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Proposed statement on auditing standards and statement on standards for attestation engagements : amendments to statements on auditing standards and statements on standards for attestation engagements to incorporate the internal control-integrated framework report ;Amendments to statements on auditing standards and statements on standards for attestation engagements to incorporate the internal control-integrated framework report; Exposure draft (American Institute of Certified Public Accountants), 1995, Feb. 23

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EXPOSURE DRAFT

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

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

FEBRUARY 23, 1995

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

Comments should be received by June 30, 1995, and addressed to
J. Eric Nicely, Practice Fellow, Auditing Standards Division, File 4289,
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775

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February 23, 1995

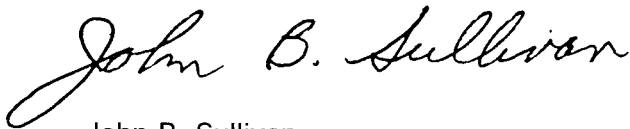
Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of a proposed Statement titled *Amendments to Statements on Auditing Standards and Statements on Standards for Attestation Engagements to Incorporate the Internal Control – Integrated Framework Report*. This proposed Statement would revise the definition and description of the internal control structure contained in statements on auditing standards and statements on standards for attestation engagements to incorporate the definition and description contained in *Internal Control – Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). A summary of other significant provisions of the proposed Statement accompanies this letter.

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

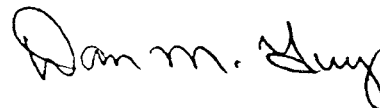
In developing guidance, the ASB considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers the differences the auditor may encounter in the audit of financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the ASB 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 August 1, 1995, for one year. Responses should be sent to J. Eric Nicely, Practice Fellow, Auditing Standards Division, File 4289, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by June 30, 1995.

Sincerely,



John B. Sullivan
Chair
Auditing Standards Board



Dan M. Guy
Vice President, Auditing

SUMMARY

Why Issued

The Auditing Standards Board (ASB) is issuing this proposed statement on auditing standards (SAS) and statement on standards for attestation engagements (SSAE) to provide auditors¹ with improved guidance on performing an audit of an entity's financial statements and performing attestation services.

The ASB is proposing changes to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), to replace the SAS No. 55 definition and description of the internal control structure with the definition and description in *Internal Control – Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). The ASB believes the COSO report rapidly is becoming a widely accepted framework for sound internal control among U.S. organizations and its acceptance and use will continue to grow. Therefore, the ASB believes it is appropriate to revise SAS No. 55 to incorporate the COSO report to provide timely and useful guidance to auditors.

In addition, the ASB is proposing changes to SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400), to conform the description of elements of an entity's internal control structure to the components of an internal control structure contained in the proposed amendment to SAS No. 55 and in the COSO report.

What It Does

This proposed Statement consists solely of amendments to existing statements. The proposed amendments are outlined in the following paragraphs.

SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319.01, .02, .06 through .22, and .66 through .69)

This proposed amendment would –

- Replace the definition of the internal control structure in SAS No. 55 with the COSO report definition.
- Replace the three elements of the internal control structure in SAS No. 55 with the five components in the COSO report.
- Replace appendix A and delete appendixes B, C, and D of SAS No. 55.
- Make editorial conforming changes for terminology throughout SAS No. 55.

SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400.01, .12 through .16, .20, .26, and .27)

¹ The term *practitioner* is used when discussing SSAEs.

This proposed amendment would —

- Replace the three elements of the internal control structure with the five components of the internal control structure contained in the proposed amendment to SAS No. 55 and the COSO report.
- Make editorial conforming changes throughout SSAE No. 2 to substitute *components* for *elements*.

How It Affects Existing Standards

As a result of amending SAS No. 55 and SSAE No. 2 to incorporate the COSO report, as outlined above, this proposed Statement also includes amendments to —

- SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.07, .26 and .42)
- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325.02 and .04)

In addition, as a consequence of the foregoing changes to existing standards, the proposed Statement would require updating the guidance in the Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit* and other audit and accounting guides that provide guidance on the internal control structure in audits of specific industries.

