1992

Comment letters on Proposed Statement on Standards for Attestation Engagements Reporting on an Entity's Internal Control Structure Over Financial Reporting

American Institute of Certified Public Accountants. Auditing Standards Board

Comment Letters 1 to 15

(1)

WILLIS A. SMITH
815 Norgate Drive
Ridgewood, N.J. 07450

Tel: (201) 444-6754

May 13, 1992

Ms. A. Louise Williamson
Technical Manager
Auditing Standards Division
File 4287
American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Williamson:

Re: Exposure Draft - Proposed Statement on Standards for Attestation Engagements
Reporting on an Entity's Internal Control Structure Over Financial Reporting

I have carefully read the proposed statement and I am confused as to what the AICPA Committee is proposing as to additional procedures that a practitioneer should follow in attesting to a management's assertation that the enterprise has maintained an effective internal control structure over financial reporting.

Paragraph 47, d states: "The practitioner's opinion on..........based on the control criteria." I could not find anywhere in the proposed statement that the term "control criteria" is defined. If the Committee is going to require the practitioner to attest to something based upon the "control criteria," I suggest that the previous paragraphs should set forth as to what is meant by "control criteria" and what constitutes an acceptable "control criteria."

Paragraph 48 leaves the practitioner hanging. The last paragraph of the "Independent Accountant's Report" states "In our opinion.........is fairly stated, in all material respects based upon [identify established or stated criteria]." Give the practitioner some instances. For example, would it be proper to say 'based upon our observations during our examination of the accounts of the Company?" What does the Committee have in mind as to the identity of established or stated criteria? After reading this proposed statement, I haven't the slightest idea.

I hope that the Committee will rewrite this proposed statement, keeping in mind that the practitioner needs examples of what additional procedures he must follow in this type of an engagement and some examples of what he must say in his opinion paragraph. Don't leave him guessing!

Very truly yours,

Willis A. Smith

Willis A. Smith

(2)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation:

Comments:

GERARD L. CARON, CPA
142 Ocean St.
Lynn, MA 01902-2007

GERARD L. CARON
142 Ocean St.
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1-800-666-3076

5-15-92

IT SEEMS TO ME THAT THE CONTROLS SHOULD BE PUT ON THE AUDITORS — WHAT GOOD IS IT TO HAVE RULES IF THE "BIG" BOYS CAN'T FOLLOW THEM, IT IS A JOKE.

Gerard L Caron

SEE "NUMBERS GAME" WSJ 5-14-92 FRONT PAGE

CUT ALONG LINE

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

(3)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: Joe R. Grady, CPA / Joe R. Grady, CPA, P.A.

Comments: ~~Gentlemen:~~

It is entirely possible that Grady will make the "Hit List" for opposition to any further issuance of "Standards." Yet, I believe it is my responsibility to future CPA's, if nothing else, to do so. Some time ago, there was appointed a Committee on Standards Overload. As I recall, that committe concluded there was such a thing, at that time and point, and to the best of my recollection, as they say, "that was the end of that." Since, there have been more and more "standards" issued, to the point that you need a data-base just to tell you what they are. They have become far too numerous for this country boy to recall. I realize this replaces, or revises, an existing standard; yet, if there were more thought given to the issuance of "standards" in the first place, there would not be the necessity of constantly revising and changing existing standards, nor would there be so many. I may be a committee of one in opposition to the constant issuance of standards, but I have surely heard discontintment expressed among fellow CPA's.

I assure you, with the pressures of this time, I will take all the help I can get, but I'm opposed to any further "mandated" assistance. We have too much.

Joe Grady CPA

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

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EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

CUT ALONG LINE

Name and Affiliation: Raymond C. Dugdale CPA Manchester NH

Comments: At first I thought that this was going to be more ~~junk~~ from the AICPA.

On second reading I find it just doesn't apply to practitioners who audit small closely held companies or non profit entities

You could do the following to set this straight right up front to avoid confusion and further reading for those who will find it not applicable.

Suggestions:

1. Make ¶ #4 ¶2. This will stop practitioners from reading any further

2. Put this section in Bold letters

3 Reword ¶2b regarding representations to make it clear that you are not talking about general mgt representations. This ¶2 should become ¶3

4) ¶5 is not clear. For instance I just finished an engagement where a client

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Comments (continued): wanted us to look at the company's internal control procedures regarding cash, a/c rec, over-the counter sales, etc. Make it clear that this is not included. Perhaps this should also be part of #2 (the old #4) or become #3.

f) #8 needs to be cleared up a bit particularly to make it clear that this is not applicable, ~~to~~ if #4 or #5 come into play.

Please excuse the poor handwriting —
I just am recovering from heart surgery.
If anything is unclear call me
at (603) 472-2314 within the next few
weeks or (603) 669-3454 thereafter

R. L. [illegible]dale

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

(5)

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J NEWTON RUMBLE, CPA, MBA
TISA Y STILTZ, CPA
SCOTT E SALSBERY, CPA
LAURIE M SARKINEN

May 21, 1992

A. Louise Williamson, Technical Manager
Auditing Standards Division
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Williamson:

Re: Exposure draft - Reporting on an Entity's Internal Control Structure Over Financial Reporting
April 20, 1992

There are six major accounting firms in the United States. These major accounting firms have the large corporations as their clients. There are thousands of smaller CPA firms, and thousands of small corporations and businesses which look to the small CPA firms as well as the large CPA firms which perform attest services. The exposure draft on reporting on internal control may be reality for the "Big Six" and for the large, well-staffed corporations, but it is not reality for the rest.

I have been in public practice for over 30 years. I have had the opportunity to serve on boards of organizations and be the client. The idea that the management of the smaller entities--the corporations, partnerships, non-profits, etc. --is prepared to make management assertions about internal control is a myth. These assertions will be written by the accountant, and signed by management only because that's what they need to do to get the audit that they must have to obtain the financing, grants, etc.

We try to say that the financial statements are the statements of management; and then, in the small firms across the country, we create those financial statements and expect the general public, the financial community, and the courts to believe that they are the statements of management. I have sat on the board of non-profit organizations which have regular monthly financial statements from their accounting departments. We receive from the auditor an engagement letter, which is agreed to, which states that financial statements are those of management. After signing this agreement, the accounting department gives the auditor a year-end trial balance together with the year-end statement, prepared internally. When the audit is completed, the board receives a financial statement that bears very little resemblance in form and/or content to that which staff prepared. For some reason, the independent CPA found it necessary to rearrange classifications of expenses, to restate assets and liabilities, to combine funds which were separate into one fund, etc., and at the same time was unable to explain to me why the staff-prepared statements did not conform to GAAP. The answer was simply, "That's the way we do it in our firm."

This is not isolated; this is not unique to Vancouver, Washington. If CPAs are unwilling to accept the format presented by a client merely because things are classified differently than that CPA is used to, will that CPA be willing to accept <u>management's</u> assertions on the internal control structure?

If a CPA is sued as the result of a report on internal control, how will that CPA be able to defend the fact that he is reporting on his own assertions about internal control?

Many members of the profession are already too far out on a limb in the liability arena, claiming that the statements are those of management, when in some cases it would be very easy to show the court that they are not. Is it time to be putting these people out on a limb with assertions on internal control?

Sincerely,

Vernon F. Peterson, CPA

VFP:nlt
mw44

(6)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: Janet L. Colbert, Ph.D., CPA, CIA, Assoc. Professor, Auburn Univ.

Comments: 1. Title. The title is inappropriate, as the proposed SSAE addresses reporting on management assertions about the internal control structure (not the internal control structure, itself).

2. Inherent risk (para. 19). What is the definition of inherent risk, as it is used here (sixth item)? Is the definition that presented in SAS 47?

3. Placed in operation. SAS 55 discusses: the design of control policies and procedures, whether they have been placed in operation, and operating effectiveness (para. 16, 17). The proposed SSAE discusses only design and operating effectiveness (para. 17, 18 c and d, 23).

4. Control policies operating at certain times (para. 33). The proposed SSAE states that controls over physical inventory operate only at certain times, as opposed to continuously. Is the intent here to indicate that controls over counting physical inventory operate only at certain times?

5. Management's representations (para. 45b). Should management also represent that it has evaluated the design of the internal control structure?

Instructions for Response Form

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Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
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May 26, 1992

Auditing Standards Division, File 4287
AICPA
1211 Avenue Of Americas
New York, N.Y. 10036-8775

Attention: A. Louise Williamson

Regarding your request for our comments on the exposure draft of April 20, 1992, "Proposed Statement On Standards For Attestation Engagements, Reporting On An Entity's Internal Control Structure Over Financial Reporting", our comments are

- AICPA, Professional Standards, vol.1, AU sec. 319 "Consideration of the Internal Control Structure in a Financial Statement Audit", which is referenced throughout the exposure draft, should be clarified;

- this exposure draft should be edited to be consistent with the following proposed clarifications to AU sec. 319.

In Appendix B, .67 Glossary of Selected Terms and Concepts, of AU sec. 319, we propose the following definitions be

- added to the glossary.

  - Account record The record for the posting entry data of an accountable transaction corresponding to a journal entry. In a manual double entry environment, the record is a blank ledgersheet with a debit column, credit column and balance column.

  - Accountable transaction Any transaction requiring a journal entry in one or more journals and posting entries in corresponding account records.

  - Accounting records The accounting records are the journal and account records.

- clarified by replacing "record" with "journalize, post" to read as follows.

- Accounting system The methods and records estabished to identify, assemble, "journalize, post", and report an entity's transactions and to maintain accountability for the related assets and liabilities.

- added to the glossary.

  - Audit trail The backward track followed from the posting entry to the journal entry to the supporting evidential matter.

  - Classify The process of decribing an accountable transaction in order to record the journal entry and corresponding posting entries.

  - Financial recordkeeping The process of journalizing and posting resulting in account balances being maintained in all ledgers thereby establishing an audit trail for recorded accountability.

  - Journal A collection of journal records in a book, computer file, etc. In a manual environment, journals are traditionally referred to as the books of original entry.

  - Journalize The process of recording a journal entry.

  - Journal entry The data written in the journal record.

  - Journal record The record for the original entry of an accountable transaction. In the traditional manual environment, the record is a blank line on a columnar journal sheet.

- clarified by replacing "record, process, summarize" with "classify, journalize, post" to read as follows.

  - Internal control structure policies and procedures relevant to an audit The policies and procedures in an entity's internal control structure that pertain to the entity's ability to "classify, journalize, post", and report financial data consistent with management's assertions embodied in the financial statements or that pertain to data the auditor uses to apply auditing procedures to financial statement assertions.

- added to the glossary.

  - _Ledger_ A collection of account records in a book, computer file, etc. In a manual environment, ledgers are traditionally referred to as the books of final entry.

  - _Post_ The process of recording a posting entry.

  - _Posting date_ The recording date of the posting entry.

  - _Posting entry_ The data written in the account record.

  - _Transaction date_ The accounting date as defined by law, custom, etc for purposes of litigation, matching income to expense, etc.

  - _Trial balance_ The list or abstract of money amounts and their totals, or of debit balances and credit balances of all accounts in a particular ledger.

In AU Sec. 319 itself, we propose in paragraph

- .06 in the 7th line to replace "record, process, summarize" with "journalize, post";

- .10 in the 2nd line to replace "record" with "journalize, post" and at the

  - 1st bulleted paragraph, to replace "identify and record" with "identify, journalize and post";

  - 2nd bulleted paragraph, in the 1st line to replace "describe" with "classify, journalize and post" and on the next line to replace "classification of transactions" with "financial recordkeeping";

  - 3rd bulleted paragraph, in the 1st line to replace "record" with "report".

- 4th bulleted paragraph, to replace entirely "Determine the time period in which the transactions occurred to permit recording of transactions in the proper accounting period" with..."Record the transaction date and posting date for each transaction journalized and posted to permit reporting of transactions in the proper accounting period."

Paragraph 10, Accounting System, edited with the proposed clarified definitions now reads as follows.

******

The accounting system consists of the methods and records established to identify, assemble, analyze, classify, journalize, post and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will-

- Identify, journalize and post all valid transactions.

- Classify, journalize and post on a timely basis the transactions in sufficient detail to permit proper financial recordkeeping for financial reporting.

- Measure the value of transactions in a manner that permits reporting their proper monetary value in the financial statements.

- Record the transaction date and posting date for each transaction journalized and posted to permit reporting of transactions in the proper accounting period.

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In AU Sec. 319, we continue to propose in paragraph

- .11, at the

    - 2nd bulleted paragraph, in the 4th line to replace "recording" with "journalizing and posting";

    - 5th bulleted paragraph, in the 4th line after the word "controls", to insert "(for example, trial balances automatically compared against their corresponding control totals)."

- .12, at the

    - 5th bulleted paragraph, which says "Its methods of processing data", replace it with "Its data processing and financial recordkeeping methods".

- .19, in the

    - 9th line to replace "processing" with "for financial recordkeeping is double-entry and". After the proposed substitution, the sentance, beginning 3 lines up, now reads.."The auditor also considers his assessments 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 "for financial recordkeeping is double-entry and" is based on manual procedures independent of the computer or is highly dependent on computerized controls".

- .21 at the

    - 3rd bulleted paragraph, in the 2nd line to replace "specific accounts in the financial statements involved in the processing and reporting of transactions" with "how specific ledger accounts are included and reported on in the financial statements".

    - 4th bulleted paragraph, in the 1st line to replace "accounting processing" with "financial recordkeeping and accounting processes through to trial balances" and at the end of this bulleted paragraph after the word "data" to add "included in trial balances".

    - 5th bulleted paragraph, in the 2nd line after the word "statements" insert "from trial balances through to adjusting those balances for statement purposes".

Paragraph .21, Understanding of Accounting System, edited with the proposed clarified definitions now reads as follows.

******

The auditor should obtain sufficient knowledge of the accounting system to understand-

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

- How those transactions are initiated.

- The accounting records, supporting documents, machine-readable information, and "how specific ledger accounts are included and reported on in the financial statements".

- The "financial recordkeeping and accounting processes through to trial balances" involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data "included in trial balances".

- The financial reporting process used to prepare the entity's financial statements "from trial balances through to adjusting those balances for statement purposes" including significant accounting estimates and disclosures.

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Continuing along in AU Sec. 319, we further propose in paragraph

- .23, in the

    - 6th line after the word "operation" insert the sentance "This should always include documentation of the audit trail for all classes of transactions in the entity's operations that are significant to the financial statements."

- .24,in the

    - 5th line to replace "accounting records" with "financial recordkeeping". Beginning in the preceding line, the edited phrase now reads "'...may provide an understanding of the "financial recordkeeping" designed to process those transactions."'(Inferring also processing them through to trial balances).

We conclude our comments with

- Appendix C,

  - .68 Flow Chart-Consideration of the Internal Control Structure in a Financial Statement Audit.

    - From the box that says "ACCOUNTING SYSTEM, and Paragraphs .10, .21", there is a dotted line to another box. In that box, at letter (d), replace "Accounting processing" with "Financial recordkeeping and accounting processes through to trial balances".

- Appendix D,

  - .69 Other Selected Management Control Objectives.

    - In paragraph 2, beginning at the end of the 3rd line, replace "record, process, summarize" with "journalize, post".

    - In paragraph 6, in the 3rd line replace the words "initial record of the transaction is prepared" with "original entry of the transaction is journalized".

The reason for our comments is clarity in our professional communications by using terminolgy which has meaning to accountants who are charged with the responsibility for competently implementing and applying practice standards.

Sincerely,

Ronald Marks

AU Section 319

Consideration of the Internal Control Structure in a Financial Statement Audit

(Supersedes section 320) *

Source: SAS No. 55.

Effective for audits of financial statements for periods beginning on or after January 1, 1990, unless otherwise indicated.

.01 This section provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards.[1] It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

Summary

.02 An entity's internal control structure, for purposes of this section, consists of three elements: the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements 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.

.03 After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. 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. 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.

.04 After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be

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* This section also supersedes Auditing Interpretations of section 320, *The Auditor's Study and Evaluation of Internal Control* (section 9320.01—.06).

[1] This section revises the second standard of fieldwork of the ten generally accepted auditing standards as follows:

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.

available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

.05 The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

Elements of an Internal Control Structure

.06 An entity's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. Although the internal control structure may include a wide variety of objectives and related policies and procedures, only some of these may be relevant to an audit of the entity's financial statements. Generally, the policies and procedures that are relevant to an audit pertain to the entity's ability to record, process, summarize and report financial data consistent with the assertions embodied in the financial statements.[2] Other policies and procedures, however, may be relevant if they pertain to data the auditor uses to apply auditing procedures. For example, policies and procedures pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production statistics, may be relevant in an audit.

.07 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.

.08 For purposes of an audit of financial statements, an entity's internal control structure consists of the three following elements:

- The control environment
- The accounting system
- Control procedures

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

Control Environment

.09 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- The functioning of the board of directors and its committees, particularly the audit committee
- Methods of assigning authority and responsibility

---

[2] The terms *financial statement assertions* and *assertions* are used throughout this section to refer to the five categories of management's assertions that are embodied in the account balance, transaction class, and disclosure components of financial statements as discussed in section 326, *Evidential Matter,* paragraphs .03—.08.

- Management's control methods for monitoring and following up on performance, including internal auditing
- Personnel policies and practices
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies

The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. (The control environment factors are discussed in greater detail in paragraph .66.)

Accounting System

.10 The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration 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.

Control Procedures

.11 Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties that 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 duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail

INSERT

of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

General Considerations

.12 The applicability and importance of specific control environment factors, accounting system methods and records, and control procedures that an entity establishes should be considered in the context of—

- The entity's size.
- Its organization and ownership characteristics.
- The nature of its business.
- The diversity and complexity of its operations.
- Its methods of processing data.
- Its applicable legal and regulatory requirements.

For example, a formal written code of conduct or an organizational structure that provides for formal delegation of authority may be significant to the control environment of a large entity. However, a small entity with effective owner-manager involvement may not need a formal code or organizational structure. Similarly, a small entity with effective owner-manager 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 procedures.

.13 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 under ongoing supervision by management to determine that it is operating as intended and that it is modified as appropriate for changes in conditions.

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

.15 The potential effectiveness of an entity's internal control structure is subject to inherent limitations. Mistakes in the application of 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 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 or procedures.

Consideration of the Internal Control Structure in Planning an Audit

.16 The auditor should obtain a sufficient understanding of each of the three elements 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 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.
- Consider factors that affect the risk of material misstatements.

- Design substantive tests.

.17 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, 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, procedure, or record was applied, the consistency with which it was applied, and by whom. This section does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

.18 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

.19 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 assessments 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 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 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 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 Accounting System

.21 The auditor should obtain sufficient knowledge of the accounting system to understand—

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data. INSERT
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures. INSERT

Understanding of Control Procedures

.22 Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he is also likely to obtain knowledge about some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting 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 procedures obtained from the understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components.

Procedures to Obtain Understanding

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

.24 For example, the auditor's prior experience with the entity may provide an understanding of its classes of transactions. Inquiries of appropriate entity personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records designed to process those transactions and whether they have been placed in operation. Similarly, in obtaining an understanding of the design of computer-programmed control procedures and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation to understand control procedure design and may inspect exception reports generated as a result of such control procedures to determine that they have been placed in operation.

.25 The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

Documentation of Understanding

.26 The auditor should document the understanding of the entity's internal control structure elements obtained to plan the audit. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

Consideration of the Internal Control Structure in Assessing Control Risk

.27 Section 326, *Evidential Matter,* states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions.

.28 The risk of material misstatement [3] in financial statement assertions consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control

[3] For purposes of this section, a material misstatement in a financial statement assertion is an error or irregularity as defined in section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* that either individually or when aggregated with other errors or irregularities in other assertions would be material to the financial statements taken as a whole.

structure policies or procedures. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

.29 Assessing control risk is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions. After obtaining the understanding of the internal control structure, the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.[4]

.30 Assessing control risk at below the maximum level involves—

- Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- Performing tests of controls to evaluate the effectiveness of such policies and procedures.

.31 In identifying internal control structure policies and procedures relevant to specific financial statement assertions, the auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balances or transaction classes and, therefore, can often affect many assertions. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

.32 Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

.33 Internal control structure policies and procedures can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that policy or procedure may be in reducing control risk for that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing control risk for that assertion than policies and procedures more directly related to that assertion, such as matching shipping documents with billing documents.

.34 Procedures directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure are referred to as

[4] Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. The term *maximum level* is used in this section to mean the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

tests of controls. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures. For entities with a complex internal control structure, the auditor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

.35 Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

.36 The conclusion reached as a result of assessing control risk is referred to as the *assessed level of control risk.* In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs .46 through .60. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the internal control structure policies and procedures relevant to an assertion are designed and operating effectively.

.37 The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this section as substantive tests.

.38 As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor may do one or more of the following:

- Change the nature of substantive tests from a less effective to a more effective procedure, such as using tests directly toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity.
- Change the timing of substantive tests, such as performing them at year end rather than at an interim date.
- Change the extent of substantive tests, such as using a larger sample size.

Documentation of the Assessed Level of Control Risk

.39 In addition to the documentation of the understanding of the internal control structure discussed in paragraph .26, the auditor should document the basis for his conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure, and the nature of the entity's documentation of its internal control structure.

Relationship of Understanding to Assessing Control Risk

.40 Although understanding the internal control structure and assessing control risk are discussed separately in this section, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of the internal control structure (discussed in paragraphs .23 through .25) is to provide the auditor with knowledge necessary for audit planning. The objective of tests of controls (discussed in paragraphs .34 through .35) is to provide the auditor with evidential matter to use in assessing control risk. However, procedures performed to achieve one objective may also pertain to the other objective.

.41 Based on the assessed level of control risk the auditor expects to support and audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining the understanding of the internal control structure. In addition, even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of the policies and procedures relevant to certain assertions and, consequently, serve as tests of controls. For example, in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. Although these procedures provide knowledge about the design of the entity's budgeting policies and whether they have been placed in operation, they may also provide evidential matter about the effectiveness of the design and operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In some circumstances, that evidential matter may be sufficient to support an assessed level of control risk that is below the maximum level for the presentation and disclosure assertions pertaining to expenses in the income statement.

.42 When the auditor concludes that procedures performed to obtain the understanding of the internal control structure also provide evidential matter for assessing control risk, he should consider the guidance in paragraphs .46 through .60 in judging the degree of assurance provided by that evidential matter. Although such evidential matter may not provide sufficient assurance to support an assessed level of control risk that is below the maximum level of certain assertions, it may do so for other assertions and thus provide a basis for modifying the nature, timing, or extent of the substantive tests that the auditor plans for those assertions. However, such procedures are not sufficient to support an assessed level of control risk below the maximum level if they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a policy or procedure relevant to an assertion.

Further Reduction in the Assessed Level of Control Risk

.43 After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

.44 In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of the internal control structure in planning the substantive tests for those assertions.

.45 For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

Evidential Matter to Support the Assessed Level of Control Risk

.46 When the auditor assesses control risk at below the maximum level, he should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment. Evidential matter varies substantially in the assurance it provides to the auditor as he develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusion to which it leads, all bear on the degree of assurance evidential matter provides.

.47 These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and reperformance of a policy or procedure that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.

Type of Evidential Matter

.48 The nature of the particular policies and procedures that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those policies and procedures. For some policies and procedures, documentation of design or operation may exist. In such circumstances, the auditor may decide to inspect the documentation to obtain evidential matter about the effectiveness of design or operation.

.49 For other policies and procedures, however, such documentation may not be available or relevant. For example, documentation of design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control procedures, such as segregation of duties or some control procedures performed by a computer. In such circumstances, evidential matter about the effectiveness of design or operation may be obtained through observation or the use of computer-assisted audit techniques to reperform the application of relevant policies and procedures.

Source of Evidential Matter

.50 Generally, evidential matter about the effectiveness of the design and operation of policies and procedures obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. For example, evidential matter about the proper segregation of duties that is obtained by the auditor's direct personal observation of the individual who applies a control procedure generally provides more assurance than making inquiries about the individual. The auditor should consider, however, that the observed application of a policy or procedure might not be performed in the same manner when the auditor is not present.

.51 Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control procedure. When the auditor determines that a specific control procedure may have a significant effect in reducing control risk to a low level for a specific assertion, he ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control procedure.

Timeliness of Evidential Matter

.52 The timeliness of the evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of internal control structure policies and procedures for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement these tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for a control procedure performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the program executes the control effectively. The auditor may then perform tests of controls directed toward the design and operation of other control procedures pertaining to the modification and the use of that computer program during the audit period to obtain evidential matter about whether the programmed control procedure operated consistently during the audit period.

.53 Evidential matter about the effective design or operation of internal control structure policies and procedures that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit.

To evaluate the use of such evidential matter for the current audit, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the prior audits, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make those evaluations, and the evidential matter about design or operation that may result from substantive tests performed in the current audit. The auditor should also consider that the longer the time elapsed since the performance of tests of controls to obtain evidential matter about control risk, the less assurance it may provide.

.54 When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in the internal control structure, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the additional evidential matter about the effectiveness of design and operation to be obtained in the current period.

.55 When the auditor obtains evidential matter about the design or operation of internal control structure policies and procedures during an interim period, he should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the interim period, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make that evaluation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive test performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in the internal control structure, including its policies, procedures, and personnel, that occur subsequent to the interim period.

Interrelationship of Evidential Matter

.56 The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to evaluate the effective design or operation of an internal control structure policy or procedure. To obtain sufficient evidential matter in such circumstances, the auditor may perform other tests of controls pertaining to that policy or procedure. For example, an auditor may observe that programmers are not authorized to operate the computer. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries about the frequency and circumstances under which programmers may have access to the computer and may inspect documentation of past instances when programmers attempted to operate the computer to determine how such attempts were prevented or detected.

.57 In addition, when evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, accounting system, and control procedures. Although an individual internal control structure element may affect the nature, timing, or extent of substantive tests for a specific financial statement assertion, the auditor should consider the evidential matter about an individual element in relation to the evidential matter about the other elements in assessing control risk for a specific assertion.

.58 Generally, when various types of evidential matter support the same conclusion about the design or operation of an internal control structure policy or procedure, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of an internal control structure policy or procedure, the assurance provided decreases. For example, based on the evidential matter that the control environment is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control procedures, the auditor obtains evidential matter that such procedures are ineffective, he may reevaluate his conclusion about the control environment and, among other things, decide to perform auditing procedures at additional locations.

.59 Similarly, evidential matter indicating that the control environment is ineffective may adversely affect an otherwise effective accounting system or control procedure for a particular assertion. For example, a control environment that is likely to permit unauthorized changes in a computer program may reduce the assurance provided by evidential matter obtained from evaluating the effectiveness of the program at a particular point in time. In such circumstances, the auditor may decide to obtain additional evidential matter about the design and operation of that program during the audit period. For example, the auditor might obtain and control a copy of the program and use computer-assisted audit techniques to compare that copy with the program that the entity uses to process data.

.60 An audit of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him to modify the nature, timing, or extent of the other planned tests of controls for assessing control risk. In addition, information may come to the auditor's attention as a result of performing substantive tests or from other sources during the audit that differs significantly from the information on which his planned tests of controls for assessing control risk were based. For example, the extent of misstatements that the auditor detects by performing substantive tests may alter his judgment about the assessed level of control risk. In such circumstances, the auditor may need to reevaluate the planned substantive procedures, based on a revised consideration of the assessed level of control risk for all or some of the financial statement assertions.

Correlation of Control Risk With Detection Risk

.61 The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such misstatements may exist in the financial statements. The auditor uses this evidential matter as part of the reasonable basis for an opinion referred to in the third standard of field work, which follows:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

.62 After considering the level to which he seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the substantive tests performed.

.63 Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.

.64 The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls is to evaluate whether an internal control structure policy or procedure operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction. The auditor should recognize, however, that careful consideration should be given to the design and evaluation of such tests to ensure that both objectives will be accomplished.

Effective Date

.65 This section is effective for audits of financial statements for periods beginning on or after January 1, 1990. Early application of the provisions of this section is permissible.

Appendix A

.66 Control Environment Factors

1. This appendix discusses the control environment factors identified in paragraph .09.

Management Philosophy and Operating Style

2. Management 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; and management's emphasis on meeting budget, profit, and other financial and operating goals. These characteristics have a significant influence on the control environment, particularly when management is dominated by one or a few individuals, regardless of the consideration given to the other control environment factors.

Organizational Structure

3. An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity's organizational units, including the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

Audit Committee

4. An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

Methods of Assigning Authority and Responsibility

5. These methods affect the understanding of reporting relationships and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of—

- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes.

Management Control Methods

6. These methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management control methods include consideration of—

- Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.

- Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
- Using such methods at appropriate management levels to investigate variances from expectations and to take appropriate and timely corrective action.
- Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

Internal Audit Function

7. The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.*

Personnel Policies and Practices

8. These policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

External Influences

9. These are influences established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as examinations by bank regulatory agencies. They also include review and follow-up by parties outside the entity concerning entity actions. External influences are ordinarily outside an entity's authority. Such influences, however, may heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may also prompt management to establish specific internal control structure policies or procedures.

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* Section 322, *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.

Appendix B

.67 Glossary of Selected Terms and Concepts

Accounting system The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

Assertions Management representations that are embodied in the account balance, transaction class, and disclosure components of financial statements. They include (1) existence or occurrence, (2) completeness, (3) rights and obligations, (4) valuation or allocation and (5) presentation and disclosure.

Assessed level of control risk The level of control risk the auditor uses in determining the detection risk to accept for a financial statement assertion and, accordingly, in determining the nature, timing, and extent of substantive tests. This level may vary along a range from maximum to minimum as long as the auditor has obtained evidential matter to support that assessed level.

Assessing control risk The process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting misstatements in financial statement assertions.

Control environment The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods of assigning authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and practices, and (8) external influences concerning the entity.

Control procedures The policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Control risk The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures.

Detection risk The risk that the auditor will not detect a material misstatement that exists in an assertion.

Inherent risk The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

Internal control structure The policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.

Internal control structure policies and procedures relevant to an audit The policies and procedures in an entity's internal control structure that pertain to the entity's ability to record, process, summarize, and report financial data consistent with management's assertions embodied in the financial statements or that pertain to data the auditor uses to apply auditing procedures to financial statement assertions.

Maximum level of control risk The greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

Operating effectiveness How an internal control structure policy or procedure was applied, the consistency with which it was applied, and by whom.

Placed in operation An entity is using an internal control structure policy or procedure.

