Control Structure

The proposed change to SSAE No. 2 would revise Paragraph 12 to read:

The components that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. For example, management may select the definition of an internal control structure based on the internal control framework set forth in *Internal Control--Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. *Internal Control--Integrated Framework* and SAS No. 55 describe an entity's internal control structure as consisting of five components--control environment, risk assessment, control activities, information and communication, and monitoring. If management selects another definition of an internal control structure, this list of components may not be relevant.

Because the Board has stated that it believes that the COSO report is rapidly becoming a widely accepted internal control framework and that its acceptance and use will continue to grow, we believe that SSAE No. 2 should, at least subtly, encourage the practitioner to recommend that management select the definition of an internal control structure based on the COSO report. At a minimum, we suggest that the Board revise and expand the last two sentence of Paragraph 12 into three sentences, such as "This report is becoming a widely accepted framework for sound internal control among U.S. organizations and its acceptance and use will continue to grow. *Internal Control--Integrated Framework* and SAS No. 55 describe an entity's internal control structure as consisting of five components--control environment, risk assessment, control activities, information and communication, and monitoring. However, if management chooses to select another definition of an internal control structure, this list of components may not be relevant."

Grammar and Terminology

In our review of the Exposure Draft, we noticed at least three grammatical errors or inconsistencies in terminology. First, the proposed change to Paragraph 2 of SAS No. 55 specifically deletes the word 'the' before the term 'control environment'; however, the proposed change to Paragraph 2 of SAS No. 60 does not. Second, the first sentence in the proposed change to Paragraph 4, Appendix A of SAS No. 55 begins "While every entity should embrace the control environment factors discussed in paragraphs 3 through 9,...." Control environment factors are only discussed in Paragraph 3 of Appendix A; risk assessment and control activities are discussed in

Mr. J. Eric Nicely

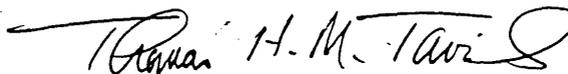
Page 3

May 23, 1995

Paragraphs 4 through 9. Third, unlike footnote references in other AICPA original pronouncements and the *Codification of Statements on Auditing Standards*, certain footnotes in the Exposure Draft are not numbered. Therefore, before the proposed Statements are issued in final form, we suggest that the AICPA Auditing Standards Division technical staff review the grammar and terminology used for correctness and consistency.

We appreciate the opportunity to comment on the 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,

A handwritten signature in cursive script, appearing to read "Thomas H. McTavish".

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

EXPOSURE DRAFT

FILE 4289

9

PROPOSED STATEMENT ON AUDITING STANDARDS AND
STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

AMENDMENTS TO STATEMENTS ON AUDITING STANDARDS AND STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS TO INCORPORATE THE *INTERNAL CONTROL -- INTEGRATED FRAMEWORK REPORT*

February 23, 1995

Comment Date: June 30, 1995

Name and Affiliation: **Claude L. Vickers, State Auditor, State of Georgia
Department of Audits and Accounts**

We acknowledge that the COSO report is becoming a widely accepted framework for sound internal control. It is our understanding that the GAO, in a letter dated May 4, 1994 from the U.S. Comptroller General, has endorsed the COSO report after certain addendums were made. Accordingly, since we are a governmental audit organization and the GAO has endorsed the COSO report, we believe SAS No. 55 should be amended to incorporate the concepts and terminology of the COSO report.

It will be necessary to train staff in amended sections concerning the Components of an Internal Control Structure and Consideration of the Internal Control Structure in Planning an Audit; however paragraphs 23 through 65 of SAS 55 do not change, much of which addresses assessing risk. Thus, for the most part, we do not anticipate audit related implementation problems.

While it appears that the COSO report is becoming widely adopted, management of the majority of our audit engagements has not planned to adopt the COSO report recommendations. This presents a problem for our audit organization because the COSO report clarifies management's responsibility of providing for an adequate internal control structure. Accordingly, in evaluating the control environment, we will have to consider management's attitudes toward providing for an adequate internal control structure, and report accordingly.

FRANCIS T. NUSSPICKEL, CPA
FRANK G. FUSARO, CPA
JEFFERY R. HOOPS, CPA
RICHARD MELNIKOFF, CPA
MARYANN M. WINTERS, CPA
JOSEPH L. CHARLES, CPA
ALAN E. WEINER, CPA
ROBERT L. GRAY, CPA

PRESIDENT-ELECT
VICE-PRESIDENT
VICE-PRESIDENT
VICE-PRESIDENT
VICE-PRESIDENT
SECRETARY
TREASURER
EXECUTIVE DIRECTOR



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nysscpa

10

June 1, 1995

Mr. J. Eric Nicely, Practice Fellow
Auditing Standards Division
File 4289
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Proposed Statement on Auditing Standards and
Statement on Standards for Attestation Engagements
-Amendments to Statements on Auditing Standards and
Statements on Standards for Attestation Engagements
to Incorporate the Internal Control-Integrated Framework Report

Dear Mr. Nicely:

We are enclosing the comments of the New York State Society of Certified Public Accountants in response to the above proposed statement. The comments were prepared by the Society's Auditing Standards and Procedures Committee.

If you have any questions regarding the comments, please call us and we will arrange for someone from on the committees to contact you.

Thank you for your consideration.

Very truly yours,

John J. O'Leary, CPA
Chairman, Auditing Standards &
Procedures Committee

Walter M. Primoff, CPA
Director, Professional Programs

Enclosures

cc: Accounting & Auditing Committee Chairmen

/srb

Mr. J. Eric Nicely
Page Two
June 1, 1995

**Response of Auditing Standards and Procedures Committee
On
Amendments to Statements on Auditing Standards and Statements on
Standards for Attestation Engagements to Incorporate the Internal Control-
Integrated Framework Report**

•The terminology in the document relates to manual record keeping and does not reflect the current state of computer generated records.

•The wording in sentences 3,4, and 5 of paragraph 21 should be deleted and replaced by the wording in paragraph 4 of Appendix A.

•Paragraph 29 should be expanded to provide guidance on the nature and scope of the auditor's procedures.

•The material under the third bullet of paragraph 9 of Appendix A should be modified to indicate that physical controls would identify inventory losses on a more timely basis than periodic physical inspection.

•Paragraph 10 of Appendix A states that certain types of control activities are not relevant because of highly effective controls applied by management. While the Committee agrees with this comment, it believes over reliance on controls applied by management is inappropriate and, in some circumstances, controls exercised solely by management may be a cause of concern for the auditor.

•Paragraph 15 of Appendix A states that small or midsized organizations may not need extensive accounting procedures, sophisticated accounting records, or formal control procedures such as a formal credit policy, information security policy, or competitive bidding processes. The Committee believes such wording may be misunderstood and result in erroneous conclusions. The Committee believes paragraph 15 should be revised to indicate that many small or midsized organizations have such controls in place and their internal control structure is clearly stronger as a result.

•Although not affected by the intended changes, the Committee believes footnote 2 on page 26 is confusing and should be rewritten.



STATE OF FLORIDA

OFFICE OF THE AUDITOR GENERAL



CHARLES L. LESTER, C.P.A.
AUDITOR GENERAL

June 20, 1995

TELEPHONE:
904/488-5534
S/C 278-5534

Mr. J. Eric Nicely, Practice Fellow
Auditing Standards Division, File 4289
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Nicely:

I am responding to the Exposure Draft of the Proposed Statement on Auditing Standards and Statement on Standards For Attestation Engagements, *Amendments to Statements on Auditing Standards and Statements on Standards For Attestation Engagements To Incorporate the Internal Control - Integrated Framework Report*, dated February 23, 1995 (ED).

Overall, I support the ED in its intent to incorporate the COSO Report. The inclusion of "entity's risk assessment" as a separate component of the entity's internal control structure is an important change and reinforces the issue that the time has come to require entities' management to document, evaluate, and report on their significant internal control structure objectives and components. However, as it stands now, this requirement would be auditor driven. Therefore, this requirement should be promulgated through normal channels that provide for due process on-behalf of the affected entities. Other parties, perhaps FASB and GASB, should address the importance of management's primary role in the internal control structure.

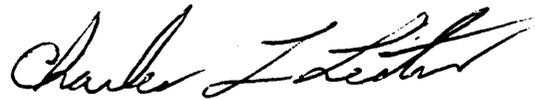
The ED, in paragraph 6, defines an entity's internal control to include the categories: (a) reliability of financial reporting, (b) compliance with applicable laws and regulations, and (c) effectiveness and efficiency of operations. However, the ED, in paragraphs 9 through 11, 13, 15, 17, 29, 31, and 32, appears to limit the auditors' responsibilities in a financial statement audit to only the category of reliability of financial reporting. If applicable, I suggest that the ED include additional explanations for the conditions that should require the auditor to include the other categories, especially

Mr. Nicely
June 20, 1995
Page 2

the compliance category, as part of a financial statement audit (i.e., audits performed under SAS No. 74, *Compliance Auditing Considerations In Audits Of Governmental Entities And Recipients of Governmental Financial Assistance*). Perhaps compliance with applicable laws and regulations should be identified as an additional management assertion.

I have included other comments relating to certain matters as shown on Attachment A. I appreciate the opportunity to respond to the ED.

Sincerely,



Charles L. Lester

CLL/sd

Attachment

ATTACHMENT - A
STATE OF FLORIDA
OFFICE OF THE AUDITOR GENERAL
COMMENTS ON THE ED FOR AMENDMENTS TO SAS
TO INCORPORATE THE *INTERNAL CONTROL - INTEGRATED FRAMEWORK* REPORT
FEBRUARY 23, 1995

1. SAS No. 55, Paragraph 15, should include additional information to further explain the differences between the entity's risk assessment and the auditor's risk assessment.
2. The documentation of management's risk assessment may be nonexistent or very limited. Some of the risk assessment factors are similar to GASB's Service Efforts and Accomplishments guidance (i.e., what are the objectives and how should they be measured or evaluated, etc.). Other factors in management's risk assessments involve the operating style and thoughts of mid and top management which is seldom documented. What is the degree of importance that the auditing community should emphasize regarding documentation of management's risk assessments? For example, would it be acceptable if management can adequately describe the undocumented system and there have been no identified significant failures?
3. SAS No. 55, Paragraph 12 and Appendix A, Paragraph 3, include two new control environment factors consisting of (1) Integrity and ethical values, and (2) Commitment to competence. Normally, auditors may not accept clients, or would resign from an engagement if there were concerns about the client's integrity. However, in some cases, the auditor may be engaged by someone other than the audited entity to perform an audit for which management's integrity may not be acceptable and the auditor will be required to document these factors in the audit working papers. I am concerned that such documentation will require the inclusion the auditor's personal opinions and judgements relevant to the individual personal character of relevant auditee staff. Although the auditor's working papers are usually confidential, there are situations whereas these working papers may be obtained and reviewed by other than the audit staff. Accordingly, the ED should provide specific guidance relating to how such sensitive and confidential information should be documented and assessed in the working papers, or perhaps it should not be included at all.
4. SAS No. 55, Paragraph 2, the last sentence should be revised as, "In all audits, the auditor should obtain a sufficient understanding of each of the internal control structure components to plan the audit by performing procedures to understand their design and the extent placed in operation relating to the internal control structure objectives and relevant to audit planning." The terminology, as presented in the ED, appears to limit the auditor's understanding to only the component of control activities.
5. SAS No. 55, Paragraph 7, the last sentence includes the term "specific aspect." The term is vague and another term (such as component factor, see paragraph 12), should be used to assist in providing a clearer understanding. Also, should each components' individualized parts be identified as "factors," in the ED the same as that used for the control environment component

ATTACHMENT - A
STATE OF FLORIDA
OFFICE OF THE AUDITOR GENERAL
COMMENTS ON THE ED FOR AMENDMENTS TO SAS
TO INCORPORATE THE *INTERNAL CONTROL - INTEGRATED FRAMEWORK* REPORT
FEBRUARY 23, 1995

in paragraph 12? For example, the categories described under control procedures in paragraph 11 of the existing SAS were useful during the course of an audit.

6. SAS No. 55, Paragraphs 14 and 17, should these paragraphs be made consistent in terminology as to identifying the parts or elements of financial reporting (identify, assemble, analyze, classify, record, process, summarize, and report)?.
7. SAS No. 55, Paragraph 17, to clarify the last sentence, delete the term "entity's activities" and add the term "entity's operations."
8. Throughout the ED, terms (such as internal control structure policies and procedures, policies and procedures, control procedures, internal controls, or controls) are inconsistently used when it appears that the term control activities should be used. The ED should be reviewed and changed, as appropriate, to ensure that appropriate terminology is consistently used.

INSTITUTE OF
**MANAGEMENT
ACCOUNTANTS**
CERTIFIED MANAGEMENT ACCOUNTANT PROGRAM

MANAGEMENT ACCOUNTING
PRACTICES COMMITTEE
1994-95 MEMBERS

June 21, 1995

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Staff -
Management Accounting Practices
Louis Bigay, CPA, Director

Mr. J. Eric Nicely
Practice Fellow
Auditing Standards Division
American Institute of Certified Public Accountants
New York, NY 10036-8775

SUBJECT: Response to AICPA Exposure Draft, "Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control-Integrated Framework Report" (File #: 4289)

Dear Mr. Nicely:

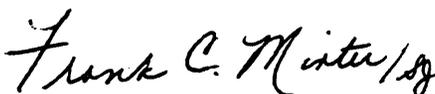
The Management Accounting Practices (MAP) Committee of the Institute of Management Accountants (IMA) appreciates the opportunity to comment on the above Exposure Draft.

As we understand the Exposure Draft, it would revise the definition and description of internal control by incorporating in audit and attestation standards the definition and description contained in "Internal Control-Integrated Framework" published by COSO. Accordingly, it updates the audit and attestation standards to provide guidance to auditors in their evaluation of internal controls in audit and attestation engagements.

We believe that the COSO internal control framework is becoming more widely recognized and will be used by companies in evaluating their internal controls. However, it is also our understanding that this auditing and attestation standard, when finalized, would not require companies to adopt the COSO internal control model. It merely establishes standards for auditors' evaluation of internal control.

Based on the understanding of the Exposure Draft as we explained above, we believe that incorporation of the COSO's definition and description of internal control into audit and attestation literature would be an important enhancement.