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**PROPOSED CHANGE TO SAS NO. 55,
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN
A FINANCIAL STATEMENT AUDIT**

(Amends Statement on Auditing Standards No. 55, AICPA,
Professional Standards, vol. 1, AU sec. 319.01, .02,
.06 through .22, and .66 through .69)*

[Explanation]

This amendment revises the definition and description of the internal control structure contained in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, to incorporate the definition and description contained in *Internal Control – Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report). The Auditing Standards Board (ASB) believes the COSO report is rapidly becoming a widely accepted framework for sound internal control among U.S. organizations and its acceptance and use will continue to grow. Therefore, the ASB believes it is appropriate to revise SAS No. 55 to incorporate the COSO report to provide timely and useful guidance to auditors. New language is shown in boldface italics. In addition, conforming changes to other portions of SAS No. 55 are made to change terminology — such as (a) *elements* to *components* and (b) *control procedures* to *control activities* as well as paragraph numbers in cross-referencing. The amendment is effective for audits of financial statements for periods beginning on or after January 1, 1997. Early application of the provisions of this Statement is permissible.

[Text of Proposed Change]

1. This Statement 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 ***defines internal control***, describes the ***elements components*** of an internal control structure, and explains how an auditor should consider the internal control structure in planning and performing an audit. ***In particular, this Statement provides guidance about implementing the second standard of fieldwork of the ten generally accepted auditing standards: "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."***

* *The amendments to SAS No. 55, paragraphs 1, 2, 6 through 22, and 66 through 69, are made to incorporate the definition and description contained in the internal control framework set forth in Internal Control – Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission.*

¹—This Statement 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.~~

SUMMARY

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

ELEMENTS COMPONENTS OF AN INTERNAL CONTROL STRUCTURE

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

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

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

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

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

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

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

[Replace paragraph 6 with the following.]

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

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

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

[Replace paragraphs 9 through 13 with the following.]

Control Environment

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

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

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

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

Risk Assessment

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

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

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

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

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

Control Activities

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

- *Performance reviews*
- *Information processing*

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

- *Physical controls*
- *Segregation of duties*

Information and Communication

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

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

Monitoring

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

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

Application to Small and Midsized Entities

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

LIMITATIONS OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

14- 22. An internal control structure should be designed and operated to provide reasonable assurance that an entity's objectives are achieved. The concept of reasonable assurance recognizes that the cost of an entity's internal control structure should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and

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

~~15-~~ **23.** The potential effectiveness of an entity's internal control structure is subject to inherent limitations. Mistakes in the application of **internal control structure** policies and procedures may arise from such causes as misunderstanding of instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, the ~~policies and procedures~~ **control activities** that require segregation of duties can be circumvented by collusion among persons both within and outside the entity and by management override of certain policies and procedures.

CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN PLANNING AN AUDIT

~~16-~~ **24.** The auditor should obtain a sufficient understanding of each of the ~~three elements~~ **five components** of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant **internal control structure** policies **and** procedures ~~and records~~ and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to —

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

~~17-~~ **25.** Whether an internal control structure policy or procedure has been *placed in operation* is different from its *operating effectiveness*. In obtaining knowledge about whether policies **or** procedures ~~or records~~ have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy **or** procedure ~~or record~~ was applied, the consistency with which it was applied, and by whom. **For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on.** This Statement does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

~~18-~~ **26.** The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentations in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding the Internal Control Structure

~~19-~~ **27.** In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his **or her** assessment of inherent risk, ~~his~~ judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including whether the method of controlling **data information** processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As an entity's operations and

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

Understanding of Control Environment

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

Understanding of Risk Assessment

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

Understanding of Control Activities Procedures

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

Understanding of Accounting System Information and Communication

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

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

- 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.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

In addition, the auditor should obtain sufficient knowledge of the means the entity uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.