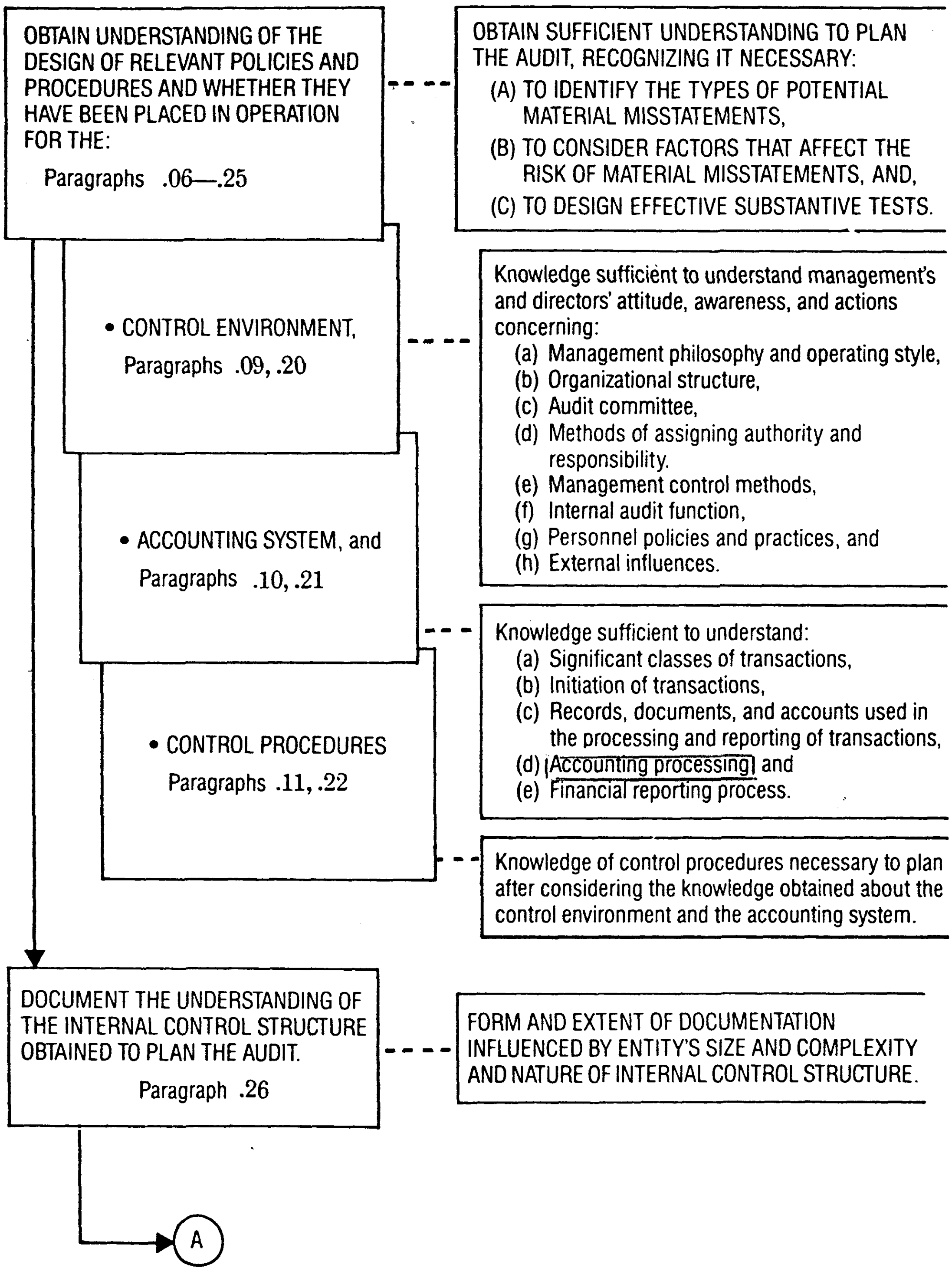
Substantive tests Tests of details and analytical procedures performed to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

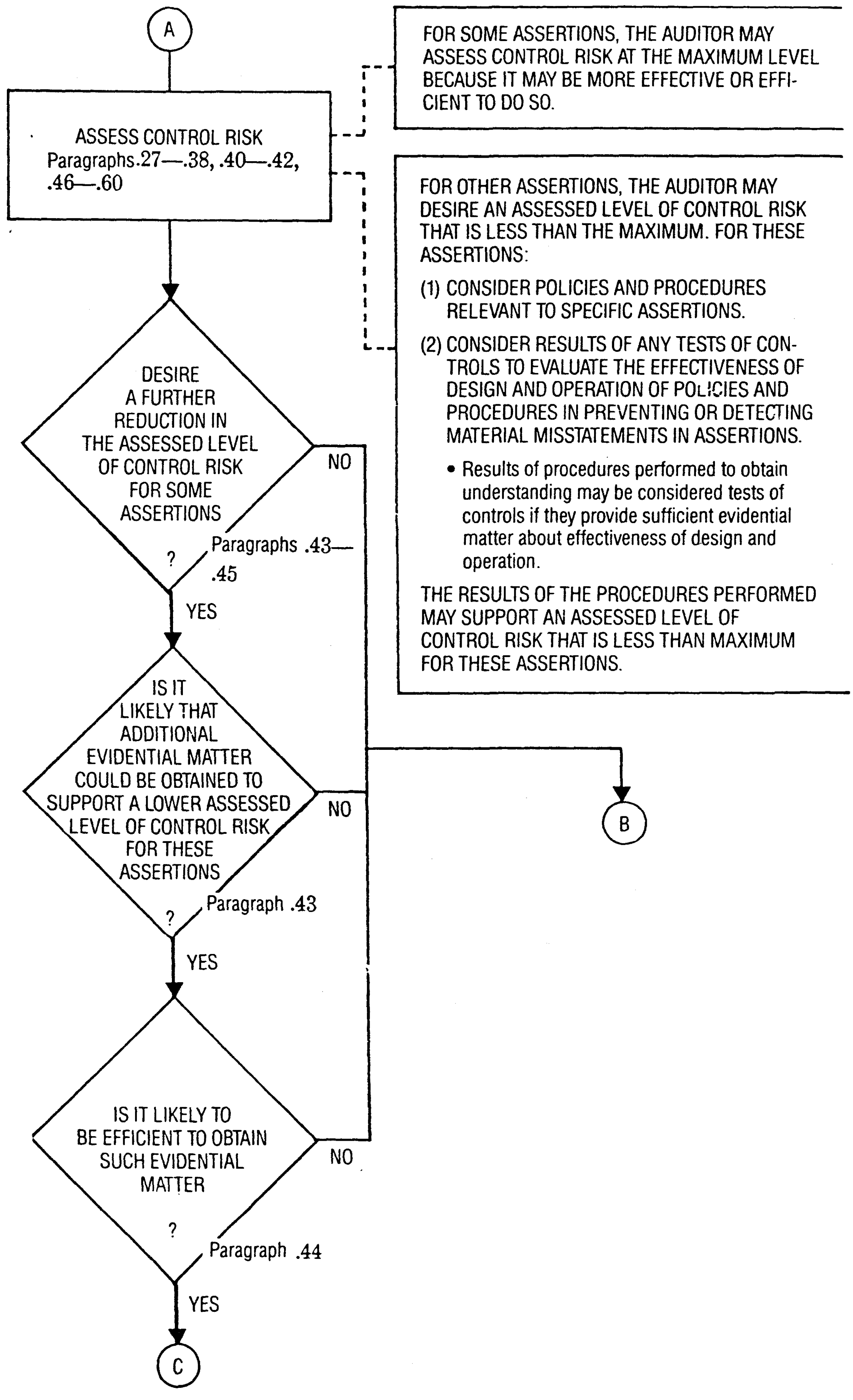
Tests of controls Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

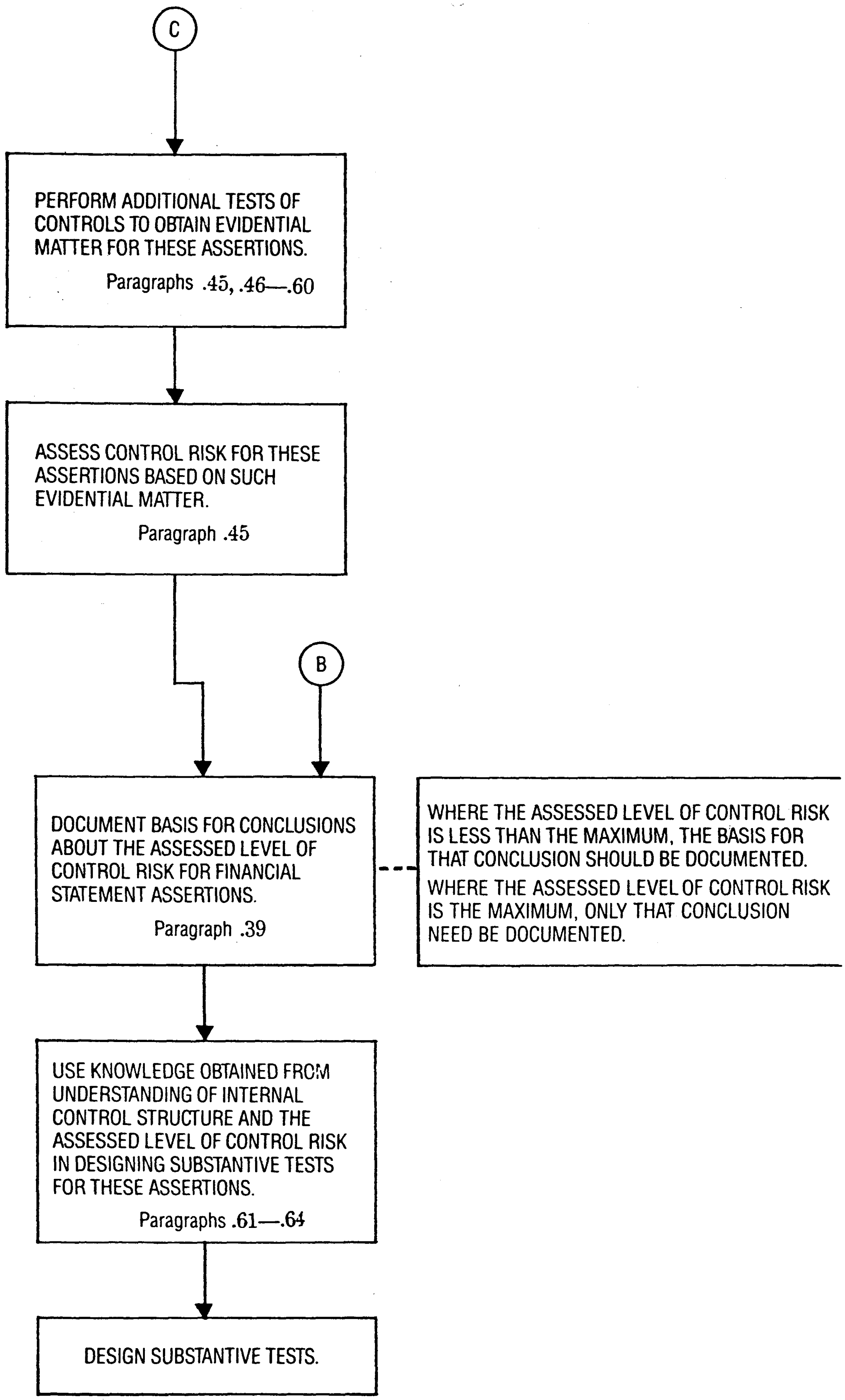
Understanding of the internal control structure The knowledge of the control environment, accounting system, and control procedures that the auditor believes is necessary to plan the audit.

Appendix C

.68 Flow Chart—Consideration of the Internal Control Structure in a Financial Statement Audit




A
ASSESS CONTROL RISK
Paragraphs .27—.38, .40—.42, .46—.60
FOR SOME ASSERTIONS, THE AUDITOR MAY ASSESS CONTROL RISK AT THE MAXIMUM LEVEL BECAUSE IT MAY BE MORE EFFECTIVE OR EFFICIENT TO DO SO.
FOR OTHER ASSERTIONS, THE AUDITOR MAY DESIRE AN ASSESSED LEVEL OF CONTROL RISK THAT IS LESS THAN THE MAXIMUM. FOR THESE ASSERTIONS:
(1) CONSIDER POLICIES AND PROCEDURES RELEVANT TO SPECIFIC ASSERTIONS.
(2) CONSIDER RESULTS OF ANY TESTS OF CONTROLS TO EVALUATE THE EFFECTIVENESS OF DESIGN AND OPERATION OF POLICIES AND PROCEDURES IN PREVENTING OR DETECTING MATERIAL MISSTATEMENTS IN ASSERTIONS.
• Results of procedures performed to obtain understanding may be considered tests of controls if they provide sufficient evidential matter about effectiveness of design and operation.
THE RESULTS OF THE PROCEDURES PERFORMED MAY SUPPORT AN ASSESSED LEVEL OF CONTROL RISK THAT IS LESS THAN MAXIMUM FOR THESE ASSERTIONS.
DESIRE A FURTHER REDUCTION IN THE ASSESSED LEVEL OF CONTROL RISK FOR SOME ASSERTIONS ?
Paragraphs .43—.45
NO
YES
IS IT LIKELY THAT ADDITIONAL EVIDENTIAL MATTER COULD BE OBTAINED TO SUPPORT A LOWER ASSESSED LEVEL OF CONTROL RISK FOR THESE ASSERTIONS ?
Paragraph .43
NO
YES
B
IS IT LIKELY TO BE EFFICIENT TO OBTAIN SUCH EVIDENTIAL MATTER ?
Paragraph .44
NO
YES
C


C
PERFORM ADDITIONAL TESTS OF CONTROLS TO OBTAIN EVIDENTIAL MATTER FOR THESE ASSERTIONS.
Paragraphs .45, .46—.60
ASSESS CONTROL RISK FOR THESE ASSERTIONS BASED ON SUCH EVIDENTIAL MATTER.
Paragraph .45
B
DOCUMENT BASIS FOR CONCLUSIONS ABOUT THE ASSESSED LEVEL OF CONTROL RISK FOR FINANCIAL STATEMENT ASSERTIONS.
Paragraph .39
WHERE THE ASSESSED LEVEL OF CONTROL RISK IS LESS THAN THE MAXIMUM, THE BASIS FOR THAT CONCLUSION SHOULD BE DOCUMENTED.
WHERE THE ASSESSED LEVEL OF CONTROL RISK IS THE MAXIMUM, ONLY THAT CONCLUSION NEED BE DOCUMENTED.
USE KNOWLEDGE OBTAINED FROM UNDERSTANDING OF INTERNAL CONTROL STRUCTURE AND THE ASSESSED LEVEL OF CONTROL RISK IN DESIGNING SUBSTANTIVE TESTS FOR THESE ASSERTIONS.
Paragraphs .61—.64
DESIGN SUBSTANTIVE TESTS.

Appendix D

.69 Other Selected Management Control Objectives

1. The concepts and terminology introduced in this section clarify and update former SAS No. 1, section 320, *The Auditor's Study and Evaluation of Internal Control*, by incorporating the concepts concerning audit evidence and audit risk that have evolved in practice and that have been established by Statements on Auditing Standards issued subsequent to that section. This appendix discusses some of the basic concepts in SAS No. 1, section 320, that are implicit in an internal control structure but that are not explicitly discussed in this section. Although these concepts have general application, the organizational and procedural means for applying them may differ considerably from case to case because of the variety of circumstances involved.

Management Objectives

2. Establishing and maintaining an internal control structure is an important management responsibility. In establishing specific internal control structure policies and procedures concerning an entity's ability to record, process, summarize and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include the following:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Access to Assets

3. The objectives of safeguarding assets requires that access to assets be limited to authorized personnel. In this context, access to assets includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access to assets is required in the normal operations of a business and, therefore, limiting access to authorized personnel is the maximum feasible constraint. The number and competence of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires appropriate physical segregation and protective equipment or devices.

Comparison of Recorded Accountability With Assets

4. The purpose of comparing recorded accountability with assets is to determine whether the actual assets agree with the recorded accountability. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories.

5. If the comparison reveals that the assets do not agree with the recorded accountability, it provides evidence of unrecorded or improperly recorded

transactions. The converse, however, does not necessarily follow. For example, agreement of cash count with the recorded balance does not provide evidence that all cash received has been properly recorded.

6. This illustrates an unavoidable distinction between fiduciary and recorded accountability: the former arises immediately upon acquisition of an asset; the latter arises only when the initial record of the transaction is prepared.

7. As to assets that are susceptible to loss through errors or irregularities, the comparison with recorded accountability should be made independently. The frequency with which such comparison should be made for the purpose of safeguarding assets depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sales. Similarly, the value and vulnerability of some products may make frequent complete inventories worthwhile.

8. The frequency with which comparison of recorded accountability with assets should be made for the purpose of achieving reliability of the records for preparing financial statements depends on the materiality of the assets and their susceptibility to loss through errors and irregularities.

9. The action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and cause of the discrepancy. Appropriate action may include adjustment of the accounting records, filing of insurance claims, revision of procedures, or administrative action to improve the performance of personnel.

[The next page is 307.]

• GEORGE M. PARKER,
ACCOUNTANT
ENROLLED TO PRACTICE BEFORE
THE INTERNAL REVENUE SERVICE

• MEMBER NATIONAL SOCIETY OF
PUBLIC ACCOUNTANTS

• MEMBER GEORGIA ASSOCIATION
OF PUBLIC ACCOUNTANTS

• ACCOUNTING

• BOOKKEEPING AND
WRITE-UP

• TAX SERVICES AND
REPRESENTATION
BEFORE IRS

• MANAGEMENT ADVISORY
SERVICES

• FINANCIAL PLANNING

• INVESTMENT PLANNING
AND COUNSELING

GEO. PARKER & ASSOC, INC.
ACCOUNTING AND TAX CONSULTANTS
SUITE 304
235 EAST PONCE DE LEON AVENUE
DECATUR, GEORGIA 30030

(404) 378-8837

June 2, 1992

Ms A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, N. Y. 10036-8775

Dear Ms Williamson:

re: Exposure Draft
Attestation Engagements
Dated: 4-20-92
File #: 4287

The above exposure draft has made some substantial improvement in the Auditors Reporting on Internal Control. However, one major issue that was not addressed in this exposure draft, as well as SAS No. 30, was the Publicly Held vs Non-Publicly Held Companies. Accordingly, it is felt that the exposure draft should be more responsive to the needs of small business.

Non-Publicly Held Companies, because of their size, will often not be able to have the "separate function" doctrine in place that larger companies have. In order to have maximum internal control, the separate function doctrine is a very key element to this end. Accordingly, these companies often rely on the integrity of management for certain control measures.

It is felt that the exposure draft should be modified to make a distinction between Publicly Held Companies and Non-Publicly Held Companies. That an "exception" procedure should be allowed for Non-Publicly held companies. That this exception would allow the auditor to place a greater emphasis on Managements Report by recognizing that a particular internal control area was a management controlled function.

There will be some that will argue that to some extent this is already in place by virtue of "the auditors judgement." This is not entirely true. The auditor does have discretionary judgement. However, the Exposure Draft makes no distinction between the small, non-publicly held company, and the large Fortune 500 company. Accordingly, he is not able to say that I am placing a greater reliance on Managements Report for this reason.

Sincerely,

George M. Parker

(9)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation:

Comments:

- CONSIDER SPECIFYING IN PARAGRAPH 45 CRITERIA FOR WHO SHOULD SIGN THE MANAGEMENT REPRESENTATION (IE; WHO, IN PARTICULAR, SHOULD ASSERT MANAGEMENTS VIEW OF ITS INTERNAL CONTROLS).

- PARAGRAPH 8 - SHOULD INDEPENDENCE BE SPECIFICALLY STATED AS A CONDITION OF ACCEPTANCE; OR IS THIS PRESUMED.

- SAS 60 SAYS YOU CAN ISSUE A "NO MATERIAL WEAKNESS LETTER"; DOES THAT NEED TO BE REITERATED HERE. ALSO - SAS 60 PROHIBITS A "NO REPORTABLE CONDITIONS" LETTER - SHOULD THAT BE RE-EMPHASIZED.

MARK GREENSTEIN
6/19/92

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

10

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: Charles I. Bunn, Jr. - Wilson & Bunn, P.A.
101 Johnston Street - Smithfield NC 27577-4559

Comments:

I have read this document and find that the material is too difficult for me to understand, and that even the circumstances that suggest the need for this statement are unclear. I can not imagine a circumstance that would require management to issue an opinion on its internal control system; it would be helpful if that were explained further.

GENERAL COMMENT: Having performed several quality reviews of small firms (1-3 professionals), a common complaint that I hear is that these standards are not written so that they can be understood without supplemental explanation. Such supplemental material is often only available through a CPE course offered by the AICPA. By writing standards above the level of understanding of the average practitioner, the AICPA is breeding contempt among its members. I suggest that the AICPA embark on a public relations campaign directed to the really small firms and include such things as free supplemental information with newly issued pronouncements, as well as taking advantage of your own version of Grammatik to rewrite the standards in simpler language. Quality reviews are helping practitioners, definitely. Yet the firms are perceiving the AICPA to be the cause of the difficulties they are having in complying with (understanding) professional standards.

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

(11)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: Bruce D. Norling, CPA
410 Boston Post Rd
Sudbury MA 01776
member AICPA, Mass Society of CPAs
Reviewer in Quality Review Program

Comments:

Agree w/o exception the contents of this proposed SAS and believe it can be issued in present form.

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:

A. Louise Williamson, Technical Manager

Auditing Standards Division

AICPA, 1211 Avenue of the Americas

12

FINANCIAL EXECUTIVES
INSTITUTE

Joseph A. Sciarrino
Vice President and Technical Director

June 18, 1992

A. Louise Williamson
Technical Manager
Auditing Standards Division
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Williamson:

The Committee on Corporate Reporting (CCR) of the Financial Executives Institute (FEI) appreciates the opportunity to comment on the Exposure Draft of the proposed statement on standards for attestation engagements entitled, "Reporting on an Entity's Internal Control Structure over Financial Reporting" (ED).

Overall, the CCR has serious concerns and reservations with the approach taken in the ED. It appears that the fundamental issue in the ED is the elimination of SAS 30 guidance in favor of establishing a new foundation for reporting which is premised upon, and limits reporting to, only those instances in which management has actually made an "assertion" about the effectiveness of the entity's internal control structure. The CCR believes this approach is much too restrictive. We continue to believe that the current SAS 30 guidance, which states that "An independent accountant may express an opinion on a system of internal accounting control of any entity for which financial statements in conformity with generally accepted accounting principles, or any other criteria applicable to such statements, can be prepared" (AU 642.37), should be retained.

Although we understand the desires of certain financial institutions and regulators for definitive attestation guidance related to reporting on an entity's internal control structure over financial reporting, the CCR believes that investors, industry, all other users of financial statements, as well as the integrity of the auditing profession, would be better served by avoiding attempts at guidance such as are included in this proposed ED. We believe it would be more responsible for independent auditors to

10 Madison Ave., P.O. Box 1938, Morristown, NJ 07962-1938 (201) 898-4600

"step up to the plate" and recognize their existing obligations. This could be accomplished by modifying the scope paragraph of the auditor's report to indicate ". . . that an audit was performed in accordance with generally accepted auditing standards, including a review of internal financial controls . . ." and to further disclose the extent to which such internal financial controls were relied upon as part of their examination. Should the auditor conclude that the audit scope needs to be expanded and substantive testing increased because internal controls are inadequate, this decision could be clearly disclosed in their respective audit report so that readers can better understand those instances in which controls cannot be relied upon.

When one views the ED in conjunction with the most current COSO draft and the Federal legislation actively supported by the AICPA, it appears that there is a continuing move to mandate practice requiring management to include an assertion on the effectiveness of the internal control structure over financial reporting and for such assertion to be accompanied by an auditors' report. The CCR strongly opposes any suggested mandate and continues to believe that the form and extent to which management reports on the entity's internal accounting controls should be voluntary and determined by each entity's unique operating situation. Furthermore, the CCR questions if the rationale for the proposed separate "attestation" approach is merely an attempt to reduce an auditors' liability exposure and/or to aid in justifying additional fees. As U.S. industry strives to be more competitive on a global basis, the last thing needed is increased reporting complexity and resulting cost. CCR believes that should the ED be finalized in its current form, it will cause concern to be raised about the value added of the independent accountants' services to both their clients and to the public.

Our specific comments on the ED are as follows:

Paragraph Reference	**Comments**
General (as comment relates to many paragraphs)	The proposed reporting guidelines should be expanded to encompass those situations in which management has included wording in its report such as ". . . management is responsible for maintaining a system of internal controls designed to provide reasonable assurance that assets are safeguarded . . .", etc., but stops short of an assertion that the internal control system is effective. CCR believes that independent accountants are eminently qualified and should continue to be permitted to render an opinion/report on whether or not the internal control structure over financial reporting does or does not meet its intended objectives (i.e., paragraphs AU 642.37, AU 642.38 and AU 642.39 of existing SAS 30).

Paragraph Reference	Comments
47.c.	The ED requires the auditors' report to include a separate paragraph indicating that ". . . because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected." In addition, the Ed notes, ". . . that the paragraph should state that projections of any evaluation of the internal control structure over financial reporting to future periods is subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate." Such qualifying language serves only to reduce the credibility of the management report.
60.	Auditors are required to disclaim an opinion on management's cost/benefit statement if the management report notes that it is believed the cost of correcting a weakness would exceed the benefits to be derived from implementing new policies and procedures. There is a one-sided exception to this directive which focuses on situations in which the auditor believes the client's cost/benefit statement is a material misstatement of fact. CCR believes that this outright prohibition against concurrence with management on such issues is not indicative of the auditor's ability to render quality services. Users of the report have a right to the auditor's opinion, whether positive or negative.
84.	The ED attempts to distinguish between an auditor and a practitioner merely because of a differentiation between reporting on internal control and reporting on financial statements. The CCR believes most clients, including a vast preponderance of audit committee members, already expect independent auditors to identify material weaknesses in internal controls, even in the absence of management reports. Therefore, we are concerned that users of the proposed attestation reports will fail to understand and accept the external auditors' more limited "practitioner" role.

Paragraph Reference	**Comments**
86.	This paragraph states ". . . whether an entity is in compliance with those provisions [the internal accounting control provision] of the FCPA is a legal determination. A practitioner's examination report issued under this statement does not indicate where an entity is in compliance with those provisions." It is the understanding of CCR that the current FCPA definition of internal control was based on the AICPA literature. Accordingly, it does not appear rational for the auditing profession to extend their scope of services in the internal control area while at the same time distancing themselves from providing clients with some positive degree of comfort regarding compliance with a directly related law. The CCR is concerned that in the existing political environment, auditors would desire to reduce the value of their professional services to both their clients and the public at large. Such action can only lead to further regulatory controls.

CCR would be pleased to discuss any aspect of our comments, should you desire.

Sincerely,

Joseph A. Sciarrino/afc

Joseph A. Sciarrino

JAS/afc

(13)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: GEORGE P. FOLEY GEORGE P. FOLEY CPA

Comments: Outlining that the practitioner should affirm, qualify or express adverse opinions on the company's internal control structure when management includes a assertion in the body of the report or by a like kind statement in the client's letter of representation establishes a prudent standard for the practitioner. Also where a material weakness that impacts the financial reporting process, not precluding the possibility of material misstatements in the financial ~~mis~~ statement, management must declare or state in their opinion on internal control the weakness. Said weaknesses are "reportable conditions" and must be communicated to the respective elements of the organization (Board of Directors, Audit Committee, Chief financial officer or accounting officer), when management disagrees on the materiality weakness ~~there~~ should be standard practice. ~~M~~ Management communications in writing from the practitioner during the attest process and in the final stages of the engagement precludes mgmt claims that they lack adequate time to address the weakness. Subsequent written communication

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CUT ALONG LINE

Comments (continued): from management that they will take corrective action after the opinion date can be disclosed in the body of the opinion, but cannot change the qualified or adverse nature of the opinion. Also where there is no ~~no~~ mutual assent by practitioner and management, each respective party should consult legal counsel.

Para. 40 b Paragraph by itself is confusing. Restructuring of paragraphs could facilitate understanding.

George P. Foley CPA.

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036-8775

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EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: R.J. McDonnell, Director, Office of Financial Approvals/Maritime Administration/DOT

Comments:

The assertion "Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected", is a negative characterization of internal controls and raises doubts in management as to the effectiveness and worthiness of such controls. The inherent limitation referred to in the definition is not characteristic of internal controls rather it is the dynamic characteristic of risks which are constantly changing due to internal as well as external forces. These risks are present in all endeavors.

The "traditional" inherent limitations paragraph should be revised in order to focus on risk, the primary condition which is the relative gulf between the effectiveness of internal controls and the occurrence of negative results.

The control structure, like any other endeavor, is subject to inherent risk. Furthermore, there is no fundamental difference in the underlying cause for "inherent", "control" and "detection" risks as set forth in SAS 55. Risks are imbedded in all endeavors. Only when risks are recognized and accepted may effective control structures be implemented and monitored to keep up with changing negative outcomes.

The unintended negative result of any endeavor is an inherent risk effecting not only internal controls but accordingly the auditor's ability to detect a material misstatement. While risks are present in all endeavors, degrees of responsibility may be established.

Management is primarily responsible for the internal control structure which affects the auditor's ability to detect material misstatements. However, the inherent risk to the auditor of not detecting material misstatements is also present which should be acknowledged and addressed. The acknowledgement of inherent risks in the audit report provides a basis for qualifications regarding the potential for financial statements being materially misstated.

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued): The internal control structure addressed in audit reports should be characterized in a positive manner to reinforce and assure the effective review and updating of such controls by management. Furthermore, the identification and focus on inherent risks justifies and encourages management, as well as the auditor, to constantly monitor potential risks as well as controls in order to "stay on top of" ever changing and expanding negative outcomes.

Return responses to:

A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

ILLINOIS CPA SOCIETY & FOUNDATION

(15)

July 20, 1992

Ms. A. Louise Williamson
Technical Manager
Auditing Standards Division
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Re: Exposure Draft--Proposed Statement on Standards for Attestation Engagements "Reporting on an Entity's Internal Control Structure over Financial Reporting" File Reference #4287

Dear Ms. Williamson:

The Auditing Services Committee of the Illinois CPA Society is pleased to submit its response to the request for comments on the above Exposure Draft. The first several comments are pervasive in nature; the later comments address specific paragraphs and issues.

Point in Time Versus Period Reporting

A basic concern running throughout the proposed Standard is whether management's assertion and the practitioner's opinion are directed to the effectiveness of the internal control structure at a date or for a period of time. While the Standard indicates that the most common choice will be at a date, "effective internal control structure over financial reporting as of December 31, 19xx" is misleading wording. Only the balance sheet is at that date; the other three financial statements are operating statements covering a period of time, probably the year ended that date. Thus, the report wording would imply that the internal controls over amounts for the operating statements were effective for the entire reporting period. If this is not what was intended, the point must be clarified.

Consider the following example. If the client had ineffective controls over the operating statements in effect through December 15th, and then corrected the weaknesses so the controls were effective through year-end, can you say that the controls over financial reporting as of

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December 31st were effective? Disclosure of reportable conditions and material weaknesses that were discovered to have existed during the period but corrected as of year-end would provide the user with better information to evaluate the internal control structure over all of the financial statement reporting. This issue affects several paragraphs in the Statement, such as 1, 33, and 35.

Extension of SAS 55 (AU 319) Concepts

The proposed statement extends some of the concepts of internal control structure that exist in SAS 55. We believe that SAS 55 should be amended to include these extensions, so that the presentation of internal control structure matters is centralized rather than fragmented across several pronouncements. This is especially true since this proposed statement is an Attestation Standard, not a SAS.

This issue arises in parts of paragraphs 15 and 16 of this proposed statement dealing with the limitations of the internal control structure, and the paragraph below the bullet points in part c of paragraph 25, in talking about the meaning of "safeguarding of assets."

Completeness of Examples

The proposed statement would benefit from inclusion of more complete illustrations, either in the body of the document or in appropriate appendices.

Most small businesses (and some larger ones) do not posses the expertise to compose a management assertion report. Paragraph 3 is rather vague about the form and content of this report. Should the definition of internal control selected by management (paragraph 10) be included? How should the disclosure of material weaknesses (paragraph 39), the description of cost/benefit (paragraph 60), or the description of subsequent events (paragraph 68) be worded? Examples would be extremely useful to avoid the need for each company to "reinvent the wheel."

An example should illustrate the wording suggested for describing the "established criteria" in the opinion paragraph when these are the criteria established by the AICPA. These are, after all, the criteria upon which the discussion in much of the exposure draft revolves. This would first appear in the opinion paragraph of the report in paragraph 48.

Specifically Directed Concerns:

Paragraph 1

The summary accompanying the exposure draft forcefully indicates that the practitioner can not issue an opinion on a company's internal control structure, but only on management's assertion regarding it. However, the summary does not become part of the official pronouncement. It would be useful for the Statement itself to make this point.

Paragraph 9

Are there situations in which the practitioner who assisted management in developing an assertion on the internal control structure should be precluded from issuing an opinion on that assertion?

Paragraph 19, Bullet Point 6

The concept of inherent risk in this setting should be developed in some depth. Is it the likelihood that management will assert that the internal control structure is effective, when in fact it is not? Is it the likelihood that controls covering a particular financial statement assertion will be inadequate?

Paragraphs 22 and 23

It is unclear whether paragraph 22 would allow a practitioner to issue an opinion on management's assertion when management has not documented its understanding of the internal control structure. Our reading is that management documentation is required, which we do not believe should be the case. The requirement of paragraphs 22 and 23 might better be stated as: "The practitioner must document his understanding of the internal control structure. Management may have developed appropriate documentation that the accountant can also utilize."

Paragraph 25

This might simply reference SAS 55 (AU 319.09-319.11) instead of reciting the specifics of the elements of an internal control structure. This is especially true because it follows from one specific definition of internal control structure, which need not be the one adopted by management in making its assertion. Also, the original wording in AU 319.11 more clearly indicates that the last sentences in bullet points c3 and c4 are intended to be examples, not requirements.

Paragraph 27

The discussion of specific control criteria should be tied to the idea of controls covering specific assertions for each significant account or major class of transactions. If the AICPA criteria are adopted, they require that controls over all major specific assertions in the financial statements must be considered if the practitioner is to express an opinion.

Paragraph 39

The definition of material weaknesses and the idea of how material weaknesses differ from reportable conditions deserve elaboration. Practitioners need concrete guidance on how to make these distinctions, in the hope of avoiding disagreements with management and ensuing litigation. We strongly encourage the Auditing Standards Board to provide clarification in this area.

Paragraph 40

It would be useful in paragraph (a) to indicate which of these ranges is for overstatement errors and which is for understatements.

Paragraph 45

Footnote 7 states that AU 333.9 gives guidance on the date on which management should sign the representation. There is no such reference in AU 333.9. Furthermore, the reason given in AU 333.9 for dating the report as of completion of field work, namely the possibility of post balance sheet events requiring disclosure in the financial statements is not immediately relevant in this attestation engagement. At the very least, the reason would be that controls exist to insure that relevant post balance sheet events are recognized and evaluated for possible disclosure in the financial statements.

Paragraph 55

Are there minimum standards for required disclosure of material weaknesses? AU 642.40 required a description of the material weaknesses, an indication of whether they result from the absence of control procedures or the degree of compliance with them, and a description of the general nature of potential errors or irregularities that might occur as a result of the weaknesses. These minimum disclosure standards should be retained.

Paragraph 61

This paragraph provides wording to be used when material weaknesses were found in the internal control structure, and management's assertion is presented in a document containing an audit report. It seems that this wording would be useful in other situations as well, such as when no material weaknesses were found but the audit report was other than unqualified because of concerns about fair presentation.

Paragraph 70

Perhaps the report wording should indicate that the opinion relates to this segment only and should not be extrapolated to other segments.