Sincerely,



Frank C. Minter, Chairman
Management Accounting Practices Committee

EXPOSURE DRAFT

FILE 4289

PROPOSED STATEMENT ON AUDITING STANDARDS AND STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

AMENDMENTS TO STATEMENTS ON AUDITING STANDARDS AND STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS TO INCORPORATE THE *INTERNAL CONTROL - INTEGRATED FRAMEWORK REPORT*

February 23, 1995

Comment Date: June 30, 1995

Name and Affiliation: Accounting Principles and Auditing Standards Committee
Comments: of the Florida Institute of Certified Public Accountants

The Committee has reviewed and discussed the exposure draft of the proposed Amendments to Statements On Auditing Standards And Statements On Standards For Attestation Engagements To Incorporate The Internal Control - Integrated Framework Report. The Committee endorses the exposure draft in its entirety and commends the Auditing Standards Board for the amendments, particularly as they address internal control issues in small and mid-sized entities.

Instructions for Response Form

This form may be used for comments or suggestions relating to any aspect of the exposure draft that is of concern to you. For convenience, the most significant points have been identified in the summary that accompanies this exposure draft. Return this response form to the address indicated on the reverse side by the comment date.

ASSOCIATION of GOVERNMENT ACCOUNTANTS

June 26, 1995

Mr. J. Eric Nicely
Practice Fellow, Auditing Standards Division—File 4289
American Institute of Certified Public Accountants (AICPA)
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Nicely:

On behalf of the Financial Management Standards Committee, we appreciate the opportunity to comment on the *Proposed Statement on Auditing Standards (SAS) and Statement on Standards for Attestation Engagements—Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control—Integrated Framework Report* exposure draft. We submit the following comments and recommendations for consideration by the Auditing Standards Board (Board).

Effective Dates

In reviewing the exposure draft, we noted that the four proposed changes contained different effective dates. The proposed change to Statement on Auditing Standards (SAS) No. 55 would be effective for audits periods beginning on or after January 1, 1997, with earlier application permissible; that for Statement on Standards for Attestation Engagements (SSAE) No. 2 would be effective for an examination when management's assertion is as of December 15, 1996, with earlier application encouraged; and that for SAS Nos. 60 and 70 would be effective for audits for periods beginning after January 1, 1997, with no mention of earlier application. If the Board intends to issue an omnibus SAS and a separate SSAE, a common effective date would greatly simplify the implementation process for the auditor or practitioner.

Components of an Internal Control Structure

Paragraph 20 states, "Monitoring is a process that assesses the quality of the internal control structure's performance over time. It involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis . . ." The phrase on a "suitably timely basis" needs to be defined more quantitatively. This same comment applies to paragraph 16 under **Monitoring**.

Management's Definition of Internal Control Structure

The proposed change to SSAE No. 2 would revise paragraph 12 to read:

The components that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. For example, management may select the definition of an internal control structure based on the internal control framework set forth in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. *Internal Control—Integrated Framework* and SAS No. 55 describe an entity's internal control structure as consisting of five components—control environment, risk assessment, control activities, information and communication, and monitoring. If management selects another definition of an internal control structure, this list of components may not be relevant.

Because the Board has stated that it believes the COSO report is rapidly becoming a widely accepted internal control framework and its acceptance and use will continue to grow, we believe SSAE No. 2 should, at least subtly, encourage the practitioner to recommend that management select the definition of an internal control structure based on the COSO report. At a minimum, we suggest the Board revise and expand the last two sentences of paragraph 12 into three sentences stating,

This report is becoming a widely accepted framework for sound internal control among US organizations and its acceptance and use will continue to grow. *Internal Control—Integrated Framework* and SAS No. 55 describe an entity's internal control structure as consisting of five components—control environment, risk assessment, control activities, information and communication, and monitoring. However, if management selects another definition of an internal control structure, this list of components may not be relevant.

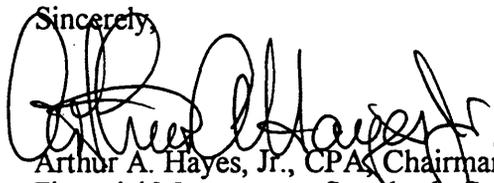
Grammar and Terminology

In our review of the exposure draft, we noticed several grammatical errors or inconsistencies in terminology.

- The proposed change to paragraph 2 of SAS No. 55 deletes “the” before “control environment”; however, the proposed change to paragraph 2 of SAS No. 60 does not.
- The first sentence in the proposed change to paragraph 4, appendix A, of SAS No. 55 begins, “While every entity should embrace the control environment factors discussed in paragraphs 3 through 9, . . .” Control environment factors are only discussed in paragraph 3 of appendix A; risk assessment and control activities are discussed in paragraphs 4 through 9.
- Unlike footnote references in other AICPA original pronouncements and the *Codification of Statements on Auditing Standards*, certain footnotes in the exposure draft are not numbered. To ensure that the final statements are correct and consistent with other pronouncements and standards, the AICPA Auditing Standards Division’s technical staff should review the grammar and terminology of the statements.
- The third sentence in the proposed change to paragraph 2 of SAS No. 60 states, “Specifically, these are matters coming to the auditor’s attention that, in his judgment, should be communicated to the audit committee . . .” To keep with the precedence set in the revisions to SAS No. 55, “his” should be changed to “his or her.”

We do not think the glossary of terms (appendix B) and the flowchart (appendix C) should have been removed from the proposed exposure draft. They provided a framework for quick reference and easier comprehension of the auditor’s and/or practitioner’s responsibility for obtaining an understanding of the internal control structure. We strongly recommend that these appendices be revised as applicable and retained in the final statement or included in the revised audit guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, and referenced there.

We appreciate the opportunity to comment on the exposure draft. If you have any questions, please contact me or Dianne Mitchell of my staff.

Sincerely,

Arthur A. Hayes, Jr., CPA, Chairman
Financial Management Standards Committee

AAH/dkm/fwe



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June 28, 1995

J. Eric Nicely
Practice Fellow
Auditing Standards Division - File 4289 and File 2121
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Nicely:

The Institute of Internal Auditors (IIA) submits the following comments regarding the AICPA Auditing Standards Board's (ASB) Exposure Drafts (EDs) on the "*Amendments to Statements on Auditing Standards (SAS) and Statements on Standards for Attestation Engagements (SSAE) to Incorporate the Internal Control-Integrated Framework Report*" and "*Omnibus Statement on Auditing Standards and Statement on Standards for Attestation Engagements-1995*".

The IIA recognizes that the AICPA ASB members did not include the broader definition of the internal control structure described in the Committee of Sponsoring Organizations (COSO) *Internal Control-Integrated Framework Report* because the primary focus of the EDs was on reliability of financial statement auditing procedures and reporting. However, The IIA believes that the definition of internal control should include references to the safeguarding of assets which is contained in the COSO Report Addendum to "Reporting to External Parties". In that regard, The IIA makes the following recommendations to further improve the guidance on performing audits consistent with the framework contained in the COSO Report:

SAS No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit.

Add to Paragraph 6, Page 10: "... and (d) safeguarding of assets."

Add to Appendix A: Monitoring, a footnote at the end of Paragraph 18, Page 21, which states: "SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*", provides guidance about factors that affect the auditor's consideration of the work of internal auditors in an audit."

SSAE No. 2, Reporting on an Entity's Internal Control Structure Over Financial Reporting.

Add Back to Footnote 3 to Paragraph 1, Page 22: "... (for example, controls over safeguarding of assets or...regulations) should...financial reporting."

Mr. J. Eric Nicely
June 28, 1995
Page Two

SAS No. 70, Reports on the Processing of Transactions by Service Organizations.

Add to Paragraph 26, Page 24, and Paragraph 42, Page 25 at the end of the control environment sentence: "Control environment may include...and responsibility, including safeguarding of assets."

SAS No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit.

Add to Paragraph 4, Page 26: "However, the auditor may ...of the internal control structure, including the safeguarding of assets."

Thank you for this opportunity to respond.

Regards,


William G. Bishop III, CIA



June 28, 1995

Curtis C. Verschoor
Ledger and Quill Alumni
Research Professor
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Mr. Eric J. Nicely, Practice Fellow
Auditing Standards Division
AICPA
1211 Avenue of Americas
New York, NY 10036-8775

By fax 212 596-6213

Dear Eric:

I have the following comments in addition to the minor corrections I gave you in person.

In general, the ED is deficient on a macro level for several reasons:

1. **SAS No. 55 should be reviewed in its entirety and revised substantively.** In the more than 7 years since SAS No. 55 was issued, there are strong indications within both the CPA profession and academia, that SAS 55 has not achieved its goal of requiring practitioners to utilize a substantially increased level of understanding of a broader spectrum of internal controls. The subject matter of this pronouncement is critically important to the successful completion of each and every audit engagement. The original issuance of SAS No. 55 was clouded by the greatest expression of dissent in ASB history. Therefore, its content should not be reissued unchanged without being challenged and thus be reaffirmed, without full consideration of possible improvements that would make it more effective. To fail to communicate lessons to all auditors that have been learned over 7 years of use is unwise and not in the public interest.

It is interesting to note that as early as 1992, Kinney and Felix presented research conclusions that implementation of SAS No. 55 had had mixed success at best. They also state that the variance in auditing practice has been increased by the issuance of SAS No. 55, a very worrisome phenomenon. There appears to be considerable support for the view that the contents of SAS No. 55 need a full analysis and complete evaluation - a good overhaul. Commencement of that chore should not be postponed any further.

2. **The Electronics Project should be integrated into this revision.** A current project on the ASB agenda involves the impact of recent developments in electronic data processing on internal control. This issue should be dealt with promptly and included in this revision of SAS No.55. The ASB should avoid "compartmentalized thinking" that avoids any consideration of issues that are relevant to the topic at hand but "not within the stated mission of the task force". In general, the ASB would be able

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to better achieve its mission by adopting a concept of broadening rather than narrowing its definition of task force mandates.

3. The objective of the revision has not been achieved. The proposed minor language changes contained in the ED do not "incorporate the COSO report to provide timely and useful information" as stated in the SUMMARY of the ED. The thrust of the COSO report is to broadly define the internal control structure of an organization as a permeating process having a broad rather than a narrowly focused application.

Footnote 3 of the proposed change to SAS No. 60 correctly states that the internal control structure "refers to the policies and procedures (actually the COSO term is 'activities') established to provide assurance that specific entity objectives will be achieved." Yet the SAS No. 55 ED narrowly concerns itself with only the reliability of financial reporting controls. It ignores mention of any controls relating to the effectiveness and efficiency of operations including the safeguarding of assets and compliance with applicable laws and regulations which are emphasized in the COSO report and should be incorporated into auditing literature in the new SAS No. 55.

4. The narrow focus adopted is inconsistent with auditing pronouncements of international bodies. International counterparts of the AICPA have encouraged use of a broader concept of internal control. The CICA's "Guidance on Criteria of Control" sets out a broad understanding of control systems that "are not limited to procedures aimed at ensuring the reliability of financial information and the safeguarding of the organization's assets: they include all aspects and processes within the organization that enable it to have reasonable assurance of achieving any given objective, whether it relates to financial reporting, compliance with the law, or the efficiency and effectiveness of operations." The ICAEW encourages but does not require directors to "extend the scope of their statement on internal control to cover their responsibility for the wider aspects of internal control rather than just internal financial control." As you know, Cadbury requires a public director statement on the effectiveness of internal control, not just internal financial control.

The following comments deal with more specific points:

1. Para 6 of Proposed New SAS No. 55: Although this is the definition of internal control in COSO, the ED curiously avoids describing it as such. This should be one of the most important aspects of COSO that should be included in the ED.

2. Para 9 of Proposed New SAS No. 55: Misleadingly implies that the COSO internal control objectives relating to compliance with laws and regulations and also economical and efficient operations, including the safeguarding of assets, are not relevant to an audit of financial statements. This cannot be true. Auditors need to understand their client's existing controls over the safeguarding of assets in order to plan the audit of such assets. They need to understand their client's existing controls over the risks of failure to comply with laws and regulations in order to plan their examination of contingent liabilities.

3. **Para 18 of Appendix A to Proposed New SAS No. 55** should be revised to "communicate information about **strengths and weaknesses**". Internal auditing is an appraisal function within the organization that examines and evaluates activities, giving reasonable assurance to senior management and the board as to whether the risk of failure to achieve the objectives set by the organization is being held within tolerable limits. The description of internal auditing contained in SAS No. 55 should conform to the language contained in the professional standards issued by the Institute of Internal Auditors. (*See Exhibit I*)

4. **Para 12 of Proposed New SSAE No. 2** in the second sentence incorrectly states that management may "select the definition of an internal control structure." The context dictates that the phrase be "selects a **description of the components of an internal control structure.**" The same comment applies to the last sentence.

5. **Para 2 of Proposed New SAS No. 60** defines reportable conditions in the internal control structure very narrowly (although not using the terminology of COSO) in spite of the fact that footnote 3 to this document defines internal controls broadly. It is inconceivable that an auditor should have no responsibility to advise audit committees that they have become aware of internal control deficiencies relating to the COSO objectives of compliance with applicable laws and regulations and of uneconomical or inefficient operations, including inadequate safeguarding of assets. The fact that conflicting statements describing additional auditor responsibilities are contained elsewhere in another SAS (although not referred to here) is not an acceptable solution. All major auditor considerations relating to the internal control structure should be set forth in one place.

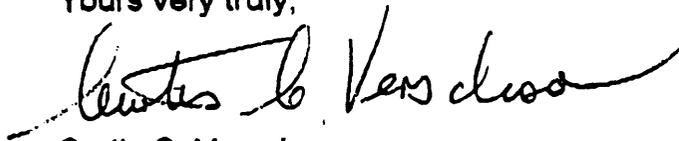
As previously mentioned in person, I suggest:

- using "components", a COSO term, instead of "policies and procedures" in paras 9 and 10
- adding "effective" before internal control structure in para 19, first sentence;
- substituting "when information is received from" instead of "by relations with" in para 20, last sentence;

In summary, I view the Exposure Draft as unacceptably flawed in its present form, and recommend it be substantially revised.

Thank you for considering these comments.

Yours very truly,



Curtis C. Verschoor
Ledger & Quill Alumni Research Professor

Introduction

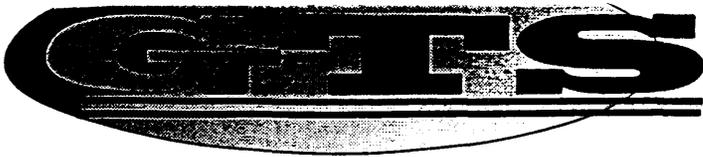
Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost.

The members of the organization assisted by internal auditing include those in management and the board. Internal auditors owe a responsibility to both, providing them with information about the adequacy and effectiveness of the organization's system of internal control and the quality of performance. The information furnished to each may differ in format and detail, depending upon the requirements and requests of management and the board.