Understanding of Monitoring

32. The auditor should obtain sufficient knowledge of the major types of activities the entity uses to monitor the internal control structure over financial reporting, including how those activities are used to initiate corrective actions.

[Paragraphs 23 through 65 in SAS No. 55, which will become paragraphs 33 through 75 in the revised Statement, are unchanged except for conforming changes. These changes involve only changes in terms — such as (1) elements to components, (2) control procedures to control activities, and (3) he or his to she or her — and paragraph numbers in cross referencing.]

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

APPENDIX A: INTERNAL CONTROL STRUCTURE COMPONENTS

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

CONTROL ENVIRONMENT

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

3. *The control environment encompasses the following factors:*

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

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

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

Application to Small and Midsized Entities

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

RISK ASSESSMENT

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

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

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

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

Application to Small and Midsized Entities

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

CONTROL ACTIVITIES

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

9. Generally, control activities that may be relevant to an audit may be categorized as internal controls that pertain to —

- ***Performance Reviews*** — These control activities include reviews of actual performance versus budgets, forecasts, and prior periods; relating different sets of data — operating or financial — to one another, together with analyses of the relationships and investigative and corrective actions; and review of functional or activity performance, such as a bank's consumer loan manager's review of reports by branch, region and loan type for loan approvals and collections.
- ***Information Processing*** — A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are general controls and application controls. General controls commonly include controls over data center operations, system software acquisition and maintenance, access security, and application system development and maintenance. These controls apply to mainframe, minicomputer, and end-user environments. Application controls apply to the processing of individual applications. These controls help to ensure the completeness and accuracy of transaction processing, authorization, and validity.

- **Physical Controls** – These activities encompass the physical security of assets, including adequate safeguards over access to assets and records such as secured facilities; authorization for access to computer programs and data files; and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on the circumstances. Normally, these controls would not be relevant because any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit because those controls would need to be effective to ensure reliable financial reporting.
- **Segregation of Duties** – Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties.

Application to Small and Midsized Entities

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

INFORMATION AND COMMUNICATION

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

12. An effective information system 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.**

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

14. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made orally and through the actions of management.

Application to Small and Midsized Entities

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

MONITORING

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

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

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

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

Application to Small and Midsized Entities

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

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

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

[Explanation]

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

[Text of Proposed Change]

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

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

[Paragraph 12 would be amended as follows.]

ELEMENTS *COMPONENTS* OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

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

~~an entity's internal control structure as defined in SAS No. 55. based on the internal control framework set forth in Internal Control — Integrated Framework,¹ published by the Committee of Sponsoring Organizations of the Treadway Commission.[#] Internal Control — Integrated Framework and SAS No. 55 describe an entity's internal control structure as consisting of five components — control environment, risk assessment, control activities, information and communication, and monitoring.~~ If management selects another definition of an internal control structure, the description of the elements contained in those paragraphs **this list of components** may not be relevant.

[Paragraphs 13 through 16 would be superseded.]

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

[Paragraph 26 would be replaced with the following.]

~~26-~~ **22.** *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 component of the internal control structure.***

[Paragraph 27 would be superseded.]

¹ *As noted in footnote 6, this report also contains control criteria.*

[#] *This definition is consistent with the definition contained in SAS No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 319). However, SAS No. 55 is not intended to provide criteria for evaluating internal control effectiveness.*

^{**} *As discussed in paragraph 12, the components that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. Paragraph 12 lists the components the practitioner should understand if management decides to evaluate and report on the entity's internal control structure based on the definition of an internal control structure in Internal Control — Integrated Framework. If management selects another definition, this list of components may not be relevant.*

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

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

[Explanation]

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

[Text of Proposed Change]

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

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

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

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

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

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

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

[Explanation]

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

[Text of Proposed Change]

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

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

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

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