Paragraphs 71 and 72

An example of management's assertion report for this case would be very useful. Since this is an opinion about an assertion regarding a proposed internal control structure, the date wording is misleading. Perhaps the wording can be

> [identify management's assertion, for example, that W Casino's internal control structure over financial reporting proposed as of December 31, 19xx is

suitably designed to prevent or detect material misstatements in the financial statements on a timely basis.]

Paragraph 73

Again, an example of management's report would be desirable. There is also the question of how a practitioner would know whether the regulatory agency has used due process in developing the control criteria. Guidance on how the practitioner can make this determination is critical.

Paragraphs 74 through 77

Are the requirements of these paragraphs applicable only when management's assertion is based on criteria specified by a regulatory agency that did not follow due process? If that is not the case, a new bold face heading above paragraph 74 would be necessary to avoid confusion.

Paragraph 78

The first word in the third sentence should apparently be "ordinarily" rather than "otherwise."

The above represents the views of the Illinois CPA Society rather than that of any of the individual members of the committee or any of the firms or organizations with which they are associated.

Very truly yours,

John M. Kiss

John M. Kiss
Chairman Audit Services Committee

JMK:ao

(10)

Telephone:
(916) 445-0255

STATE OF CALIFORNIA
Office of the Auditor General
660 J STREET, SUITE 300
SACRAMENTO, CA 95814

Kurt R. Sjoberg
Auditor General (acting)

July 28, 1992

A. Louise Williamson, Technical Manager
Auditing Standards Division
File 4287
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, N.Y. 10036-8775

Dear Ms. Williamson:

We have read the proposed statement on standards for attestation engagements titled "Reporting on an Entity's Internal Control Structure Over Financial Reporting." Although our office does not engage in such type of attestation, we want to make a few brief comments on the proposed statement.

Since our office is normally not involved in engagements that require us to follow attestation standards, we cannot fully assess the effect of moving AU section 642 to the attestation standards. It certainly seems reasonable to move those auditing sections that are not directly related to financial statement audits out of the AU sections. However, the requirement that only management assertions are attested to and that only criteria established by a recognized body be used may limit the potential for this type of attestation service.

Except for paragraph 28, we do not have any conceptual or logical problems. Paragraph 28 deals with testing the design of a specific internal control structure policy or procedure. We think that this paragraph is unclear. It is difficult to visualize testing the design effectiveness as opposed to the operating effectiveness. Why should accountants test the design? Is it implied that the accountant gets involved in the design stage? If so, are we not talking more about efficiency rather than effectiveness? Unless the nature of paragraph 28 is made more clear, we recommend that it be deleted, together with the language in other parts of the document that are related to this paragraph.

Other than paragraph 28, we only have one suggestion for a minor edit change. The last sentence of paragraph 22 states: "No one particular form of documentation is necessary,..." We recommend that this part of the sentence be changed to: "A particular form of documentation is not prescribed,..." In our opinion, this would reflect better the true intent of the sentence.

We appreciate the opportunity to comment on the exposure draft. If you have any questions, please contact me or Curt Davis, deputy auditor general, at (916) 445-0255.

Sincerely,

Kurt Sjoberg

KURT R. SJOBERG
Auditor General (acting)

17

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
CENTENNIAL BUILDING, ST. PAUL, MN 55155 • 612/296-4708
JAMES R. NOBLES, LEGISLATIVE AUDITOR

July 31, 1992

Ms. A. Louise Williamson, Technical Audit Manager
Auditing Standards Division, File 4287
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Williamson:

Enclosed is the response of the Minnesota Office of the Legislative Auditor to the AICPA Proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting Exposure Draft*. The following staff participated in the development of this response:

John Asmussen, Deputy Legislative Auditor
Warren Bartz, Audit Manager
Tom Donahue, Audit Manager
Claudia Gudvangen, Audit Manager
Margaret Jenniges, Audit Manager
Jeanine Leifeld, Audit Manager
Renee Redmer, Audit Manager
Jim Riebe, Quality Control Director

We appreciate the opportunity to respond to this Exposure Draft and hope you find our comments useful.

Sincerely,

John Asmussen
Deputy Legislative Auditor

Enclosure

Minnesota Office of the Legislative Auditor
Response to the AICPA Exposure Draft
Reporting on an Entity's Internal Control
Structure Over Financial Reporting

We have three concerns with the *Reporting on an Entity's Internal Control Structure Over Financial Reporting Exposure Draft (ED)*. Our first concern is the relationship between the Exposure Draft and existing literature requiring government auditors to report on internal control. A second matter is whether or not definitive criteria exists for management to use in evaluating the effectiveness of the entity's internal control structure. Finally, the readability of the audit opinions presented in this ED and other AICPA literature concerns us.

Relationship Between This Exposure Draft and Existing Literature Requiring Government Auditors To Report On Internal Control

Generally accepted government auditing standards require auditors to report on internal control as part of a financial statement or financial related audit. Specifically, the third supplemental reporting standard for government financial audits *(Government Auditing Standards)* requires the auditor to prepare a written report on their understanding of the entity's internal control structure. It also requires that the report address the auditor's assessment of control risk.

Similarly, AICPA Statement of Position 90-9, *The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act*, contains additional guidance on the auditor's responsibility for reporting on the internal control structure in a financial statement audit. Another source of guidance is Statement on Auditing Standards (SAS) No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*.

Paragraph 7. of the ED references these and other standards associated with audit services provided in connection with an entity's internal control structure. Our concern is that these standards were developed when Statement on Auditing Standards No. 30 was the authoritative basis for auditor reports on internal control. SAS No. 30 allowed auditors to report on internal control. That is, it did not preclude auditors from reporting on internal control in the absence of a related management assertion. By superceding SAS No. 30, the *Government Auditing Standards*, SAS No. 68, and SOP 90-9 lose their authoritative foundation. As a result, they appear to be in conflict with other AICPA guidance on auditor reports, including this ED, which restricts auditors to report only on management's assertions. We would like clarification on this point.

A related question is whether the ED allows auditors to construct management's assertion on the effectiveness of the internal control structure. Paragraph 9. indicates that management may engage the practitioner to gather information to enable management to evaluate the effectiveness of the internal control structure. This implies that management would always initiate auditor services for reports on internal control: either to satisfy a regulatory requirement, or to obtain its own assessment of the effectiveness of the internal control structure.

However, we believe that in the government sector management should not have this discretion. In our opinion, auditor reports on internal control in the government sector are essential. They provide an independent assessment about whether management is meeting its obligation to maintain an effective internal control structure in the administration of public funds.

Criteria to Evaluate the Effectiveness of the Internal Control Structure

Paragraph 8. of the ED specifies conditions that must exist for a practitioner to report on management's assertion about the effectiveness of an entity's internal control structure. One condition is that management evaluate the effectiveness of the entity's internal control structure using reasonable criteria established by a recognized body (paragraph 8.b.). A major concern to us is the lack of reasonable control criteria. Although regulatory agencies have developed such criteria, we are not aware of other criteria that would apply generally to internal control structures. Until the profession adopts reasonable control criteria such as the *Internal Control-Integrated Framework Exposure Draft* published by the Committee of Sponsoring Organizations of the Treadway Commission or similar criteria, we question the practicality of this requirement.

Readability of Auditor Reports on Internal Control

We would again like to communicate our dissatisfaction with the suggested language used in the report examples contained in this Exposure Draft and other AICPA pronouncements. For example, paragraph 48 contains a standard audit report to use in an examination of management's assertion about the effectiveness of the entity's internal control structure. The report language is unusually complex and difficult to read. Factors contributing to this are excessively long sentences, frequent multiple clauses, many prepositional phrases, and the predominant use of passive rather than active voice. Similar weaknesses exist in the modified report examples contained in paragraphs 58 and 66. Our analysis suggests that readers would need higher than an advanced college education to understand this report. We strongly believe that written communication with our readers is of vital importance to our profession. Therefore, we must significantly improve our reports so that they are clear, concise, and easily understood by our readers.

(18)

STATE AUDITOR OF MISSOURI
JEFFERSON CITY, MISSOURI 65102

MARGARET KELLY, CPA
STATE AUDITOR

(314) 751-4824

July 30, 1992

Ms. A. Louise Williamson
Technical Manager
Auditing Standards Division, File 4287
American Institute of Certified Public
Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Williamson:

Enclosed are our comments on the proposed Statement on Standards for Attestation Engagements entitled "Reporting on an Entity's Internal Control Structure Over Financial Reporting."

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

Sincerely,

Margaret Kelly

Margaret Kelly, CPA
State Auditor

Enclosures

COMMENTS - PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS, "REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING"

The Office of Missouri State Auditor appreciates the opportunity to comment on the American Institute of Certified Public Accountants' (AICPA's) proposed Statement on Standards for Attestation Engagements (SSAE), "Reporting on an Entity's Internal Control Structure Over Financial Reporting." Although we generally support the issuance of the proposed SSAE, we have indicated below several suggestions for improvements or clarifications.

OTHER ATTEST SERVICES

paragraph 5 - Paragraph 5 of the proposed SSAE refers the practitioner to the guidance in the Attestation Standards when he or she is engaged to apply agreed-upon procedures to and report on management's assertion about the effectiveness of the internal control structure over financial reporting. We suggest the AICPA consider including specific guidance to address any unique concerns (e.g., reporting language) related to such an engagement that would not be addressed by the current standards for agreed-upon procedures engagements. The draft for the proposed SSAE, "Compliance Attestation," (published in the May minutes of the Auditing Standards Board) does include specific guidance for an engagement to apply agreed-upon procedures to management's assertion about the effectiveness of an entity's internal control structure over compliance.

paragraph 6 - Paragraph 6 states that the practitioner should not accept an engagement to **review** and report on management's assertion about the effectiveness of the internal control structure but does not explain why. This statement might be followed by a sentence similar to that appearing in paragraph 6 of the proposed SSAE, "Compliance Attestation": "The scope and level of assurance in a review engagement could vary to such an extent that a review report would be less understandable to users than a report on the performance of agreed-upon procedures or on an examination."

EXAMINATION ENGAGEMENT

Testing and Evaluating the Design Effectiveness of Internal Control Structure Policies and Procedures

paragraph 28 - Paragraph 29 lists procedures commonly performed to test the **operating** effectiveness of control structure policies and procedures. To be consistent with paragraph 29, paragraph 28 might do the same for tests of the **design** effectiveness. AU sec. 319.34 states:

> Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures. For entities with a complex internal control structure, the auditor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

MANAGEMENT'S REPRESENTATIONS

paragraph 45 - We suggest paragraph 45 be followed by statements regarding the effect of management's refusal to provide written representations. These statements might be modeled after paragraph 68 of the proposed SSAE, "Compliance Attestation." Paragraph 68 indicates:

> Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to require a qualified opinion or disclaimer of opinion on management's assertion about the entity's compliance with specified requirements. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

REPORTING STANDARDS

Management's Assertion Presented in a Separate Report

paragraph 47 -

1. Since all reports illustrated in the proposed SSAE are entitled Independent Accountant's Report, we suggest paragraph 47 state that the first required report element is "A title that includes the word independent" (similar to paragraph 53 of the proposed SSAE, "Compliance Attestation").

2. We also suggest the AICPA consider whether the introductory paragraph of the report should identify management's responsibility for the internal control structure over financial reporting and the practitioner's responsibility to express an opinion on management's assertion regarding that internal control structure. Such statements would be consistent with the requirements for the introductory paragraphs of:

   a. The auditor's report on financial statements (AU sec. 508.08).

   b. The auditor's report on compliance with specific compliance requirements for major federal financial assistance programs in audits conducted under the Single Audit Act of 1984 (AU sec. 801.80).

   c. The practitioner's report on management's assertion about an entity's compliance with specified requirements (paragraph 53 of proposed SSAE, "Compliance Attestation").

   If paragraph 47 is modified to require the statements regarding management and practitioner responsibilities, the example reports in paragraphs 48, 51, 66, 70, 72, and 77 would need to be modified accordingly.

REPORT MODIFICATIONS

Material Weaknesses

paragraph 60 - We suggest paragraph 60 clarify the placement of the disclaimer statement within the example reports discussed in paragraphs 55, 58, and 59.

Scope Limitations

paragraph 63 - The scope paragraph should conclude with this sentence: "We believe that our examination provides a reasonable basis for our opinion."

paragraph 64 - We suggest the proposed SSAE be modified to include an example of a report disclaiming an opinion on management's assertion about the effectiveness of the internal control structure.

Opinion Based in Part on the Report of Another Practitioner

paragraph 66 - The modifications to the introductory and opinion paragraphs in paragraph 66 are similar to those in AU sec. 508.13 for an audit of the financial statements when the auditor's opinion is based in part on the report of another auditor. Based on AU sec. 508.13, however, we suggest the reference in paragraph 66 to the standard scope paragraph be replaced by the appropriate text for that paragraph:

> Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination **and the report of the other accountants** provide a reasonable basis for our opinion. [emphasis added]

The modification needed to the last sentence of the paragraph is not evident in the proposed SSAE.

Subsequent Events

paragraph 68 - We suggest paragraph 68 be modified to indicate the appropriate location for the explanatory paragraph referred to in the last sentence. For example, paragraph 68 might include a parenthetical phrase similar to the one appearing in the next-to-last line of paragraph 54.

paragraph 69 - The last sentence of paragraph 69 refers the practitioner to AU sec. 561.06 for guidance on actions to be taken when, subsequent to the date of the practitioner's report, information is discovered that may have existed at that date.

paragraph 69 (cont.)

Since AU sec. 561.06 is specific to financial statement audits, we believe the guidance should be modified as necessary for engagements to report on the internal control structure and added to the proposed SSAE. This change would be consistent with paragraphs 78-81 which modify the guidance in AU sec. 550, "Other Information in Documents Containing Audited Financial Statements," for the engagements covered by the proposed SSAE.

Management's Assertion Based on Criteria Specified by a Regulatory Agency That Did Not Follow Due Process

paragraph 77 -

1. We suggest the AICPA reconsider the introductory and scope paragraphs to determine whether they can be made less repetitive. The second sentence of the scope paragraph, except for the reference to AICPA standards, essentially repeats the sentence comprising the introductory paragraph.

2. Paragraph 77 might clarify how the example report would be modified for the situation discussed in paragraph 74--the need to report certain conditions not reported by management that are not in conformity with the agency's criteria.

OTHER COMMENTS

In addition to providing the comments above, we have also enclosed a marked draft with several suggested editorial changes.

EXPOSURE DRAFT

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

(Supersedes SAS No. 30,
Reporting on Internal Accounting Control**)**

APRIL 20, 1992

Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting

Comments should be received by August 14, 1992, and addressed to
A. Louise Williamson, Technical Manager, Auditing Standards Division, File 4287
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036–8775

SUMMARY

Why Issued

The Auditing Standards Board is considering the issuance of this proposed statement on standards for attestation engagements to provide guidance to practitioners who are engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting.

What It Does

This proposed Statement provides guidance to assist the practitioner in—

- Accepting an engagement.
- Planning the engagement.
- Obtaining an understanding of the internal control structure.
- Testing and evaluating the design effectiveness and the operating effectiveness of internal control structure policies and procedures.
- Forming an opinion on management's assertion, using material weakness as the basis for determining whether the practitioner's opinion should be modified.
- Communicating reportable conditions.

This proposed guidance would apply to auditors of insured depository institutions who examine management's assertions about the effectiveness of the internal control structure over financial reporting, as required by the Federal Deposit Insurance Corporation Improvement Act of 1991.

How It Would Change Existing Standards

This proposed Statement would supersede Statement on Auditing Standards (SAS) No. 30, *Reporting on Internal Accounting Control* (AICPA, *Professional Standards*, vol. 1, AU sec. 642). It differs from SAS No. 30 in that the proposed Statement—

- Requires practitioners to consider whether management's assertion is based on reasonable criteria against which it can be evaluated, and whether the assertion is capable of reasonably consistent estimates or measurement using those criteria. (Unlike SAS No. 30, this proposed Statement does not define the specific criteria.)
- Precludes the practitioner from reporting directly on the company's internal control structure. (Unlike SAS No. 30, this proposed Statement does not allow the practitioner to report directly on the company's internal control structure. Instead, the practitioner reports on management's assertion only.)
- Precludes the practitioner from issuing a public report unless management's assertion is included in a separate written report that accompanies the practitioner's report.
- Requires the practitioner to limit his or her report on management's assertion about the company's internal control structure when management elects to present its assertion only in a representation letter and not in a separate written report.
- Updates the definition of internal control, including terminology and concepts that are consistent with SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.*

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
- *Members of the AICPA Council and technical committees.*
- *State society and chapter presidents, directors, and committee chairpersons.*
- *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
- *Persons who have requested copies.*

AICPA

American Institute of Certified Public Accountant[s]

1211 Avenue of the Americas
New York, NY 10036-8775
(212) 575-6200 Telex: 70-339[illegible]
Telecopier (212) 575-3846

April 20, 1992

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board, of a proposed statement on standards for attestation engagements titled *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. This proposed Statement would supersede Statement on Auditing Standards No. 30, *Reporting on Internal Accounting Control*. A summary of the proposed Statement also accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate consideration of responses by the Auditing Standards Board, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from attestation engagements. It also considers the differences that an auditor may encounter in an attestation engagement involving small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the Board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the AICPA after September 14, 1992, for one year. Responses should be sent to the Auditing Standards Division, File 4287, in time to be received by August 14, 1992.

Sincerely,

Donald L. Neebes

Donald L. Neebes
Chairman
Auditing Standards Board

Dan M. Guy

Dan M. Guy
Vice President
Auditing Standards Division

TABLE OF CONTENTS

Note: On the following pages, the symbol means "delete."

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

APPLICABILITY

1. This Statement provides guidance to the practitioner who is engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting *as of a point in time.*[1] An entity's internal control structure over financial reporting[2] includes those policies and procedures that pertain to an entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both.[3] A practitioner engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure should comply with the general, fieldwork, and reporting standards in the Statement on Standards for Attestation Engagements (SSAE) *Attestation Standards* (AICPA, *Professional Standards,* vol. 1, AT sec. 100), and the specific performance and reporting standards set forth in this Statement.

2. Management may present its written assertion about the effectiveness of the entity's internal control structure in either of two forms:

a. A separate report that will accompany the practitioner's report

b. A representation letter to the practitioner (in this case, however, the practitioner should restrict the use of his or her report to management and others within the entity and, if applicable, to specified regulatory agencies)

A practitioner should not consent to the use of his or her examination report on management's assertion about the effectiveness of an entity's internal control structure in a general-use document unless management presents its written assertion in a separate report that will accompany the practitioner's report.

3. Management's written assertion about the effectiveness of an entity's internal control structure may take various forms. Throughout this document, for example, the phrase, "management's assertion that W Company maintained an effective internal control structure over financial reporting as of [*date*]," illustrates such an assertion. Other phrases, such as "management's assertion that W Company's internal control structure over financial reporting is sufficient to meet the stated objectives" may also be used. However, a practitioner should not provide assurance on an assertion that is so subjective (for example, a "very effective" internal control structure) that people having competence in and using the same or similar measurement and disclosure criteria would not ordinarily be able to attain materially similar estimates or measurements.

4. The guidance in this Statement does not apply if management does not present a written assertion. In this situation, there is no assertion by management on which the practitioner can provide assurance. However, management may engage the practitioner to provide certain nonattest services in connection with the entity's internal control structure. For example, management may engage the practitioner to provide recommendations on improvements to the entity's internal control structure. A practitioner engaged to provide such nonattest services should consider the guidance in the Statement on Standards for Consulting Services (AICPA, *Professional Standards,* vol. 2, CS sec. 100).

OTHER ATTEST SERVICES

5. A practitioner may also be engaged to provide other types of services in connection with an entity's internal control structure. For example, he or she may be engaged to apply *agreed-upon procedures* to and report on management's assertion about the effectiveness of the entity's internal control structure. For such engagements, the practitioner should refer to the guidance in the *Attestation Standards.*

6. Although a practitioner may *examine* or *apply agreed-upon procedures* to management's assertion about the effectiveness of the entity's internal control structure, he or she should not accept an engagement to *review* and report on such a management assertion.

7. The appendix presents a listing of Statements on Auditing Standards that provide guidance for a practitioner engaged to provide other services in connection with an entity's internal control structure. Under the Securities Exchange Act of 1934, certain reports on the entity's internal control structure are

[1] Ordinarily, management will present its assertion about the effectiveness of the entity's internal control structure over financial reporting as of the end of the entity's fiscal year; however, management may select a different date for its assertion. A practitioner also may be engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting *during a period of time.* In that case, the guidance in this Statement should be modified accordingly.

[2] Throughout this Statement, an entity's internal control structure over financial reporting is referred to simply as its "internal control structure."

[3] A 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 25*c*, or other operating controls or controls over compliance with laws and regulations) should refer to the guidance in the Statement on Standards for Attestation Engagements (SSAE) *Attestation Standards* (AICPA, *Professional Standards,* vol. 1, AT sec. 100) and to paragraph 7 of this Statement.

required. Rule 17a-5 requires such a report for a broker or dealer in securities. AICPA Statement of Position (SOP) 89-4, *Reports on the Internal Control Structure of Brokers and Dealers in Securities*, contains a sample report that a practitioner might use in such circumstances. In addition, Form N-SAR requires a report on the internal control structure of an investment company. A sample report that a practitioner might use in such situations is included in the Audit and Accounting Guide *Audits of Investment Companies*, published by the American Institute of Certified Public Accountants. Such information, included in the Appendix to this Statement, in Rule 17a-5, and in Form N-SAR, is not covered by this Statement.

CONDITIONS FOR ENGAGEMENT ACCEPTANCE

8. A practitioner may *examine* and report on management's assertion about the effectiveness of an entity's internal control structure if the following conditions are met:

a. Management is sufficiently knowledgeable about the entity's internal control structure to accept responsibility for the assertion about the effectiveness of the entity's internal control structure.

b. Management evaluates the effectiveness of the entity's internal control structure using reasonable criteria for effective internal control structures established by a recognized body. Such criteria are referred to as "control criteria" throughout this Statement.[4]

c. Sufficient competent evidential matter exists or could be developed to support management's evaluation.

d. Management presents its written assertion, as discussed in paragraph 2, about the effectiveness of the entity's internal control structure based upon the control criteria referred to in its report.

9. Management is responsible for maintaining an effective internal control structure. In some cases, management may evaluate and report on the effectiveness of that structure without the practitioner's assistance. However, management may engage the practitioner to gather information to enable management to evaluate the effectiveness of the entity's internal control structure.

ELEMENTS OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

10. The 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 Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). Paragraphs 11 through 14 describe the elements that constitute an entity's internal control structure as defined in SAS No. 55. If management selects another definition of an internal control structure, the description of the elements contained in those paragraphs may not be relevant.

11. SAS No. 55 describes an entity's internal control structure as consisting of three elements—the control environment, the accounting system, and control procedures—and including the policies and procedures established to provide reasonable assurance that specific entity objectives are achieved.

12. An entity's control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and the emphasis placed on it within the entity. It represents the collective effects of various factors, described in paragraph 25*a*, on establishing, enhancing, or mitigating the effectiveness of specific internal control structure policies and procedures. An effective control environment interacts with elements of the accounting system and with control procedures to help provide reasonable assurance that specific entity objectives are achieved.

13. As further described in paragraph 25*b*, the entity's accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

14. Control procedures are those policies and procedures in addition to the control environment and accounting system that management establishes to help ensure that specific entity objectives are met. As described in paragraph 25*c*, they have various objectives and are applied at various organizational and data processing levels within an entity. They may also be integrated into specific components of the control environment and the accounting system.

LIMITATIONS OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

15. There are inherent limitations that should be recognized when considering the effectiveness of any internal control structure. In the application of many control policies and procedures, the potential exists for errors to arise from causes such as misunderstood instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, policies and procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, irregularities perpetrated by manage-

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[4] Criteria issued by the AICPA, regulatory agencies, and other bodies composed of experts that follow due process procedures, including procedures for broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose.

Criteria established by a regulatory agency that do not follow such due process procedures also may be considered reasonable criteria for use by the regulatory agency. However, the practitioner would have to modify his or her report by adding a paragraph that limits its distribution to those within the entity and to the regulatory agency (see paragraphs 72 through 76).

Paragraph numbers are incorrect.

3

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does

Word should be "does" to agree with noun "agency."

ment may not be susceptible to prevention or detection by specific control policies or procedures, because management may not be subject to the controls that deter employees or may override those controls.

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

EXAMINATION ENGAGEMENT

17. The practitioner's objective in an engagement to examine and report on management's assertion about the effectiveness of the entity's internal control structure is to express an opinion about whether management's assertion regarding the effectiveness of the entity's internal control structure is fairly stated, in all material respects, based upon the control criteria. The practitioner's opinion relates to the fair presentation of management's assertion about the effectiveness of the entity's internal control structure taken as a whole, and not to the effectiveness of each individual element (control environment, accounting system, and control procedures) of the entity's internal control structure. Therefore, the practitioner considers the interrelationship of the elements of an entity's internal control structure in achieving the objectives of the control criteria. To express an opinion on management's assertion, the practitioner accumulates sufficient competent evidence about the design and operating effectiveness of the entity's internal control structure to attest to management's assertion, thereby limiting attestation risk to an appropriately low level. When evaluating the design effectiveness of specific control policies and procedures, the practitioner considers whether the control policy or procedure is suitably designed to prevent or detect material misstatements on a timely basis. When evaluating operating effectiveness, the practitioner considers how the policy or procedure was applied, the consistency with which it was applied, and by whom it was applied.

Suggest deleting this repetitive phrase.

18. Performing an examination of management's assertion about the effectiveness of an entity's internal control structure involves (*a*) planning the engagement, (*b*) obtaining an understanding of the internal control structure, (*c*) testing and evaluating the design effectiveness of the internal control structure policies and procedures, (*d*) testing and evaluating the operating effectiveness of the internal control structure policies and procedures, and (*e*) forming an opinion about whether management's assertion regarding the effectiveness of the entity's internal control structure is fairly stated, in all material respects, based up on the control criteria.

Word "upon" is used in this phrase elsewhere.

Planning the Engagement

19. *General Considerations.* Planning an engagement to examine and report on management's assertion about the effectiveness of the entity's internal control structure involves developing an overall strategy for the scope and performance of the engagement. When developing an overall strategy for the engagement, the practitioner should consider factors such as the following:

- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, government regulations, and technological changes
- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and production, distribution, an compensation methods
- Knowledge of the entity's internal control structure obtained during other professional engagements
- The extent of recent changes, if any, in the entity, its operations, or its internal control structure
- Management's method of evaluating the effectiveness of the entity's internal control structure based upon the control criteria
- Preliminary judgments about materiality levels, inherent risk, and other factors relating to the determination of material weaknesses
- The type and extent of evidential matter supporting management's assertion about the effectiveness of the entity's internal control structure
- The nature of specific internal control structure policies and procedures designed to achieve the objectives of the control criteria, and their significance to the internal control structure taken as a whole
- Preliminary judgments about the effectiveness of the internal control structure

Phrase used in AU sec. 311.07

20. *Multiple Locations.* A practitioner planning an engagement to examine management's assertion about the effectiveness of the internal control structure of an entity with operations in several locations should consider factors similar to those he or she would consider in performing an audit of the financial statements of an entity with multiple locations. It may not be necessary to understand and test controls at each location. In addition to the factors listed in paragraph 19, the selection of locations should be based on

factors such as (*a*) the similarity of business operations and internal control structures at the various locations, (*b*) the degree of centralization of records, (*c*) the effectiveness of control environment policies and procedures, particularly those that affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations, and (*d*) the nature and amount of transactions executed and related assets at the various locations.

21. *Internal Audit Function.* Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function. An important responsibility of the internal audit function is to monitor the performance of an entity's controls. One way internal auditors monitor such performance is by performing tests that provide evidence about the effectiveness of the design and operation of specific internal control structure policies and procedures. The results of these tests are often an important basis for management's assertions about the effectiveness of the entity's internal control structure. A practitioner may find the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), helpful when assessing the competence and objectivity of internal auditors, the extent of work to be performed, and other matters.

22. *Documentation.* Internal control structure policies and procedures and the control objectives that they were designed to achieve should be appropriately documented to serve as a basis for management's and the practitioner's reports. Such documentation is generally prepared by management. However, at management's request, the practitioner may assist in preparing or gathering such documentation. This documentation may take various forms: entity policy manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, or completed questionnaires. No one particular form of documentation is necessary, and the extent of documentation may vary depending upon the size and complexity of the entity.

Obtaining an Understanding of the Internal Control Structure

23. A practitioner generally obtains an understanding of the design of specific policies and procedures by making inquiries of appropriate management, supervisory, and staff personnel; by inspecting entity documents; and by observing entity activities and operations. The nature and extent of the procedures a practitioner performs vary from entity to entity and are influenced by his or her knowledge of the internal control structure obtained in previous professional engagements, understanding of the industry in which the entity operates, and judgments about materiality.

Testing and Evaluating the Design Effectiveness of Internal Control Structure Policies and Procedures

24. As discussed in paragraph 10, the elements that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. Paragraph 25 describes the elements of the internal control structure that the practitioner should understand if management decides to evaluate and report on the entity's internal control structure based on the definition of an internal control structure contained in SAS No. 55. If management selects another definition of an internal control structure, the description of the elements contained in paragraph 25 may not be relevant.

25. To evaluate the design of an entity's internal control structure, the practitioner should obtain an understanding of the internal control structure policies and procedures within each element (control environment, accounting system, and control procedures) of the internal control structure. These elements are described below.

a. An entity's control environment includes—
   - Management's philosophy and operating style.
   - The entity's organizational structure.
   - The functioning of the board of directors and its committees, particularly the audit committee.
   - Methods of assigning authority and responsibility.
   - Management's control methods for monitoring and following up on performance, including internal auditing.
   - Personnel policies and practices.
   - Various external influences that affect an entity's operations, such as examinations by regulatory agencies.

b. An entity's accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will—
   - Identify and record all valid transactions.
   - Describe the transactions on a timely basis and in sufficient detail to permit proper classification for financial reporting.
   - Measure the value of transactions in a manner that permits reporting of 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.

c. An entity's control procedures may be categorized as procedures that pertain to—

Change phrases to be similar to those in AU sec. 319-11, eliminating unclear pronoun references "It," "This," and "These."

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunity of any person to both perpetrate and conceal errors or irregularities in the normal course of his or her duties. It includes assigning to different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records and appropriate monitoring, to help ensure the proper recording of transactions and events. This includes the such as monitoring of prenumbered shipping documents. the use
- Adequate safeguards over access to and use of assets and records. These include secured facilities and authorized access such as to computer programs and data files.
- Independent checks on performance and proper valuation such as of recorded amounts. These include clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the details of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

26. Any of the elements of the internal control structure may include policies and procedures designed to achieve the objectives of the control criteria. Some control structure policies and procedures may have a pervasive effect on achieving many overall objectives of these criteria. For example, computer general controls over program development, program changes, computer operations, and access to programs and data help assure that specific controls over the processing of transactions are operating effectively. In contrast, other control structure policies and procedures are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific control policies and procedures, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

27. The practitioner should focus on the significance of internal control structure policies and procedures in achieving the objectives of the control criteria rather than on specific policies and procedures in isolation. The absence or inadequacy of a specific policy or procedure designed to achieve the objectives of a specific criterion may not be a deficiency if other policies or procedures specifically address the same criterion. Further, when one or more internal control structure policy or procedure achieves the objectives of a specific criterion, the practitioner may not need to consider other policies or procedures designed to achieve those same objectives.

28. Tests of the effectiveness of the design of a specific internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Such tests will vary depending upon the nature of the specific policy or procedure, the nature of the entity's documentation of the specific policy or procedure, and the complexity and sophistication of the entity's operations and systems.

Testing and Evaluating the Operating Effectiveness of Internal Control Structure Policies and Procedures

29. To evaluate the operating effectiveness of an entity's internal control structure, the practitioner performs tests of relevant control structure policies and procedures to obtain sufficient evidence to support the opinion in the report. Tests of the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied, and by whom it was applied. Such tests ordinarily include inquiries of appropriate personnel, inspection of relevant documentation, observation of the entity's operations, and reapplication or reperformance of the internal control structure procedure.

30. The evidential matter that is sufficient to support a practitioner's opinion on management's assertion is a matter of professional judgment. However, the practitioner should consider matters such as the following:

- The nature of the internal control structure policy or procedure
- The significance of the internal control structure policy or procedure in achieving the objectives of the control criteria
- The nature and extent of tests of the operating effectiveness of internal control structure policies and procedures performed by the entity, if any
- The risk of noncompliance with the internal control structure policy or procedure, which might be assessed by considering the following:
  - Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
  - Whether there have been changes in controls
  - The degree to which the control relies on the effectiveness of other controls (for example, control environment policies and procedures or computer general controls)

- Whether there have been changes in key personnel who perform the control or monitor its performance
- Whether the control relies on performance by an individual or by electronic equipment
- The complexity of the control policy or procedure
- Whether more than one control achieves a specific objective

31. Management or other entity personnel may perform tests of the operating effectiveness of certain internal control structure policies and procedures and provide the practitioner with the results of such tests. Although the practitioner should consider the results of such tests when evaluating the operating effectiveness of control structure policies and procedures, it is the practitioner's responsibility to obtain sufficient evidence to support his or her opinion. When evaluating whether sufficient evidence has been obtained, the practitioner should consider that evidence obtained through his or her direct personal knowledge, observation, reperformance, and inspection is more persuasive than information obtained indirectly, such as from management or other entity personnel. Further, judgments about the sufficiency of evidence obtained and other factors affecting the practitioner's opinion, such as the materiality of identified control deficiencies, should be those of the practitioner.