The internal auditing department is an integral part of the organization and functions under the policies established by senior management and the board. The statement of purpose, authority, and responsibility (charter) for the internal auditing department, approved by senior management and accepted by the board, should be consistent with these *Standards for the Professional Practice of Internal Auditing*.

The charter should make clear the purposes of the internal auditing department, specify the unrestricted scope of its work, and declare that auditors are to have no authority or responsibility for the activities they audit.

Throughout the world internal auditing is performed in diverse environments and within organizations which vary in purpose, size, and structure. In addition, the laws and customs within various countries differ from one another. These differences may affect the practice of internal auditing in each



Governmental
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June 28, 1995

American Institute of Certified Public Accountants
J. Eric Nicely, Practice Fellow
Auditing Standards Division, File 4289
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Mr. Nicely:

We appreciate this opportunity to comment on the exposure draft of *Proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagements: Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control-Integrated Framework Report*.

We support this amendment to incorporate the COSO report into the professional standards. It is our hope that the COSO report will be adapted to provide a framework for organizations (particularly government organizations and other organizations that receive government funds) to use when reporting to external parties on their internal controls over financial reporting, safeguarding of assets, and compliance with laws and regulations. We believe that such reporting is appropriate and necessary. The same criteria that organizational management uses to establish internal controls and to provide assertions on them can then be used by the auditor to evaluate and report on those controls.

While the COSO report is being incorporated into the authoritative literature, we would like to offer the suggestion that the description of internal control as a "structure" be dropped. The term "structure" implies a permanent, solid thing. COSO more appropriately defines internal control as a "process." Process signifies action, and action is necessary to establish effective control. Internal control is, in reality, a fluid, changing series of activities in response to constantly changing events and circumstances. An entity has an organizational structure that remains the same regardless of who is occupying certain positions. An entity has an internal control process that becomes more or less effective depending on who is occupying certain positions.

Other than this suggestion, we support the proposed changes to SASs and SSAEs. Please call me at (606) 226-9682 if you have any questions.

Sincerely,

Lucinda V. Upton

2431 Highway 1016
431 South Broadway

P.O. Box 547
Suite 321

Berea, Kentucky 40403
Lexington, Kentucky 40508

Phone/Fax (606) 986-7987
Phone/Fax (606) 226-9682

(10)

EXPOSURE DRAFT

AMENDMENTS TO STATEMENTS ON AUDITING STANDARDS AND
STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS
TO INCORPORATE THE INTERNAL CONTROL - INTEGRATED
FRAMEWORK REPORT

DATED: FEBRUARY 23, 1995

COMMENT DATE: JUNE 30, 1995

NO: 800081

RESPONSE PREPARED BY:

ACCOUNTING AND AUDITING STANDARDS COMMITTEE

LA SOCIETY OF CPAS

JON FLAIR, CHAIRMAN

KEITH BESSON, MEMBER

MARY SANDERS, MEMBER

ALBERT ROEVENS, JR., MEMBER

RAYMOND PRINCE, MEMBER

JOHN CAMERON, MEMBER

RESPONSE SUBMITTED BY:

JON FLAIR, CHAIRMAN

COMMENTS

THERE WAS GENERAL AGREEMENT AMONG A MAJORITY OF THE RESPONDENTS THAT THE PROPOSALS IN THE EXPOSURE DRAFT ARE NECESSARY, IN VIEW OF THE WIDE ACCEPTANCE OF THE COSO REPORT. THERE WAS PARTICULAR AGREEMENT WITH PARAGRAPH 9, THAT NOT ALL INTERNAL CONTROL OBJECTIVES AND POLICIES ARE IMPORTANT TO THE CONTENT OF THE FINANCIAL STATEMENTS, WITH PARAGRAPH 21, ADDRESSING SMALL AND MIDSIZED ENTITIES, AND WITH THE GUIDANCE

CONTAINED IN APPENDIX A.

SPECIFIC CONCERNS WERE NOTED IN THE FOLLOWING AREAS:

ONE MEMBER FELT THAT THE NEW DEFINITION OF THE INTERNAL CONTROL STRUCTURE AND ITS FIVE COMPONENTS ARE MORE AMBIGUOUS THAN THE DEFINITION AND ELEMENTS CURRENTLY USED IN PROFESSIONAL STANDARDS.

PARAGRAPH 12 - THE FACTORS DEALING WITH MANAGEMENT'S PHILOSOPHY AND OPERATING STYLE, AND A COMMITMENT BY MANAGEMENT TO COMPETENCE, APPEAR VERY ABSTRACT. CONSEQUENTLY, THE AUDITOR'S ABILITY TO DOCUMENT AND ASSESS THESE AREAS MAY BE VERY LIMITED.

PARAGRAPH 15 - THE TERM "RISK ASSESSMENT" AS A COMPONENT OF THE INTERNAL CONTROL STRUCTURE IS CONFUSING, COMPARED TO THE AUDITOR'S ASSESSMENT OF AUDIT RISK IN A FINANCIAL STATEMENT AUDIT. A NEW AND DISTINCT TERM FOR THIS INTERNAL CONTROL STRUCTURE COMPONENT MAY BE DESIRABLE.



Coopers & Lybrand L.L.P.
a professional services firm

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New York, NY 10020-1157

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facsimile (212) 536-3500
(212) 536-3035

June 28, 1995

Mr. J. Eric Nicely
Practice Fellow, Auditing Standards Division
File 4289
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Nicely:

We are pleased to submit this letter in support of the issuance of the proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagements, Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the *Internal Control -- Integrated Framework Report*.

Within the context of overall support for the amendments, we have the following suggestions for improvement in the Statements:

Proposed Change to SAS No. 55

The intention of SAS No. 55 is to describe those aspects of the internal control structure that may be applicable to a financial statement audit. It is not the intention of SAS No. 55 to describe those attributes of the internal control structure that make it effective. The control risk assessment process contained in SAS No. 55 leads the auditor to identify those aspects of the internal control structure that enable the auditor to reduce the assessed level of control risk. In most instances, the proposed amendment strikes the right tone in describing, in a neutral fashion, aspects of the internal control structure. However, there are certain examples in which an evaluative tone has been taken, and we suggest that these be changed.

For example, the fourth sentence of paragraph 21 contains a specific point that relates to the effectiveness of the control environment in small and mid-sized entities. We suggest the sentence be revised to read, "Similarly, smaller entities might not have independent or outside members on their boards of directors." Also, we suggest that the second sentence of paragraph 21 be revised to read, "For example, smaller entities with *active* management involvement may not *have* extensive accounting procedures, ..."; this same change should be made in paragraph 15 of Appendix A. Along the same lines, we suggest modifying the second sentence of paragraph 3 of Appendix A to read, "Factors that affect the *assessment* of ...", and deleting the last sentence of paragraph 4 of Appendix A.

In addition, the reference in paragraph 4 of Appendix A to SAS No. 55 to "paragraphs 3 through 9" should be changed to "paragraph 3."

Coopers & Lybrand L.L.P., a registered limited liability partnership, is a member firm of Coopers & Lybrand (International).

Proposed Change to SSAE No. 2

The example of a definition of a internal control structure in the second sentence of paragraph 12 has been changed from the one described in SAS No. 55 to the internal control framework set forth in the COSO report, which is an appropriate change. However, the third sentence has a reference to SAS No. 55 which is unnecessary and possibly confusing. Footnote # to the second sentence provides the necessary connection to SAS No. 55. We suggest deleting the reference to SAS No. 55 in the third sentence of paragraph 12.

* * * * *

Please contact James S. Gerson at (212) 536-2243 if you have any questions.

Very truly yours,

Coopers & Lybrand L.L.P.



July 3, 1995

J. Eric Nicely
Practice Fellow
Auditing Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Nicely:

Re: File No. 4289

We are pleased to comment on the Proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagements, *Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the "Internal Control - Integrated Framework" Report* (the "proposed amendments"). We support the issuance of the proposed amendments; however, we do offer the following recommendations and other comments for consideration.

PROPOSED CHANGES TO SAS NO. 55

Paragraph 12

As most of the bullets to paragraph 12 list factors with characteristics, we recommend that the third bullet be revised to read, "Board of directors or audit committee **participation.**"

Paragraph 20

We believe that the last sentence of paragraph 20 is not completely accurate: "Monitoring activities also occur by relations with external parties such as customer complaints about charges and regulators commenting about the entity's internal control structure." A customer may make a complaint about charges and get their account corrected without any follow-up by the company; accordingly, no monitoring activity has occurred. As discussed in *Internal Control - Integrated Framework* (the "COSO report"), customer complaints and communications from regulators provide sources of information that may indicate problems or highlight areas in need of improvement; and therefor, can result in the performance of monitoring activities.

Paragraph 33 (AU 319.23)

As this paragraph is not included in the exposure draft, it is unclear whether the first sentence of the paragraph will be revised consistent with paragraph 25 in the exposure draft (i.e., “knowledge of the design of the relevant **internal control structure policies; and procedures; and records** pertaining to . . .”).

Paragraphs 68-69 (AU 319.58-.59)

The last two sentences of AU 319.58 and the first sentence of AU 319.59, which talk about evaluating the *effectiveness* of the control environment, appear to require further revision to incorporate the concepts of the internal control structure components as defined in the COSO report and as incorporated in the proposed amendments. The COSO report describes the control environment as providing “an atmosphere in which people conduct their activities and carry out their control responsibilities” and that “an evaluator should consider each control environment factor in determining whether a *positive* control environment exists” (emphasis added). The “tone at the top” may be to achieve the company’s targeted results “no matter what it takes” and to assign few control responsibilities; if everyone follows the tone and performs the minimal assigned control functions, the control environment may be evaluated as effective but with negative results. Accordingly, the auditor should be directed towards modifying tests based on the absence of a positive control environment.

PROPOSED CHANGE TO SSAE NO. 2

Paragraph 12

We recommend that the last sentence read as follows: “If management selects another definition of an internal control structure, **these five components** may not be relevant.”

Paragraph 22

We believe that this paragraph should be revised to incorporate only the relevant internal control structure policies and procedures; for example, in reporting on an entity’s internal control structure over financial reporting, the practitioner would not necessarily consider certain operational controls to be relevant. Accordingly, we recommend that paragraph 22 be revised to read as follows:

To evaluate the design of an entity’s internal control structure, the practitioner should obtain an understanding of the **relevant** internal control structure policies and procedures within each component of the internal control structure.

July 3, 1995
J. Eric Nicely
Page 3

PROPOSED CHANGE TO SAS NO. 70

Paragraph 7

We recommend that the second sentence of paragraph 7 be revised, to be consistent with the proposed changes to AU 319, as follows:

This understanding would include knowledge about the design of relevant *internal control structure* policies, and procedures, ~~and records~~ and whether they have been placed in operation by the entity.

* * * * *

Please contact John A. Fogarty [(203) 761-3227] if you have any questions or if there is any other way in which we might be helpful.

Sincerely,

Deloitte & Touche LLP

21

STATE AUDITOR OF MISSOURI
JEFFERSON CITY, MISSOURI 65102

MARGARET KELLY, CPA
STATE AUDITOR

July 3, 1995

(314) 751-4824

Mr. J. Eric Nicely
Practice Fellow
American Institute of Certified
Public Accountants
Auditing Standards Division, File 4289
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Nicely:

Enclosed are our comments on the proposed Statement titled *Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control--Integrated Framework Report*.

If you have any questions regarding our comments, please contact Myrana Gibler, Audit Manager, of my office at (314)751-4213.

Sincerely,


Margaret Kelly, CPA
State Auditor

Enclosures

**COMMENTS - AMENDMENTS TO STATEMENTS ON
AUDITING STANDARDS AND STATEMENTS ON STANDARDS FOR
ATTESTATION ENGAGEMENTS TO INCORPORATE THE
INTERNAL CONTROL—INTEGRATED FRAMEWORK REPORT**

The Office of Missouri State Auditor appreciates the opportunity to comment on the proposed Statement.

Proposed Changes to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*

General Comments

On page 9 the explanation for the changes states, "The Auditing Standards Board (ASB) believes the COSO report is rapidly becoming a widely accepted framework for sound internal control among U.S. organizations and its acceptance and use will continue to grow. Therefore, the ASB believes it is appropriate to revise SAS No. 55 to incorporate the COSO report to provide timely and useful guidance to auditors." However, as a state audit organization, we do not support the proposed changes to SAS No. 55.

Among the entities that we audit (state and certain local governments), the COSO report is not widely known or accepted as a sound framework for internal control; we doubt whether most of these entities have even heard of the report. Many government officials that we deal with, particularly those of small, local governments, have little or no understanding of internal control concepts. Therefore, the number of parts in the internal control structure and the names assigned to them are meaningless to such officials.

For us as auditors, the proposed changes to SAS No. 55 seem to be a potentially costly matter of form over substance. The basic definition of internal control and the process for considering the internal control structure in a financial statement audit will not change. However, replacing the SAS No. 55 elements of the control structure with the COSO report components will require us to make time-consuming and costly changes to our office audit manuals and training packages. Considering the pervasiveness of internal control discussions throughout AICPA literature and other published guidance, these types of changes would appear to be costly for the profession as a whole.

We also do not expect the SAS No. 55 changes to result in our auditors having an improved understanding of the internal control structure or its consideration in an audit. Instead, the terminology changes within the control structure will likely be confusing, at least in the short-term, especially since there seems to be some overlap among the control environment factors or control structure components discussed in

appendix A. For example, under paragraph 3 on the control environment (pages 17 and 18):

1. Integrity and ethical values are discussed as a separate factor; however, the bullets for assignment of authority and responsibility and human resources policies and practices include related references (“policies relating to appropriate business practices” in the former bullet and “evidence of integrity and ethical behavior” in the latter bullet).
2. Commitment to competence is discussed as a separate factor; however, the bullets for assignment of authority and responsibility and human resources policies and practices mention related concepts (e.g., “knowledge and experience of key personnel” in the former bullet and “commitment to competent and trustworthy people” in the latter bullet).
3. The bullet for assignment of authority and responsibility states that this factor “includes policies and communications directed at ensuring that all personnel understand the entity’s objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.” This information seems similar to paragraph 13’s discussion of communication under the information and communication component (page 21).

Specific Comments

page 12, paragraph 16, second sentence - Because the construction “to address risks to achieve the entity’s objectives” may be unclear, we suggest the sentence be revised to state, “They help ensure that risks are addressed through appropriate actions and, consequently, the entity’s objectives are achieved.”

page 13, paragraph 21, last sentence - Because the object of the pronoun “which” may be unclear, we suggest the sentence be revised to state, “Conversely, when small or midsized entities are involved in complex transactions or are subject to legal and regulatory requirements also found in larger entities, a more formal means of ensuring that internal control objectives are achieved may be required.”

page 16 - The note after paragraph 32 indicates that paragraphs 23 through 65 of SAS No. 55, which will become paragraphs 33 through 75 in the revised Statement, are unchanged except for conforming changes. However, during our review of the proposed changes to SSAE No. 2, *Reporting on an Entity’s Internal Control Structure Over Financial Reporting*, we noted that the reference to testing the design effectiveness of control structure policies and procedures was deleted from paragraph 16 (page 23). Since current AU Section 319.34 discusses tests of design effectiveness, we suggest the AICPA consider whether that paragraph needs to be changed to reflect the change to SSAE No. 2.

page 17 - The note at the top of the page indicates that current appendices A through D of SAS No. 55 will be deleted. Since the revised Statement will continue to be a rather long, complex document, we suggest that appendix D, the flowchart of the auditor's consideration of the internal control structure, be updated and retained.

page 17, paragraph 3 - Management's Philosophy and Operating Style

1. We suggest the word "conscientiousness" in the fifth line be elaborated on (similar to the phrases preceding and following it). For example, if the word is intended to refer to management's emphasis on care and precision in financial reporting, that idea should be clearly stated.
2. The phrase "accounting functions" in the last line could be deleted since paragraphs 11 and 12 (page 20) indicate those functions are part of information processing.

page 18, paragraph 4, last sentence - Because the object of the pronoun "This" may be unclear, we suggest the sentence be revised to state, "In addition, although smaller entities might have no independent or outside members on their boards of directors, their control environments may not be adversely affected."

page 19, paragraph 6 - New or Revamped Information Systems - We suggest the word "ineffective" be deleted in the second line, since significant or rapid changes in information systems could change the risk in an effective internal control structure also.

page 19, paragraph 8 - Because the construction "to address risks to achieve the entity's objectives" may be unclear, we suggest the sentence be revised to state, "Control activities are the policies and procedures that help ensure that risks are addressed through appropriate actions and, consequently, the entity's objectives are achieved."

page 19, paragraph 9 - Information Processing - We suggest the last sentence be restructured. Although we believe "completeness and accuracy" was intended to modify only "transaction processing," the phrase could be interpreted to modify "authorization" and "validity" also. One possible revision is "These controls help ensure that transactions are valid, properly authorized, and completely and accurately processed."

Other Comments

We suggest the AICPA review the proposed Statement to determine whether it can be made less repetitive--for example:

1. The components of the internal control structure are defined three times--in paragraph 7 (page 10), in paragraphs 12 through 20 (pages 11 through 13), and in appendix A (pages 17 through 21). As a minimum, we believe the definitions

in paragraph 7 could be eliminated without significant impact on the reader (similar to current AU Section 319.08, which identifies but does not define the three elements of the internal control structure since the definitions appear later in the section).

2. The second sentence of paragraph 15 could be deleted since paragraph 13 states the purpose of the entity's risk assessment (page 12).
3. Paragraph 21 (page 13) could be limited to the first sentence and a reference to appendix A; we see no need to repeat examples between paragraph 21 and the appendix.
4. In paragraph 3 of appendix A (page 17), the first two sentences regarding integrity and ethical values state similar ideas; we believe either sentence would be sufficient alone.

In addition, we have noted a number of suggested editorial revisions on the enclosed draft to improve the consistency, conciseness, or accuracy of the document.

SUMMARY

2. An entity's internal control structure, ~~for purposes of this Statement,~~ consists of ~~three elements~~ **five components**: the control environment, *risk assessment*, ~~the accounting system,~~ control ~~activities~~ *procedures*, *information and communication*, and *monitoring*. In all audits, the auditor should obtain a sufficient understanding of each of the ~~three elements~~ **five components** to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

ELEMENTS COMPONENTS OF AN INTERNAL CONTROL STRUCTURE

6. *Internal control*[†] is a process — effected by an entity's board of directors, management, and other personnel — designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) compliance with applicable laws and regulations, and (c) effectiveness and efficiency of operations.

~~8. 7.~~ For ~~purposes of an audit of financial statements,~~ An entity's internal control structure consists of the ~~three~~ following ~~elements~~ **five components**:

- ~~The~~ Control environment — *The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of the internal control structure, providing discipline and structure.*
- *Risk assessment* — *Risk assessment is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.*
- ~~The accounting system~~
- Control ~~procedures~~ *activities* — *Control activities are the policies and procedures that help ensure management directives are carried out.*
- *Information and communication* — *Information and communication are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.*
- *Monitoring* — *Monitoring is a process that assesses the quality of the internal control structure's performance over time.*

Dividing the internal control structure into these ~~three elements~~ **five components** facilitates discussion of its nature and how the auditor considers it in an audit. The auditor's primary consideration, however, is whether an *specific aspect of the* internal control structure ~~policy or procedure~~ affects financial statement assertions rather than its classification into any particular category *component*.

8. *The five components of the internal control structure* ^{Shortened} ~~are applicable~~ ^{apply} to every entity, but the way the components are applied should be considered in the context of —

[†] In the remainder of this Statement, internal control is referred to as internal control structure.

- *The entity's size*
- *The entity's organization and ownership characteristics*
- *The nature of the entity's business*
- *The diversity and complexity of the entity's operations*
- *The entity's methods of processing data*
- *Applicable legal and regulatory requirements*

[Replace paragraph 6 with the following.]

9. *Although an entity's internal control structure addresses objectives in each of the categories referred to in paragraph 6, not all of these objectives and related internal control structure policies and procedures are relevant to an audit of the entity's financial statements. Generally, the internal control structure policies and procedures that are relevant to an audit pertain to the entity's objective of preparing financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.³ Other objectives and policies and procedures, however, may be relevant if they pertain to data the auditor uses to apply auditing procedures. For example, internal control structure policies and procedures pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production statistics, may be relevant in an audit.*

This word is not used in paragraph 6 regarding the objectives of external control.

~~7-~~ 10. An entity generally has internal control structure policies and procedures that are not relevant to an audit and therefore need not be considered. For example, policies and procedures concerning the effectiveness, economy, and efficiency of certain management decision-making processes, such as the appropriate price to charge for its products, or whether to make expenditures for certain research and development or advertising activities, although important to the entity, do not ordinarily relate to a financial statement audit.

11. *Paragraphs 12 through 20 provide an overview of the five internal control structure components as they relate to a financial statement audit. A more detailed discussion of these components is provided in appendix A.*

[Replace paragraphs 9 through 13 with the following.]

Control Environment

12. *The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of the internal control structure, providing discipline and structure. Control environment factors include:*

- *Integrity and ethical values*
- *Commitment to competence*

³ *The term comprehensive basis of accounting other than generally accepted accounting principles is defined in SAS No. 62, Special Reports (AICPA, Professional Standards, vol. 1, AU sec. 623.04). Hereafter, reference to generally accepted accounting principles in this Statement includes, where applicable, an other comprehensive basis of accounting.*

- *Board of directors or audit committee*
- *Management's philosophy and operating style*
- *Organizational structure*
- *Assignment of authority and responsibility*
- *Human resource policies and practices*

Risk Assessment

13. Risk assessment for financial reporting purposes is an entity's identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles.

14. An entity's risk assessment process should consider external and internal events and circumstances that may occur and adversely affect its ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.⁵

Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment*
- *New personnel*
- *New or revamped information systems*
- *Rapid growth*
- *New technology*
- *New lines, products, or activities*
- *Corporate restructurings*
- *Foreign operations*

15. An entity's risk assessment differs from the auditor's assessment of audit risk in a financial statement audit. The purpose of an entity's risk assessment is to identify, analyze, and manage risks that affect entity objectives. In a financial statement audit, the auditor assesses inherent and control risk to evaluate the likelihood that material misstatements exist in the financial statements.

Control Activities

16. Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels. Generally, control activities that may be relevant to an audit may be categorized as internal controls that pertain to –

- *Performance reviews*
- *Information processing*

policies and procedures
Consider using this phrase for consistency.

⁵ *These assertions are discussed in SAS No. 31, Evidential Matter (AICPA, Professional Standards, vol. 1, AU sec. 326).*

- Physical controls
- Segregation of duties

Information and Communication

17. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to identify, assemble, analyze, classify, record, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets and liabilities. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities.

18. Communication involves providing a clear understanding of individual roles and responsibilities pertaining to the internal control structure over financial reporting.

Monitoring

Compound subject "Establishing and maintaining" requires a plural verb.
are

19. Establishing and maintaining an internal control structure is an important management responsibility. To provide reasonable assurance that an entity's objectives will be achieved, the internal control structure should be monitored by management to consider whether it is operating as intended and that it is modified as appropriate for changes in conditions.

20. Monitoring is a process that assesses the quality of the internal control structure's performance over time. It involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis and taking necessary actions. Monitoring can be done through ongoing activities or separate evaluations. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. Monitoring activities also occur by relations with external parties such as customer complaints about charges and regulators commenting about the entity's internal control structure.

"Assessment" and "taking" are not parallel grammatical structures.

Application to Small and Midsized Entities

Consider inserting a word such as "corrective" or "follow-up" here.

21. Small and midsized entities may use less formal means to ensure that internal control objectives are achieved. For example, smaller entities with effective management involvement may not need extensive accounting procedures, sophisticated accounting records, or formal control procedures, such as a formal credit policy, information security policy, or competitive bidding processes. Smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Similarly, smaller entities might not need an independent or outside member on their boards of directors to have an effective control environment. Conversely, small or midsized entities may be involved in complex transactions or may be subject to legal and regulatory requirements also found in larger entities, which might require more formal means to ensure that internal control objectives are achieved.

LIMITATIONS OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

22. An internal control structure should be designed and operated to provide reasonable assurance that an entity's objectives are achieved. The concept of reasonable assurance recognizes that the cost of an entity's internal control structure 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 an internal control structure, the precise measurement of costs and

for consistency, policies and procedures

benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.

~~45-~~ 23. The potential effectiveness of an entity's internal control structure is subject to inherent limitations. Mistakes in the application of **internal control structure** policies and procedures may arise from such causes as misunderstanding of instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, the ~~policies and procedures~~ **control activities** that require segregation of duties can be circumvented by collusion among persons both within and outside the entity and by management override of certain policies and procedures.

CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN PLANNING AN AUDIT

~~46-~~ 24. The auditor should obtain a sufficient understanding of each of the ~~three elements~~ **five components** of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant **internal control structure** policies **and** procedures ~~and records~~ and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to –

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

Consider adding this phrase for consistency
it was applied

~~47-~~ 25. Whether an internal control structure policy or procedure has been *placed in operation* is different from its *operating effectiveness*. In obtaining knowledge about whether policies *or* procedures ~~or records~~ have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy *or* procedure ~~or record~~ was applied, the consistency with which it was applied, and by whom. *For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on.* This Statement does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

~~48-~~ 26. The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentations in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding the Internal Control Structure

~~49-~~ 27. In making a judgment about the understanding of the internal control structure 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 substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his *or her* assessment of inherent risk, his judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including whether the method of controlling **data information** processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As an entity's operations and

systems become more complex and sophisticated, it may be necessary to devote more attention to internal control structure **components** elements to obtain the understanding of them that is necessary to design effective substantive tests. ~~For example, when auditing past due loans of a financial institution that uses computer produced reports of such loans, the auditor may be unable to design appropriate substantive tests without knowledge of the specific control procedures concerning the completeness and classification of loans.~~

Understanding of Control Environment

~~20- 28.~~ The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but not act on them. ~~For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.~~

Understanding of Risk Assessment

29. The auditor should obtain sufficient knowledge of the entity's risk assessment process to understand how management **considers** risks relevant to financial reporting objectives, estimates their significance, assesses the likelihood of their occurrence, and decides about actions to address those risks.

Consider using this word for consistency with paragraphs 7 and 13.

identifies

Understanding of Control Activities Procedures

~~22- 30.~~ Because some control procedures are integrated in specific components of the control environment and accounting system, As the auditor obtains an understanding of the **other four components** (control environment and accounting system, risk assessment, information and communication, and monitoring), he or she is also likely to obtain knowledge about some control **activities procedures**. For example, in obtaining an understanding of the documents, records, and processing steps in the **accounting financial reporting information** system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control **activities procedures** obtained from the understanding of the ~~control environment and accounting system~~ **other four internal control structure components** in determining whether it is necessary to devote additional attention to obtaining an understanding of the control **activities procedures** to plan the audit. Ordinarily, audit planning does not require an understanding of the control **activities procedures** related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to **them** those components.

Understanding of Accounting System Information and Communication

~~24- 31.~~ The auditor should obtain sufficient knowledge of the ~~accounting system~~ **information system relevant to financial reporting** to understand —

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.

[Note: Appendixes A, B, C, and D of SAS No. 55 will be deleted by this amendment and replaced with the following appendix.]

APPENDIX A: INTERNAL CONTROL STRUCTURE COMPONENTS

1. This appendix discusses the five internal control structure components set forth in paragraph 7 and briefly described in paragraphs 12 through 20 as they relate to a financial statement audit.

CONTROL ENVIRONMENT

2. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of the internal control structure, providing discipline and structure.

3. The control environment encompasses the following factors:

- **Integrity and Ethical Values** – The effectiveness of internal control structure policies and procedures cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of other internal control structure components. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioral standards to personnel through policy statements and codes of conduct and by example.
- **Commitment to Competence** – Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- **Board of Directors or Audit Committee** – An entity's control consciousness is influenced significantly by the entity's board of directors and audit committee. Factors that affect the effectiveness of the board or audit committee include its independence from management, experience and stature of its members, extent of its involvement and scrutiny of activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors.
- **Management's Philosophy and Operating Style** – Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting (conservative or aggressive selection from available alternative accounting principles, conscientiousness, and conservatism with which accounting estimates are developed); and management's attitudes toward information processing, accounting functions, and personnel.
- **Organizational Structure** – An entity's organizational structure provides the framework within which its activities for achieving entitywide objectives are planned, executed, controlled, and monitored. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. An entity

This word is used in fourth line of this bullet design

Use a comma before the last item in a series for consistency.

Heading and first line of paragraph 3 on page 17.

develops an organizational structure suited to its needs. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

- **Assignment of Authority and Responsibility** – This control environment factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable. *Insert comma before last item in series.*
- **Human Resource Policies and Practices** – Human resource policies and practices relate to hiring, orientation, training, evaluating, counseling, promoting, compensating and remedial actions. For example, standards for hiring the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Application to Small and Midsized Entities

4. While every entity should embrace the control environment factors discussed in paragraphs 3 through 9, small and midsized entities may implement the control environment factors differently than larger entities. For example, smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. In addition, smaller entities might not have independent or outside members on their boards of directors. This, however, may not affect the entity's control environment adversely.