32. The nature of the policies and procedures influences the nature of the tests of controls the practitioner can perform. For example, the practitioner may examine documents regarding control structure policies and procedures for which documentary evidence exists. However, documentary evidence regarding some control environment policies and procedures (such as management's philosophy and operating style) often does not exist. In these circumstances, the practitioner's tests of controls would consist of inquiries of appropriate personnel and observation of entity activities. The practitioner's preliminary judgments about the effectiveness of control environment policies and procedures often influence the nature, timing, and extent of the tests of controls to be performed to obtain evidence about the operating effectiveness of control structure policies and procedures in the accounting system and other control procedures.

33. The period of time over which the practitioner should perform tests of controls is a matter of judgment; however, it varies with the nature of the control policies and procedures being tested and with the frequency with which specific control procedures operate and specific policies are applied. Some control structure policies and procedures operate continuously (for example, controls over sales) while others operate only at certain times (for example, controls over the preparation of interim financial statements and controls over physical inventory). The practitioner should perform tests of controls over a period of time that is adequate to determine whether, as of the date selected by management for its assertion, the control structure policies and procedures necessary for achieving the objectives of the control criteria are operating effectively.

34. Management may present a written assertion about the effectiveness of internal control structure policies and procedures related to the preparation of interim financial information. Depending on management's assertion, the practitioner should consider whether to perform tests of internal control structure policies and procedures in effect during one or more interim periods to form an opinion about the effectiveness of such policies and procedures in achieving the related interim reporting objectives.

35. Prior to the date as of which it presents its assertion, management may change the entity's internal control structure policies and procedures to make them more effective or efficient, or to address control deficiencies. In these circumstances, the practitioner may not need to consider control structure policies or procedures that have been superseded. For example, if the practitioner determines that the new control policies or procedures achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the practitioner to assess their design and operating effectiveness by performing tests of controls, the practitioner will not need to consider the design and operating effectiveness of the superseded control structure policies or procedures.

Forming an Opinion on Management's Assertion

36. When forming an opinion on management's assertion about the effectiveness of an entity's internal control structure, the practitioner should consider all evidence obtained, including the results of the tests of controls and any identified control deficiencies, to evaluate the design and operating effectiveness of the internal control structure policies and procedures based on the control criteria.

Similar phrase used in AU sec. 325.02

DEFICIENCIES IN AN ENTITY'S INTERNAL CONTROL STRUCTURE

37. During the course of the engagement, the practitioner may become aware of significant deficiencies in the entity's internal control structure. The practitioner's responsibility to communicate such deficiencies is described in paragraphs 43 and 44.

Reportable Conditions

38. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), defines reportable conditions as matters coming to an auditor's attention that in his or her judgment represent significant deficiencies in the design or operation of the internal control structure that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent

with the assertions of management in the financial statements.

Material Weaknesses

Word should be "does" to agree with noun "operation."

does

39. A reportable condition may be of such magnitude as to be considered a material weakness. SAS No. 60 defines a material weakness as a condition in which the design or operation of one or more of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Therefore, the presence of a material weakness will preclude management from asserting that the entity has an effective internal control structure. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, management may qualify its assertion (that is, assert that the internal control structure is effective "except for" the material weakness noted).[5]

40. When evaluating whether a reportable condition is also a material weakness, the practitioner should recognize that—

a. The amounts of errors or irregularities that might occur and remain undetected range from zero to the gross financial statement amounts or transactions that are exposed to the reportable condition.

b. The risk of errors or irregularities is likely to be different for the different possible amounts within that range. For example, the risk of errors or irregularities in amounts equal to the gross exposure might be very low, but the risk of smaller amounts might be progressively greater.

41. In evaluating whether the combined effect of individual reportable conditions results in a material weakness, the practitioner should consider—

a. The range or distribution of the amounts of error or irregularities that may result during the same accounting period from two or more individual reportable conditions.

b. The joint risk or probability that such a combination of errors or irregularities would be material.

42. Evaluating whether a reportable condition is also a material weakness is a subjective process that depends on such factors as the nature of the accounting system and of any financial statement amounts or transactions exposed to the reportable condition, the overall control environment, other control procedures, and the judgment of those making the evaluation.

Communicating Reportable Conditions and Material Weaknesses

43. A practitioner engaged to examine and report on management's assertion about the effectiveness of the entity's internal control structure should communicate reportable conditions to the audit committee[6] and identify the reportable conditions that are also considered to be material weaknesses. Such a communication should preferably be made in writing.

44. Because timely communication may be important, the practitioner may choose to communicate significant matters during the course of the examination rather than after the examination is concluded. The decision about whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

MANAGEMENT'S REPRESENTATIONS

45. The practitioner should obtain written representations from management—[7]

a. Acknowledging management's responsibility for establishing and maintaining the internal control structure.

b. Stating that management has performed an evaluation of the effectiveness of the entity's internal control structure and specifying the control criteria used.

c. Stating management's assertion about the effectiveness of the entity's internal control structure based upon the control criteria.

d. Stating that management has disclosed to the practitioner all reportable conditions and identified those that it believes to be material weaknesses in the internal control structure.

e. Describing any material irregularities and any other irregularities that, although not material, involve management or other employees who have a significant role in the entity's internal control structure.

f. Stating whether there were, subsequent to the date of management's report, any changes in the internal control structure or other factors that might significantly affect the internal control structure, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

REPORTING STANDARDS

46. The form of the practitioner's report depends on the manner in which management presents its written assertion.

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[5] Paragraphs 53 through 61 contain guidance the practitioner should consider when reporting on a management assertion that contains, or should contain, a description of a material weakness.

[6] If the entity does not have an audit committee, the practitioner should communicate with individuals whose authority and responsibility are equivalent to those of an audit committee, such as the board of directors, the board of trustees, an owner in an owner-managed entity, or those who engaged the practitioner.

[7] Paragraph 9 of SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), provides guidance on the date as of which management should sign such a representation letter and the date on which member(s) of management should sign it.

a. If management's assertion is presented in a separate report that accompanies the practitioner's report, the report is considered appropriate for general distribution and the practitioner should use the form of report discussed in paragraphs 47 and 48.

b. If management presents its assertion only in a representation letter to the practitioner, the practitioner should restrict the distribution of the report to management, to others within the entity, and, if applicable, to specified regulatory agencies, and the practitioner should use the form of report discussed in paragraphs 49 through 51.

Management's Assertion Presented in a Separate Report

(1) X

47. When management presents its assertion in a separate report that will accompany the practitioner's report, the practitioner's report should include—

a. An identification of management's assertion about the effectiveness of the entity's internal control structure over financial reporting.

b. A statement that the examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, that it included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as the practitioner considered necessary in the circumstances. In addition, the report should include a statement that the practitioner believes the examination provides a reasonable basis for his or her opinion.

c. A paragraph stating that, because of inherent limitations of any internal control structure, errors or irregularities may occur and not be detected. In addition, the paragraph should state that projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

d. The practitioner's opinion on whether management's assertion about the effectiveness of the entity's internal control structure over financial reporting as of the specified date is fairly stated, in all material respects, based up on the control criteria. X

Word "upon" is used in this phrase elsewhere.

48. The following is the form of report a practitioner should use ~~when he or she has examined management's assertion about the effectiveness of an entity's internal control structure as of a specified date.~~ in such circumstances.

<u>Independent Accountant's Report</u>

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].[8]

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Management's Assertion Presented Only in a Letter of Representation to the Practitioner

49. Sometimes, management may present its written assertion about the effectiveness of the entity's internal control structure in a representation letter to the practitioner but not in a separate report that accompanies the practitioner's report. For example, an entity's board of directors may request the practitioner to report on management's assertion without requiring management to present a separate written assertion.

50. Paragraph 46 of the SSAE *Attestation Standards* states:

> The practitioner who accepts an attest engagement should issue a report on the assertions or withdraw from the attest engagement. When a report is issued, the assertions should be identified by referring to a separate presentation of assertions that is the responsibility of the asserter. The presentation of assertions should generally be bound with or accompany the practitioner's report. Because the asserter's responsibility for the assertion should be clear, it is ordinarily not sufficient merely to include the assertion in the practitioner's report.

When management does not present a written assertion that accompanies the practitioner's report, the practitioner should modify the report

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[8] The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control structure as management uses in its report, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting.

(1) Introductory sentence for example report could be shortened since circumstances were previously identified -- management's assertion presented in a separate report.

to include management's assertion about the effectiveness of the entity's internal control structure and add a paragraph that limits the distribution of the report to management, to others within the entity, and, if applicable, to a specified regulatory agency.

Move "that" inside brackets to be consistent with other examples.

51. A sample report that a practitioner might use in such circumstances follows.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion, included in its representation letter dated February 15, 19XX, that [*identify management's assertion, for example,* W *Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*]. [date] that

[*Standard scope, inherent limitations, and opinion paragraphs*]

[*Limitation on distribution paragraph*]

This report is intended for the information and use of the board of directors and management of W Company [*and, if applicable, a specified regulatory agency*] and should not be used by third parties for any other purpose.

REPORT MODIFICATIONS

52. The practitioner should modify the standard reports in paragraphs 48 and 51 if any of the following conditions exist:

a. There is a material weakness in the entity's internal control structure (paragraphs 53 through 61).

b. There is a restriction on the scope of the engagement (paragraphs 62 through 64).

c. The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's own report (paragraphs 65 and 66).

d. A significant subsequent event has occurred since the date of management's assertion (paragraphs 67 through 69).

e. Management presents an assertion about the effectiveness of only a segment of the entity's internal control structure (paragraph 70).

f. Management presents an assertion only about the suitability of design of the entity's internal control structure (paragraphs 71 and 72).

g. Management's assertion is based upon criteria established by a regulatory agency without following due process (paragraphs 73 through 77).

Material Weaknesses

53. If the examination discloses conditions that, individually or in combination, result in one or more material weaknesses (paragraphs 39 through 42), the practitioner should modify the report. The nature of the modification depends on whether management includes, in its assertion, a description of the weakness and its significance in the achievement of the objectives of the control criteria.

54. *Management Includes the Material Weakness in its Assertion.* If management includes in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, and if it appropriately modifies its assertion about the effectiveness of the entity's internal control structure in light of that weakness,[9] the practitioner should both modify the opinion paragraph by including a reference to the material weakness and add an explanatory paragraph (following the opinion paragraph) that describes the weakness.

55. The following is the form of the report, ~~modified with explanatory language, that a practitioner should use~~ when management includes in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, and when it appropriately modifies its assertion about the effectiveness of the entity's internal control structure in light of that weakness. in such circumstances. (2)

Independent Accountant's Report

[*Standard introductory, scope, and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion that, except for the effect of the material weakness described in its report, [*identify management's assertion, for example,* W *Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

[*Explanatory paragraph*]

As discussed in management's assertion, the following material weakness exists in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on the achievement of the objectives of the control criteria.*][10] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.[11]

56. *Disagreements With Management.* In some circumstances, management may disagree with the practitioner over the existence of a material weakness and, therefore, not include in its assertion a description of such a weakness and its effect on the achievement of the objectives of the control criteria. In such cases, the practitioner should express either a qualified or an adverse opinion on management's assertion, depending on the significance of the weakness and its effect on the achievement of the objectives of the control criteria.

[9] As stated in paragraph 39, the existence of a material weakness precludes management from asserting that an entity's internal control structure is effective.

[10] The language used by the practitioner ordinarily should conform with management's description of the effect of the material weakness on the effectiveness of the entity's internal control structure.

[11] This description of a material weakness differs from the definition of material weakness discussed in paragraph 39. Although a practitioner should consider the definition contained in paragraph 39 when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report.

(2) Introductory sentence for example report could be shortened since paragraph 54 identifies circumstances.

57. In other circumstances management may describe a material weakness but not modify its assertion that the entity's internal control structure is effective.[12] In this case, the practitioner should express either a qualified or an adverse opinion on management's assertion, depending on the significance of the weakness and its effect on the achievement of the objectives of the control criteria.

58. The following is the form of the report a practitioner should use when he or she concludes that a qualified opinion is appropriate in the circumstances.

Independent Accountant's Report

[*Standard introductory, scope, and inherent limitations paragraphs*]

[*Explanatory paragraph*]

Our examination disclosed the following condition, which we believe is a material weakness in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on the achievement of the objectives of the control criteria.*] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

[*Opinion paragraph*]

In our opinion, except for the effect of the material weakness described above, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

59. The following is the form of the report a practitioner should use when he or she concludes that an adverse opinion is appropriate in the circumstances.

Independent Accountant's Report

[*Standard introductory, scope and inherent limitations paragraphs*]

[*Explanatory paragraph*]

Our examination disclosed the following condition, which we believe is a material weakness in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on achievement of the objectives of the control criteria.*] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.

Remove this phrase to be consistent with examples in paragraphs 55 and 58.

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above, on the achievement of the objectives of the control criteria, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is not fairly stated based upon [*identify established or stated criteria*].

60. If management's assertion contains a statement that management believes the cost of correcting the weakness would exceed the benefits to be derived from implementing the new policies and procedures, the practitioner should disclaim an opinion on management's cost-benefit statement. The practitioner may use the following sample language to disclaim an opinion on management's cost-benefit statement:

> We do not express an opinion or any other form of assurance on management's cost-benefit statement.

However, if the practitioner believes that management's cost-benefit statement is a material misstatement of fact, he or she should consider the guidance in paragraphs 80 and 81 and take appropriate action.

61. *Management's Assertion Includes the Material Weakness and Is Presented in a Document Containing the Audit Report.* If the practitioner issues an examination report on management's assertion about the effectiveness of the entity's internal control structure within the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report that describes the material weakness:

> These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on these financial statements.

Scope Limitations

62. An unqualified opinion on management's assertions about the effectiveness of the entity's internal control structure can be expressed only if the practitioner has been able to apply all the procedures he or she considers necessary in the circumstances. Restrictions on the scope of the engagement, whether imposed by the client or by the circumstances, may require the practitioner to qualify or disclaim an opinion. The practitioner's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on management's assertion about the effectiveness of the entity's internal control structure.

63. For example, management may have implemented control procedures to correct a material weakness identified prior to the date of its assertion. However, unless the practitioner has been able to obtain evidence that the new procedures were appropriately designed and have been operating effectively for a sufficient period of time,[13] he or she should refer to the material weakness described in the report and qualify his or her opinion on the basis of a scope limitation. The following is the form of the report a practitioner should use when restrictions on the scope of the examination cause the practitioner to issue a qualified opinion.

[12] See footnote 10.

[13] See guidance in paragraph 33.

Independent Accountant's Report

[*Standard introductory paragraph*]

[*Scope paragraph*]

Except as described below, our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances.

[*Standard inherent limitations paragraph*]

[*Explanatory paragraph*]

Explanatory paragraphs in paragraphs 58 and 59 include this phrase. Conditions which we believe are

Our examination disclosed the ~~following~~ material weaknesses in the design or operation of the internal control structure of W Company in effect at [*date*]. A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. Prior to December 20, 19XX, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. Although the Company implemented a new cash receipts system on December 20, 19XX, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Opinion paragraph*]

In our opinion, except for the effect of matters we may have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

64. When restrictions that significantly limit the scope of the examination are imposed by the client, the practitioner generally should disclaim an opinion on management's assertion about the effectiveness of the entity's internal control structure.

Opinion Based in Part on the Report of Another Practitioner

65. When another practitioner has examined management's assertion about the effectiveness of the internal control structure of one or more subsidiaries, divisions, branches, or components of the entity, the practitioner should consider whether he or she may serve as the principal practitioner and use the work and reports of the other practitioner as a basis, in part, for his or her opinion on management's assertion. If the practitioner decides it is appropriate for him or her to serve as the principal practitioner, he or she should then decide whether to make reference in the report to the examination performed by the other practitioner. In these circumstances, the practitioner's considerations are similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on an entity's financial statements. AU section 543, "Part of Audit Performed By Other Independent Auditors" (AICPA, *Professional Standards*, vol. 1), which provides guidance on (*a*) the auditor's considerations when deciding whether he or she may serve as the principal auditor and, if so, whether to make reference to the audit examination performed by the other auditor practitioner and (*b*) the form and content of the principal auditor's report, may be useful to the practitioner.

Changed these lines to agree with AU sec. 543.01

66. When the practitioner decides to make reference to the report of the other practitioner as a basis, in part, for the practitioner's opinion on management's assertion, the practitioner should disclose this fact when describing the scope of the examination and should refer to the report of the other practitioner when expressing the opinion. The following form of the report is appropriate in these circumstances.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [***identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX***] included in the accompanying [*title of management report*]. We did not examine management's assertion about the effectiveness of the internal control structure over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 19XX. Management's assertion about the effectiveness of B Company's internal control structure over financial reporting was examined by other accountants whose report has been furnished to us, and our opinion, insofar as it relates to management's assertion about the effectiveness of B Company's internal control structure over financial reporting, is based solely on the report of the other accountants.

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, based on our examination and the report of the other accountants, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Subsequent Events

67. Changes may occur subsequent to the date of management's assertion but before the date of the practitioner's report. As described in paragraph 45, the practitioner should obtain management's representations relating to changes that might have occurred subsequent to the date of its assertion that might significantly affect the internal control structure and, therefore, the practitioner's report. Additionally, to obtain information about whether changes have occurred that might affect management's assertion about

the effectiveness of the entity's internal control structure and, therefore, the practitioner's report, he or she should inquire about and examine, for this subsequent period, the following:

a. Relevant internal auditor reports issued during the subsequent period
b. Independent auditor reports (if other than the practitioner's) of reportable conditions or material weaknesses
c. Regulatory agency reports on the entity's internal control structure
d. Information about the effectiveness of the entity's internal control structure obtained through other professional engagements

68. If the practitioner obtains knowledge about subsequent events that he or she believes significantly affect management's assertion about the effectiveness of the entity's internal control structure as of the date of management's assertion, the practitioner should ascertain that management has adequately described in its assertion these events and their effect on the internal control structure. If management has not included such a description and appropriately modified its assertion, the practitioner should add to his or her report an explanatory paragraph that includes such a description.

69. The practitioner has no responsibility to keep informed of events subsequent to the date of his or her report; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of the report on an audit of financial statements described in AU section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AICPA, *Professional Standards*, vol. 1). The guidance in that section requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor considers (*a*) whether the facts would have changed the report if he or she had been aware of them and (*b*) whether there are persons relying on management's assertion about the effectiveness of the entity's internal control structure. Based on these considerations, detailed guidance is provided for the auditor in paragraph 6 of AU section 561.

Management's Assertion About the Effectiveness of a Segment of the Entity's Internal Control Structure

70. When engaged to report on management's assertion about the effectiveness of only a segment of an entity's internal control structure (for example, the internal control structure over financial reporting of an operating division), a practitioner should follow the guidance in this Statement and issue a report using the guidance in paragraphs 48 through 64, modified to refer to the segment of the entity's internal control structure examined. In this situation, the practitioner may use a report such as the following.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial, reporting as of December 31, 19XX*], included in the accompanying [*title of management report*].

Delete comma which does not appear in introductory paragraph under paragraph 78.

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Management's Assertion About the Suitability of Design of the Entity's Internal Control Structure

71. Management may present an assertion about the suitability of the design of the entity's internal control structure for preventing or detecting material misstatements on a timely basis and request the practitioner to examine and report on the assertion. For example, prior to granting a new casino a license to operate, a regulatory agency may request a report on whether the internal control structure that management plans to implement will provide reasonable assurance that the control objectives specified in the regulatory agency's regulations will be achieved. When evaluating the suitability of design of the entity's internal control structure for the regulatory agency's purpose, the practitioner should obtain an understanding of the elements of the internal control structure[14] that management should implement to meet the control objectives of the regulatory agency and identify the internal control structure policies and procedures that are relevant to those control objectives.

72. The following is a suggested form of report a practitioner may issue.[15] The actual form of the report should be modified, as appropriate, to fit the particular circumstances.[16]

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Casino's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements*

[14] See paragraph 24.

[15] Nothing in this section is intended to preclude the practitioner from using the reports on the design of a system contained in the AICPA's Audit and Accounting Guide *Audits of Casinos*.

[16] This report assumes that the control criteria of the regulatory agency have been subjected to due process and, therefore, are considered reasonable criteria for reporting purposes. Therefore, there is no limitation on the distribution of this report.

in the financial statements on a timely basis as of December 31, 19XX] included in the accompanying [*title of management report*].

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, evaluating the design of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Standard inherent limitations paragraph*]

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that W Casino's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

When management presents such an assertion about an entity's internal control structure that has already been placed in operation, the practitioner should modify his or her report by adding the following to the scope paragraph of the report:

> We were not engaged to examine and report on the operating effectiveness of W Casino's internal control structure over financial reporting as of December 31, 19XX, and, accordingly, we express no opinion on it.

Management's Assertion Based on Criteria Specified by a Regulatory Agency That Did Not Follow Due Process

73. A governmental or other agency that exercises regulatory, supervisory, or other public administrative functions may establish its own criteria and require reports on the internal control structures of entities subject to its jurisdiction. Criteria established by a regulatory agency may be set forth in audit guides, questionnaires, or other publications. The criteria may encompass specified aspects of an entity's internal control structure and specified aspects of administrative control or compliance with grants, regulations, or statutes. If such criteria have been subjected to due process procedures, including the broad distribution of proposed criteria for public comment, a practitioner should use the form of report illustrated in paragraph 48 or 51, depending on the manner in which management presents its assertion. If, however, such criteria have not been subjected to due process procedures, the practitioner should modify the report by adding a separate paragraph that limits the distribution of the report to the regulatory agency and to those within the entity.

Changed these lines to be consistent with example in paragraph 51

74. If a regulatory agency requires management to report all conditions (whether material or not) that are not in conformity with the agency's criteria, the practitioner should determine whether all conditions of which he or she is aware have been reported by management. If the practitioner concludes that management has not reported all such conditions, he or she should describe them in the report.

75. For purposes of these reports, a material weakness is—

a. A condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the applicable grant or program might occur and not be detected on a timely basis by employees in the normal course of performing their assigned functions.

b. A condition in which the lack of conformity with the regulatory agency's criteria is material in accordance with any guidelines for determining materiality that are included in such criteria.

76. When the practitioner issues this form of report, he or she does not assume any responsibility for the comprehensiveness of the criteria established by the regulatory agency. However, the practitioner should report any condition that comes to his or her attention during the course of the examination that he or she believes is a material weakness, even though it may not be covered by the criteria.

for the circumstances discussed above.

77. The following report illustrates one that a practitioner might use ~~when he or she has examined management's assertion about the effectiveness of the entity's internal control structure based upon criteria established by a regulatory agency.~~ (3) X

Independent Accountant's Report

[*Introductory paragraph*] [date]

We have examined management's assertion, included in its representation letter dated February 15, 19XY X [*identify management's assertion, for example, that W Company's internal control structure over financial reporting as of December 31, 19XX is adequate to meet the criteria established by ______ agency, as set forth in its audit guide dated ______*].

[*Scope paragraph*]

We understand that W Company has been awarded a grant of [*amount*] from [*agency*] for the period [*date*] through [*date*]. We have examined, in accordance with standards established by the American Institute of Certified Public Accountants, management's assertion about the adequacy of specific internal control structure policies and procedures over financial reporting to meet the criteria established by [*agency*], as set forth in section ______ of its audit guide issued [*date*]. Accordingly, our examination included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods is are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Word should be "are" to agree with noun "projections."

(3) Introductory sentence for report could be shortened since paragraph 73 identifies circumstances.

Might be clearer to identify agency by name.

[*Opinion paragraph*]

We understand that the [agency] considers internal control structure policies and procedures over financial reporting that meet the criteria referred to in the second paragraph of this report adequate for its purpose. In our opinion, based on this understanding and on our examination, management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is adequate to meet the criteria established by ______ agency*] is fairly stated, in all material respects, based upon such criteria.

as of December 31, 19XX

Add date to be consistent with other examples.

[*Limitation on distribution paragraph*]

This report is intended for the information and use of the board of directors and management of W Company and [agency] and should not be used by other third parties for any other purpose.

This word does not appear in limitation paragraph shown in paragraph 51.

OTHER INFORMATION IN A CLIENT-PREPARED DOCUMENT CONTAINING MANAGEMENT'S ASSERTION ABOUT THE EFFECTIVENESS OF THE ENTITY'S INTERNAL CONTROL STRUCTURE

78. An entity may publish various documents that contain other information in addition to management's assertion on the effectiveness of the entity's internal control structure and the practitioner's report thereon. The practitioner may have performed procedures and issued a report covering this other information (for example, an audit report on the entity's financial statements), or another practitioner may have done so. Otherwise, the practitioner's responsibility with respect to other information in such a document does not extend beyond the management report identified in his or her report, and the practitioner has no obligation to perform any procedures to corroborate any other information contained in the document. However, the practitioner should read the other information not covered by the practitioner's report or by the report of the other practitioner and consider whether it, or the manner of its presentation, is materially inconsistent with the information appearing in management's report, or with the manner of its presentation.

79. If the practitioner believes that the other information is inconsistent with the information appearing in management's report, he or she should consider whether management's report, the practitioner's report, or both require revision. If the practitioner concludes that these do not require revision, he or she should request management to revise the other information. If the other information is not revised to eliminate the material inconsistency, the practitioner should consider other actions, such as revising his or her report to include an explanatory paragraph describing the material inconsistency, withholding the use of his or her report in the document, or withdrawing from the engagement.

80. If the practitioner discovers in the other information a statement that he or she believes is a material misstatement of fact, he or she should discuss the matter with management. In connection with this discussion, the practitioner should consider whether he or she possesses the expertise to assess the validity of the statement, whether standards exist by which to assess the manner of presentation of the information, and whether there may not be valid differences of judgment or opinion. If the practitioner concludes that a material misstatement exists, the practitioner should propose that management consult with some other party whose advice might be useful, such as the entity's legal counsel.

81. If, after discussing the matter, the practitioner concludes that a material misstatement of fact remains, the action taken will depend on his or her judgment in the circumstances. The practitioner should consider steps such as notifying the entity's management and audit committee in writing of his or her views concerning the information and consulting his or her legal counsel about further action appropriate in the circumstances.

RELATIONSHIP OF THE PRACTITIONER'S EXAMINATION OF AN ENTITY'S INTERNAL CONTROL STRUCTURE TO THE OPINION OBTAINED IN AN AUDIT

82. The purpose of a practitioner's examination of management's assertion about the effectiveness of an entity's internal control structure is to express an opinion about whether management's assertion that the entity maintained an effective internal control structure as of a point in time is fairly stated, in all material respects, based on the control criteria. In contrast, the purpose of an auditor's consideration of the internal control structure in an audit of financial statements conducted in accordance with generally accepted auditing standards is to enable the auditor to plan the audit and determine the nature, timing, and extent of tests to be performed. Ultimately, the results of the auditor's tests will form the basis for the auditor's opinion on the fairness of the entity's financial statements in conformity with generally accepted accounting principles. The auditor's responsibility in considering the entity's internal control structure is discussed in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*.

upon

Inserted comma and changed word to "upon" to agree with example reports.

83. In a financial statement audit, the auditor obtains an understanding of the internal control structure by performing procedures such as inquiries, observations, and inspection of documents. After he or she has obtained this understanding, the auditor assesses the control risk for assertions related to significant account balances and transaction classes. The auditor assesses control risk for an assertion at maximum if he or she believes that policies and procedures are unlikely to pertain to the assertion, that policies and procedures are unlikely to be effective, or that an evaluation of their effectiveness would be inefficient. When the auditor assesses control risk for an assertion at below maximum, he or she

and disclosure components of the financial statements.

(phrase above appears in AU sec. 319.02) identifies the internal control structure policies and procedures that are likely to prevent or detect material misstatements in that assertion and performs tests of controls to evaluate the effectiveness of such policies and procedures.

84. Although an auditor's consideration of the internal control structure in a financial statement audit generally is more limited than that of a practitioner engaged to examine management's assertion about the effectiveness of the entity's internal control structure, the two considerations are similar in nature. Thus, knowledge the practitioner obtains about the entity's internal control structure as part of the examination of management's assertion may serve as the basis for his or her understanding of the internal control structure in an audit of the entity's financial statements. Similarly, the practitioner may consider the results of tests of controls performed in connection with an examination of management's assertion, as well as any material weaknesses identified, when assessing control risk in the audit of the entity's financial statements.

85. While an examination of management's assertions about the effectiveness of the entity's internal control structure and an audit of the entity's financial statements may be performed by the same practitioner, the former can be performed by a different practitioner as long as he or she obtains the necessary understanding of the entity's internal control structure as described in paragraph 25. If the audit of the entity's financial statements is performed by another practitioner, the practitioner may wish to consider any material weaknesses and reportable conditions identified by the auditor and identify any disagreements between management and the auditor concerning such matters.

RELATIONSHIP TO THE FOREIGN CORRUPT PRACTICES ACT

86. The Foreign Corrupt Practices Act of 1977 (FCPA) includes provisions regarding internal accounting control for entities subject to the Securities and Exchange Act of 1934. Whether an entity is in compliance with those provisions of the FCPA is a legal determination. A practitioner's examination report issued under this Statement does not indicate whether an entity is in compliance with those provisions.

EFFECTIVE DATE

87. This Statement is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting begining after December 15, 1993. Earlier application of this Statement is encouraged.

APPENDIX

The following Statements on Auditing Standards (SASs) contain guidance for practitioners engaged to provide other services in connection with an entity's internal control structure.

- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance on identifying and communicating reportable conditions that come to the auditor's attention during an audit of financial statements.
- SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), provides guidance to auditors on reporting on an entity's internal control structure in audits conducted in accordance with Government Auditing Standards.

Title of publication should be in italics or underlined.

- SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 642), provides guidance to auditors of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other auditors, as well as guidance on how other auditors should use such reports.

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

19

August 4, 1992

Ms. A. Louise Williamson
Technical Manager, Auditing Standards Division (File 4287)
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Williamson:

We have reviewed the Exposure Draft of the proposed Statement on Standards for Attestation Engagements, entitled Reporting on an Entity's Internal Control Structure Over Financial Reporting, and submit the following comments for consideration by the Auditing Standards Board. We have presented our comments in paragraph sequence, when appropriate, to simplify your review process.

1. The first sentence of Paragraph 7 states "The appendix presents a listing of Statements on Auditing Standards that provide guidance for a practitioner engaged to provide other services in connection with an entity's internal control structure." The appendix, on Page 23, lists three specific Statements on Auditing Standards (SAS's)---SAS No. 60, SAS No. 68, and SAS No. 70.

   The process for developing auditing standards is a dynamic and evolutionary process. For example, since April 1988, the AICPA has issued twenty individual SAS's; SAS No. 63, issued in April 1989, was superseded by SAS No. 68 just 33 months later. We believe an appendix, listing applicable SAS's at any one point in time, would soon become outdated and potentially misleading to the practitioner. Therefore, we suggest that the Board delete the appendix in the final Statement, and revise the first sentence of Paragraph 7 to read "A practitioner engaged to provide other services in connection with an entity's internal control structure should consider the guidance in certain Statements on Auditing Standards, including SAS No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit, SAS No. 68, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance, and SAS No. 70, Reports on the Processing of Transactions by Service Organizations."

2. Footnote 4 and Paragraph 73 both place a different responsibility on the auditor if management's assertion is based on criteria specified by a

regulatory agency which have not been subjected to due process procedures. For example, Paragraph 73 states "If...such criteria have not been subjected to due process procedures, the practitioner should modify the report by adding a separate paragraph that limits the distribution of the report to the regulatory agency and to those within the entity." However, the proposed Statement does not provide guidance for the auditor in determining whether the regulatory agency did in fact follow due process procedures. Is a management statement sufficient documentation? Should the auditor communicate directly with the regulatory agency on each engagement? Should the auditor assume that due process procedures were not followed, unless otherwise stated? We suggest that Footnote 4 and Paragraph 73 be expanded in the final Statement to adequately explain the auditor's responsibility in determining whether the regulatory agency followed due process procedures.

3. Paragraphs 19 through 22 address planning the engagement. However, no mention is made in these paragraphs, or elsewhere in the proposed Statement, of an engagement letter. We suggest that the final Statement at least alert the auditor that the use of an engagement letter in an engagement to report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting is good business practice.

4. Footnote 1 states that "A practitioner also may be engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting *during a period of time*. In that case, the guidance in this Statement should be modified accordingly." The proposed Statement contains no other guidance on this potential modification. Paragraphs 33 and 35 discuss the appropriate period of time over which the auditor should perform tests of controls and the auditor's consideration of policies and procedures that have been superseded, respectively. Because the guidance in these two important paragraphs could be significantly different, based on the type of engagement, we suggest that the Board expand the narrative in Paragraphs 33 and 35 to also include specific guidance for the auditor engaged to examine and report on management's assertion *during a period of time*.