Reference appears incorrect; only paragraph 3 applies.

RISK ASSESSMENT

5. Risk assessment for financial reporting purposes is an entity's identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles.

6. An entity's risk assessment process should consider external and internal events and circumstances that may occur and adversely affect its ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- **Changes in Operating Environment** – Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- **New Personnel** – New personnel may have a different focus on or understanding of the internal control structure.

- **New or Revamped Information Systems** – Significant and rapid changes in information systems can change the risk of an ineffective internal control structure.
- **Rapid Growth** – Significant and rapid expansion of operations can strain the internal control structure and increase the risk of a breakdown in controls.
- **New Technology** – Incorporating new technologies into production processes or information systems may change the risk associated with the internal control structure.
- **New Lines, Products, or Activities** – Entering into business areas or transactions with which an entity has little experience may render the internal control structure ineffective and in need of modification.
- **Corporate Restructurings** – Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with the internal control structure.
- **Foreign Operations** – The expansion or acquisition of foreign operations carries new and often unique risks that may alter the effectiveness of the internal control structure.

Application to Small and Midsized Entities

7. The basic concepts of the risk assessment process should be present in every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small and midsized entities than in larger ones. All entities should have established financial reporting objectives, but they may be recognized implicitly rather than explicitly in smaller entities. Management can learn about risks related to these objectives through direct personal involvement with employees and outside parties.

CONTROL ACTIVITIES

8. Control activities are the policies and procedures that help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels.

9. Generally, control activities that may be relevant to an audit may be categorized as internal controls that pertain to internal controls policies and procedures. X

- **Performance Reviews** – These control activities include reviews of actual performance versus budgets, forecasts, and prior periods, relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; and review of functional or activity performance, such as a bank's consumer loan manager's review of reports by branch, region, and loan type for loan approvals and collections. X

- **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 operations, system software acquisition and maintenance, access security, and application system development and maintenance. These controls apply to mainframe, minicomputer, and end-user environments. Application controls apply to the processing of individual applications. These controls help to ensure the completeness and accuracy of transaction processing, authorization, and validity. X

since it seems to modify "records" or "assets and records" when it is intended to modify "safeguards"

- **Physical Controls** – These activities encompass the physical security of assets, including adequate safeguards over access to assets and records (such as secured facilities, authorization for access to computer programs and data files; and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on the circumstances. Normally, these controls would not be relevant because any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit because those controls would need to be effective to ensure reliable financial reporting.
- **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 in the normal course of his or her duties.

Application to Small and Midsized Entities

10. The concepts underlying control activities in small or midsized organizations are likely to be similar to those in larger entities, but the formality with which they operate varies. Further, smaller entities may find that certain types of control activities are not relevant because of highly effective controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities. An appropriate segregation of duties often appears to present difficulties in smaller organizations. Even companies that have only a few employees, however, may be able to assign their responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

INFORMATION AND COMMUNICATION

11. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to identify, assemble, analyze, classify, record, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets and liabilities. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities.

12. An effective information system ^{Shortened} gives appropriate consideration ^s to establishing methods and records that will –

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

13. Communication involves providing a clear understanding of individual roles and responsibilities pertaining to the internal control structure over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels are essential to ensure that exceptions are reported and acted on.

14. 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.

Application to Small and Midsized Entities

Was this word intended to be "activities"?

15. Information systems in small or midsized organizations are likely to be less formal than in larger organizations, but their role is just as significant. Smaller entities with effective management involvement may not need extensive accounting procedures, sophisticated accounting records, or formal control procedures, such as a formal credit policy, information security policy, or competitive bidding processes. Effective communication may be less formal and easier to achieve in a small or midsized company than in a larger-enterprise due to the smaller organization's size and (its) fewer levels as well as (its) greater visibility and availability of management.

management's

Shortened

MONITORING

16. Monitoring is a process that assesses the quality of the internal control structure's performance over time. It involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis and taking necessary actions. Monitoring can be done through ongoing activities or separate evaluations.

"Assessment" and "taking" are not parallel grammatical structures.

Consider inserting a word such as "corrective" or "follow-up" here.

17. Ongoing monitoring procedures are built into the normal recurring activities of an entity and include regular management and supervisory activities. Managers of sales, purchasing, and production at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations.

18. In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities. They regularly provide information about the functioning of the internal control structure, focusing considerable attention on evaluating the design and operation of internal controls. They communicate information about weaknesses and recommendations for improving the internal control structure.

structure policies and procedures

Shortened

19. Some monitoring activities are established and exercised by parties outside an entity that affect an entity's operations and practices. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators also may communicate with the entity concerning matters that affect the functioning of the internal control structure, for example, communications concerning examinations by bank regulatory agencies.

unnecessary

Application to Small and Midsized Entities

external

20. Ongoing monitoring activities of small and midsized entities are more likely to be informal and are typically a by-product of the overall management of the entity's operations. Management's close involvement in operations often will bring to light significant variances from expectations and inaccuracies in financial data.

disclose word choice

for consistency. Policies and procedures

PROPOSED CHANGE TO SSAE NO. 2, REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

(Amends Statement on Standards for Attestation Engagements
No. 2, AICPA, *Professional Standards*, vol. 1, AT sec.
400.01, .12 through .16, .20, .26, and .27)

[Explanation]

This amendment conforms the description of elements of an entity's internal control structure to the components of an internal control structure contained in amended SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and in *Internal Control – Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). New language is shown in boldface italics. References hereinafter to SAS No. 55 refer to the proposed amendment to SAS No. 55, pages 9 to 21 of this exposure draft. In addition, conforming changes will be made to substitute the word *components* for *elements*. The amendment is effective for an examination of management's assertion when the assertion is as of December 15, 1996, or thereafter. Early application is encouraged.

[Text of Proposed Change]

The word "permissible" is used on page 9 in the explanation.

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

³A practitioner engaged to provide assurances on management's assertion about the effectiveness of an entity's internal control structure other than over financial reporting (for example, ~~controls over safeguarding of assets other than those described in paragraph 27c, or other operating controls or controls over compliance with laws and regulations~~) should refer to the guidance in SSAE No. 1 (AICPA, *Professional Standards*, vol. 1, AT sec. 100, "Attestation Standards"). In addition, the guidance in this Statement may be helpful in attestation engagements to report on management's assertion about internal controls over other than financial reporting.

[Paragraph 12 would be amended as follows.]

ELEMENTS COMPONENTS OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

12. The *components* ~~elements~~ that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. For example, management may select the definition of an internal control structure ~~contained in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). Paragraphs 13 through 16 describe the elements that constitute~~

PROPOSED CHANGE TO SAS NO. 70, REPORTS ON THE PROCESSING OF TRANSACTIONS BY SERVICE ORGANIZATIONS

(Amends Statement on Auditing Standards
No. 70, AICPA, *Professional Standards*, vol. 1,
AU sec. 324.07, .26, and .42)

[Explanation]

This amendment is proposed to reflect the changes proposed in the amendment to SAS No. 55. See pages 9 to 21 of this exposure draft. New language is shown in boldface italics. The amendment is effective for audits of financial statements for periods beginning after January 1, 1997.

internal control structure
[Text of Proposed Change]

7. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), states that an auditor should obtain a sufficient understanding of each of the ***five components*** ~~three elements~~ of the entity's internal control structure to plan the audit. This understanding should include knowledge about the design of relevant policies, procedures, ~~and records~~ and whether they have been placed in operation by the entity. In planning the audit, ~~such~~ knowledge should be used to —

- Identify types of potential misstatements. *and changed second sentence to agree with corresponding sentence of paragraph 24 on page 14.*
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

26. After obtaining a description of the relevant policies and procedures, the service auditor should determine whether the description provides sufficient information for user auditors to obtain an understanding of those aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure. The description should contain a discussion of the features of the service organization's policies and procedures that would have an effect on a user organization's internal control structure. Such features are relevant when they directly affect the service provided to the user organization. ***They may include features, activities, or policies or procedures generally considered to be part of the control environment, risk assessment, control activities, information and communication, and monitoring.*** ***Control environment may include hiring practices and key areas of authority and responsibility. Risk assessment may include the identification of risks associated with processing specific transactions. Control activities may include policies and procedures over the modification of computer programs and are ordinarily designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of policies and procedures. Information and communication may include ways in which user transactions are initiated and processed. Monitoring may include the involvement of internal auditors.*** They may include features generally considered to be part of the control environment, specific activities that may represent a user organization's accounting system or a portion thereof, or specific policies and procedures designed to control such functions. ~~Control environment elements may include hiring practices and the involvement of internal auditors. Accounting system elements would include the~~

The "Control environment" is usually preceded by "the"

~~ways in which user transactions are initiated and processed. Control structure policies and procedures employed by a service organization, such as policies and procedures over the modification of computer programs, ordinarily are designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of policies and procedures.~~

ose (Changed to agree with third line of paragraph 26 on page 24.)

42. After obtaining a description of the relevant policies and procedures, the service auditor should determine whether the description provides sufficient information for user auditors to obtain an understanding of the aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure. The description should contain a discussion of the features of the service organization's policies and procedures that would have an effect on a user organization's internal control structure. Such features are relevant when they directly affect the service provided to the user organization. *They may include features, activities, or policies or procedures generally considered to be part of the control environment, risk assessment, control activities, information and communication, and monitoring. Control environment may include hiring practices and key areas of authority and responsibility. Risk assessment may include the identification of risks associated with processing specific transactions. Control activities may include policies and procedures over the modification of computer programs and are ordinarily designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of policies and procedures. Information and communication may include ways in which user transactions are initiated and processed. Monitoring may include the involvement of internal auditors.* They may include features generally considered to be part of the control environment, specific activities that may represent a user organization's accounting system or portion thereof, or specific policies and procedures designed to control such functions. Control environment elements may include hiring practices and the involvement of internal auditors. Accounting system elements would include the ways in which user transactions are initiated and processed. Control structure policies and procedures employed by a service organization, such as policies and procedures over the modification of computer programs, ordinarily are designed to meet specific control objectives. The specific control objectives of the service organization should be set forth in the service organization's description of policies and procedures.

The X
See note on page 24-

**PROPOSED CHANGE TO SAS NO. 60,
COMMUNICATION OF INTERNAL CONTROL
STRUCTURE RELATED MATTERS NOTED IN AN AUDIT**

(Amends Statement on Auditing Standards
No. 60, AICPA, *Professional Standards*, vol. 1,
AU sec. 325.02 and .04)

[Explanation]

This amendment is proposed to reflect the changes proposed in the amendment to SAS No. 55. See pages 9 to 21 of this exposure draft. New language is shown in boldface italics. The amendment is effective for audits of financial statements for periods beginning after January 1, 1997.

[Text of Proposed Change]

2. During the course of an audit, the auditor may become aware of matters relating to the internal control structure that may be of interest to the audit committee. The matters that this Statement requires for reporting to the audit committee are referred to as *reportable conditions*. Specifically, these are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.² Such deficiencies may involve aspects of the internal control structure *components elements* of (a) the control environment, (b) *risk assessment the accounting system*, or (c) control *activities procedures*, (d) *information and communication*, and (e) *monitoring*. (See the Appendix for examples of reportable conditions.)

4. The auditor's objective in an audit of financial statements is to form an opinion on the entity's financial statements taken as a whole. The auditor is not obligated to search for reportable conditions. However, the auditor may become aware of possible reportable conditions through consideration of the *components elements* of the internal control structure,³ application of audit procedures to balances and transactions, or otherwise during the course of the audit. The auditor's awareness of reportable conditions varies with each audit and is influenced by the nature and extent of audit procedures and numerous other factors, such as an entity's size, its complexity, and the nature and diversity of its business activities.

These profound changes were made in SAS No. 55 but not be feasible for SAS No. 60 if only the two paragraphs above will be replaced.
or her

² The auditor should also consider matters coming to his attention that relate to interim financial reporting outside the entity in the communication contemplated by this Statement.

³ The *internal control structure* refers to the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. (See Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, for additional key definitions.)

(22)

July 5, 1995

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**Amendments to Statements on Auditing Standards
and Statements on Standards for Attestation Engagements
to Incorporate the *Internal Control—Integrated Framework* Report**

Dear Mr. Nicely:

Ernst & Young supports the efforts of the Auditing Standards Board to amend various sections of the Statements on Auditing Standards and Statement on Standards for Attestation Engagements No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, as contained in the exposure draft Proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagements, *Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the "Internal Control—Integrated Framework" Report*. We believe that generally the exposure draft effectively incorporates into the *AICPA Professional Standards* the definition and description of "internal control structure" that are contained in the report *Internal Control—Integrated Framework*, published by The Committee of Sponsoring Organizations of the Treadway Commission (COSO). However, we have the following comments that should be reflected in the final document.

- Paragraph 20 and Appendix A paragraphs 16–19. The COSO report recognizes and states that parties external to an entity, such as regulators, the independent auditors, customers, and others transacting business with the entity, are not part of the entity's internal control structure but do assist management in fulfilling its responsibility to monitor internal control. We endorse the COSO report's remarks relating to the assistance external parties provide, and believe that the exposure draft's discussions of the internal control component of *Monitoring* should be expanded to incorporate the concept that external auditors through their performance of audit and extended audit services, such as when an entity engages them to assist with the performance of internal audit activities or to extend their audit services when the entity does not maintain an internal audit function, assist management in its monitoring activities, as long as the external auditors do not assume management's operational or decision-making responsibilities. Accordingly, we recommend that paragraph 20 be revised to read as follows:

"Monitoring is a process that assesses the quality of the internal control structure's performance over time. It involves assessment by appropriate personnel of the design and operation of controls on a suitably timely basis, and taking necessary actions. The process is accomplished through ongoing activities, separate evaluations, or a combination of the

63

two. In many entities, internal auditors, or personnel performing similar functions, perform internal control evaluations as part of their regular duties or upon special requests of the board of directors, senior management, or subsidiary or divisional executives. Similarly, management may use the work of external auditors in considering the effectiveness of the internal control structure. For example, independent auditors assist management in fulfilling its responsibility to monitor internal control through their performance of audit and extended audit services, such as when an entity engages them to assist with the performance of internal audit activities or to extend their audit services when the entity does not maintain an internal audit function, as long as the independent auditors do not assume management's operational or decision-making responsibilities. In addition to external auditors, other external parties frequently provide important information on the functioning of an entity's internal control structure. These include customers, vendors, and others doing business with the entity, and regulators. Reports from external sources (e.g., customer complaints and satisfaction surveys, regulatory reports) should be considered for their internal control implications, and when appropriate, corrective actions should be taken."

We believe this recommendation is consistent with the analyses of the AICPA Ethics Committee and the Public Oversight Board staff regarding the performance by external auditors of extended audit services.