5. Paragraph 40a. appears to contain a technical error. This subparagraph states that the auditor, in evaluating whether a reportable condition is also a material weakness, should recognize that "The amounts of errors or irregularities that might occur and remain undetected range from zero to the gross financial statement amounts or transactions that are exposed to the reportable condition." If the errors are unrecorded transactions, we believe

that the amounts of the errors could potentially exceed the gross financial statement amount. Therefore, we suggest that Paragraph 40a. be revised to read "The amounts of errors or irregularities that might occur and remain undetected range from zero to more than the gross financial statement amounts or transactions that are exposed to the reportable conditions."

6. Paragraph 60 provides sample language for the auditor to disclaim an opinion on management's cost-benefit statement. However, the proposed guidance does not indicate whether this language should be a presented as a separate paragraph or included as a sentence within the previously-illustrated opinion paragraph. Although we assume the disclaimer would be presented as a separate paragraph immediately following the auditor's opinion paragraph, we believe, for consistency within the profession, that Paragraph 60 should be revised to indicate the appropriate location of the sample language within the report.

7. Paragraph 64 states that "When restrictions that significantly limit the scope of the examination are imposed by the client, the practitioner generally should disclaim an opinion on management's assertion about the effectiveness of the entity's internal control structure." The proposed Statement contains approximately ten different examples of auditor's reports; however, perhaps by oversight, it does not include an example of a disclaimer of opinion. To provide more comprehensive guidance in the final Statement, we suggest that the Board include an example of a disclaimer of opinion on management's assertion, immediately following the narrative in Paragraph 64.

8. Paragraph 87 states "This Statement is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting beginning after December 15, 1993. Earlier application of this Statement is encouraged." As currently drafted, we believe this paragraph is ambiguous. We question whether the Board intends that the final Statement be effective for examinations beginning after December 15, 1993, <u>or</u> for assertions beginning after December 15, 1993. Because of the normal complexities associated with scheduling an engagement, the exact beginning date of an examination may be difficult to pinpoint. Therefore, to improve clarity, we suggest that the first sentence of Paragraph 87 be revised to read "This Statement is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting when the assertion is as of, or for the period ended, December 15, 1993 or thereafter."

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

Sincerely,

Thomas H. McTavish

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

(20)

HSCPA
Hawaii Society of
Certified
Public
Accountants

August 4, 1992

Ms. A. Louise Williamson
Techical Manager
Auditing Standards Division
File 4287
American Institute of Certified Public Accountants
1211 Avenue of Americas
New York, New York 10036-8775

Ladies and Gentlemen:

The Hawaii Society of Certified Public Accountants Accounting & Auditing Standards Committee has reviewed the Proposed Statement on Standards for Attestation Engagements on "Reporting on an Entity's Internal Control Structure Over Financial Reporting". We have the following comments.

We sense that the statement has been proposed to provide guidelines to accountants for reporting on management's assertions which are being proposed or required by regulatory bodies. We suggest that the statement be restricted to those situations where the regulators have specified the criteria to be used by management in their reporting on the entity's internal control structure over financial reporting. We believe this is necessary because it is not clear to us that there are adequate guidelines to be used in determining an appropriate internal control structure, notwithstanding the reference to SAS 55 in Paragraph 10. In addition, we believe that the statement should require that management specify the criteria used in their evaluation of the internal control structure in their report and that the accountants' attestation report also refer to these criteria. In the event that management does not include the criteria in their report, we recommend that the accountant specify the criteria used by management in the attestation report.

We believe the proposed statement should include suggestions for the management reporting model with alternative language suggested for the attestation report to respond to the language used by management in its report.

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Paragraph 35 appears to be permissive in that it allows management to make modifications to the internal control structure policies and procedures subsequent to the year end, but prior to the reporting by management and the accountant. We believe that management's reporting on the internal control structure is generally related to financial statements being presented. We believe the public is entitled to assume that management's report on internal control structure relates to the transactions which are included in those financial statements. Accordingly, we believe it inappropriate that modifications to the internal control structure subsequent to the year end be considered "corrective" to internal control structures in operation for those transactions resulting in the financial statements. Accordingly, we suggest that, if corrective measures be made subsequent to year end, appropriate explanation be included in management's report and, if not included in management's report, commented on in the accountants' attestation report.

Reportable conditions and material weaknesses are discussed in Paragraphs 38 through 44. While it is clear that management would likely have to include explanation of material weaknesses in their report, it is not clear whether there is generally the expectation that reportable conditions would not be presented. The sometimes fine line between reportable conditions and material weaknesses will be exacerbated in this process.

The proposed statement will supersede SAS 30 to preclude a practitioner from reporting directly on the company's internal control structure. While we believe that the litigious climate might have been the primary reason for taking this course of action, we wonder whether the public is being adequately served by such a preclusion. If the accountants are not able to perform such a service, who is?

We appreciate being given the opportunity to express our thoughts on the exposure draft.

Very truly yours,

I. Patrick Griggs
Chairman
Accounting & Auditing Standards Committee

IPG:tlh:283

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EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: JAMES H. OAKES, JAMES OAKES, P.C.

Comments:

It seems that at one time attestation engagement standards were separated by pronouncements from auditing standards and now they are going to be more commingled than ever before. Very confusing and unnecessary. Internal control reports for audits are separately issued anyway under auditing standards. Internal control reports for attestation engagements should be under attestation standards.

This is only one thesis but the way the AICPA commingled with the FASB ministry - form more may be on the way. You are the people who said auditors were giving unqualified opinions and accountant's don't always review their work

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

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August 11, 1992

Ms. A. Louise Williamson
Technical Manager
Auditing Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: File Reference No. 4287, "Reporting on an Entity's Internal Control Structure Over Financial Reporting"

Dear Ms. Williamson:

This letter is in response to the request for comments on the proposed Statement on Standards for Attestation Engagements entitled "Reporting on an Entity's Internal Control Structure Over Financial Reporting."

Although we believe the proposed standard provides helpful and improved guidance in some areas, we do not support the issuance of this standard as proposed. Our objections are discussed under "Principal Comments" below. The remainder of this letter contains a number of suggestions to improve and clarify the guidance should the Board decide to issue this standard in substantially the same form as the exposure draft.

Principal Comments

Management's Assertion

We object to what we consider to be an unnecessary and unwarranted restriction on the types of services the accountant may provide with respect to reporting on the adequacy of internal control. The SSAE allows the accountant to report publicly on internal control only when management evaluates, and then presents its own assertion in a separate written report that accompanies the accountant's report, and on a restricted basis only if management presents its assertion in a representation letter. Further, the SSAE would supersede SAS No. 30 which permits an auditor to study and evaluate, and express an opinion on, the adequacy of internal control in an unrestricted report without a separate evaluation and explicit statement by management.

We do not believe that a separate evaluation and written assertion by management is needed to make it clear to report users as to where the responsibility lies for devising and maintaining an adequate system of internal control. That responsibility can be effectively communicated in either the accountant's report or a management report. The form of report set forth in SAS No. 30 contains such a statement of responsibility. When management (whether in its own report or through the accountant's communication) explicitly acknowledges its responsibility for maintaining an effective system of internal control over financial reporting, the assertion as to the effectiveness of the system is undeniably imbedded in that acknowledgment. Readers should, and are entitled to, presume that management believes, and has a basis for that belief, that that responsibility has been properly discharged, unless management (or the accountant) states otherwise. We submit that this is really no different than when the auditor renders an opinion on financial statements based on management's acknowledgment in the management report and representation letter of only its <u>responsibility</u> for the financial statements. Unfortunately, the discharge of management's responsibility for internal control (and compliance with laws and regulations for that matter) can't be quantified and easily depicted in a communication vehicle like financial statements.

There have been and will continue to be situations in which management is unable to make a meaningful and timely assessment of the adequacy of its internal control system (or portions thereof) and may, for that very reason, engage an accountant to review and provide management with his or her own assessment, along with recommendations for improvement. To preclude accountants from providing that service (other than as a "consulting service") is not, in our view, responsive to the marketplace, nor is it in the public interest.

Stated from a different perspective, a well trained accountant has the competence to review and evaluate controls and provide <u>his or her own</u> opinion on their design and effectiveness. To prohibit the accountant from expressing anything but a second opinion on management's views is an unwarranted restriction of a potentially valued service, and is contrary to public interest.

<u>Form of Report</u>

Our other principal objection is the form of report in the SSAE. Because the report is internally inconsistent and because it calls for an opinion on management's assertion about the effectiveness of internal control rather than on the structure itself, we believe the report is unclear, confusing and likely to be misunderstood by users.

An internal inconsistency exists between the introductory and scope paragraphs. Specifically, the introductory paragraph states that the accountant has examined management's assertion, but the scope paragraph describes that the accountant has examined the internal control structure. Absent the introductory paragraph, a reader would expect the accountant to express an opinion on the entity's internal controls independent of management's separate assessment.

When an accountant expresses "an opinion on an opinion," readers might draw misleading inferences. First, users might conclude that the accountant performed less work than if he or she were reporting directly on internal control since he or she may have reviewed only the methodology management used in making its evaluation. Secondly, and perhaps more importantly, users might believe that the only evidential matter obtained was that which management gathered in support of its own assessment--the implication being that the basic approach to the engagement is inherently biased toward accepting management's assertion rather than making an objective study independent of management.

Furthermore, from a user's perspective, there should be consistency in reporting by the auditor on an entity's financial statements and the system of internal control over financial reporting. When management includes in its management report, an acknowledgement of its responsibility for the financial statements and the internal control structure, or even asserts that the financial statements are fairly presented and the internal control system is effective, the nature of the accountant's separate assurances on those implied or explicit assertions should be consistent. That is, the auditor should report directly on the subject matter of those assertions.

The Board, in the recently issued SAS No. 70, supported the notion of reporting directly on internal controls. Service auditor reports, of course, are provided not only to user auditors, but to service organizations and user organizations.

Finally, we are aware of discussions which involve the performance of <u>both</u> an audit of the financial statements <u>and</u> an examination of controls. The possibility of having two reports (or even one expanded report) further emphasizes the need for simplified, streamlined language.

<u>Recommendations</u>

To address our concerns, we offer the following suggestions:

- First, restrict the scope of the proposed SSAE to those engagements in which an accountant has been retained to report on internal control when management presents its written assertion (whether implied in a statement of responsibility or explicitly) about the effectiveness of the entity's internal control structure over financial reporting in a separate report that will accompany the accountant's report.

- Amend (but do not supersede) SAS 30, "Reporting on Internal Accounting Control," in order to permit accountants to continue to accept engagements to report (on a restricted basis) on the adequacy of internal control systems absent a separate written statement of responsibility or explicit assertion by management. (SAS 30 should also be amended to reflect necessary updating.)

- Finally, make the following changes to the form of report:

    - State in the introductory paragraph that the accountant has examined the internal control structure (rather than management's assertion). For example, the following wording puts the emphasis in the right place: "We have examined the internal control structure to evaluate management's assertion that W Company...."

    - Expand the scope paragraph to describe the objective of the examination, similar to the SAS No. 58 and 70 reports. The objective in this case is to determine whether the internal control structure is free of material weaknesses. Appropriate wording might be "Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants, and was designed to provide reasonable assurance that the internal control structure is free of material weaknesses. Our examination included obtaining an understanding ...."

    - Include a statement about management's responsibility for the internal control structure (its implied - or explicit - assertion).

    - Reword the opinion paragraph to focus directly on what the accountant really did, and on what the reader really wants to know; i.e., the objective of an effective internal control structure and whether that objective was achieved. For example, the opinion paragraph might read as follows:

> "In our opinion, W Company maintained an internal control structure over financial reporting at December 31, 19XX, that was sufficient to permit the preparation, in all material respects, of reliable published financial statements."

We believe these changes should be adopted by the Board because they would permit accountants to continue to provide additional services with respect to internal control that the business community, regulators and the public believe are of value, and would result in a more meaningful and understandable report form with respect to engagements covered by the pronouncement.

Specific Comments

Footnote 3 to paragraph 1 does not contain helpful guidance, and we fail to see the purpose of this footnote. It refers the reader to the general Attestation Standards for guidance on performing engagements on internal control other than financial reporting, yet there really is no additional "guidance" in the general standards for such engagements. It also refers the reader to paragraph 7 of this statement, which discusses broker/dealer reports. We suggest this footnote be revised to acknowledge that the guidance in this standard may be helpful in engagements to report on internal controls other than those over financial reporting.

The last sentence of paragraph 3 refers to "estimates" and "measurements" which do not seem particularly relevant in an internal control engagement. We suggest that this guidance be changed to something such as "... would not ordinarily be able to arrive at similar conclusions."

In the last sentence of paragraph 4, why shouldn't the practitioner follow (or at least refer to, as in paragraph 5) rather than merely consider, the guidance in the consulting standards?

Paragraph 8a precludes a practitioner from accepting an engagement to examine and report on internal control unless management is sufficiently knowledgeable about the internal control structure to accept responsibility for its assertion. How will a practitioner evaluate whether or not management is "sufficiently knowledgeable"? The important point is that management should acknowledge its responsibility. The concept of "sufficiently knowledgeable" is inherent in paragraph 8b, and should be deleted from paragraph 8a.

Paragraph 8b requires an evaluation by management, but the SSAE provides little guidance as to how extensive this evaluation must be. Can it, for example, be based on management's assessment of all the internal audits performed over the past year? For smaller companies, can this condition be met if the practitioner performs all the work to gather the information, as suggested in the last sentence of paragraph 9? Since this may be a contentious issue, the Board should consider adding more guidance.

The three factors cited in the last part of the last sentence of paragraph 23 are really just three of the factors the practitioner should consider during the planning phase of the engagement. Accordingly, the last part of this sentence could be improved by changing it to "...are influenced by the knowledge of the internal control structure obtained when planning the engagement."

Paragraphs 24 and 25 are primarily a description of the internal control structure, and do not fit very well under the heading "Testing and Evaluating the Design Effectiveness of Internal Control Structure Policies and Procedures." We suggest moving this heading between paragraphs 25 and 26.

We do not understand the first sentence of paragraph 31, the relevant part of which states "Management...<u>may</u> perform tests of the operating effectiveness of certain internal control structure policies and procedures and provide the practitioner with the results...." Isn't management <u>required</u> to evaluate the effectiveness of the internal control structure? This sentence could be revised to state "Management or other entity personnel may provide the practitioner with the results...."

Paragraph 34 should be revised to make it clear that if management's assertion does cover interim financial information (either explicitly or implicitly), the practitioner should test (not just consider testing) controls over interims.

It does not seem clear in reading paragraphs 39 to 53 that the practitioner has a responsibility to design the examination to provide reasonable assurance of detecting all material weaknesses. We suggest a clear statement of this detection responsibility be included.

Paragraph 45 requires a management representation letter in any engagement to report on management's assertions about the effectiveness of the internal control structure over financial reporting. Since the SSAE is not limited only to examination engagements, this would also apply to agreed-upon procedures engagements. This requirement, which is consistent with the latest draft of the compliance attestation document, is a subtle point that is likely to be missed by practitioners asked to perform agreed-upon procedures, and who will stop reading this document at paragraph 5 which refers them to the <u>Attestation Standards</u>. Those standards, of course, do not require a management representation letter.

ARTHUR
ANDERSEN

ARTHUR ANDERSEN & CO. SC

Paragraph 47d includes the phrase "in all material respects" in the practitioner's opinion. We do not understand the meaning of this phrase, and believe it should be deleted. Unlike financial statements, management's assertion is contained in a single statement (the internal control structure is or not effective), rather than a detailed presentation of the description and objectives of the internal control structure, for which the phrase "in all material respects" would be relevant.

Very truly yours,

Arthur Andersen & Co.

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August 12, 1992

A. Louise Williamson
Technical Manager
Auditing Standards Division
File 4287
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Williamson:

Thank you for the opportunity to comment on the proposed Statement on Standards for Attestation Engagements.

The proposed new statement is timely and needed in order to enable auditors to render opinions pursuant to the new requirements imposed by The Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (PL 102-242). The Act creates an immediate need to establish guidance for institutions covered by the Act with respect to the terms of engagement and content, form, and format of the auditor's evaluation of managements statement on internal controls. However, the proposed standard gives us the impression that other current auditing standards including SAS 55, SAS 60, and SAS 1 may not be universally applicable to attestation as well to financial statement audits. This is an impression that we do not think you want to convey.

It seems like the proposal does not coordinate the work already being done for financial statement engagements with the work needed to attest to internal controls. Three examples are as follows:

1) Paragraph 84 appears to suggest that the auditor's consideration of internal controls in a financial statement audit would not meet the requirements of an attestation audit. I suggest that an auditor who depends on internal controls as part of financial statement audit planning and performance should have no less understanding than in an attestation engagement.

2) Paragraph 9 appears to suggest that the auditor may be engaged to gather information to enable management to evaluate the effectiveness of the entity's internal control structure. It seems to me that this work also provides the auditors an understanding of the systems within the scope of the work performed and should be coordinated with managements effort as part of the annual audit in order to control fees.

3) Paragraph 86 suggests that compliance with the internal accounting control provisions of the Foreign Corrupt Practices Act is not within the scope of this Standard. I suggest that this reluctance to accept responsibility for this portion of the Foreign Corrupt Practices Act is not defensible inasmuch as the FCPA accounting provisions incorporate language from SAS 1.

The breadth of the draft statement suggests to us that additional work is necessary for evaluation of internal controls. For example paragraphs 24 through 33 appear to add to existing standards somewhat like a rider on legislation. It implies the standards for evaluating internal controls where used in financial statement audits are somehow different. We do not concur that additional procedures for internal control evaluation are necessary. There is sufficient guidance in existing literature. However, if present standards are inadequate, they should be amended but not as part of this exposure draft. The new statement should deal more narrowly and specifically with the attestation process itself for this new act.

We must be careful not to undermine the existing structure, albeit on an exception basis, for communication of internal control weaknesses from accountants to management, the audit committee, the board of directors, the SEC, and the shareholders for financial statement engagements. Many boards and audit committees rely upon these communications, knowing the scope of the audit. In financial statement audit engagements, the auditors may also agree to rely on procedures not related to the internal controls. In such instances, it should be made clear in the audit opinion that the auditors are not relying on internal controls.

The current version of the Financial Fraud Detection and Disclosure Act (HR 4313), which does not require a formal attestation, requires reporting of material internal control weaknesses to management, the board of directors, and the SEC. It seems like the current Standards adequately provide for follow up on all issues raised in the legislation.

Thank you again for the opportunity to comment.

Sincerely,

Frederick J. Hirt

Frederick J Hirt

cc: Financial Executives Institute CCR AICPA Subcommittee

(24)

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

August 14, 1992

Ms. A. Louise Williamson, Technical Manager
Auditing Standards Division
File 4287
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

RE: Exposure Draft - Proposed Statement on Standards for Attestation Engagements - Reporting on an Entity's Internal Control Structure over Financial Reporting

Dear Ms. Williamson:

We have reviewed subject exposure draft and submit the following comments for consideration by the Auditing Standards Board.

1. The title of the document could be misinterpreted as applying to consideration of the internal control structure in financial statement audits. To avoid such possible confusion, we recommend that a reference to "management's assertion" be added to the title.

2. Paragraph 1, footnote 1 indicates that management may select a date different than the entity's fiscal year-end for its assertion about the effectiveness of the entity's internal control structure. Therefore, we believe a requirement that a management representation concerning that date should be included in paragraph 45.

3. Paragraph 6 prohibits a practitioner from accepting an engagement to review, presumably as defined in the Codification of Statements on Standards for Attestation Engagements, and report on management assertions concerning the internal control structure, but gives no reason for such prohibition.

4. Paragraph 22 states that at management's request, the practitioner may assist the entity in preparing or gathering the documentation of its internal control structure policies and procedures and the control objectives they were designed to achieve. We believe that the Auditing Standards Board should clarify its definition of

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"documenting" because, carried to an extreme, such "assistance" could cause a potential conflict of interest. Summarizing an entity's written internal control structure policies is different than designing and documenting its internal control structure. We would consider the latter to be a conflict of interest.

5. Paragraphs 53 through 61 on "Material Weaknesses," do not address a situation in which management agrees with the practitioner about the existence of a material weakness, but has not included the weakness in its assertion about the effectiveness of the entity's internal control structure. We believe this situation should be addressed.

If you have any questions concerning this response, please contact David I. Williams or Jaimie Soulvie of the Professional Practice staff of my Office at (602) 255-4385.

Sincerely,

Douglas R. Norton

Douglas R. Norton
Auditor General

cc: Kinney Poynter, NSAA

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Division for CPA Firms

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August 14, 1992

Mr. John B. Sullivan, Chairman
Auditing Standards Board
File 4287
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Sullivan:

Re: Exposure Draft on Proposed Statement on Standards for Attestation Engagements "Reporting on an Entity's Internal Control Structure Over Financial Reporting"

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.

We recognize that initially the proposed statement would apply principally to auditors of insured depository institutions who examine assertions provided by management regarding the effectiveness of internal controls over financial reporting. Consequently, it should not have an immediate impact on the practice of most local CPA firms. However, if the proposals containing similar requirements under consideration by the Securities and Exchange Commission and other legislative and regulatory bodies are enacted, this proposed statement could ultimately affect local firms. Therefore, TIC reviewed the exposure draft and provides the following comments and suggestions for your consideration.

Conditions for Engagement Acceptance

Paragraph 8 states that the practitioner should ensure that management is **sufficiently knowledgeable** about the entity's internal control structure to accept responsibility for an assertion about the effectiveness of that structure. It has been TIC's experience that most small business managers have a good understanding of their company's operations but generally lack an understanding of the terms and concepts used in SAS No. 55, "Consideration of the Internal Control Structure in a Financial Statement Audit." Accordingly, TIC believes it will be difficult for the practitioner to conclude management is "sufficiently knowledgeable" about the entity's internal control structure, as contemplated by the proposed statement. The final statement should provide guidance to help the practitioner make that assessment. Perhaps a more descriptive definition of the phrase "sufficiently knowledgeable" could be included in the statement. Alternatively, the statement should permit the practitioner to be engaged by management to assist in developing management's assertions about the entity's internal control structure.

Limitations of an Entity's Internal Control Structure

Although the presence of an independent board of directors, audit committee and/or internal audit function is desirable, it should be noted that a lack thereof does not necessarily indicate the effectiveness of an entity's internal control structure may be limited. TIC members believe that management integrity of the highest caliber can compensate for the lack of such independent bodies. The final statement should incorporate this notion in its guidance.

Testing and Evaluating the Design Effectiveness of Internal Control Structure Policies and Procedures

In order to evaluate the design of an entity's internal control structure, paragraph 25 states that the practitioner should gain an understanding of the internal control structure policies and procedures within the three internal control structure elements. The proposed guidance does not discuss how the integrity and ethical values of management affect an entity's control environment or how the competence of personnel impacts their ability to adhere to established controls. The experience of TIC members shows that a commitment to high ethical standards can influence the attitude of personnel and, thereby, encourages adherence to established procedures and controls. Furthermore, the validity of internal controls can be confirmed by competent personnel through their ability to perform them properly. Integrity, ethical values and competence are cited as key factors of the control environment in "Internal Control - Integrated Framework," a report to be issued by the Committee of Sponsoring Organizations of the Treadway Commission. In most small business environments, these factors are particularly important since they can compensate for the lack of other basic controls. TIC believes these factors should also be considered by the practitioner when testing and evaluating the design effectiveness of an entity's internal control structure.

Testing and Evaluating the Operating Effectiveness of Internal Control Structure Policies and Procedures in Effect During Interim Periods

Paragraph 34 provides guidance when reporting on management's written assertion about the effectiveness of internal controls related to financial reporting for an interim period. Although it states that the practitioner should perform tests of controls in effect during one or more interim periods, it does not provide guidance on the extent of tests that should be performed. The scope of tests required will depend on a number of factors, including the size of the entity, the availability of records and the complexity of the internal control structure. To help the practitioner develop the judgment needed to evaluate the extent of tests required, the statement should outline the factors that would be considered.

The proposed guidance does not indicate whether the scope of interim examinations and reports would be limited to the reporting objectives of a specific interim period or whether it would encompass the reporting objectives related to all interim periods. It may be desirable to permit the practitioner to limit the scope of the opinion to a specific period tested. It would also be helpful if the "Reporting Standards" section included examples of reports that could be used when reporting on interim periods.

Management's Representations

The guidance in paragraph 45 states that the practitioner should obtain written representation from management asserting that all reportable conditions have been disclosed to the practitioner and that apparent material weaknesses have been identified. The practitioner has been trained to distinguish between reportable conditions and material weaknesses but managers of small entities will not have a conceptual understanding of these terms. These terms could have markedly different meanings to each party. This greatly increases the potential for miscommunication between management and the practitioner. The final statement should use terminology that is consistent with management's terminology or provide for the definition of terms used within the representation letter.

Relationship of the Practitioner's Examination of an Entity's Internal Control Structure to the Opinion Obtained in an Audit

This section compares an examination and report on management's assertion about the effectiveness of internal controls to procedures performed by the practitioner during a financial statement audit. The proposed statement principally provides guidance when reporting on the effectiveness of controls **as of a point in time**, although the guidance can be modified for reporting on controls in effect **during a period of time.** Since the tests of controls performed in conjunction with an audit ordinarily encompass an entire year, it may be beneficial to emphasize further the distinction between these two different reports. TIC believes this would help the practitioner distinguish between these two types of engagements.

Other Comments

The proposed statement would supersede SAS No. 30, "Reporting on Internal Accounting Control," which currently provides guidance to the practitioner engaged to report on the system of internal accounting control. Once SAS No. 30 is superseded, the practitioner will be precluded from reporting on an entity's internal control structure, except as required by Government Auditing Standards. Since the proposed statement principally stems from the need to address the reporting requirements mandated by the Federal Deposit Insurance Corporation ("FDIC") Improvement Act of 1991, the TIC does not believe there is a need to abolish existing standards for reports on internal controls.

TIC is concerned that other governmental agencies may consider adopting requirements similar to those mandated by the FDIC for recipients of federal funds. The prohibition in the proposed statement precluding the practitioner from reporting directly on the internal control structure may give impetus to such changes in other governmental requirements. Many small, non-profit organizations have difficulty attracting knowledgeable accounting personnel and lack adequate resources to properly train their staff. Consequently, they would have great difficulty complying with the management reporting requirement contemplated by the proposed statement. These new requirements would place an excessive burden on the organizations that can least afford it. Therefore, TIC recommends that the concept of reporting on internal controls contained in SAS No. 30 not be superseded. Instead, SAS No. 30 should be updated to conform with the current terminology in SAS No. 55, "Consideration of the Internal Control Structure in a Financial Statement Audit."

*   *   *

We appreciate the opportunity to present these comments on behalf of all local and regional firms. We would be pleased to discuss our comments with you or representatives of the Auditing Standards Divison at your convenience.

Sincerely,

Judith H. O'Dell

Judith H. O'Dell, Chair
PCPS Technical Issues Committee

JHO:al
File 2221

cc: Dan M. Guy, Vice President, Auditing Standards Division
A. Louise Williamson, Technical Manager, Auditing Standards Division
PCP Executive and Technical Issues Committees

(26)

ERNST & YOUNG

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August 14, 1992

Auditing Standards Board
American Institute of Certified Public Accountants
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Reporting on an Entity's Internal Control Structure Over Financial Reporting

Ernst & Young supports the above-captioned proposed Statement on Standards for Attestation Engagements because we believe it provides appropriate guidance for accountants engaged to report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting. We agree with the use of the attestation standards model for reporting on an entity's internal control structure, rather than the direct reporting on an entity's internal control structure currently provided in Statement on Auditing Standards (SAS) No. 30, "Reporting on Internal Accounting Control." We also agree with grandfathering the internal control reports in existing AICPA auditing literature (e.g., Statement of Position 89-4, "Reports on the Internal Control Structure of Brokers and Dealers in Securities," and the report on internal control required by the SEC contained in the audit and accounting guide, "Audits of Investment Companies").

We believe the final statement should specifically state that the guidance in the forthcoming report of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), "Internal Control—Integrated Framework," is an example of the criteria for evaluating an entity's internal control structure. We also believe the proposed statement would be improved by providing additional performance and reporting guidance for accountants engaged to report on management's assertion about an entity's internal control structure over interim financial reporting as well as annual financial reporting, and by providing additional reporting guidance when management's report on the entity's internal control structure adequately describes the inherent limitations of the entity's internal control structure.

Criteria for Evaluating an Entity's Internal Control Structure

A necessary prerequisite for accountants to issue a general distribution report on management's assertion is that management evaluate the effectiveness of the entity's internal control structure using reasonable criteria for effective internal control structures established by a recognized body. However, the proposed statement does not provide examples of such criteria. We believe that the guidance in the COSO report, "Internal Control—Integrated Framework," which reflects the input and acceptance of a wide cross-section of parties interested in strong internal controls, meets the definition of "reasonable criteria." We suggest that that guidance be referred to in the statement.

Reporting on Management's Assertion About the Internal Control Structure Over Interim Financial Reportingy

The proposed statement assumes that management will present its assertion as of a point in time, ordinarily as of the end of the entity's fiscal year. We strongly agree with this approach. However, we also believe the final statement should provide performance and reporting guidance when management's assertion encompasses the entity's internal control structure over interim financial reporting as well as annual financial reporting. The guidance should refer to the discussion of the characteristics of interim financial information in paragraph 8 of SAS No. 71, "Interim Financial Information;" provide guidance on the nature, timing, and extent of procedures that accountants might perform in testing and evaluating the design and operating effectiveness of the entity's internal control structure over interim financial reporting; and provide guidance for reporting on management's assertion when there are material weaknesses in the internal control structure over interim financial reporting but not in the internal control structure over annual financial reporting.

Reporting Guidance When Management's Report Adequately Describes the Inherent Limitations of the Entity's Internal Control Structure

When management's report on an entity's internal control structure adequately describes the inherent limitations of the entity's internal control structure, and both the accountants' and management's reports are presented in the same document (for example, in an annual report to shareholders), the inherent limitations paragraph in the accountants' report is redundant. In such circumstances, we believe that an inherent limitations paragraph in the accountants' report is not necessary, and we suggest that it not be required.

* * * * *

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

Sincerely,

Ernst + Young

(21)

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

August 14, 1992

Ms. A. Louise Williamson
Technical Manager
Auditing Standards Division
File 4287
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Williamson:

This letter presents the U.S. General Accounting Office's (GAO) comments on the proposed Statement on Standards for Attestation Engagements (SSAE), Reporting on an Entity's Internal Control Structure Over Financial Reporting.

Overall, we appreciate the profession's proactive role in gaining wider acceptance of public reporting on internal controls. But we believe that this proposed SSAE has missed an opportunity to extend the scope of internal control reporting. To capitalize on this opportunity, we believe the Auditing Standards Board should address the concerns expressed in this letter before it issues the final SSAE. This should be done either by amending the draft where it conflicts with our concerns or making it clear that the Board will give prompt attention to them.

To provide a context for our suggestions, we believe the profession's responsibility, is not just to the "client." The judicial, congressional, and regulatory viewpoint is that the auditor has far broader responsibilities to the general public, and in the case of regulated institutions, to the regulators. For example, court decisions have stated that by certifying the public reports that depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client and owes ultimate allegiance to the corporations' creditors and stockholders and to the investing public. With this broader responsibility in mind, the profession and the Auditing Standards Board need to step forward and take a more assertive role in encouraging the CPA to take steps to improve accountability through additional auditing and reporting. We believe our following suggestions, if adopted, will assist the profession in taking a more assertive role with respect to internal controls.

First, the Auditing Standards Board should incorporate in the proposed SSAE some of the basic concepts that are implicit in an internal control structure but are not explicitly discussed in the SSAE. SAS No. 30 specifically cites that the broad objectives of internal accounting controls includes providing reasonable assurance that assets are safeguarded from unauthorized use or disposition. By failing to include similar guidance in the proposed SSAE, it appears that the Board is backing off a long standing practice. Without focus on the safeguarding of assets as a key element of financial reporting controls, the auditor may not perform tests of the physical protection or other internal controls that are designed to provide reasonable assurance that losses of assets due to theft or misappropriation are detected or prevented. Sufficient testing of these controls by the independent auditor is an integral part of improving accountability.

Second, the Auditing Standards Board should expand the scope of the proposed SSAE to specifically address internal control objectives where CPAs can perform important services. We believe the time has come for auditors to address the controls that can provide reasonable assurance of preventing or detecting noncompliance with significant laws and regulations. Increasingly, auditors are being required to take responsibility for this critical area. For example, the Single Audit Act of 1984 and OMB Circular A-133 require the auditor to test controls over compliance with laws and regulations. The Federal Deposit Insurance Corporation Improvement Act of 1991 requires the CPA to apply procedures agreed upon to objectively determine the extent of compliance with designated laws and regulation. In addition to requiring reporting on controls over compliance with laws and regulations, this SSAE should encourage the auditor and his client to broaden the attestation of controls to include in the financial reporting objective the financial reports used by top management and directors. These reports are used to run the company and are a very important part of the control structure.

We believe the Auditing Standards Board can remedy the present narrow focus of this SSAE by taking a similar approach to the one we have adopted for audits of U.S.

government entities. Our methodology, used in performing all our financial statement audits, requires the auditor to identify control objectives for each type of control that, if achieved, would provide the entity with reasonable assurance that losses of assets, noncompliance with laws, or misstatements of transactions material in relation to the financial statements would be prevented or detected. Our control objectives are set forth are as follows:

- Assets are safeguarded against loss from unauthorized use or disposition.

- Transactions are executed in accordance with (budget authority and with) laws and regulations tested by the auditor.

- Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and to maintain accountability for assets.

We believe that a similar broad-based approach to internal controls should also be applied in the private sector reporting to provide more comprehensive accountability to the corporation's creditors and stockholders, to the investing public, and to regulators.

The Auditing Standards Board could help to achieve expansion of internal controls coverage by requiring CPAs, when planning the engagement, to consider with audit committees and other individuals charged with the fiduciary responsibility for accountability, the benefits which might be derived from the auditor's performing additional work on internal controls. The benefits of such work would include both stronger controls and satisfaction of users' needs for information about controls. The individuals charged with fiduciary responsibility should be assisted by CPAs to consider these benefits as well as the related costs to achieve them.

Third, the proposed SSAE should not preclude the CPA from reporting directly on the entity's internal control structure. Since SAS No. 30 permitted direct reporting without an assertion from management, we believe the proposed SSAE's restrictions represent a step backward. We do not believe that the auditor should be precluded from accepting an engagement in situations where management has not formally evaluated the effectiveness of the internal control structure or where the auditor believes that management's evaluation may be inadequately designed or implemented. There will be occasions where management will be unwilling or unable to make an assertion, but where audit committees and others need the work to be done. Although we prefer to have the auditor report on management assertions, we believe that the auditor can independently evaluate the effectiveness of the internal control structure, especially in those situations where the auditor is performing an audit of the financial statements.

In addition, the SSAE should not attempt to restrict direct reporting on internal controls in the government sector. According to Government Auditing Standards, unless restricted by law or regulation, copies of the auditor's reports should be made available for public inspection. Public availability of auditor's reports has been a long-standing requirement in government, primarily as a method of ensuring accountability and as a method of informing the public of agency activities and problems. The proposed SSAE conflicts with the guidance and requirements in the government sector by limiting the use of the CPA's report when management elects to present its assertion only in a representation letter and not in a separate written report.

Fourth, the Auditing Standards Board should also require the CPA to focus on the respective roles of the chief executive officer and the audit committee in ensuring that internal controls are effective. The chief executive officer is ultimately responsible and should assume "ownership" of the control system. In the federal government, the secretary of a department is required by law to take responsibility for the control system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment. In addition, the chief executive officer is in position to both change and monitor the control system. In a number of corporate or audit failures, the control system was overridden by the chief executive officer, and the board of directors failed in its supervisory role. An audit committee of the board of directors is in a unique position to perform an essential control function because it has the authority to question top management but also auditors and others regarding how top management is carrying out its responsibilities. It is also able to ensure that any needed corrective action is taken. We believe the SSAE should encourage the auditor to ascertain the nature and extent of the chief executive officer's role in internal control, to work with the audit committee to perfect the committee's oversight of top management's control functions, and to advocate to top management and the audit committee the importance of an auditor's examination and report on internal controls.

Finally, the SSAE should also require the auditor's written report to disclose reportable conditions, as well as material weaknesses. Material weaknesses are infrequent, often resulting in "empty" auditor's reports. The array of reportable conditions gives a more complete picture of the control conditions affecting the entity which should be useful to readers of the financial statements in appraising the future of the entity. Government Auditing Standards require the reporting of all reportable conditions.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

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NEW YORK STATE SOCIETY
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CERTIFIED PUBLIC ACCOUNTANTS
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nysscpa

August 18, 1992

Ms. A. Louise Williamson, Technical Manager
Auditing Standards Division, File 4287
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

RE: AICPA Auditing Standards Board Exposure Draft, dated April 20, 1992, of a proposed Statement on Standards for Attestation Engagements titled "Reporting on an Entity's Internal Control Structure Over Financial Reporting"

Dear Ms. Williamson,

We are forwarding herewith comments of the Auditing Standards and Procedures Committee of the Society in response to the AICPA's request for comments on the above-titled Exposure Draft.

If you have any questions regarding these comments, please let me know and I will arrange for someone from the Committee to contact you.

Very truly yours,

Walter Primoff /dr

Walter M. Primoff, CPA
Director of Professional Programs

WMP:dr
Enclosures

cc: Accounting & Auditing Committee Chairmen

COMMENTS OF THE AUDITING STANDARDS AND PROCEDURES COMMITTEE OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS ON THE AICPA AUDITING STANDARDS BOARD EXPOSURE DRAFT, DATED APRIL 20, 1992, OF A PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS TITLED "REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING"

The Auditing Standards and Procedures Committee is pleased to offer its comments on the above-titled Exposure Draft. These comments are presented in the sequence in which the subject matter appears in the Draft.

RELATIONSHIP OF THE PRACTITIONER'S EXAMINATION OF AN ENTITY'S INTERNAL CONTROL STRUCTURE TO THE OPINION OBTAINED IN AN AUDIT

Paragraphs 82 to 84 bring to the fore a conceptual problem that is not new, but for which guidance has not been adequately given, either previously or in the current document.

Paragraph 84 states that the auditor's consideration of the internal control structure in a financial statement audit is "...similar in nature" to the examination of a management assertion about an entity's internal control structure. This creates a conflict if the auditor has chosen, as suggested in paragraph 83, to assess control risk for an assertion at maximum (choosing not to rely on internal control because, for example, he or she believes that an evaluation of the effectiveness of the policies and procedures would be inefficient) and subsequently the auditor is called upon to attest to an assertion that an effective structure is in place.

Further, if an examination of such structure is performed for attestation purposes subsequent to the audit and it reveals a material weakness, to what extent does the auditor have an obligation to revisit the audit or reconsider the wording of his or her previously issued report? Will the auditor's notations in the work papers -- for example stating that, for any number of reasons, reliance will not be placed on the internal control structure for testing purposes -- create a conflict which could be detrimental in today's litigious environment? These matters should be addressed in the statement.

APPLICABILITY

The Committee anticipates that the requirements imposed by the new standard can be accommodated by publicly held entities subject to the rules of the Securities and Exchange Commission. The Committee, however, has some concerns about the ability of small privately held entities to comply with these standards.

Smaller entities typically have fewer formal internal control procedures; most do not have an internal audit staff. In fact, many small entities likely do not meet all of the conditions for engagement acceptance enumerated in paragraph 8 of the Draft and that would preclude the accountant from reporting under any circumstances for these entities now that Statement on Auditing Standards No. 30 would be eliminated.

Renewed interest in internal control reports prompted by this proposed statement may influence lending banks to now request such assertions from privately held entities and those entities will find it impossible or, at a minimum, burdensome and costly to comply. This section of the proposed statement should clarify to which entities the statement applies and provide some relief for smaller, privately held entities.

OTHER ATTEST SERVICES

Paragraph 6 precludes the practitioner from accepting an engagement to review and report on management's assertion about the effectiveness of the entity's internal control structure. No explanation is provided for this exclusion. It is the feeling of the Committee that a review should be permitted, consistent with the views presented in the preceding paragraphs. For example, an assertion that identified procedures "if in place" would provide an effective internal control structure might be permitted.

CONDITIONS FOR ENGAGEMENT ACCEPTANCE

The condition, in paragraph 8(b), that management evaluate the effectiveness of the entity's internal control structure "...using reasonable criteria for effective internal control structures established by a recognized body" raises the question as to what are such "reasonable criteria". The reference in footnote 4 is inadequate, in the Committee's view, to identify the specifics of these "control criteria". This is perhaps the most important aspect of the Draft which requires further amplification and guidance. Further discussion on this point, with cross reference to Statement on Auditing Standards No. 55, might fulfill this need.

<u>EXAMINATION ENGAGEMENT - Testing and Evaluating the Design Effectiveness of Internal Control Structure Policies and Procedures</u>

Paragraphs 24 to 27 deal with obtaining an <u>understanding</u> of the internal control structure policies and procedures within each element of the internal control structure. Only paragraph 28 deals directly with testing and evaluation. Accordingly, it seems to the Committee that paragraphs 24 to 27 more properly belong under the preceding subheading, i.e., "Obtaining an Understanding of the Internal Control Structure".

<u>DEFICIENCIES IN AN ENTITY'S CONTROL STRUCTURE - Material Weaknesses</u>

Further clarification is needed in paragraph 40 to explain, in (a), the meaning of "gross financial statement amounts" and, in (b), the circumstances under which the "...risk of errors or irregularities is likely to be different for the different possible amounts within that range." These expressions can be confusing to many practitioners without further guidance.

(29)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: WANDA LORENZ, MANAGING PARTNER, LANE GORMAN TRUBITT, L.L.P.

Comments:

Paragraph no. 85 states that an examination of management's assertions about the effectiveness of the entity's internal control structure and an audit of the entity's financial statements may be performed by the same practitioner or different practitioners. If different practitioners are involved, the guidance suggests that "...the practitioner may wish [emphasis added] to consider any material weaknesses and reportable conditions identified by the auditor and identify any disagreements between management and the auditor concerning such matters." I believe that "may wish" is too soft. Communication such as that required by SAS No. 7 or SAS No. 50 should be required. This is especially true since management's assertions about the effectiveness of the entity's internal control structure over financial reporting can be at the end of the entity's fiscal year, or at a different date selected by management. Unless communication with the auditor of the financial statements is required, I believe that there could be a potential for "opinion shopping" with regard to management's assertion about the effectiveness of an entity's internal control.

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

(30)

CPC International Inc. / International Plaza Englewood Cliffs New Jersey 07632

JAMES E. HEALEY
COMPTROLLER

August 11, 1992

A. Louise Williamson
Technical Manager
Auditing Standards Division, File 4287
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Williamson:

CPC International Inc. is pleased to comment on the exposure draft of a proposed Statement on Standards for Attestation Engagements, "Reporting on an Entity's Internal Control Structure Over Financial Reporting."

We disagree strongly with the basic principle underlying the proposed Statement. That principle, as we understand it, is that auditors should no longer be allowed to express an opinion on an entity's system of internal accounting control, but should be restricted to expressing concurrence with a "management assertion" about the effectiveness of internal accounting controls.

We agree that it is a basic responsibility of management to develop, implement and maintain an adequate internal control structure. And we agree that an important part of that responsibility is to evaluate the effectiveness of the control structure in achieving commonly accepted internal control objectives. But we do not agree that the only role for the independent auditor (or "practitioner" as he is called in the exposure draft) in this process is to wait until management has prepared a written "assertion" and then offer a limp, half-hearted statement as to whether "management's assertion is fairly stated, in all material respects, based upon..."

In many cases management fulfills a large part of its responsibility for monitoring and evaluating the effectiveness of internal accounting controls by relying on the work done by the independent auditor. The auditing profession, if it is to continue to exist as we know it, must be prepared to accept its role as an active participant in the process of assuring the reliability and the integrity of financial reporting.

Independent auditors typically have the training and the experience to perform the evaluation described in paragraph 8b of the exposure draft as a step management must be able to take on its own before the "practitioner" would even be allowed to get involved. We believe this sort of limitation on the scope of services which independent auditors can offer clients would work to the ultimate disadvantage of the public accounting profession.

We notice that the work that would have to be done to support an opinion on a "management assertion" is essentially the same as what would be needed to support a straightforward opinion of the effectiveness of the internal control structure under SAS No. 30. The difference in approach appears to be motivated by a desire to limit the liability exposure of the independent auditor.

We are aware of the litigation crisis facing the public accounting profession. Almost every day we see another news report about a jury award against a public accounting firm running into millions of dollars and many times the size of the related fees. We strongly support the profession's efforts to stem this tide and to protect itself and its members from abusive litigation. We support recent legislative proposals that would limit the applicability of joint and several liability. We support adoption of the so-called "English rule" under which those who lose in litigation would be required to pay the winner's legal costs. We support proposals to allow public accounting firms to operate as corporations with limited liability.

But we do not believe it is in the profession's best interests to defend itself by retreating from those services which independent auditors are uniquely qualified to provide. If the profession is to rebuild its credibility, its members must have the courage to offer clear, unequivocal opinions on matters within their technical competence.

We recommend that the exposure draft be withdrawn, and that the guidance in SAS No. 30 be retained. If it should be necessary for an auditor to express concurrence with a "management assertion" on internal control the auditor ought to be able to do so by expressing his or her own opinion on the effectiveness of the internal control system.

Sincerely,

J E Healey

James E. Healey

A:MFASB

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31

August 18, 1991

Ms. A. Louise Williamson
Technical Manager
American Institute of Certified
Public Accountants
Auditing Standards Division
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Williamson:

We are pleased to submit our comments on the proposed SSAE, Reporting on an Entity's Internal Control Structure Over Financial Reporting.

Footnote 3

We do not believe this footnote provides sufficient guidance when reporting on controls over operations or compliance with laws and regulations. We recommend that this footnote be deleted.

Footnote 4

We believe the COSO report should be referred to as representing criteria for effective internal control structures established by a recognized body. We are not aware of any other criteria that presently meet this requirement, and suggest the following addition to the end of the first paragraph:

"For example, the Committee of Sponsoring Organizations of the Treadway Commission's report, "Internal Control - Integrated Framework," provides reasonable criteria against which management may evaluate and report on the effectiveness of the entity's internal control structure."

Paragraph 8c

We suggest that "competent" be removed from the phrase "Sufficient competent evidential matter" to be consistent with SSAE 100.36 - .40.

Paragraph 39

We suggest that this paragraph state explicitly that a cost/benefit consideration can never eliminate a material weakness.

The discussion of "the significance of the material weakness" in the last sentence suggests the notion of varying degrees of material weaknesses. We believe this will add confusion while not providing substantive guidance. We recommend that the phrase, "depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, " be deleted.

Paragraphs 51 and 77

We recommend the addition of the following footnote:

"If the report is a matter of public record, the following sentence should be added to the end of the report: However, this report is a matter of public record and its distribution is not limited."

Paragraphs 56 - 58

As discussed above in paragraph 39, we do not believe the practitioner has a basis for determining the significance of a particular material weakness. We, therefore, recommend the following:

- Delete the last sentence in paragraph 56
- Combine paragraph 57 with paragraph 56
- Revise the second sentence of paragraph 57 as follows:
  "In ~~this case~~ either of these circumstances, the practitioner should express ~~either a qualified or~~ an adverse opinion on management's assertion ~~, depending on the significance of the weakness and its effect on the achievement of the objectives of the control criteria~~.
- Delete paragraph 58

Paragraph 61

We recommend that the prescribed statement also be required when the examination report is presented in a separate document.

Paragraph 65

The end of the paragraph directs the reader to AU Section 543 for a discussion of the form and content of the report, even though the topic is covered in the next paragraph. We suggest deleting "(a)" - in the sixth line from the end - and "and (b) the form and content of the report," - in the second line from the end.

Paragraph 69

We believe guidance should be added after this paragraph to address a situation where the examination report is as of a date subsequent to the audit report and a material weakness is discovered (e.g., the audit is as of December 31 while the examination is as of March 31). We recommend that the practitioner be referred to AU Section 390 for additional guidance in this situation.

Paragraph 78

We suggest the following addition to the second sentence:

"The practitioner may have performed procedures and issued a report covering some or all of this other information . . . "

Also, we suggest the addition ", or whether such information contains a material misstatement of fact." to the end of the last sentence.

Paragraph 84

The statement that the auditor's consideration in an audit is similar in nature to that in examining management's assertion on internal control is misleading. We believe this type of statement will serve to exacerbate the already wide expectation gap regarding auditors' responsibilities with respect to internal control. In the vast majority of instances, the auditor's work in an internal control attestation engagement entails significantly more work. Therefore, we suggest the first sentence be modified to delete the first word "Although", and the final phrase, "the two considerations are similar in nature."

If you have any questions regarding our comments, please contact James S. Gerson (212-536-2243) or A.J. Lorie (212-536-2119) in our National office.

Very truly yours,

Coopers + Lybrand

(32)

FILE 4287

EXPOSURE DRAFT

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992
Comment date: August 14, 1992

Name and Affiliation:

Comments: RESOLUTION TRUST CORPORATION

OFFICE OF CONTRACTOR OVERSIGHT AND SURVEILLANCE

(SEE PLEASE ATTACHMENT)

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

EXPOSURE DRAFT
PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS
REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

Name and Affiliation: RESOLUTION TRUST CORPORATION
OFFICE OF CONTRACTOR OVERSIGHT AND SURVEILLANCE
1735 I Street
Room 1016A
ATTN: Bruce Gallus
Washington, D.C. 20006

Comments: Paragraph 6

Paragraph 6 states that "a practitioner ..... should not accept an engagement to review and report on such a management assertion."

Why not? Can the ED include within paragraph 6 a reason(s) why a practitioner should not accept a review engagement of this nature?

Presumably, a review engagement would cost less than an examination but still provide an acceptable level (moderate) of assurance. The moderate level of assurance may be sufficient for the purposes of say, a government regulatory body, whose goal is to obtain broad but limited coverage of the control structures of its private contractors.

Paragraph 8b.

The ED introduces the term "control criteria" and often refers to the concept of the internal control structure achieving "the objectives of the control criteria" (paragraph 17).

Can the ED provide (in a footnote) an example(s) of a control criteria so as to distinguish a control criteria from the commonly used term "control objective"?

Generally, the practitioner views the control structure as having control objectives that are achieved through the entities control structure policies and procedures. How does the concept of a control criteria fit this commonly held view?

Paragraph 19	To maintain consistency with SAS No. 68 and the commonly used expression "laws and regulations," we suggest changing the first bullet in paragraph 19 to "Matters affecting ..... such as ..... government <u>laws</u> and regulations."
Paragraph 77	1) In the report language, would the Board consider inserting the following phrase "and <u>Government Auditing Standards</u> [if the entity is a recipient of federal assistance]" after "the American Institute of Certified Public Accountants." Inserting this phrase would assist in bringing the attest standards into agreement with the AICPA's Statements on Auditing Standards (specifically, SAS No. 68) and remind auditors of the need to address the Yellow Book reporting requirements. 2) Would the Board consider deleting the phrase "based upon such criteria" in the last sentence of the next to the last paragraph of the sample report. The phrase does not seem to add anything new, it may be redundant, and it confuses what is otherwise a straightforward conclusion.

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EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992
Comment date: August 14, 1992

Name and Affiliation:

Comments: Management of smaller companies does not possess the knowledge or expertise to make an assertion about the effectiveness of the entity's internal control structure.

The written assertion is as of a point in time but the controls could have been inadequate during the period or become ineffective immediately after the period. The ED covers subsequent events but there is no discussion about ineffective controls during the period.

The ED states "management may present its written assertion about the entity's internal control structure in either of two forms." A representation letter to the practitioner is the easiest. The ED should be more specific as to when each can and should be used. The ED appears to require a written representation letter when either form is used.

It has always been the duty of the auditor to study the internal control structure in order to limit substantive testing, not to agree or disagree with management's assertion.

The ED does not address a disagreement with management's assertion and the auditor's inability to render an unqualified opinion on those assertion except to communicate such deficiencies to the audit committee, etc. The expense involved with giving a report on management's assertions at a time other than

Instructions for Response Form

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CUT ALONG LINE

Comments (continued): in conjunction with an audit have not been considered.

If a practitioner gathers information to enable management to evaluate the effectiveness of an entity's internal control structure, there appears to be a conflict of interest.

Provided By:

Auditing Standards Committee

Maryland Association of Certified Public Accountai

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

South Carolina Association
of Certified Public Accountants
570 Chris Drive
West Columbia, SC 29169
(803) 791-4181

(34)

July 15, 1992

A. Louise Williamson, Technical Manager
Auditing Standards Division, File 4287
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Williamson:

The Technical Standards Committee of the South Carolina Association of Certified Public Accountants has reviewed the Exposure Draft of the Proposed Statement on Standards for Attestation Engagements entitled "Reporting on an Entity's Internal Control Structure over Financial Reporting." Although the proposed statement may be useful for some businesses, particularly those in certain regulated industries, we wonder about the usefulness of the statement with respect to other businesses including most, if not all, small businesses.

Why is the Auditing Standards Board considering the issuance of this statement? What is its purpose? The summary to the exposure draft states that the statement would "provide guidance to practitioners who are engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting." That is more a statement of the primary modification of existing standards than it is a reason why the changes are necessary. The final sentence in the section of the summary captioned "What It Does" perhaps may provide the principal reason for the proposed statement. The statement would apply to auditors of "insured depository institutions" who examine "management's assertion" about the effectiveness of their internal control structures over financial reporting. If that is the principal reason for the statement and the changes to existing standards, then restrict the applicability of the statement to "insured depository institutions" and businesses in other specifically identified regulated industries.

It is hard to justify the changes to existing standards as they apply to other businesses, especially small businesses. It is particularly hard to understand why a practitioner's report on an examination of the effectiveness of a client's internal control structure should focus on management's assertion when the practitioner's report on an audit of the same client's financial statements instead focuses on the financial statements. In an audit of a client's financial statements, most of the work "consists of obtaining and evaluating evidential matter concerning the <u>assertions</u> in such financial statements". (AU Sec. 326.02) We test the assertions; however, our report focuses on the fairness of the financial statements' presentation of the client's financial position, results of operations and cash flows. What is important to a reader of the audit report is the fairness of presentation of the financial statements, not a listing of and report on management's assertions. Management's assertions are embodied in the financial statements. So too is management's assertion embodied in the internal control structure. What is important to the reader of a practitioner's report on the examination of the internal control structure of a business is the effectiveness of the internal control structure not what management says about it.

Existing standards, as expressed in SAS No. 30, "Reporting on Internal Accounting Control" may need to be updated to include internal control structure terminology and concepts consistent with SAS no. 55; however, those standards remain appropriate for small businesses and most other businesses and entities.

If there is other justification for the changes to existing standards, then the reasons should be clearly described in the proposed statement. Should that be the case, we would make two additional comments:

First, the changes to existing standards outlined in the proposed statement focus primarily on management's assertion; yet, only paragraph three out of eighty-seven paragraphs really discusses what management's assertion is and how it may be expressed. The proposed statement makes several references to a separate report prepared by management which would accompany the practitioner's report. Paragraph two is the first such reference. Yet, the proposed statement offers no guidance whatsoever as to the form and content of management's report. Additional guidance and, perhaps, examples should be provided in these areas.

Finally, the proposed statement requires, in paragraphs fifty-three and fifty-four, that when there are material weaknesses in the internal control structure, even when management includes in its assertion a complete description of the weakness and its effect, the practitioner's modified report should also fully <u>describe</u> the weakness. This seems to be redundant. When an auditor's opinion on financial statements is qualified, it is necessary for the auditor to disclose in his report the reason for the qualification. The auditor should also include in his report an explanatory paragraph describing the principal effects on the financial statements of the matter causing the qualification <u>unless</u> "such disclosures are made in a note to the financial statements, (then) the explanatory paragraph may be shortened by referring to it." (SAS No. 58, paragraph 51-52) Perhaps such a reference to disclosure in management's report could be allowed in this Statement also.

Thank you for the opportunity to comment. We will be happy to provide clarification of our response or to answer any questions you might have.

Yours truly,

James W. Litchfield, CPA

James W. Litchfield, CPA
Chairman, Technical Standards Committee
South Carolina Association of
Certified Public Accountants

JWL:rd

CC: Members of the Committee
H. McRoy Skipper, CPA
Lollie B. Coward, SCACPA

35

EXPOSURE DRAFT
PROPOSED STATEMENT ON STANDARDS
FOR ATTESTATION ENGAGEMENTS

Reporting On An Entity's
Internal Control Structure Over
Financial Reporting

April 20, 1992
Comment Date: August 14, 1992

Name and affiliation: Glenn J. Vice, Chairman
Lindsay J. Calub, Member
Deborah D. Dees, Member
Jon Flair, Member
William D. McCaskill, Member
J.M. Fried, Jr. Member
Jimmie L. Self, Member
Deborah R. Zundel, Member

Accounting and Auditing
Standards Committee
Louisiana Society of CPA's

Comments:

Paragraph #	
1	The statement provides guidance about the effectiveness of an entity's internal control structure over financial reporting as of a point in time. It also indicates in the footnote that guidance in the statement should be modified if the engagement is for a period of time. It seems that the basic guidance should be based on performing the engagement during a period of time. When evaluating and testing the effectiveness of an entity's internal control structure the procedures will ordinarily include inquiries, inspection of documents, observation of operations and various other procedures that is applied over a period of time.
2	In paragraph 4 it indicates that this guidance is not applicable if management does not present a written assertion. It is not clear why management may present its assertion in a representation letter. In the representation letter management is still required to present its written assertions. It would seem that management should be required to present its assertion only in a separate report that accompanies the practitioner's report since in both forms proposed the assertions by management would be the same.

6 The statement says that a practitioner may examine management's assertion but should not accept an engagement to review and report on such a management assertion. This is the interpretation since "or" is used in the phrase "may examine or apply agreed-upon procedures." The word "and" should be used since the intent of paragraph 6 is to indicate that if agreed-upon procedures are performed then the guidance in the attestation standards should be followed as stated in paragraph 5.

8 Omits the definition of specific criteria to be used, unlike SAS 30. Wouldn't an agreed upon definition be preferred? States that management evaluates the effectiveness of the entity's internal control structure using reasonable criteria for effective internal control structures established by a recognized body.

10 The word "selected" would imply to me that there is a list somewhere from which management would choose. Consider using the word "established". The last sentence states that if management selects another definition of an internal control structure, the description of the elements contained in those paragraphs may not be relevant. (This statement refers to paragraphs 11 through 14 of SAS No. 55). However, no guidance was found that would help the practitioner to determine if another internal control structure besides the definition in SAS 55 would be "reasonable criteria" for an effective internal control structure other than the criteria must be established by a recognized body.

13 - 14 Paragraphs are worded poorly. Should be rewritten to simplify. For example: Para. 13 - The entity's accounting system, further described in paragraph 25b, consists of ....; Para. 14 - In addition to the control environment and accounting system, control procedures are those policies and procedures that management establishes ...... Also, the overall timing of management's report and the auditor attestation is unclear. Unlike a balance sheet in which numbers can be validated after closing, it is difficult to attest to controls after a period of time has passed. This draft was not specific enough about this.

17 Discusses the objective of a practitioner's engagement - an opinion on the effectiveness of the entity's internal control structure taken as a whole. However, it is unclear whether under this statement a practitioner could also give an opinion on one or more management assertions regarding the internal control structure related to specific accounting cycle's or classes of accounts (for example: each receipts, budgetary controls, etc.). I believe this statement should cover these possibilities, in order for the statement to be sufficiently broad, comprehensive, and internally consistent.

35 States that a practitioner does not need to consider control structure policies and procedures that have been superceded. We think that he should consider such, if only to determine that the new ones achieve the goal of being more effective or efficient. We agree that he should not need to comment on them in the report.

40 it is not coherent in that if the clause preceding "or" is deleted, the sentence would state that the range is "from zero to transactions that are exposed .....". I think it means "from zero to the <u>amounts</u> of transactions that are exposed ..." (underlined word added). It appears inaccurate, relative to the clause preceding "or", because if the gross financial statement amounts are understated, the range would be greater than "from zero to the gross financial statement amounts".

43 Says that communication to the audit committee on reportable conditions and material weaknesses should preferable by in writing. We believe that it should always be in writing.

49 See comments for paragraph 2.

50 - 51 It is indicated that if management does not present a written assertion that accompanies the practitioner's report, the practitioner should modify the report and this section also provides a sample report. In paragraph 4, it is indicated that guidance in the statement does not apply if management does not present a written assertion.

73 Reference is made to due process procedures. More guidance should be provided to on what are due process procedures.

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August 24, 1992

Ms. A. Louise Williamson, Technical Manager
Auditing Standards Division
American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036-8775

**Proposed Statement on Standards for Attestation Engagements
Reporting on An Entity's Internal Control
Structure Over Financial Reporting
File 4287**

Dear Ms. Williamson:

We are pleased to have this opportunity to provide our comments on the Exposure Draft.

Reporting on internal controls has always been a highly judgmental matter and is likely to continue in that vein regardless of the specificity of criteria which may be developed by bodies of experts following due process. Accordingly, we are extremely concerned that a practitioner's report on management's assertion as to the effectiveness of an entity's internal control structure does not create a new expectation gap. Our comments in this letter include recommendations intended to minimize the size of any such gap.

In addition, we are not comfortable in evaluating the appropriateness of a reporting mechanism which assumes that certain effectiveness criteria will be developed, without authoritative criteria in place at the present time. We assume that the criteria included in the report of the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") will be the basis for an evaluation of effectiveness; however, such report has not yet been issued in final form. While we are aware of the need for the "cart before the horse" scenario in this case, it should be understood that our comments might be different if there were authoritative effectiveness criteria against which this ED could be evaluated.

This discomfort is particularly relevant to the concern expressed in our comment letter to COSO that the exhibits in its original exposure draft focused on large entities, making it difficult for small entities to tailor internal control evaluations to their circumstances. While the text of the Framework section of the February 1992 COSO draft incorporates additional broad guidance for small companies, the exhibits remain oriented to large companies.

Our specific comments are as follows:

Applicability

Paragraph 3 appropriately prohibits the practitioner from providing assurance on assertions that are excessively subjective (e.g. "a very effective internal control structure"). It seems to us that an assertion that an entity has "an effective" internal control structure also could be considered very subjective without a clear definition in management's assertion, or in the practitioner's report on that assertion, of the criteria for determining effectiveness. In that regard, we suggest including the definition of a material weakness in the standard language of either management's assertions or the practitioner's report, similar to the manner in which this is described in an auditor's report on a stockbroker's internal accounting controls required by SEC Rule 17a-5.

While the determination of a material weakness is difficult to understand and is highly subjective, reference to it in management's assertion or in the practitioner's report should provide the reader a clearer understanding of the term "effective". Without this sharper focus, readers may hold management and the practitioner to an inappropriate threshold for evaluating and reporting on the internal control structure. This could result in either an expectation gap or in unnecessary and costly procedures being done by each in order to meet the expectations of financial statement users.

Conditions for Engagement Acceptance

As a condition for the practitioner to issue a general use report on management's assertion, paragraph 8 requires management to use reasonable criteria established by a recognized body of experts which follow due process procedures. It is not clear to us how that definition will be applied to criteria established by the Federal Deposit Insurance Corporation Improvement Act of 1991 in connection with audits of insured depository institutions. Similarly, it is not clear whether the AICPA will formally interpret whether criteria developed by other regulatory bodies meet the "due process" test or whether this assessment will be left to the practitioner.

Given the substantial distinction between general use and limited use reports, we strongly suggest that the Institute provide such interpretations.

Footnote 4 indicates that criteria issued by the AICPA, regulatory agencies and other bodies following due process procedures "usually should be considered reasonable..." While this language apparently is intended to provide for exceptions, and is similar to that contained in Attestation Standard Section AT 100.13, it raises the question as to whether criteria issued by bodies not following due process procedures might also constitute reasonable criteria, notwithstanding the second paragraph of the footnote. It also combines the AICPA with other bodies which follow due process. Accordingly, we suggest modifying the language in the first paragraph to conform more closely with Section AT 100.13 by stating more clearly that *only* criteria established by (1) the AICPA (2) other bodies of experts following due process procedures, will be considered reasonable although, in rare cases, such criteria may not so qualify.

Elements of an Entity's Internal Control Structure

Paragraph 10 provides for circumstances where management may select the definition of the entity's internal control structure and that this definition could be different from the elements of the structure defined in SAS No. 55. Given that an entity-specific definition of its internal control structure would reflect far more variables than an entity-specific definition of GAAS, we would expect that the AICPA or any other body which develops criteria following due process would consider how management and the practitioner should evaluate any criteria in the context of different definitions of the internal control structure.

Testing and Evaluating the Operating Effectiveness of Internal Control Structure Policies and Procedures

Paragraph 34 states that the practitioner "should consider whether to perform tests of internal control structure policies and procedures in effect during one or more interim periods" to opine on the effectiveness of interim reporting policies and procedures. In our view, the guidance should be stronger than "should consider" and should require such tests to be performed.

Material Weaknesses

Paragraph 39 indicates that management may qualify its assertion using "except for" language, depending on the significance of a material weakness.

However, there is no guidance as to how the auditor should evaluate whether an adverse opinion or qualification by management is appropriate.

These kinds of determinations are difficult in a financial statement context, notwithstanding the more precise parameters for acceptable GAAP and greater experience with judgments as to financial statement materiality. We imagine they would be far more difficult in dealing with an area where accepted criteria have not yet been developed. Therefore, when and if such criteria are developed, we recommend enhanced guidance in this area.

Reporting Standards – Management's Assertion Presented in a Separate Report

As previously stated, we believe there should be specific reference either in management's assertion or in the practitioner's report as to material weaknesses as the gauge of an effective system. In addition, we believe that the practitioner's report should indicate that:

- The assertion relates to the internal control structure taken as a whole and not to individual elements or accounts (see paragraph 17). This would explicitly place the reporting responsibilities on the same level as that with respect to financial statements.

- The assertion does not relate to loss of assets arising from management's operating decisions, etc. (see paragraph 25).

- There are inherent limitations (i.e. softness) in the process of evaluating the internal control structure. These include the differences among entities in the nature and complexity of policies and procedures and the complexity and sophistication of operations and systems (see paragraph 28) and the imprecise nature of the judgments themselves, even if all other factors were equal.