Conforming changes should be made to paragraphs 16 to 19 of Appendix A as follows:

Appendix A

Paragraph 16. Change the last sentence to read:

"The process is accomplished through ongoing activities, separate evaluations, or a combination of the two."

Paragraph 18. Change the first sentence to read:

"In many entities, internal auditors or personnel performing similar functions perform internal control evaluations as part of their regular duties or upon special requests of the board of directors, senior management, or subsidiary or divisional executives."

Add to the end of paragraph 18:

"Similarly, management may use the work of external auditors in considering the effectiveness of the internal control structure. For example, independent auditors assist management in fulfilling its responsibility to monitor internal control through their performance of audit and extended audit services, such as when an entity engages them to assist with the performance of internal audit activities or to extend

their audit services when the entity does not maintain an internal audit function, as long as the independent auditors do not assume management's operational or decision-making responsibilities."

Paragraph 19. Replace the first two sentences with the following:

"In addition to external auditors, other external parties frequently provide important information on the functioning of an entity's internal control structure. These include customers, vendors, and others doing business with the entity, and regulators. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges and provide other relevant information in response to customer satisfaction surveys."

Add to the end of paragraph 19:

"Reports from external sources should be considered for their internal control implications, and when appropriate, corrective actions should be taken."

The appendix to this letter includes certain additional comments.

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

Sincerely,

Ernst & Young LLP

Specific comments on the proposed statement are indicated below.

<u>Reference</u>	<u>Proposed Change to SAS No. 55. Consideration of the Internal Control Structure in a Financial Statement Audit</u>
Paragraphs 13 and 15 and Appendix A - paragraph 5	<p>We believe paragraph 15, which specifically addresses the difference between an entity's risk assessment for financial reporting purposes and the auditor's assessment of risk in a financial statement audit, is unnecessary, may lead to confusion when contemplating the other four components of an entity's internal control structure, and should be deleted. Concerns regarding the possible misinterpretation of the <i>Risk Assessment</i> component of the internal control structure may be addressed by the following revision to paragraph 13, including the addition of a footnote that would cross reference it to AU Section 312, <i>Audit Risk and Materiality in Conducting an Audit</i>. A conforming change to Appendix A - paragraph 5 (without the addition of the footnote) should be made.</p> <p>13. An entity's risk assessment for financial reporting purposes is its an <i>entity's</i> identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles^x.</p> <p>^x AU Section 312, <i>Audit Risk and Materiality in Conducting an Audit</i>, provides guidance regarding the auditor's assessment of risk in a financial statement audit.</p>
Appendix A - paragraph 4	<p>The language in the first sentence of this paragraph is misleading. Because all the <i>Control Environment</i> factors discussed in the exposure draft are not necessarily relevant to all entities (e.g., <i>Board of Directors or Audit Committee</i>), it is not appropriate to say that, "<u>every entity should embrace</u> the control environment factors discussed in paragraphs 3 through 9," (emphasis added). We believe that the sentence should be amended as follows:</p> <p>4. While every entity should embrace the control environment factors discussed in paragraphs 3 through 9, Small and midsized entities may implement the control environment factors differently than larger entities.</p>
<u>Reference</u>	<u>Proposed Change to SAS No. 70. Reports on the Processing of Transactions by Service Organizations</u>
Explanation	<p>Since SAS No. 70, <i>Reports on the Processing of Transactions by Service Organizations</i>, deals with service auditors' reports as contrasted with financial statement audits, and therefore originally was effective for service auditors' reports dated after a specified date, we believe that the amendment similarly should be effective for "service auditors' reports dated after January 1, 1997," rather than for "audits of financial statements for periods beginning after January 1, 1997."</p>

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July 7, 1995

Mr. J. Eric Nicely
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Dear Mr. Nicely:

We are pleased to respond to the AICPA Auditing Standards Board's request for comment on the exposure draft: "Proposed Statement on Auditing Standards and Statement on Standards for Attestation Engagements, *Amendments to Statement on Auditing and to Statement on Standards for Attestation Engagements to Incorporate the Internal Control Integrated Framework Report*" (the Proposed Statement). We support the issuance of the Proposed Statement, however, we have certain comments and suggestions that we believe are needed to improve the Proposed Statement (paragraph numbers refer to the renumbered paragraph numbers as if amended).

Broad Concern Relating to SASs and SSAEs

While we support the issuance of the Proposed Statement, and we understand that "conforming" changes will be made throughout the SASs and SSAEs to reflect consistent terminology, we are left with a broad concern about how all the SASs and SSAEs hold together. The SASs and SSAEs appear to be an ever-growing patchwork quilt of standards resulting in inconsistencies in concepts and terminology, not to mention apparent grammatical lapses, that may cause confusion and misunderstanding among practitioners. The concepts and terminology in the paragraphs of SAS No. 55 that were not proposed for amendment, in our opinion, present some prime examples of these inconsistencies. Further, the "incorporation" of the COSO concepts into the standards raises questions as to whether SAS No. 47 needs to be reexamined or clarified. The Board's project on Fraud (SAS No. 53) also may be difficult to resolve without further exacerbating the problem we perceive, particularly in how the auditor's responsibility for fraud will relate to the audit risk model and to the auditor's consideration of internal control as articulated in the Proposed Statement.

We encourage the Board to commence a broad review of the SASs and SSAEs as part of its future agenda.

COSO Report

The [Explanation] paragraph of the Proposed Statement indicates that the Board believes it is appropriate to revise SAS No. 55 to "incorporate" the COSO report. The COSO report technically is not "being incorporated" into SAS No. 55. Rather, the Proposed Statement

Mr. J. Eric Nicely
July 7, 1995
Page 2

incorporates the definition, and descriptions of the components, of internal control from the COSO report. The [Explanation] should be revised to reflect this important distinction.

Comments on Proposed Change to SAS No. 55

SUMMARY – The heading, “SUMMARY,” preceding paragraph 2 should be deleted. Paragraphs 2 through 4 constitute important imperatives rather than summarizing what the SAS contains. If anything, paragraph 1 is the summary.

Paragraph 2 – The last sentence of this paragraph is unnecessarily complex, and even circular, in that it says, “...obtain a sufficient understanding of each of the five components ... by performing procedures to understand the design of policies and procedures relevant to” The term, “policies and procedures,” as used in this sentence, appears to comprise the five components. However, that term also is used to describe one of the components, “Control Activities.” We suggest the following changes to the second sentence to avoid confusion (see related comments on paragraph 24 and on SAS No. 70, paragraph 7):

In all audits, the auditor should obtain an ~~sufficient~~ understanding of each of the five components, ~~to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation,~~ **sufficient to plan the audit. This understanding should include knowledge about the design of the aspects of internal control relevant to audit planning and whether they have been placed in operation by the entity.**

Paragraphs 3 and 4 – The last two sentences of paragraph 3, and the entire paragraph 4, both of which discuss reducing the assessed level of control risk, appear duplicative. We recommend the following changes to the last two sentences of paragraph 3 and eliminating paragraph 4:

... Alternatively, the auditor may ~~obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk~~ **desire to seek a reduction of the assessed level of control risk below the maximum level for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a reduction is likely to be available and whether performing tests of controls to obtain such evidential matter would be efficient. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.**

Paragraph 6 – The Proposed Statement sets up the definition and components of internal control as absolutes in the proposed change to SAS No. 55. However, paragraph 12 and the footnote to paragraph 22 of the proposed change to SSAE No. 2 states that the components are a function of the definition of internal control selected by management, which may or may not be the same as the COSO definition. The proposed change to SAS No. 55 does not acknowledge that alternative definitions of internal control may be used by an entity. We suggest that the Board clarify this apparent conflict.

Mr. J. Eric Nicely
July 7, 1995
Page 3

Paragraph 6, Footnote 1 – We believe that the use of the terminology “Internal Control Structure” in place of the defined term, “Internal Control”, throughout the Statement is contradictory to the definition of internal control as a process. The word “structure” is static and the word “process” is dynamic. Continued usage of “structure” will only result in confusion, and is in conflict with the notion of embracing the COSO framework that gives rise to the very proposal at hand. This comment also is applicable to the proposed Appendix A to SAS No. 55 and to the proposed changes to SSAE No. 2 and SAS Nos. 60 and 70, as well as to the second standard of fieldwork.

Paragraph 9 – The term “internal control structure policies and procedures” is introduced in this paragraph without a clear definition of what it means. This is particularly confusing given the definition of “control activities” in paragraph 7 as “... the policies and procedures that help ensure management directives are carried out.” It is unclear whether internal control structure policies and procedures mean control activities only or whether the term is intended to be more expansive. We recommend that the term “internal control structure policies and procedures” be replaced throughout the document with the term, introduced in paragraph 7, “aspect(s) of internal control.” This terminology is already used in SAS No. 60 and, to a limited degree, in SSAE No. 2. Also, SAS No. 70 uses the similar terminology, “aspects of the service organization’s policies and procedures.” We believe “aspects of internal control” is more meaningful and less confusing. This comment also is applicable to the proposed Appendix A to SAS No. 55, and to the proposed changes to SSAE No. 2, and SAS No. 70.

Paragraph 9 – SAS No. 54, *Illegal Acts By Clients*, provides that the auditor is responsible for designing the audit to provide reasonable assurance of detecting noncompliance with laws and regulations that has a direct and material effect on the financial statements. Accordingly, we recommend that a discussion be added to this paragraph, or as a new paragraph 10, of how the policies and procedures that pertain to the objective of compliance with applicable laws and regulations are relevant to an audit.

Paragraph 13 – This sentence ignores the possibility that financial statements may be prepared on a comprehensive basis of accounting other than generally accepted accounting principles. We recommend changing this paragraph to read (see related comment to paragraph 5 of the proposed Appendix A):

“An entity’s risk assessment activities relevant to planning the audit of financial statements are the identification, analysis, and management of risks affecting management’s assertions in the financial statements.”

Paragraph 14 – A SAS is not the place to say what an entity’s risk assessment process “should” do. We suggest that the first clause of the first sentence, “An entity’s risk assessment process should consider ... events and circumstances that,” be replaced with: “Risks that are relevant to external financial reporting objectives are those internal and external events and circumstances that” See related comment to paragraph 6 of the proposed Appendix A.

Paragraph 15 – SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, describes inherent and control risks as two different risks. Accordingly, we suggest the following changes to the last sentence be more consistent with SAS No. 47:

Mr. J. Eric Nicely
July 7, 1995
Page 4

In a financial statement audit, the auditor assesses inherent and control ~~risk risks~~ to evaluate the likelihood that material misstatements ~~exist could occur~~ in the financial statements.

Paragraph 16 – We believe that significant differences of opinion exist as to the extent of the auditor’s consideration of controls over the safeguarding of assets. Accordingly, we suggest that the Board provide more guidance in the body of the Proposed Standard on safeguarding. We suggest the following clarifying language:

“Physical controls encompass controls over the safeguarding of assets. Such controls may be relevant to audit planning in situations in which assets are susceptible to theft and not subject to physical inspection, as may be the case, for example, with inventories counted at other than the reporting date.”

Paragraph 17 – We recommend rewording the paragraph similar to the following:

“The information system relevant to financial reporting objectives consists of the methods and records established to identify, assemble, analyze, classify, record and report the entity’s transactions and accounting estimates, (as well as events and circumstances) in conformity with generally accepted accounting principles (or an other comprehensive basis of accounting).”

This rewording removes the inference that the accounting system, in its entirety, is relevant to the audit (most entities’ accounting systems are designed for internal, as well as external reporting). It removes the assertion that “... the methods and records established...to maintain accountability for the related assets and liabilities...” are “...relevant to financial reporting objectives...” It recognizes accounting estimates, which are not “transactions.” And it eliminates the last sentence which appears to be gratuitous. See related comments on paragraphs 11 and 12 of the proposed Appendix A.

Paragraphs 19 and 20 – The discussion of monitoring is very general whereas the other components of internal control are discussed in terms of how they are relevant to planning an audit. We suggest that the discussion of monitoring be revised to focus on how it is relevant to audit planning.

Paragraph 20 – With respect to the last sentence, monitoring activities do not just “...occur by relations with outside parties...”; management must do something with the information obtained from those “relations with outside parties.” We suggest revising this sentence to read:

“Monitoring activities may include using information from interactions with external parties, such as customer complaints and regulators’ comments, to evaluate the effectiveness of design and operation of internal control.”

Paragraph 21 – We believe that this paragraph should be more emphatic that the concepts of the COSO report apply to all organizations, no matter what their size. Accordingly, we recommend that the first sentence be replaced with the following:

Mr. J. Eric Nicely
July 7, 1995
Page 5

“The concepts underlying the components of internal control are applicable to entities of every size. However, the design of the aspects of the five components may vary among entities based on various factors, including the size and complexity of the entity.”

Additionally, the statement in the fourth sentence of this paragraph that “... smaller entities might not need an independent or outside member on their boards ...” is much broader than the discussion in the COSO report which makes a single exception to the general need for independent board members in the case of an owner managed-entity that uses no outside capital. Accordingly, we suggest that the above phrase be changed as follows:

... smaller entities might not need ~~as a majority of independent or outside member members~~ on their boards ...

Paragraph 22 – In order to avoid any confusion as to whether the auditor is responsible for the internal control of an entity, we suggest the following change to the first sentence of this paragraph:

~~An~~ **Management is responsible for designing and operating an entity’s internal control structure should be designed and operated** to provide it reasonable assurance that an entity’s objectives are achieved.

Paragraphs 22 and 23 – The topic of these paragraphs is the same as paragraphs 17 and 18 of SSAE No. 2 yet the discussion is significantly different. We see no reason why the discussions should be different and suggest that changes be made either to SAS No. 55 or SSAE No. 2, or both, to conform the two standards.

Paragraph 24 – Consistent with our comment on Paragraph 2 above, we suggest that the first and second sentences of this paragraph be revised to read:

“The auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit of the entity’s financial statements. This understanding should include knowledge about the design of the aspects of internal control relevant to audit planning and whether they have been placed in operation by the entity.”

Paragraph 30 – In discussing the auditor’s understanding of the other four components of internal control, paragraphs 28, 29, 31 and 32 each begin with an imperative that “the auditor should obtain sufficient knowledge of [the component] to understand” We believe that, to be consistent, paragraph 30 also should begin with a statement such as the following:

“The auditor should obtain sufficient knowledge of an entity’s control activities to understand how management’s directives to address risks to achieving the entity’s financial reporting objectives are carried out.”

Paragraph 31 – As clarification, we suggest that a sentence be added to the end of the paragraph to parallel the concept in the last sentence of paragraph 30, such as:

Mr. J. Eric Nicely
July 7, 1995
Page 6

“Ordinarily, audit planning does not require the auditor to obtain an understanding of the information system relevant to each account balance, transaction class, and disclosure requirement component in the financial statements.”