- The practitioner has no responsibility to keep informed of events subsequent to the report date (see paragraph 69).

- The internal control structure could change, which could result in a different assessment as to its effectiveness.

In our opinion, these changes are necessary to educate readers as to the parameters of the evaluation process. Since this type of reporting will be new, it is critical that readers have a clear basis for making their own judgments about a particular entity.

Report Modifications – Material Weaknesses

We suggest that the explanatory paragraph in paragraph 55 appear before the opinion paragraph. Under SAS 58, paragraphs appearing after the opinion paragraph in the auditor's report are normally reserved for uncertainties. Since the circumstance in paragraph 55 is not an uncertainty, we recommend its repositioning to minimize confusion among readers.

We also believe that the report language in paragraph 61 should be included in the practitioner's report whether or not management's assertion is included in the same document. If, in what we expect would be infrequent cases, the financial statements are included only in a separate document, it is still likely that many financial statement users would also read the practitioner's report on management's assertion. These users should also have the benefit of understanding that the report on the financial statements is unaffected by the material weaknesses.

* * *

We would be pleased to discuss our views with you at your convenience.

Very truly yours,

BDO Seidman

By Wayne Kolins

Wayne Kolins
National Director of Accounting
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(37)

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CHASE

August 14, 1992

A. Louise Williamson
Technical Manager-Auditing Standards Division
American Institute of Certified Public Accountants
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New York, NY 10036-8775

Re: File Ref. No. 4287

Dear Ms. Williamson:

The Chase Manhattan Corporation ("Chase") appreciates the opportunity to comment on the Exposure Draft of the Proposed Statement on Standards for Attestation Engagements, "Reporting on an Entity's Internal Control Structure over Financial Reporting (the "ED").

Chase believes that the ED represents a step backward from the practical guidance currently contained in SAS 30.

We maintain that the ED's approach is overly restrictive and will negatively impact American industry by imposing additional costs and process burden without any apparent benefit to preparers or users of financial statement information. It is inappropriate in this age of world-wide competition to saddle industry with additional costs that our foreign competitors do <u>not</u> have to bear.

Chase is also well aware of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") requirement for management to make an assertion about the effectiveness of its internal control structure and to have that assertion attested to by its auditors. However, current auditing standards already provide sufficient guidance to auditors to evaluate management's assertion. Auditors should be considering the effectiveness of a company's internal control structure when rendering an opinion on the company's financial statements. Therefore, auditors should continue to be allowed to report directly on the system of internal control. Additionally, it would seem that the guidance used to perform this evaluation should be applied to attest to management's assertion of internal control effectiveness, whether it be objective or subjective, without mandating additional "control criteria" to be used.

Chase is particularly concerned about the addition of the concept of "control criteria" as contained in the ED. If this concept is ultimately retained, then no <u>single</u> set of control criteria should be mandated, be it COSO (the internal control report finalized by the Committee of Sponsoring Organizations of the Treadway Commission) or any other criteria established under due process.

Each company's internal control system is unique. Furthermore, COSO's drafts have been tremendously broad in scope and will impose tremendous costs and complexity if auditors are explicitly or even implicitly compelled to audit to that document.

Chase also objects to the proposed requirement to disclose publicly all material weaknesses. This is more appropriate for confidential communications between companies and their auditors and regulators.

We thank the AICPA for the opportunity to respond to this proposal. If you should have any further questions, please contact me at (212) 968-3817 or David M. Morris at (212) 968-3769.

Very truly yours,

(38)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: Arizona Society of CPA's - Auditing Standards Committee

Comments:

See Attached

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
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Arizona Society of C.P.A.'s
Auditing Standards Committee

The following represents comments made by the Auditing Standards Committee of the Arizona Society of Certified Public Accountants. It is not intended to represent the views of the society as a whole, but rather the views of the committee for auditing standards.

The committee reviewed the exposure draft "Proposed Statement on Standards for Attestation Engagements - Reporting on an Entity's Internal Control Structure over Financial Reporting." and has the following comments:

Paragraph 8b:

The concept of "Control Criteria" is inadequately defined, and vague. We believe that key words in a term should not be used in the definition of the term.

Paragraph 39:

The committee felt that whereas a reportable condition could be used to support a "clean" or a qualified opinion depending on the seriousness and pervasiveness of the condition, a material weakness by definition is significant enough to preclude management from asserting that "except for" the material weakness the system of internal controls is effective. If management utilizes an "except for" material weakness assertion in its report, the practitioner should be required to issue an adverse opinion on the internal control structure.

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August 17, 1992

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Dear Ms. Williamson:

Re: File No. 4287
Exposure Draft—Proposed Statement on Standards for Attestation Engagements,
Reporting on an Entity's Internal Control Structure Over Financial Reporting
— April 20, 1992 —

We recognize the profession's need for guidance in connection with reporting on an entity's internal control structure over financial reporting, and support the issuance of appropriate attestation standards to provide such guidance. However, we believe there are several significant issues that need to be resolved in this Exposure Draft for it to provide useful and effective guidance. Our comments are divided into two sections, the first dealing with those issues deemed most critical, in order of importance. The second section comprises our comments addressing less significant issues or editorial matters and are arranged sequentially by paragraph citation.

Critical Issues

- We are concerned with the lack of useful and effective guidance for the practitioner to use in determining whether a particular set of criteria on internal controls would meet the definition of "control criteria" as described in paragraph 8(b) of the Exposure Draft. The only guidance provided in the Exposure Draft is in footnote 4 which states that, "Criteria issued by the AICPA, regulatory agencies, and other bodies composed of experts that follow due process procedures, including procedures for broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose." This footnote does not provide any effective guidance to the practitioner in determining whether a particular set of criteria are appropriate in reporting on management's assertion about the effectiveness of an internal control structure over financial reporting. The Exposure Draft should, at a minimum, describe what would constitute acceptable "control criteria." We suggest that any set of control criteria must have, at a minimum, the elements of an internal control structure specified in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*.

Perhaps the most troublesome aspect of the provisions of the Exposure Draft is that they serve to promote the notion that there may be more than one set of acceptable control criteria appropriate for general distribution, each of which may be significantly different from the others but with which the practitioner would attest to the same broad assertion—effectiveness of internal control structure over financial reporting. This detracts from the usefulness of the auditor's attestation report, since presumably, unqualified attestation reports for general distribution, could be prepared with respect to each set of criteria. Users of these "clean reports" would be unable to compare such attestation reports on assertions of various entities choosing different control criteria. For example, the elements of an internal control structure discussed in Statement on Auditing Standards (SAS) No. 55 would be considered acceptable criteria. How would a user compare an attestation report based on this criteria to an unqualified report based on some other criteria such as the criteria specified by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its draft report? Is one better than the other? Which one is "generally accepted?"

We believe one (and only one) specific set of control criteria should be identified as "generally accepted" for use in evaluating internal controls for a general distribution report.

- Paragraph 43 of the Exposure Draft states that the practitioner should communicate "reportable conditions" to the entity's audit committee. According to SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, reportable conditions represent matters coming to an auditor's attention "that represent significant deficiencies in the design or operation of the internal control structure that could adversely effect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management and financial statements." If a company has one or more reportable conditions that do not individually or in the aggregate constitute material weaknesses, the practitioner is not required to qualify his attestation report or in any way, refer to the reportable conditions. We believe that the users of the attestation report would not comprehend why matters "that represent significant deficiencies in the design or operation of the internal control structure ..." would not receive comment in management's assertion or the practitioners attestation report thereon. While practitioners may be cognizant of the distinction between a reportable condition and a material weakness, the users may not. Accordingly, we recommend that when "reportable conditions" as defined in SAS No. 60 are identified by the practitioner and communicated to an entity's audit committee, the attestation report should refer to the fact that such conditions existed and were communicated to the entity's audit committee. Such conditions would not result in a <u>qualification</u> of the attestation report unless they were also material weaknesses.

- We do not believe there should be an option to express an "except for" qualified opinion when the practitioner identifies a material weakness and management does not qualify its assertion as to effectiveness, as currently permitted in paragraphs 56 through 58 of the Exposure Draft. Considering the magnitude of the condition needed to be considered a "material weakness," omission of its disclosure from management's assertion that the internal control structure is "effective," makes such assertion a total misrepresentation, regardless of whether the internal control structure elements, other than the identified material weakness, are deemed effective. An adverse opinion should be the only alternative in this situation.

- It is not clear what the practitioner's reporting responsibility is with respect to "Type 2" subsequent events (i.e., those that would not affect management's assertion for the period or point in time reported on). If the practitioner becomes aware of a significant subsequent event, such as a breakdown in internal controls, occurring after the period (or point in time) covered in the attestation report but before its issuance, the Exposure Draft does not require comment in either management's assertion or the attestation report thereon. We believe that significant subsequent events of this type constitute important information to be communicated to the users of the attestation report. Accordingly, we recommend the Exposure Draft provide guidance as to when and how disclosure of such events would be required.

- We concur with the Board's decision to require reports issued under this Exposure Draft to be on management's *assertion* rather than directly on the effectiveness of an entity's internal control structure.

Other Comments

- Paragraph 8(a) requires that management must be "sufficiently knowledgeable about the entity's internal control structure to accept responsibility for the assertion ...". It would be difficult for the attestor to decide whether management is, in fact, "sufficiently knowledgeable." It should be enough that management takes responsibility for the assertion. This requirement should be deleted.

- Due to the significance of the guidance, footnote 4 to paragraph 8(b) should be included as part of the Statement's text.

- Paragraph 11 of the Exposure Draft incorrectly describes SAS No. 55's definition of internal control structure over financial reporting, which is the only aspect of internal control structure addressed in this Exposure Draft (according to paragraph 1 and footnote 2). The opening part of paragraph 6 of SAS No. 55 describes internal control structure as consisting of "the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved." The remainder of the passage narrows the explanation to the aspects of internal control structure "relevant to an audit of the entity's financial statements," i.e., internal control structure over financial reporting. The Exposure Draft's paragraph 11 says internal control structure over financial reporting *includes* the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. We recommend paragraph 11 of the Exposure Draft be conformed to SAS No. 55.

- As described in paragraph 20, a practitioner planning a multi-location engagement should consider "factors similar to those he or she would consider in performing an audit of the financial statements of an entity with multiple locations." Rather than a loose analogy to an audit, it would be helpful to weight and explain the application of the 13 factors specifically adduced — i.e., those in paragraph 19, and items (a) through (d) in paragraph 20.

- Paragraph 20, item (c), states "the effectiveness of the control environment policies and procedures," permits reliance on the control environment in one location for purposes of determining whether to understand and test controls in other locations. There is not always sufficient basis for believing that in a decentralized environment the effectiveness of the control environment in one location adequately supports conclusions about whether understanding and testing controls should occur at another location. This item should be clarified.

- Paragraph 21 states "a practitioner may find the guidance in SAS No. 65 ... helpful when assessing the competence and objectivity of internal auditors ...". We recommend that sentence be changed to "a practitioner *should follow* the guidance in SAS No. 65 ...".

- Paragraph 25 says the practitioner should evaluate design of an entity's internal control structure by obtaining an understanding of the relevant policies and procedures. However the first bullet under that statement is "Management's philosophy and operating style." The auditor cannot follow the guidance on this item because "management's philosophy and operating style" does not typically consist of policies and procedures. We recommend paragraph 25 be changed to state "the practitioner should obtain an understanding of the internal control structure policies and procedures *where applicable* ...".

- The opening sentence of paragraph 25 states, "To evaluate the design of an entity's internal control structure, the practitioner should obtain an understanding of the internal control structure policies and procedures ...". This implies that an *understanding* is of itself, enough to evaluate the design. We suggest the sentence be changed to "As a prerequisite to evaluating the design ...".

- Paragraph 29 is not consistent with SAS No. 55. Tests of operating effectiveness in SAS No. 55 were procedures "such as" the items at the end of paragraph 29 here. But the Exposure Draft states, "Such tests ordinarily include ... *and* ...". Thus, all the procedures (inquiry, inspection of documents, observation of operations, and re-performance) are deemed ordinarily applicable. We recommend SAS No. 55 language be used.

- Paragraph 46(b) of the Exposure Draft provides that if management presents its assertion only in a representation letter, the practitioner should restrict the distribution of the report "to management, to others within the entity and, if applicable, *to specified regulatory agencies* ... [Emphasis added]". We believe that if distribution of the report will include regulatory agencies, then management's assertion must be in a separate report that accompanies the practitioners report. Including the assertion only in a representation letter to the practitioner, should be permitted only for attestation reports that are not circulated to any third-party.

- Paragraph 67 of the exposure draft states "*changes* may occur subsequent to the date of management's assertion ...[Emphasis added]". It is unclear what is meant by the word "changes". We suggest that the wording in paragraph 45(f) ("changes in internal control or other factors ...") be substituted for the word "changes."

- Paragraph 70 of the Exposure Draft describes an illustrative report to be used when the practitioner is engaged to report on management's assertion about the effectiveness of only a segment of an entity's internal control structure. We recommend that in such an engagement, the practitioner's report include a disclaimer on the internal control structure as a whole.

- Paragraph 73 describes situations when management's assertion is based on criteria specified by a regulatory agency that *did not follow due process*. We recommend that the statement provide a definition of what is contemplated by the phrase "due process" through a footnote to paragraph 73.

- Paragraph 85, first sentence. This sentence should be revised. The attestor of a particular entity's assertions regarding its internal control structure, who has not also performed the financial statement audit of the same entity must comply with every aspect of the Exposure Draft's provisions, not just the requirements for an "understanding." The Attestation Standards define the requirements (e.g., adequate technical training and proficiency, adequate knowledge of subject matter), which we suggest should be incorporated here.

* * * *

We would be pleased to discuss any of our comments contained in this letter.

Very truly yours,

KPMG Peat Marwick

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WASHINGTON SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

August 19, 1992

A. Louise Williamson, Technical Manager
AICPA Auditing Standards Division
1211 Avenue of the Americas
New York, NY 10036-8775

RE: File 4287

Dear Ms. Williamson:

This letter sets forth the comments and recommendations of the Accounting Principles and Auditing Standards Committee of the Washington Society of Certified Public Accountants (WSCPA) regarding the exposure draft on the proposed statement on standards for attestation engagements (SSAE), "Reporting on an Entity's Internal Control Structure Over Financial Reporting." The comments and recommendations do not necessarily represent the opinions of the Board of Directors or the membership at large of the WSCPA.

Regulatory requirements:

If adopted, this SSAE will apply to all engagements to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting. However, in light of developments such as the passing of the Federal Deposit Insurance Corporation Improvement Act of 1991 (the Act), it seems that a large portion of such engagements (if not the majority) will relate to satisfying regulatory requirements. We feel the references to regulatory requirements could be improved.

The exposure draft summary refers to the fact that the proposed guidance would apply to auditors of insured depository institutions who examine management's assertions about the effectiveness of the internal control structure over financial reporting, as required by the Act. No reference appears in the body of or appendix to the guidance, however.

Footnote 4 to paragraph 8.b. describes possible sources of control criteria. This seems to be a very critical

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element of this proposed guidance not only because it addresses criteria established by a regulatory agency, but also because it defines acceptable sources of control criteria and the effect the source has on the auditor's report.

Paragraphs 73 though 76 contain the most meaningful discussion of the impact of the guidance as it relates to regulatory requirements. This discussion, however, is presented under "Report Modifications."

We feel these concepts should be given more prominence in the document and that a more explicit discussion of the relationship between the proposed statement and regulatory agencies would help the practitioner to better evaluate the applicability of this proposed guidance.

Financial reporting during a period of time:

Footnote one to paragraph one states that a practitioner may be engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting "during a period of time" rather than "at a point in time" and that the guidance should be modified accordingly. There are no suggested modifications included, however. We feel the statement should include suggested modifications to the guidance should the practitioner be so engaged. We also feel the guidance should specifically address whether it is appropriate for the practitioner to accept an engagement subsequent to the date or period of time their report will cover.

We appreciate the opportunity to comment. If you desire additional clarification on any of our comments or recommendations please contact us.

Sincerely,

William R. Kauppila, CPA
JLK

William R. Kauppila, Chairman
Accounting Principles and
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(41)

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August 31, 1992

Ms. A. Louise Williamson
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AICPA Auditing Standards Division
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Re: File No. 4287

Dear Ms. Williamson:

We are pleased to comment on the Proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. We support the issuance of the proposed statement and offer the following comments for consideration.

SPECIFIC COMMENTS

Our comments with respect to specific issues are as follows:

Paragraph 31

The intent of this paragraph is that tests of operating effectiveness by management should not reduce the practitioner's level of testing and that consideration of management's tests by the practitioner should be directed toward whether the practitioner's planned level of testing should be increased or directed toward specific matters as a result of any *deficiencies* or other matters noted by management that certain internal control structure policies and procedures may not be operating effectively. Accordingly, we believe the second sentence of paragraph 31 should be rewritten; otherwise practitioners may interpret this sentence to mean that they may decrease their level of testing based on the absence of any deficiencies being reported by management.

Paragraph 34

The guidance in paragraph 34 tells the practitioner to *consider* whether it is necessary to perform tests of internal control structure policies and procedures in effect during one or more interim periods to form an opinion on management's assertion about interim financial reporting. This is inconsistent with the tenor of the advice contained in paragraph 33 (i.e., "the practitioner should perform tests of controls over a period of time that is adequate to determine"). Paragraph 33 also speaks to controls that operate only at certain times and provides the specific example of controls over the preparation of interim financial statements. We believe that the guidance in paragraph 34 should be strengthened to *require* tests of controls for an adequate period regarding policies and procedures in situations in which management makes a written assertion about the effectiveness of internal control structure policies and procedures related to the preparation of interim financial information.

Paragraphs 38-39

These paragraphs concerning reportable conditions and material weaknesses are written from the practitioner's perspective; the practitioner is the one to determine whether a weakness is a reportable condition or a material weakness. We believe that such paragraphs need to be expanded to encompass that management can also make those determinations in their evaluation of the effectiveness of the internal control structure. Otherwise, there will be an inconsistency between the request for a representation from management described in paragraph 45.d that management has disclosed to the practitioner all reportable conditions and has identified those that it believes to be material weaknesses and the definitions in paragraphs 38 and 39. As the definition is currently drafted, management could not, in theory, make such a representation while the determination of reportable conditions and material weaknesses is dependent upon the practitioner's evaluation only.

Paragraph 40

This paragraph speaks to amounts of errors and irregularities in a range from zero to the gross financial statement amount. The only type of error that this seems to recognize is an error of commission as opposed to an error of omission. However, amounts may be missing from the financial statements and, therefore, the range of error may not be subject to quantification. Accordingly, we recommend that recognition be given that an internal control deficiency is not necessarily limited to the amount reported because the error could actually be greater than the amount reported, particularly when no amount has been reflected but an amount should have been reflected.

Paragraph 41

We believe that the evaluation of the combined effect of individual reportable conditions discussed in this paragraph should also reflect back on the discussion in paragraph 20 concerning multi-unit entities as such consideration would be important factor in the practitioner's evaluation.

Paragraph 43

The requirement that the practitioner identify the reportable conditions that are also considered to be material weaknesses expands the practitioner's responsibility beyond that of an auditor under SAS No. 60. We believe that the rationale for such expanded responsibility should be included in the proposed standard. For example, a footnote could be added stating the following:

> Although SAS No. 60 does not require an auditor to separately identify and communicate material weaknesses, the practitioner is required to do so in this Statement because of the effect of a material weakness on the practitioner's report and

> management's assertion about the effectiveness of the entity's internal control structure as discussed in paragraphs 53 through 61.

Paragraph 43 also discusses the manner in which reportable conditions are communicated. The last sentence states that "such a communication should preferably be made in writing." We believe that such statement should be clarified; for example:

> Material weaknesses should be described in the practitioner's report on management's assertion; other reportable conditions not considered to be a material weakness should also be communicated by the practitioner, preferably in writing.

<u>Paragraph 61</u>

We believe that the requirement to include a statement in the examination report that "such conditions [material weaknesses] were considered in determining the nature, timing, and extent of audit tests" applied in the audit of the financial statements should be included in all examination reports that disclose material weaknesses and not just those that are included in documents with audit reports on related financial statements.

Additionally, we believe that a discussion should be added to alert the practitioner to the possible incongruity that may result if the practitioner's report on the internal control structure over financial reporting states that "reasonable assurance" is not achievable and an auditor's report has been issued that expresses an unqualified opinion after using the language "reasonable assurance" in the scope paragraph of the auditor's report.

Another matter which we believe should be addressed when discussing the connection between the auditor's report on the financial statements and the practitioner's report on management's assertion about the effectiveness of the internal control structure are dating issues. We believe that there is a strong presumption that the practitioner's report on the internal control structure would either be dated in advance of, or simultaneously with, the audit report on the financial statements, and not thereafter; however, a paragraph should be added that discusses dating considerations.

<u>Paragraph 74</u>

We believe that the manner in which the practitioner should describe conditions that are not in conformity with a regulatory agency's criteria should be elaborated when a regulatory agency requires management to report all conditions not in conformity with the agency's criteria. Accordingly, we recommend that the proposed SSAE be revised to include the following:

- A statement to remind the practitioner that the inclusion of such disclosures may necessitate a report modification as described in paragraphs 52 through 60.

- A statement that when such conditions are not considered material that the practitioner may include a sentence in the practitioner's report that such conditions were considered in arriving at the practitioner's opinion on the financial statements as described in paragraph 61.

EDITORIAL COMMENTS

Our comments of an editorial nature are as follows:

Paragraph 8 (Footnote 4)

We believe the second sentence of the second paragraph should be modified to read "the practitioner *should* modify his or her report by adding a paragraph that limits distribution . . . " rather than "the practitioner would have to modify his or her report . . . . "

Paragraph 17

The second sentence includes, in a parenthetical comment, the elements of an internal control structure as defined by SAS No. 55. However, as paragraph 10 states, the elements that constitute an entity's internal control structure are a function of the definition selected by management. As the SAS No. 55 definition may not be selected by management, we recommend that either the parenthetical comment be removed or revised to state the following: "(e.g., if management has selected SAS No. 55, the elements would include control environment, accounting system, and control procedures)."

Paragraph 18

We believe that the paragraph could be clarified by revising the introduction to read as follows:

> Performing an examination of management's assertion about the effectiveness of an entity's internal control structure based on control criteria involves:

Paragraph 21

This paragraph states that an important responsibility of the internal audit function is to monitor the performance of an entity's control. We believe that such statement is too limited for a practitioner's interest in internal audit and recommend that a phrase similar to that contained in paragraph 13 of SAS No. 65, be used which includes the phrase "review, assess and monitor." This could then be followed by an example to illustrate one of those responsibilities (e.g,, monitoring).

Paragraph 29

The first sentence should be strengthened to require the practitioner to perform tests in evaluating the operating effectiveness of an entity's internal control structure (e.g, "the practitioner *should* perform tests"); as currently written, it may be construed as an alternative or optional procedure.

Paragraph 39

"Specific" should be eliminated from the definition of a material weakness to be consistent with the conforming changes made to SAS No. 60 which eliminated the inconsistency between paragraphs 15 and 16 of SAS No. 60. Paragraph 15 and 16 of SAS No. 60 have been revised by the AICPA to defines a material weakness as "a condition in which the design or operation of one or more of the internal control structure elements . . . . "

Paragraphs 40, 47.c, and 48

In a number of instances in the proposed statement, the phrase "errors and irregularities" has been carried over from SAS No. 30. We believe that the SAS No. 55 phrase, "misstatements of the financial statements," is a more generic phrase that should be used without the characterization of an error or irregularity. Accordingly, we believe that the paragraph in the practitioner's report concerning inherent limitations should read, in part, as follows: "because of inherent limitations in any internal control structure, *misstatements in the financial statements* may occur and not be detected."

Paragraphs 51 and 77

The limitation paragraph of the sample reports should be worded as follows to be consistent with other professional standards:

Paragraph 51:

> This report is intended for the information and use of the board of directors and management of W Company [and, *if applicable*, for filing with the (*name of specified regulatory agency*)] and should not be used for any other purpose.

Paragraph 77:

> This report is intended for the information and use of the board of directors and management of W Company and for filing with the [*name of specified regulatory agency*] and should not be used for any other purpose.

Paragraphs 48, 55, 58, 59, and 63

While footnote 2 states that an abbreviated reference is used throughout the proposed statement, we believe that the references in the scope or explanatory paragraphs of the sample reports to "the internal control structure" should be to "the internal control structure over financial reporting" or to "such internal control structure."

Paragraph 51

When management's assertions are included in its representation letter, we believe that the introductory paragraph should be expanded to state "included in its representation letter *to us* dated February 15, 19XY."

Paragraph 57 (footnote 12)

It appears that the reference to footnote 10 should be to footnote 9.

Paragraph 73

It may be helpful to add a parenthetical cross-reference to paragraph 77 to the last sentence of paragraph 73 which discusses the modification of the practitioner's report.

Paragraph 77

We believe that the introductory paragraph to the report example should also reiterate that the example assumes that the regulatory agency did not follow due process, thus requiring the paragraph limiting the distribution of the report; otherwise, it may be inadvertently used for all regulatory situations.

* * * * *

Please contact John B. Sullivan (203/761-3209) if you have any questions or if there is any other way in which we might be helpful.

Sincerely,

Deloitte & Touche

1251 Avenue of the Americas
New York, NY 10020

Telephone 212 819 5000

(42)

Price Waterhouse

August 31, 1992

AICPA Auditing Standards Division
File 4287
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Sirs:

Reporting on an Entity's Internal Control Structure
Over Financial Reporting

We are in agreement with the exposure draft generally and encourage ASB to proceed promptly with consideration of the comments it receives and issuance of a final Statement. We have a few substantive comments for your consideration and some editorial comments.

We believe the Statement sets forth the appropriate framework for reporting on the internal control structure in reports issued to the public, i.e., an auditor's opinion on the accompanying management assertion. However, the form of direct reporting on internal controls provided for by SAS 30 should continue to be permitted in engagements leading to restricted distribution reports. Therefore, we believe the proposed Statement should be restricted to reports where the auditor has been engaged to report on management's assertion on the internal control structure contained in a separate report that will accompany the auditor's report. APB 30 should be amended but not withdrawn.

The proposed Statement lacks specific recognition of the "Internal Control - Integrated Framework" report of the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Report). We recognize that the timing of the development of the COSO Report and of the proposed Statement may have caused this omission. ASB should now coordinate issuance of this Statement with the COSO Report. Further ASB should replace the discussion of the SAS 55 elements of an internal control structure with a discussion of the COSO Report components of internal control, citing the permissible use of the SAS 55 criteria in a footnote if necessary. We believe, however, that the ASB should encourage use of the COSO report so that users have a consistent frame of reference.

The Statement should provide for omitting the inherent limitations language when the practitioner's report and management's report, which contains the appropriate language, are contained in the same document, e.g., an annual report to stockholders. It could require that unless management uses the specific inherent limitations language in the Statement without modification, the inherent limitations language should be included in the practitioner's report.

Paragraph 8b, footnote 4 requires that management evaluate effectiveness using reasonable criteria established by a recognized body, and cites sources of such reasonable criteria. It seems possible, however, that as the concept of reporting on management's assertion about internal control becomes accepted, some entities might want management's assertions and the practitioners attestation thereon using criteria established by the entity, and that such criteria would be reasonable. The statement should allow restricted distribution (internal use only) attest reports in these circumstances. Reference could be made to Attestation Standards (AT 100.16 and 55).

Further, we believe the ASB should provide guidance in this or a future Statement which combines the auditor's report on financial statements and the auditor's report on the internal control structure when the two are contained in the same document.

We have the following editorial comments:

<u>Paragraph</u>

8b Insert "independently" between "Management" and "evaluates" to emphasize the need for management to evaluate the internal control structure separately from the practitioner's evaluation.

8b fn 4 second paragraph, second line. "Do" should be "does."

33 Second parenthetical example. Add "counts" or something similar to make the controls referred to ones that are applied periodically.

45 fn 7 Delete 'the date on" from the penultimate line.

51 Penultimate word. Delete "other" as the report should not be used by third parties for any purpose. Comment also applies to paragraph 77.

57 fn 12. Reference should be to footnote 9.

* * * * * * *

Thank you for the opportunity to comment on the exposure draft of the proposed Statement. We will be pleased to discuss with you any of our comments or any other aspect of the proposed Statement.

Sincerely yours,

Price Waterhouse

(43)

EXPOSURE DRAFT

FILE 4287

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

April 20, 1992

Comment date: August 14, 1992

Name and Affiliation: JULIE DUNN, THE DEXTER CORP.
ONE ELM STREET, WINDSOR LOCKS CT 0609

Comments:

The Committee of Sponsoring Organizations of the Treadway Commission issued its "Internal Control - Integrated Framework" in September 1992. This report included a common definition of internal control. Within this exposure draft, another definition of internal control was used. This, once again, produces confusion over the definition of internal control, which the Treadway Commission report was intended to eliminate. We believe this "common" definition of internal control should be used within this exposure draft.

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 or interest to you. Return this response form to the address indicated on the reverse side by the comment date.

Comments (continued):

Return responses to:
A. Louise Williamson, Technical Manager
Auditing Standards Division
AICPA, 1211 Avenue of the Americas
New York, NY 10036–8775

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Strategic Capital Management, Inc.

Dennis L. Slothower Mark T. Sumsion Duane W. Wyckoff Scott Garbutt

Cottontree Square
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FAX TRANSMISSION
DATE: 10/28/92

ATTN:	Louise Williamson
FAX#:	1-212-575-3846
PHONE#:	

FROM: Richard Reid, CPA, Controller

COMMENTS: Due to Hurricane Andrew and a change of employment, I failed to notice that I had not submitted the enclosed comment letter. If the ASB has not yet finalized consideration of the "Internal Controls Reporting" exposure draft, these comments may be useful.

Pages to Follow: 3

FLORIDA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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TELEPHONE (904) 224-2727 • FAX (904) 222-8190

July 30, 1992

Ms. A. Louise Williamson, Technical Manager
Auditing Standards Division
American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036--8775

Re: File 4287--"Reporting on an Entity's Internal Control Structure Over Financial Reporting"

Dear Ms. Williamson:

The Florida Institute of CPAs Committee on Accounting Principles and Auditing Standards (the Committee) is pleased to provide its response to the *Proposed Statement on Standards for Attestation Engagement* entitled "Reporting on an Entity's Internal Control Structure Over Financial Reporting."

In general, the Committee believes that this topic is an important one and that there is a need for additional guidance to be provided to practitioners who may be asked to provide such an attest service. While we are generally in favor with much that is included in the exposure draft, we believe that certain issues need to be clarified or addressed in more depth. These issues include:

1. Footnote 1 states that "A practitioner also may be engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting *during a period of time*. In that case, the guidance in this Statement should be modified accordingly."

   The Committee believes that the document should provide guidance on reporting for a period of time rather than merely indicating that the guidance should be modified accordingly. Indeed, much of the Committee's discussion focused on the distinction between reporting at a point in time versus a period of time. The Committee believes that the final document should contain a discussion of (1) when it might be appropriate to report at a point in time versus a period of time, (2) how the guidance should be modified when reporting for a period of time, and (3) how the report should be modified when reporting for a period of time.

2. Another matter of significant concern to the Committee was whether the guidance provided about the period of time needed to evaluate the controls (see, for example, paragraphs 35 and 63) was adequate. While there was some disagreement among the Committee members, there was a significant opinion expressed that additional guidance should be provided on this critical issue.

Ref: File 4287 Exposure Draft
July 30, 1992

3. Another matter of concern to the Committee is the applicability of this document to interim periods. First, should the report or the procedures be modified when reporting for a point in time (such as year-end) when controls for annual purposes are adequate, but there are not adequate controls for interim purposes. Secondly, what responsibility does the accountant have to examine controls over interim reporting when the attestation engagement is to report on controls in existence at year-end? The Committee strongly believes that the guidance provided in paragraph 35 needs to be clarified to address the question of interim reporting--particularly if control weaknesses existed at an interim date (thus, potentially affecting the validity of the interim financial information) but the weaknesses had been corrected by year-end.

4. Another matter regarding the question of interim periods raised by the Committee is the appropriate report to be issued when reporting either for an interim period of time or as of an interim date. The Committee suggests that the illustrative reports should include some reference to interim period to provide guidance to practitioners. Also, given the concerns expressed in (3), the Committee believes that it may be necessary to refer to interim periods in the report at year-end. As an extension of this, some members of the Committee expressed a concern that when such an attestation report is included in the annual report (or other document containing the audited financial statements and the auditor's report on those statements), readers of the attestation report may mistakenly conclude that the attestation report refers to a time period rather than to a point in time. Perhaps the Auditing Standards Board should look to additional wording which would more clearly clarify the reporting on controls at a point in time.

5. The Committee expressed a concern that the inherent limitations paragraph of the attestation report provided in paragraph 48 may confuse the readers. Unfortunately, the Committee was unable to suggest alternative wording for that paragraph.

6. The Committee notes that the exposure draft has a tone which implies many "what ifs" and other implementation issues. As such, as the Auditing Standards Board continues its deliberation on this proposed Attestation Standard, it also should consider the need to develop an implementation guide similar to that developed to aid practitioners in implementing SAS No. 55.