Comments on Proposed Appendix A to SAS No. 55

Paragraphs 4, 7, 10, 15, and 20 – We suggest that these paragraphs be eliminated and replaced with a single introductory paragraph to Appendix A similar to the following:

“This appendix contains examples of aspects and characteristics of components of internal control. The structure of these aspects and characteristics and the formality of the means used to implement them generally vary among entities depending upon, among other things, the size and complexity of a particular entity.”

Paragraph 4 – If the suggestions in our preceding comment is not implemented, we suggest the following changes to the last sentence of this paragraph:

This, however, may not affect the ~~entity's~~ control environment adversely **if the entity is owner-managed and does not use outside capital or financing.**

Paragraph 5 – Consistent with our comment on paragraph 13 of the proposed change to SAS No. 55, we recommend changing this paragraph to read:

“An entity’s risk assessment activities relevant to planning the audit of financial statements are the identification, analysis, and management of risks affecting management’s assertions in the financial statements.”

Paragraph 6 – Consistent with our comment on paragraph 14 of the proposed change to SAS No. 55, we suggest that the first clause of the first sentence, “An entity’s risk assessment process should consider ... events and circumstances that,” be replaced with: “Risks that are relevant to external financial reporting objectives are those internal and external events and circumstances that”

The last bullet in paragraph 6 on “Foreign Operations” provides no significant guidance on what the new and unique risks of foreign operations are. We suggest adding practical examples to the bullet such as foreign currency exchange rate risk and risk of expropriation of assets.

Paragraph 9 – The third bullet appears overly biased toward the idea that safeguard controls do not matter in an audit of financial statements. For example, it states that inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. That process, however, would not apply to interim financial reporting when physical counts are not made. In that situation, the lack of safeguard controls may be considered a reportable condition. We suggest that the phrase “as is frequently the case for interim reporting,” be inserted into the last sentence of the bullet after the phrase “perpetual inventory records,”.

Mr. J. Eric Nicely
July 7, 1995
Page 7

Paragraph 11 – Consistent with our comment on paragraph 17 of the proposed change to SAS No. 55, we recommend rewording the paragraph similar to the following:

“The information system relevant to financial reporting objectives consists of the methods and records established to identify, assemble, analyze, classify, record and report the entity’s transactions and accounting estimates, (as well as events and circumstances) in conformity with generally accepted accounting principles (or an other comprehensive basis of accounting).”

Paragraph 12 – Consistent with our comment on paragraph 11, we suggest that the lead-in to the bullets be revised to read as follows:

“Aspects of the information system that are relevant to audit planning are those methods and records established to –”

Paragraph 13 – Consistent with our comment on paragraph 11, we suggest changing the word “involves” in the first sentence to “includes.”

Paragraph 15 – This paragraph uses “a formal credit policy” and “competitive bidding” as formal control procedures. We believe that these represent controls relevant to *operating objectives* and that examples relevant to *financial reporting objectives* should be used instead.

Comments on Proposed Change to SSAE No. 2

In addition to the comments above which we identified as also being applicable to the proposed change to SSAE No. 2, we offer the following comments:

We recommend that the guidance provided in the “Addendum to ‘Reporting to External Parties’” volume of the COSO report (published in May 1994) be incorporated into SSAE No. 2. In the Addendum, COSO discussed the issue of, and provided a vehicle for, expanding the scope of a management report on internal control to address additional controls pertaining to the safeguarding of assets. As it is likely that practitioners will be asked to perform attestation engagements on management reports on internal control which include assertions on safeguard controls, we believe that incorporation of the Addendum would further the Board’s goal of providing timely and useful guidance to the practitioner.

Paragraphs 24 and 73 – These paragraphs use the term “control objectives” even though that term is not defined in SAS No. 55 or SSAE No. 2. We recommend, as a conforming change, deleting the word “control” as the definition of internal control refers only to achieving objectives of the entity. This comment also applies to the proposed change to SAS No. 70 which uses “control objectives” throughout.

Paragraph 32 – The third bullet appears to be describing monitoring activities. Accordingly, as a conforming change, we suggest the bullet be revised to read:

“The nature and extent of relevant monitoring activities”

Mr. J. Eric Nicely
July 7, 1995
Page 8

Comments on Proposed Change to SAS No. 70

In addition to the comments above which we identified as also being applicable to the proposed change to SAS No. 70, we offer the following comments:

Paragraph 7 – Consistent with our comments on paragraphs 2 and 24 of the proposed change to SAS No. 55, we suggest that this paragraph be revised to read:

SAS No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 319), states that the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit of the entity's financial statements. This understanding should include knowledge about the design of the aspects of internal control relevant to audit planning and whether they have been placed in operation by the entity.

This change would eliminate the reference to understanding the "records" pertaining to each component, which is not contemplated by either paragraphs 2 or 24 of the proposed change to SAS No. 55. The first sentence of current paragraph 23 of SAS No. 55 (renumbered paragraph 33) also contains the reference to "records" which we believe should be corrected by conforming the first sentence of that paragraph to the wording we suggested for paragraphs 2 and 24 above.

Paragraph 16 – The references to SAS No. 55 should be updated based upon the ultimate renumbering of the SAS No. 55 paragraphs.

Paragraphs 26 and 42 – We believe these paragraphs use many terms interchangeably which could cause confusion. If the changes recommended in our comment on paragraph 9 of the proposed change to SAS No. 55 are implemented, much of this would be resolved. If not, we recommend the following changes:

After obtaining a description of the relevant **aspects of internal control policies and procedures**, the service auditor should determine whether the description provides sufficient information for the user auditors to obtain an understanding of those aspects of the service organization's **internal control policies and procedures** that may be relevant to a user organization's internal control structure. ~~The description should contain a discussion of the features of the service organization's policies and procedures that would have an effect on the user organization's internal control structure.~~ Such **aspects features** are relevant when they directly affect the service provided to the user organization. They may include **aspects of each of the five components of the service organization's internal control: features, activities, or policies or procedures generally considered to be part of the control environment, risk assessment, control activities, information and communication, and monitoring.** **Aspects of control environment** may include hiring practices and key areas of authority and responsibility. **Aspects of risk assessment** may include the identification of risks associated with processing specific transactions. **Aspects of control activities** may include policies and procedures over the modification of computer programs and are ordinarily designed to meet specific control objectives. ~~The~~ **Such** specific control objectives ~~of the service organization~~ should be set forth in the service organization's description of

Mr. J. Eric Nicely
July 7, 1995
Page 9

policies and procedures. Aspects of information and communication may include ways in which user transactions are initiated and processed. Aspects of monitoring may include the involvement of internal auditors.

Comments on Proposed Change to SAS No. 60

We have no comments on this proposed change other than the comments above that we identified as also being applicable to the proposed change to SAS No. 60.

* * * * *

We appreciate the opportunity to provide our comments and suggestions on the Proposed Statement.

Very truly yours,

KPMG Peat Marwick LLP

KPMG Peat Marwick LLP

Price Waterhouse LLP



July 5, 1995

J. Eric Nicely
Practice Fellow
Auditing Standards Division
File 4289
American Institute of Certified
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1211 Avenue of the Americas
New York, New York 10036-8775

**Proposed Amendments to Incorporate
Internal Control - Integrated Framework**

Dear Mr. Nicely:

We support the ASB's proposal to incorporate the concepts of the "Internal Control - Integrated Framework" report into the AICPA's professional standards. We believe that ASB's formal recognition of these concepts as a common framework for consideration of internal control will be important in advancing understanding of internal control among a wide audience and hence in providing a fertile ground on which improvement in internal control techniques can grow. We do however have the following two comments:

Add "new accounting pronouncements" to the list of changes in circumstances that can change an entity's risks for financial reporting purposes.

Paragraph 29 sets forth the auditor's responsibility for obtaining an understanding of the entity's financial statement risk assessment process in the following terms:

"obtain sufficient knowledge to understand how management considers risks relevant to financial reporting objectives, estimates their significance, assesses the likelihood of their occurrences and decides about actions to address those risks."

For many financial statement components and assertions (see SAS 31) management is not going to undertake to specifically estimate their significance or assess the likelihood of their occurrence. Consequently, the auditor will be unable to fulfill this stated responsibility. Further, it is unlikely that the auditor

July 5, 1995



J. Eric Nicely
Practice Fellow
Auditing Standards Division
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Public Accountants
Page 2

will consider management's failure to act in this way as an internal control weakness warranting reporting to client management. Consequently, we suggest that the words "estimates their significance and assesses the likelihood of occurrence" be deleted from that sentence. These phrases could be included in a second sentence, such as "This knowledge might include understanding of how management estimates the significance of the risks and assesses the likelihood of occurrence."

Sincerely,

Price Waterhouse LLP

July 10, 1995

Arthur Andersen LLP

Mr. J. Eric Nicely
Practice Fellow
Auditing Standards Division
American Institute of Certified Public Accountants
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Re: File 4289, Exposure Draft of Proposed Statement entitled, "Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control-Integrated Framework Report"

Dear Eric:

This letter is in response to the request for comments on the exposure draft of the proposed statement entitled, "Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control-Integrated Framework Report."

Principal Comment

The efforts of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) culminating in their "Internal Control-Integrated Framework Report" (COSO Report) represents a significant contribution to the body of knowledge for designing, implementing, evaluating and improving internal control systems. The five components of internal control, as defined and described in the Framework portion of the COSO Report, enhance the current definition set forth in SAS 55 and should improve the ability of the auditor to gain the understanding necessary to assess control risk as required by generally accepted auditing standards.

We recognize that the use by entities, both in the private and public sector, of the Framework and other guidance in the COSO Report as control criteria will be evolutionary over a considerable period of time. However, notwithstanding the approach entities currently use to design, implement and evaluate their control systems over financial reporting, we believe that the independent auditor should use the Framework definition to discharge his or her audit responsibilities.

Accordingly, we support the proposed amendments to the auditing and attestation standards.

Mr. J. Eric Nicely
Page 2
July 10, 1995

Other Comments

We have the following specific suggestions and comments for the Board's consideration in finalizing the amendments.

It is critical that the final auditing standard not "incorporate by reference" the Framework or any other elements of the COSO Report. That is, the discussion of internal control in the SAS should stand on its own. By incorporating, either explicitly or implicitly, the Framework or other aspects of the COSO Report into the standard, the profession runs the risk that future amendments of the COSO Report could inadvertently be incorporated into professional auditing standards without appropriate due process.

Paragraphs 12 - 20 of the proposed SAS briefly describe each of the five internal control components, with a more detailed discussion provided in Appendix A. Because of the discussion in the body of the statement, auditors may either ignore or not read carefully enough the extended guidance in the Appendix. Accordingly, we suggest that the brief discussion of the components in paragraphs 12 - 20 be deleted and replaced with a reference to Appendix A (and Appendix A edited to eliminate any discussion not considered essential). Alternatively, the discussion in paragraphs 12 - 20 could be expanded to include that which is now in the Appendix and is considered essential, and delete Appendix A. A more expanded discussion could later be incorporated into the revisions to the Audit Guide, "Consideration of the Internal Control Structure in a Financial Statement Audit," and Industry Audit and Accounting Guides as appropriate.

Paragraph 9 in Appendix A describes "physical controls" and makes reference to controls over inventory losses. We presume that the controls over inventory is meant to be only an example. If Appendix A is retained, the discussion about inventory losses should be labelled as such. Also, the Board should review this guidance carefully to be sure that the discussion about safeguarding of assets is limited to controls over financial reporting, and not inadvertently extended to encompass safeguarding controls that go beyond financial reporting.

Paragraphs 19 and 20 in the body of the proposed SAS, and paragraphs 16 - 19 in Appendix A describe the "monitoring" component of the internal control structure over financial reporting. We have the following suggestions with respect to this discussion:

- o Paragraph 18 should be clear that it relates to the "separate evaluations" mentioned in paragraph 16. Accordingly, the first sentence in paragraph should read, "In many entities, internal auditors or personnel performing similar functions contribute to the monitoring of an entity's activities through separate evaluations."

ARTHUR
ANDERSEN

ARTHUR ANDERSEN & CO. SC

Mr. J. Eric Nicely
Page 3
July 10, 1995

- o Paragraph 19 somewhat overstates the "monitoring activities" performed by parties outside an entity. We suggest that the first sentence in paragraph 19 be revised to read as follows, "Communications from external parties corroborate internally generated information or indicate problems."

Relatedly, concerns have been raised as to whether performance of certain aspects of monitoring by the external auditor as a separate service, might impair independence because that component is part of the internal control structure. We understand that the Public Oversight Board has discussed these matters in its June 14, 1995, letter to the AICPA Director of Professional Ethics. Accordingly, the discussion of monitoring in the proposed SAS and in the related Appendix should be reviewed by the AICPA's Professional Ethics Executive Committee before it is finalized to ensure that it will not conflict with or present an obstacle to an appropriate resolution of the independence issue that is in the public interest. (See Attached)

In the proposed change to SSAE No. 2, "Reporting on an Entity's Internal Control Structure Over Financial Reporting," we suggest that the footnote reference to paragraph 12 which reads, "This definition is consistent. . .however, SAS 55 is not intended to provide criteria for evaluating internal control effectiveness," be deleted since it doesn't appear to serve any useful purpose.

We would be pleased to discuss our comments and suggestions at your convenience.

Very truly yours,

ARTHUR ANDERSEN LLP



PUBLIC OVERSIGHT BOARD

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June 14, 1995

Mr. Herbert Finkston
Director of Professional Ethics
American Institute of Certified Public Accountants
Harborside Financial Center
201 Plaza Three
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Assistant Technical Director

Dear Mr. Finkston:

The Public Oversight Board and its staff have discussed various issues associated with the performance of internal audit services for audit and attestation clients and have also considered the Ethics Committee's revised draft position paper on the subject. This letter sets forth the staff's views about certain independence implications associated with the performance of these services. The Board in a separate letter dated June 14, 1995 addresses other related issues it believes require consideration.

Several commentators have expressed concern that engagements by independent auditors to perform internal audit activities for audit clients or to extend the independent auditor's audit services when the client does not maintain an internal audit function (sometimes collectively referred to as providing extended audit services) could impair the auditor's independence in the context of an audit of the client's financial statements. Some believe that those same circumstances could also lead to an impairment of independence in the context of an attestation engagement to report on an entity's internal control structure over financial reporting. The impairment of independence occurs, those commentators believe, as a result of either the assumption by the independent auditor of management responsibilities, or the nature and extent of the auditor's participation in the monitoring component of internal control.