7. The last sentence of paragraph 3 seems to be unnecessarily complex. Perhaps it could be simplified in some manner.

8. Members of the Committee who deal primarily with smaller clients were particularly concerned about the provisions of paragraph 8a and 9. The current wording of those paragraphs could create a substantial problem for accountants who are dealing with smaller clients as they attempt to determine whether management is sufficiently knowledgeable about the control structure. For example, as discussed in paragraph 8b, can management's evaluation of the adequacy of the control structure be based on the CPA's representations? Many members of the Committee felt that the distinction between the CPA's and management's responsibilities should be clarified.

Ref: File 4287 Exposure Draft
July 30, 1992

In addition to these specific comments, the Committee had additional observations which fall in the realm of general observations. These are:

1. In general, Attestation Standards could contain more examples to better aid practitioners as they attempt to determine whether the standards apply. For example, the final pronouncement could contain a decision tress which would help practitioners determine whether the document is applicable (as discussed in paragraphs 4 - 7).

2. The AICPA has now issued several Attestation Standards and is now proposing that another one be issued, yet these standards do not contain any numbering system. It would seem to be prudent for the AICPA to implement a numbering system for these documents as is done with other documents (such as SASs, SSARSs, etc.) for which multiple standards are issued under one title.

Members of the Committee will be pleased to provide additional feedback to the Auditing Standards Board regarding our comment letter.

Sincerely,

Richard Reid

Richard Reid, Chairman 305/591-8850
Accounting Principles and Auditing
Standards Committee

Subcommittee:

Paul Munter	305/284-5492
Steve Kattell	904/372-6300

(45)

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November 6, 1992

VIA FAX

Mr. Dan M. Guy
Vice President
Auditing Standards Division
American Institute of
Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: Proposed SSEE "Reporting on an Entity's Internal Control Structure Over Financial Reporting"

Dear Dan:

As was suggested at the meeting on Thursday, November 5, 1992 between members of the ASB/Liaison Group from the Committee on Law and Accounting of the American Bar Association, and representatives of the Auditing ~~Standards~~ Division of the AICPA, I am sending to you herewith unofficial comments in which I have attempted to set forth certain views which have been expressed to me by various members of the Committee, including those who were present at the November 5 meeting. In view of the shortness of time, we have not been able to prepare a document approved by all of the Group.

The enclosures are:

1. An updated Summary of Comments on the COSO Report by a Task Force of the Committee; and

2. A memorandum specifically commenting on the proposed SSAE described in the above caption.

If you or any members of the Auditing Standards Division have questions, please feel free to call any member of the ASB/ Liaison Group.

Sincerely yours,

Bill

William P. Hackney

gsb

ABA Law & Accounting Committee

Summary of Comments of Task Force on COSO Report

November 5, 1992

Since late 1990 several members of the Law and Accounting Committee, sometimes self-described as a "task force" and other times as an ad hoc group, have been providing comments on successive drafts of the COSO report. During 1992, this group has consisted of Barry S. Augenbraun, Thomas E. Baker, Marshall H. Earl, Jr., Daniel L. Goldwasser, R. James Gormley, Samuel P. Gunther, Abraham M. Stanger, and William P. Hackney, Chairman.

The common theme of most of our comments to COSO was the foreseeability of certain legal implications of the Report. We argued three propositions:

1) any report to the public is a disclosure document under the Securities Laws and potentially a liability document;

2) if an erroneous report is made by "management", or by named officers who sign the report, there is a risk of personal liability; and

3) in the event of litigation based upon a misleading report, it should be the enterprise, and not an individual, which incurs liability to a third party.

Since the Report has been endorsed as a statement of authoritative standards by professional bodies and presumably may be endorsed by governmental bodies, such as the SEC, we felt that it will become binding on everyone affected by it, and the contents are likely in the judicial process to become like GAAP or GAAS, similar to specialized bodies of law, and thus will find their way into the substantive law of duty and liability.

1. As the first major point we reiterated the position of our Committee, consistently expressed to the SEC and others for many years, questioning the entire concept of a management report on internal control, our position being that entities should not be required to, and may be well-advised not to, issue management reports assuming responsibility for and making an assessment of internal controls. Needless to say, it was no surprise to us that this fell on deaf ears. And while the Report takes no position on whether a management report should or should not be issued, it did strongly take the position that if a management report is issued, it should contain an assessment of the effectiveness of the system.

So the following were our comments on the COSO Report, assuming that a report on internal controls is to be issued by the company.

2. We persuaded COSO that any report on internal control, if made at all, should be a report by the entity, not by any particular individuals in management. While it is true that the entity can only act through its officers and directors, we felt that any report to third parties is potentially a liability document; and in the context of risk to third parties, it is the entity's internal control process, not that of several specified individuals, which is devised and maintained. In the event of any such suit, we believe that the enterprise itself should be the only party to incur any liability to third parties. If a member of management has been negligent, resulting in loss to the enterprise, the entity may look to the individual for recompense, but that is an internal matter between the entity and its officers and employees; liability to third parties is another matter.

We think we were moderately successful in this regard:

-- COSO changed the name of the third document by deleting the word "Management", so that it became "Reporting to External Parties".

-- They did, however, in the text, continue to use the term "management report", but explicitly stated:

> The term "management report" traditionally has been used to mean an entity's report, signed by top management officials on behalf of the entity. Because of its common usage, the term "management report" is used in this discussion to mean such entity reports.

-- Their two illustrative reports that are included in the document are signed in the name of "XYZ Company, By" the named officers.

3. Second, we urged that whenever the company makes a statement with respect to effectiveness of internal control, the Report should describe the assessment in the form of a belief - not an assertion, or representation, or statement, but a belief - by the company. In the illustrative reports it is stated that "The Company maintains," then "the Company assessed," and then, based on that assessment, "the Company believes. . . ."

4. Third, we argued that the draft report, in discussing "reasonable assurance", occasionally seemed to talk in terms of providing assurance to external parties such as or security holders. We argued that the purpose of internal control is to provide reasonable assurance to management and the board of directors who are responsible for the financial statements; COSO agreed, and made changes to so indicate. The illustrative reports were thus changed to read, " . . . designed to provide reasonable assurance to the Company's management and board of directors. . . ."

5. Both the Framework volume and the Reporting volume frequently use the term "reliable", or "reliability", in talking

of the objectives of financial statements, or in talking about the statements themselves (reliable statements), or sometimes reliable reporting; and this term "reliability" was originally defined in the Report in terms of satisfying the five basic financial statement assertions.

We had a host of objections to the use of the term "reliable", including:

> (i) The objective of financial reporting is not "reliability," but fair presentation.
>
> (ii) The definition is dangerous in speaking in terms of satisfying the basic assertions: "reliable" then would mean "accurate".
>
> (iii) We cannot have the term "assertions" in the company report: as stated, it is a belief, not a representation.

We persuaded them that the objective of financial reporting is for the statements to be fairly presented, and that "reliability" should be so defined. They insisted upon continuing to use the word "reliable," but changed the definition of reliable to mean "fairly presented in conformity with generally accepted (or other relevant and appropriate) accounting principles".

The revised definition goes on to state that the five basic financial statement assertions (of management) "support" fair presentation. This is a very cumbersome definition, and can be interpreted to mean, "reliable" doesn't mean what you would think it does; it means "fairly presented in accordance with generally accepted accounting principles," which means something about five basic financial statement assertions referred to in the audit literature.

6. At our request, they added a specific reference to the concept of materiality in speaking of reliability and

therefore effectiveness of internal control. The "reliability" is defined as fair presentation, "within the context of materiality".

7. And lastly, the original draft had a lengthy discussion of the "prudent person" concept, in addressing the "limitations" of internal controls. We persuaded them that the prudent person concept is in law, one of tort liability for negligence, and that it was inappropriate for the Report to address any question of legal liability. That discussion has been removed in its entirety, and replaced with a discussion of the need to apply judgment in making internal control-related decisions; and the fact that human judgment can be faulty is another one of the inherent limitations of internal control.

The bottom line now is that our ad hoc group reviewing the COSO Report is, I think, at least minimally satisfied that COSO reacted positively to our concerns - they certainly did not accept all of them, but sufficiently - so that our ad hoc group has taken the position that we will recommend to our full Committee that we have no fundamental objection to the Report. It is still likely, however, that we shall prepare our own Committee Report, perhaps to be published in the Business Lawyer, alerting lawyers to the importance of the COSO Report, highlighting what we feel are the important conclusions which are of interest to lawyers and the managements of their clients, and perhaps commenting on the advantages and what we see as the disadvantages of issuing such reports -- that is, assuming the SEC has not made them mandatory. Based upon the ABA/SEC liaison committee meeting held on June 16, 1992, it appeared that the SEC proposal to make reports mandatory was not being actively pursued at that time. Of course, the FDIC Improvement Act of 1991 requires that insured depository institutions periodically furnish to applicable regulatory authorities a management statement of management's responsibility for "establishing and maintaining an adequate internal control structure and procedures for financial reporting," including an assessment of its effectiveness.

I think the principal thrust of our comments will be directed toward the text of the illustrative reports. An initial major problem is that the management reports use terms which are sometimes defined in the Framework volume not in terms of their normal, everyday meanings, but in narrow, precise ways. They remind me of a debenture indenture, where the document is virtually meaningless without elaborate definitions. I have referred to some of these legalistic definitions -- some made to try to satisfy our concerns. But the problem is that these Glossary definitions in the Framework volume do not appear in the illustrative management reports; they are not incorporated by reference; are not even referred to; and under the Securities Laws, the meaning of all terms employed in disclosures will be construed in accordance with the "ordinary" or dictionary meanings, unless defined specially in the disclosure itself. Two examples:

> The COSO illustrative reports both include the statement that even an effective internal control system has inherent limitations -- they use the phrase "including" but list only the "circumvention or overriding of controls". "Inherent limitations" is of course defined to include four other matters: the limits of human judgment, resource constraints and the need to consider the cost of controls in relation to expected benefits, the possibility of collusion, and the reality that breakdowns can occur. But these limitations nowhere appear in the text of the management report. (In fact, they are discussed fully only in the Framework, and are simply referred to in the Reporting volume.)
>
> Second example: both illustrative reports use the term "reliable" financial statements. As I noted, we think this term by itself is dreadful, particularly in a management report to third parties; but as I said, the COSO draftsmen refused to delete the word: they defined the word in the Glossary in terms of "fair presentation". But since that definition is not in the company report itself, surely a jury of lay people would likely interpret in the everyday meaning of "accurate", which is just what we wanted to avoid.

Therefore, I think we plan to suggest an alternative form of illustrative management report which avoids the use of such terms and, we hope, will be less likely to make the management report into a liability document.

W.P.H.

WPH

gsb

REED SMITH SHAW & McCLAY
MEMORANDUM

TO: Auditing Standards Division, AICPA DATE: November 9, 1992

FROM: William P. Hackney

RE: SSAE, "Reporting on an Entity's Internal Control Structure over Financial Reporting"

1. "Management's Assertion"

"Assertion". We have considerable concern over the frequent use of the term "assertion" to refer to what the COSO Report calls the "Management Report". We recognize that the term "assertion" has recently come into frequest use in ASB pronouncements, particularly in referring to management's five basic financial statement assertions (AU §326); and we note that the SSAE on Attestation Standards (AT §100) defines an attest engagement as one in which the practitioner expresses a conclusion about "the reliability of a written assertion", the word being defined as "any declaration . . . by a party responsible for it."

Nevertheless, we think the term is a very poor choice for use in any audit literature, and for the following reasons should not be continued in new pronouncements (in any case not this one).

The basic definition (Webster's Third New International) of "assert" is "to state or affirm positively, assuredly, plainly or strongly"; and in discussing the comparative use of the word "assert" with its several synonyms, it is stated that "it may imply lack of proof for the statement". The American Heritage Dictionary, in discussing synonyms, says that "assert" means "to state boldly, usually without other proof than personal authority or conviction".

"Representation" As to a "Fact" vs. "Belief". At the very least, the word "assertion" means in effect a strong representation; and we feel it is incorrect to have the company be required to make a strong representation of effectiveness as a fact. Rather, it our view that any statement by the company concerning its internal control system should be in the form of a statement of belief, not a representation as to a fact. We say this because there is no objective test to determine effectiveness, and the proposed Statement, in discussing "reportable conditions" makes this quite clear. According to both the COSO Report and the proposed Statement (¶ 52), except for such matters as a restriction on scope, reliance on another practitioner, subsequent event, or limited management assertion, the only time a management determination of effectiveness cannot be made is if there is a material weakness (¶ 39). But "material weakness" is defined in terms of "relatively low level of risk", amounts that would be "material", and detection within a "timely period", all of which are subjective. This is recognized explicitly in ¶ 42, which states that evaluation of whether a reportable condition is also a material weakness "is a subjective process", that depends in part upon the "judgment" of those making the evaluation.

Therefore, we think it is clear that the company should not be asked to make an "assertion" as to a subjective matter which can only be a matter of belief.

The expectation of the proposed Statement as to the text of the "management assertion" is shown in the various report modifications. Thus, where there is a material weakness, the accountant's report (¶ 55) describes the management's assertion as saying the following: "W Company maintained an effective internal control structure over financial reporting. . .".

On the other hand, we note that in the form of report for a qualified opinion (¶58) or an adverse opinion (¶59) the practitioner uses the phrase "we believe" in asserting that a material weakness exists. Management should not be required to make a more positive statement.

Furthermore, it is interesting that in ¶ 45(d), the management representations must identify any reportable conditions "that it believes to be material weaknesses"; and we believe that is proper usage.

"Opinion" vs. "Belief". Finally, we believe that the word "belief" is superior to "opinion". We do not believe it appropriate for senior management, some or all of whom are not learned in accounting or matters of internal control, to be asked to express an "opinion", which in a formal context implies a professional expertise as a basis for judgment.

Lawyers and accountants give "opinions" -- which are given special treatment under the Securities Act of 1933 as reports by "experts"; but the very term "expert" implies professional expertise by an outsider, not part of management.

"Company Report" vs. "Management Assertion". In order to avoid the use of the words "assertion", "declaration" or "representation", we urge the use of the word "report" in describing the document to which the attest relates.

As to the use of the term "management report," see the text of the "Summary" of our Task Force Comments to COSO at paragraph 2. For the reasons there stated, we suggest that at the very least, you insert a paragraph similar to the last paragraph on page 1 of the COSO Reporting Volume, which is quoted on page 3 of our Task Force "Comments" on that Report.

2. <u>Attesting to a Statement of Belief as to "Effectiveness"</u>.

Concern was expressed at our meeting on Thursday, November 5, 1992, to the effect that a mere statement of belief by the company does not provide a basis on which a practitioner could express an opinion. It is true that a "belief" does not admit of being subject to confirmation; but under the Attestation Standards (AT §100) the practitioner does not state whether the "assertion" (i.e., the statement of belief) is <u>accurate</u>, but merely states whether the presentation of the attestation is "presented in conformity with established . . . criteria" (AT §100.53).

If the auditor's opinion relates to an "assertion" in the form of a statement of belief, performance of the examination as described in ¶¶ 18 through 36 should be exactly the same, and should be sufficient for the practitioner to form an opinion as to the reasonableness of the belief or of the grounds for that belief.

I suggest that you insert the following paragraph following ¶ 25:

> Whether the management report as to effectiveness is stated in the form of a statement of belief or an affirmation of a fact, the practitioner needs to determine whether there exist reasonable grounds for that statement. Performing an examination of grounds for such a statement of belief involves the same considerations as an examination of an affirmation of effectiveness, as stated in paragraphs 17 and 18.

3. The Practitioner's Form of Report.

The word "presentation" in AT §100.53 causes a great deal of trouble in attempting to apply the Attestation Standards to a report on an entity's internal control structure. The opinion in AT §100 is supposed to relate to "the presentation of assertions", and whether that presentation "is presented" in conformity with the established criteria. Here, the "assertions" are "presented" in the management report, and AT §100.53 says that the opinion should be whether the "presentation" - i.e., the management report - is "presented in conformity with . . . stated criteria."

However, the "criteria" (whether in the COSO Report or in SAS 55) relate not to the management report itself but to the internal control structure. Thus the criteria in the COSO Report relate to the adequacy of the internal control components described in the Framework volume. Likewise, if the control criteria are those set forth in SAS No. 55, AU §319, as contemplated by the proposed Statement, then it is even more clear -- that the control criteria have nothing to do with the "presentation" of the management report. Instead, as stated in ¶ 17, the practitioner considers the elements of an entity's internal control structure in achieving the objectives of the control criteria; and to express an opinion, the practitioner accumulates evidence about the design and operating effectiveness of the internal control structure.

I believe that the form of the proposed opinion in the proposed Statement, as expressed or set forth in ¶¶ 17, 18 and 47(d), is inappropriate and in effect meaningless, when it says that the "assertion" is "fairly stated". The practitioner's opinion in reality does not relate to the assertion, but to the conclusion set forth in the assertion as to effectiveness.

Therefore, to say that the assertion is "fairly stated", based on the control criteria, is meaningless.

As stated in ¶ 17 of the proposed Statement, in order to express an opinion, the practitioner accumulates evidence about the design and operating effectiveness of the internal control structure in order to "attest to management's assertion". Simply to say that the "assertion" is "fairly stated" seems to relate to the <u>form</u> of the statement; whereas what is intended is for the opinion to relate to the <u>substance</u> of the statement.

Thus it appears that the Standards of Reporting as set forth in Attestation Standards (AT §100.45 <u>et</u> <u>seq</u>.) cannot be literally applied to the management report as to effectiveness of internal control.

4. <u>What Should Be the Form of the Practitioner's Report?</u>

The essence of the management report as to effectiveness is that the appropriate individuals within (and on behalf of) the company believe that its internal control structure met the stated criteria (in all material respects). The criteria in SAS No. 55 include policies and procedures within the three elements of control environment, accounting system, and control procedures; those in the COSO Report would include the seven internal control components (which appear to cover the three elements contained in SAS No. 55 as well as other matters); that is, in both cases, the internal control structure.

It appears to me that either one of two alternative possibilities would be appropriate for the text of an attest opinion on a management report:

(a) One possibility is for the practitioner's report to give an explicit opinion on whether the company's internal control structure met the criteria in all material respects. Although it may be difficult to reconcile this wording with the concept in AT §100.53 that the opinion should relate to the "presentation" of the assertion, it does relate to the conclusion presented, and would seem to be the essence of any opinion given on the management report. This seems to me to be the best and most logical approach.

(b) A second possibility would be to have the practitioner's report say that in his opinion, the management belief as to effectiveness, as stated in the management report, "is in all material respects reasonable, based upon the stated criteria"; or in the alternative, to state that in his opinion, the company "had reasonable grounds for expressing its belief that in all material respects it maintained an effective internal control structure over financial reporting as of December 31, 19XX, based upon the [stated criteria]."

An opinion as to reasonableness is not foreign to the practitioner, since a report as to prospective financial statements (AT §200.33) includes an opinion on whether the stated assumptions "provide a reasonable basis for the projection." The alternative formulation, based upon "reasonable grounds" for the belief, in effect would use the approach found in Section 11 of the Securities Act of 1933. In that provision, a person is not liable for making a statement if he had, after reasonable investigation, "reasonable ground to believe" that the statement was true.

If the opinion is phrased in terms of "reasonableness" of the belief as to effectiveness, or of the grounds for that belief, then it would appear that it does not matter whether the management report is stated in the form of a statement, a representation, or a belief; if the criteria as to structure are not met, then any one of those "assertions" would not be reasonable (or there would not be reasonable grounds for the assertion).

5. Negative Assurance.

We note that the proposed SSAE calls for an auditor's report in the form of a positive opinion, based upon an examination, and does not mention the possibility of a report in the form of negative assurance, based upon a review. Since the FDIC Improvements Act of 1991 (and the FDIC proposed Regulations thereunder) call for the accountant to make an examination of the internal control structure, and assuming the word "examination" is used in the same sense as in AT 100, an auditor's report under that Act would have to be in the form of a positive opinion. However, the Act is not applicable to the great mass of industrial and other non-financial concerns, and it would seem that the proposed SSAE should cover the possibility of providing negative assurance, as contemplated by AT §100.56 et seq.

6. Management's "Representations" (Proposed Statement ¶ 45)

We believe that the proposed Statement should make it clear that in the written "representations" (statement of belief) called for by ¶ 45, management should be able to include a paragraph similar to the "inherent limitations" paragraph set forth in the form of Independent Accountant's Report in ¶ 48.

In addition, I think it would be helpful if the proposed Statement would include a paragraph to the general effect that management in its report may include a paragraph along the following lines (taken from COSO, Reporting to External Parties, pages 2, 15 and 17):

> We understand that internal control over the preparation of published financial statements can be judged effective if our board of directors and management have reasonable assurance that such financial statements are being prepared so as to "present fairly" the relevant financial information, in conformity with generally accepted accounting principles. It is understood that even an effective internal control system, no matter how well-designed, has inherent limitations (among them, the possibility of human error or overriding of controls, and the evolving state of the art of internal controls), and therefore can provide only reasonable assurance with respect to financial statement preparation.

Since it might be questioned whether management's representations comply with ¶ 45 if they were to include a paragraph along the foregoing lines, we believe it would be necessary for the proposed Statement to explicitly negate that inference. In particular, it is possible that ¶ 15 as presently written might be interpreted as saying that any of such limitations could be a reason for the system not being effective; the important point is that a system can be effective notwithstanding those inherent limitations.

Another reason for including a paragraph along the foregoing lines is that the concept of "reasonable assurance" does not seem to be mentioned anywhere in the proposed Statement except in the form of Independent Accountant's Report dealing with a material weakness (¶ 55).

7. Miscellaneous Matters

A. Paragraph 15 lists four of the five inherent limitations described in the COSO Report, but does not seem to cover the matter of resource constraints and cost/benefit considerations.

B. Interim Financial Information (¶34). The proposed Statement calls for additional tests if management's report covers internal control structure related to preparation of interim financials. This seems inconsistent with COSO Report page 10, first full paragraph.

Agreed

C. Re ¶9: I suggest inserting "establishing and" in the first line after "for".

D. ¶17. In the central column on page 11, fourth line, I suggest adding "or components" after "elements".

Changed in marked draft

E. ¶57. Shouldn't footnote 12 refer to footnote 9?

W.P.H.

(46)

National State Auditors Association

November 10, 1992

Ms. A. Louise Williamson
Auditing Standards Division, File 4287
AICPA
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Ms. Williamson:

The National State Auditors Association (NSAA) is pleased to submit the following comments on the proposed Statement on Standards for Attestation Engagements entitled, "Reporting on an Entity's Internal Control Structure over Financial Reporting." We are grateful for the opportunity to respond to this document. It should be noted that the following comments are not intended to represent a single response for all NSAA members individually. Individual state auditors may wish to comment on this proposed Statement separately.

While many of the state auditors do not engage in any work which is subject to the attestation standards, we do offer the following comments which we believe will make the proposed Statement a more comprehensive and efficient document. Our comments are presented in paragraph number sequence for ease of review.

Title

The title of the document could be misinterpreted as applying to consideration of the internal control structure in financial statement audits. To avoid such possible confusion, we recommend that a reference to "management's assertion" be added to the title.

Other Attest Services

Paragraph 5 of the proposed Statement refers the practitioner to guidance in the "Attestation Standards" when he or she is engaged to apply agreed-upon procedures to and report on management's assertion about the effectiveness of the internal control structure over financial reporting. We suggest the AICPA consider including specific guidance to address any unique concerns (e.g., reporting language) related to such an engagement that would not be addressed by the current standards for agreed-upon procedures engagements. The draft of the proposed Statement on Standards for Attestation Engagements (SSAE), "Compliance Attestation," (published in the May minutes of the Auditing Standards Board) does include specific guidance for an engagement to apply agreed-upon procedures to management's assertion about the effectiveness of an entity's internal control structure over compliance.

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Paragraph 6 states that the practitioner should not accept an engagement to **review** and report on management's assertion about the effectiveness of the internal control structure but does not explain why. This statement might be followed by a sentence similar to that appearing in paragraph 6 of "Compliance Attestation": "The scope and level of assurance in a review engagement could vary to such an extent that a review report would be less understandable to users than a report on the performance of agreed-upon procedures or on an examination."

The first sentence of paragraph 7 states "The appendix presents a listing of Statements on Auditing Standards that provide guidance for a practitioner engaged to provide other services in connection with an entity's internal control structure." The appendix, on page 23, lists three specific Statements on Auditing Standards (SAS's)---SAS No. 60, SAS No. 68, and SAS No. 70. The process for developing auditing standards is a dynamic and evolutionary process. For example, since April 1988, the AICPA has issued twenty individual SAS's; SAS No. 63, issued in April 1989, was superseded by SAS No. 68 just 33 months later. We believe an appendix, listing applicable SAS's at any one point in time, would soon become outdated and potentially misleading to the practitioner. Therefore, we suggest that the Board delete the appendix in the final Statement, and revise the first sentence of paragraph 7 to read "A practitioner engaged to provide other services in connection with an entity's internal control structure should consider the guidance in the applicable Statements on Auditing Standards, including (but not necessarily limited to) SAS No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit, SAS No. 68, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance, and SAS No. 70, Reports on the Processing of Transactions by Service Organizations."

Conditions For Engagement Acceptance

Footnote 4 and paragraph 73 both place a different responsibility on the auditor if management's assertion is based on criteria specified by a regulatory agency which have not been subjected to due process procedures. For example, paragraph 73 states "If...such criteria have not been subjected to due process procedures, the practitioner should modify the report by adding a separate paragraph that limits the distribution of the report to the regulatory agency and to those within the entity." However, the proposed Statement does not provide guidance for the auditor in determining whether the regulatory agency did in fact follow due process procedures. Is a management statement sufficient documentation? Should the auditor communicate directly with the regulatory agency on each engagement? Should the auditor assume that due process procedures were not followed, unless otherwise stated? We suggest that Footnote 4 and paragraph 73 be expanded in the final Statement to adequately explain the auditor's responsibility in determining whether the regulatory agency followed due process procedures.

Examination Engagement

Paragraphs 19 through 22 address planning the engagement. However, no mention is made in these paragraphs, or elsewhere in the proposed Statement, of an engagement letter. We suggest that the final Statement at least alert the auditor that the use of an engagement letter in an engagement to report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting is a good business practice.

Paragraph 28 deals with testing the effectiveness of the design of a specific internal control structure policy or procedure. We think this paragraph is unclear. It is difficult to visualize testing the design effectiveness as opposed to the operating effectiveness. Paragraph 29 lists procedures commonly performed to test the operating effectiveness of control structure policies and procedures. To be consistent with paragraph 29, paragraph 28 might do the same for tests of the design effectiveness.

Footnote 1 states that "A practitioner also may be engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting *during a period of time*. In that case, the guidance in this Statement should be modified accordingly." The proposed Statement contains no other guidance on this potential modification. Paragraphs 33 and 35 discuss the appropriate period of time over which the auditor should perform tests of controls and the auditor's consideration of policies and procedures that have been superseded, respectively. Because the guidance in these two important paragraphs could be significantly different, based on the type of engagement, we suggest that the Board expand the narrative in paragraphs 33 and 35 to also include specific guidance for the auditor engaged to examine and report on management's assertion *during a period of time*.

Deficiencies In An Entity's Internal Control Structure

Paragraph 40a appears to contain a technical error. This subparagraph states that the auditor, in evaluating whether a reportable condition is also a material weakness, should recognize that "The amounts of errors or irregularities that might occur and remain undetected range from zero to the gross financial statement amounts or transactions that are exposed to the reportable condition." If the errors are unrecorded transactions, we believe that the amounts of the errors could potentially exceed the gross financial statement amount. Therefore, we suggest that paragraph 40a be revised to read "The amounts of errors or irregularities that might occur and remain undetected range from zero to more than the gross financial statement amounts or transactions that are exposed to the reportable condition."

Management Representations

Paragraph 1, footnote 1 indicates that management may select a date different than the entity's fiscal year-end for its assertion about the effectiveness of the entity's internal control structure over financial reporting. Therefore, we believe a requirement that a management representation concerning that date should be included in paragraph 45. Further, we suggest paragraph 45 be followed by statements regarding the effect of management's refusal to provide written representations. These statements might be modeled after paragraph 68 of the proposed SSAE, "Compliance Attestation." Paragraph 68 indicates:

> Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to require a qualified opinion or disclaimer of opinion on management's assertion about the entity's compliance with specified requirements. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

Reporting Standards

Since all reports illustrated in the proposed Statement are entitled Independent Accountant's Report, we suggest paragraph 47 state that the first required report element is "A title that includes the word independent" (similar to paragraph 53 of the proposed SSAE, "Compliance Attestation").

We also suggest the AICPA consider whether the introductory paragraph of the report should identify management's responsibility for the internal control structure over financial reporting and the practitioner's responsibility to express an opinion on management's assertion regarding that internal control structure. Such statements would be consistent with the requirements for the introductory paragraphs of:

a. The auditor's report on financial statements (AU sec. 508.08).

b. The auditor's report on compliance with specific compliance requirements for major federal financial assistance programs in audits conducted under the Single Audit Act of 1984 (AU sec. 801.80).

c. The practitioner's report on management's assertion about an entity's compliance with specified requirements (paragraph 53 of proposed SSAE, "Compliance Attestation").

If paragraph 47 is modified to require the statements regarding management and practitioner responsibilities, the example reports in paragraphs 48, 51, 66, 70, 72, and 77 would need to be modified accordingly.

Report Modifications

Paragraphs 53 through 61 on "Material Weaknesses," do not address a situation in which management agrees with the practitioner about the existence of a material weakness, but has not included the weakness in its assertion about the effectiveness of an entity's internal control structure. We believe this situation should be addressed in the practitioner's report by suggesting the practitioner attempt to obtain a revised assertion from management or be explained.

Paragraph 60 provides sample language for the auditor to disclaim an opinion on management's cost-benefit statement. However, the proposed guidance does not indicate whether this language should be presented as a separate paragraph or included as a sentence within the previously-illustrated opinion paragraph. Although we assume the disclaimer would be presented as a separate paragraph immediately following the auditor's opinion paragraph, we believe, for consistency within the profession, that paragraph 60 should be revised to indicate the appropriate location of the sample language within the report.

The scope paragraph as illustrated in paragraph 63 should conclude with this sentence: "We believe that our examination provides a reasonable basis of our opinion."

Paragraph 64 states that "When restrictions that significantly limit the scope of the examination are imposed by the client, the practitioner generally should disclaim an opinion on management's assertion about the effectiveness of the entity's internal control structure." The proposed Statement contains approximately ten different examples of auditor's reports; however, it does not include an example of a disclaimer of opinion. To provide more comprehensive guidance in the final Statement, we suggest that the Board include an example of a disclaimer of opinion on management's assertion, immediately following the narrative in paragraph 64.

The modifications to the introductory and opinion paragraphs in paragraph 66 are similar to those in AU sec. 508.13 for an audit of the financial statements when the auditor's opinion is based in part on the report of another auditor. Based on AU sec. 508.13, however, we suggest the reference in paragraph 66 to the standard scope paragraph be replaced by the appropriate text for that paragraph:

> Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination **and the report of the other accountants** provide a reasonable basis for our opinion.

We suggest paragraph 68 be modified to indicate the appropriate location for the explanatory paragraph referred to in the last sentence of the paragraph. For example, paragraph 68 might include a parenthetical phrase similar to the one appearing in the next-to-last line of paragraph 54.

The last sentence of paragraph 69 refers the practitioner to AU sec. 561.06 for guidance on actions to be taken when, subsequent to the date of the practitioner's report, information is discovered that may have existed at that date. Since AU sec. 561.06 is specific to financial statement audits, we believe the guidance should be modified as necessary for engagements to report on the internal control structure and added to the proposed Statement. This change would be consistent with paragraphs 78-81 which modify the guidance in AU sec. 550, "Other Information in Documents Containing Audited Financial Statements," for the engagements covered by the proposed Statement.

In paragraph 77, we suggest the AICPA reconsider the introductory and scope paragraphs to determine whether they can be made less repetitive. The second sentence of the scope paragraph, except for the reference to AICPA standards, essentially repeats the sentence comprising the introductory paragraph. Also, paragraph 77 might clarify how the example report would be modified for the situation discussed in paragraph 74--the need to report certain conditions not reported by management that are not in conformity with the agency's criteria.

Effective Date

Paragraph 87 states "This Statement is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting beginning after December 15, 1993. Earlier application of this Statement is encouraged." As currently drafted, we believe this paragraph is ambiguous. We question whether the Board intends that the final Statement be effective for examinations beginning after December 15, 1993, or for assertions beginning after December 15, 1993. Because of the normal complexities associated with scheduling an engagement, the exact beginning date of an examination may be difficult to pinpoint. Therefore, to improve clarity, we suggest that the first sentence of paragraph 87 be revised to read "This Statement is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting when the assertion is as of, or for the period ended, December 15, 1993 or thereafter."

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We trust our comments will prove useful to the AICPA as it finalizes this document. We appreciate the opportunity to respond to this Exposure Draft and we continue to be grateful to the AICPA and its various committees for striving to provide improved guidance on all accounting and auditing areas. If you require further information or have any questions in this matter, please contact Relmond P. Van Daniker, Executive Director of NASACT, at (606) 276-1147 or myself at (904) 487-9175.

Sincerely,

Charles L. Lester

Charles L. Lester
President