The staff has considered these views and has concluded that, unless the auditor performs management functions or makes management decisions, providing extended audit services need not result in an impairment of independence. The staff does not believe that the extent of the auditor's participation in the monitoring component of internal control is a relevant consideration, as long as the auditor does not assume management's operational or decision making responsibilities. Even if the principal (however measured) method by which management knows that control objectives are being achieved is through separate evaluations performed by the independent auditor, independence need not be impaired, for the following reasons.

1. Activities conducted by the independent auditor when auditing an organization's financial statements may, in certain circumstances, be the primary method by which management knows that control objectives are being achieved. On the other hand, in other circumstances, the activities conducted by the independent auditor in performing extended audit services may not be the primary means by which management monitors internal controls. The independent auditor's activities when providing either or both types of service do assist management in fulfilling its monitoring responsibility and



The Public Oversight Board is an independent, private sector body that monitors and reports on the self-regulatory programs and activities of the SEC Practice Section of the Division for CPA Firms of the American Institute of Certified Public Accountants.



may or may not be the primary method by which management monitors internal controls. However, the extent to which the independent auditor's activities assist management in fulfilling its monitoring responsibility is not relevant to the determination of independence. COSO recognizes and states that parties external to the organization, such as regulators, the independent auditor, customers and others transacting business with the enterprise, are not part of the entity's internal control system but do assist management in fulfilling its responsibility to monitor internal control. Thus, monitoring activities conducted by the independent auditor to replace the internal audit function are not internal to the organization, and are not part of the monitoring component of the internal control structure.

2. The auditor presently has a responsibility under SAS No. 60 to communicate internal control structure related matters noted in an audit and may, under SSAE No. 2, evaluate the effectiveness of internal control for the purpose of reporting on an entity's internal control structure over financial reporting. The responsibilities under those standards apply regardless of whether the entity monitors its internal control systems in any way other than through control activities that are an integral part of the accounting system. That is, in the process of meeting his or her SAS No. 60 responsibilities or in the course of performing a SSAE No. 2 engagement, and long before "outsourcing" became popular, the independent auditor may have served as an entity's principal method of monitoring and evaluating the effectiveness of its internal control system. The auditor's independence has never been considered to be impaired because of responsibilities met or undertaken under SAS No. 60 and SSAE No. 2 regardless of whether there was a separate internal audit function or whether management had other means to evaluate internal controls. The auditor's independence should not be impaired solely because those responsibilities were undertaken while serving an internal audit function.

In the final analysis, the only relevant tests that the independent auditor must meet when reporting on an entity's internal control structure over financial reporting are set forth in SSAE No. 2. That standard requires that management accept responsibility for the effectiveness of the internal control structure using criteria established by a recognized body and that sufficient evidential matter exists or could be developed to support that evaluation. Paragraph .11 of SSAE No. 2 states that "management may engage the practitioner to gather information to enable management to evaluate the effectiveness of the entity's internal control structure" and thus acknowledges that the independent auditor may, in certain circumstances, develop the support for management's evaluation.

Various commentators have also expressed the following views:

- The performance of internal audit services impairs the objectivity of the auditor when he or she considers the client's control structure in the performance of an audit and also when he or she evaluates internal control for the purpose of attesting to management's assertions about it; that is, a "second set of eyes" is no longer present.



- Some or all of these problems could be avoided if a wall were maintained between engagement teams providing internal audit services and those providing audits of the financial statements or attestations to internal control effectiveness.
- The performance of internal audit activities for financial statement audit clients is likely to lead significant numbers of people to believe that the auditor's independence was impaired, regardless of circumstances or attempts to assure independence.

The loss of a "second opinion" or "second set of eyes" when the independent auditor also performs internal control monitoring activities as part of an internal audit function may be an unfortunate result in those situations where there indeed would have been an objective second look or second opinion. In many instances, however, there is no internal audit function, and the only objective in-depth monitoring and evaluation provided to management is by the independent auditor as a result of procedures performed as part of the audit of the financial statements. Even where there is a separate internal audit function, however, the work of the internal and independent auditors is coordinated to avoid the duplication that a "second set of eyes" would bring to separate evaluations of the same internal control area. (Responsibilities under SAS No. 65 to evaluate and test the effect of internal auditors' work seem insufficient to warrant describing it as a second opinion on the effectiveness of internal control.) It would seem that, as a practical matter, even when there is a separate internal audit function, one would not expect to see separate, comprehensive evaluations by the two audit functions of the same area of the control structure.

Creating and maintaining a wall between the independent audit function and the internal audit/internal control function is neither possible nor desirable. Experience with other "walls" suggests that in practice it is simply not possible to maintain the separation in every case year after year. Even if such a wall could be built and maintained, however, its existence would prevent any benefits accruing to the public that would result from the increased knowledge of the client that an audit team might obtain from performing "extended audit services."

Lastly, the view that the public might perceive a loss of independence when the auditor performs internal audit activities is similar to the belief held by a significant minority that management consulting services performed for audit clients threaten the auditor's independence.

There are even some who believe that merely receiving audit fees from the client threatens independence. Short of a complete restructuring of the auditor-client relationship, including fee arrangements, there will always be those who see threats to independence. The profession's response to such perceptions should be the same with respect to internal audit services as it is with respect to any non-audit service -- a constant vigil to ensure that potential threats to independence, integrity, and objectivity as a result of the desire to obtain and retain clients do not become reality.

In summary, when internal audit services are performed for an audit client, we see the independence issue solely as one of not crossing the line from serving as a monitor, evaluator, and advisor to serving as decision-maker and implementer, that is, serving as management. Preparing an internal audit charter, for example, does not create an independence problem; approving it does. Nor do assessing risks and setting audit scope and project priorities impair



independence as long as management acknowledges and agrees with the conclusions. We analogize to financial statement audits: presenting management with proposed adjusting entries and a set of audited financial statements does not impair independence as long as management is willing and able to accept responsibility for the adjustments and the statements.

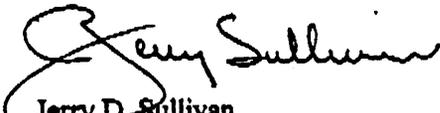
This suggests the Ethics Division would do well to remind AICPA members of the need to avoid serving in a management capacity, with respect to not only internal audit services but with respect to any non-audit service. It also suggests that accounting firms should create explicit guidance for their staffs on responsibilities with respect to internal audit functions that may be assumed by the firm and those that should remain the responsibility of management. Boards of directors and audit committees should understand the role and responsibilities of both management and the independent auditors with respect to the internal audit function, as a basis for establishing guidelines for carrying out those responsibilities and for monitoring how well they have been met. In this regard, detailed engagement letters setting forth the responsibilities of management and the independent auditor should serve to facilitate directors' and audit committees' understanding and also help preserve auditor independence by minimizing the possibility that either directors or management may expect the independent auditor to assume management responsibilities.

The Public Oversight Board, along with many others, has long believed that management should explicitly accept responsibility for internal control and should report on the effectiveness of internal control. In varying degrees, the independent auditor -- acting solely as independent auditor or as both independent and internal auditor -- can provide management with evidence to enable it to make assertions about internal control effectiveness. Performing internal audit services related to monitoring and evaluating internal control enables the independent auditor to provide assurance to management (as well as to the public) about the effectiveness of the organization's internal control system -- a service that is clearly in the public interest.

While we have reviewed this letter with the Board, it should be clearly understood that the views expressed herein are solely those of the staff.

We would be pleased to meet with you and members of the Professional Ethics Executive Committee to discuss these matters further.

Sincerely,


Jerry D. Sullivan
Executive Director

JDS/mb

cc: Thomas P. Kelley
Daniel M. Guy



National State Auditors Association

26

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July 10, 1995

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Dear Mr. Nicely:

OTHER MEMBERS

Immediate Past President
MAURICE C. CHRISTIANSEN
Auditor General
South Dakota

On behalf of the National State Auditors Association (NSAA), we appreciate the opportunity to respond to the Exposure Draft (ED), *Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control - Integrated Framework Report*. The following comments are based on the individual responses we received and are not intended to represent the views of all individual members. Individual state auditors are encouraged to comment separately.

KURT SJOBERG
State Auditor
California

We agree that the *Internal Control - Integrated Framework Report* (the COSO report) is widely accepted in the private sector and that its use in both the private and public sectors will continue to grow. Accordingly, we believe Statement on Auditing Standards (SAS) No. 55 should be amended to incorporate the concepts and terminology of the COSO report. The COSO report clarifies management's role in defining and maintaining an internal control structure which we believe is an improvement over SAS No. 55. The proposed revision will provide a common framework that will facilitate effective communication about internal controls between auditors and auditees. We also commend the proposed revision's discussion regarding small and mid-sized entities and its acknowledgment of informal systems.

THOMAS MCTAVISH
Auditor General
Michigan

BARBARA J. HINTON
Legislative Post Auditor
Kansas

We also like the additional information provided in Appendix A. However, we suggest retaining, after appropriate modification, the current SAS No. 55 Appendices B and C. In particular, we find the flowchart in Appendix C a useful tool in visualizing our audit requirements. In fact, many state auditors found this flowchart very useful in implementing SAS No. 55 and continue to use the flowchart as a tool for training new auditors. Experienced auditors also value the flowchart as a quick reference on this important audit process.

85

In addition to our general comments above, we also offer the following comments on specific sections of the document:

1. As part of their responsibilities for reviewing audits of local governments, many state auditors continually encounter working papers of auditors in which the auditor has failed to document his understanding of internal control structure or relate that understanding to the nature, timing, or extent of the audit tests applied as a part of the audit. We consider that documentation a very primary part of the audit. We urge the Auditing Standards Board (the "Board") to make it very clear within paragraphs (new) 24-32 that the auditor must document within the working papers the understanding and the relationship of the understanding to the tests applied as a part of a financial statement audit.
2. The language in paragraph 30 (in the main body of the ED) states that as an auditor obtains an understanding of the other four components, he or she is also likely to obtain knowledge about the control activities.

However, from some of the examples provided in Appendix A, an auditor may not clearly understand why these are separate components. For example, it may be difficult for an auditor to distinguish control activities pertaining to performance reviews (paragraph 9) from those associated with monitoring (paragraph 16-19). Similarly, it may be confusing to consider control activities pertaining to information processing (paragraph 9) separately from the information system (paragraphs 11 and 12).

We recommend the Auditing Standards Board consider providing additional guidance and examples that further distinguish the five components.

3. The proposed change to SSAE No. 2 would revise paragraph 12 to read:

"The components that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. For example, management may select the definition of an internal control structure based on the internal control framework set forth in *Internal Control--Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission. *Internal Control--Integrated Framework* and SAS No. 55 describe an entity's internal control structure as consisting of five components--control environment, risk assessment, control activities, information and communication, and monitoring. If management selects another definition of an internal control structure, this list of components may not be relevant."

Because the Board has stated that it believes that the COSO report is rapidly becoming a widely accepted internal control framework and that its acceptance and use will continue to grow, we believe SSAE No. 2 should, at least subtly, encourage the practitioner to recommend that management select the definition of an internal control structure based on the COSO report.

At a minimum, we suggest that the Board revise and expand the last two sentences of paragraph 12 into three sentences, such as "This report is becoming widely accepted framework for sound internal control among U.S. organizations and its acceptance and use will continue to grow. *Internal Control--Integrated Framework* and SAS No. 55 describe an entity's internal control structure as consisting of five components--control environment, risk assessment, control activities, information and communication, and monitoring. However, if management chooses to select another definition of an internal control structure, this list of components may not be relevant."

4. In reviewing the ED, we noted that the four proposed changes contained different effective dates. The proposed change to SAS No. 55 would be effective for audits for periods beginning on or after January 1, 1997, with earlier application permissible; the proposed change to Statement on Standards for Attestation Engagements (SSAE) No. 2 would be effective for an examination when management's assertion is as of December 15, 1996, with earlier application encouraged; and, the proposed changes to SAS Nos. 60 and 70 would be effective for audits for periods beginning after January 1, 1997, with no mention of earlier application. If the Board intends to issue an omnibus SAS and a separate SSAE, one common effective date would greatly simplify the implementation process for the user.

We appreciate the Auditing Standards Board's efforts on this project and the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact Kinney Poynter of NASACT at (606) 276-1147 or me at (410) 225-1400.

Sincerely,



Anthony J. Verdecchia
President



21

July 12, 1995

J. Eric Nicely, Practice Fellow
Auditing Standards Division, File 4289
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

Re: **Exposure Draft on Proposed SAS and SSAE Amendments to SAS
and SSAE to Incorporate the Internal Control-Integrated
Framework Report**

Dear Mr. Nicely:

One of the objectives that Council of the American Institute of CPAs established for the Private Companies Practice 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 proposed guidance contained in the above referenced exposure draft and is pleased to provide the following comments and suggestions.

Risk Assessment

CPAs are familiar with the term "risk assessment" as it is used in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) report introduces a different use for the term by adding it to the components of an internal control structure. TIC believes this may confuse local practitioners since we have found few who are familiar with the COSO report and its recommendations.

To remedy this, we suggest the proposed "Appendix A: Internal Control Structure Components" to SAS 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, elaborate on the content of the proposed paragraph 29 to that standard; providing examples of how an auditor of small entities might obtain the necessary knowledge of an entity's risk assessment process and what would be considered "sufficient knowledge."

Composition of Boards of Directors

TIC was pleased to see that paragraph four of the proposal's Appendix to SAS 55 recognizes there are practical limitations to the value of requiring outside directors of all entities, regardless of size. TIC had previously commented on this issue in its February 22, 1993 letter on the COSO report. We have attached a copy of that letter. To expect small entities, including those owner-managed, to have a critical mass of outside directors is unrealistic. Most small entities see no benefit in such a feature and, therefore, even if the feature was mandated by professional literature as a necessary part of an effective control environment, most would not comply with it. If the feature is ever required, auditors would likely have to cite the lack of outside directors as a weakness in internal control reports issued on such entities even though that auditor and entity did not perceive the lack as a weakness. Paragraph 21 of the proposed amendment to SAS 55 allows small entities and their auditors to use their professional judgment in determining whether outside directors are needed to ensure that the entity's control environment is effective. TIC encourages the Auditing Standards Board, when developing future guidance, to continue providing this flexibility.

* * * * *

We appreciate the opportunity to present these comments on behalf of the Private Companies Practice Section. We would be pleased to discuss our comments with you at your convenience.

Sincerely,



Robert O. Dale, Chair
PCPS Technical Issues Committee

ROD:geh
Enclosure
File 2221

cc: C. McElroy, Chair, AICPA Control Risk Audit Guide Revision
Task Force
PCP Executive and PCPS Technical Issues Committees