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# In Our Opinion...

*The Newsletter of the AICPA Auditing Standards Division\**

Volume 4 Number 3

July 1988

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## REPORTING ON INTERNAL CONTROL STRUCTURES

by Peg Fagan

The ink just dried on SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, and yet there is still a pressing need for more guidance about reporting on internal control structures. SAS No. 60 sets new requirements and provides guidance about reporting on internal control based on the understanding of the internal control structure and assessment of control risk performed as part of an audit of financial statements. However, accountants are also engaged to report on internal control structures in several ways that are not addressed in SAS No. 60, such as—

- Expressing an opinion on the entity's internal control structure in effect as of a specified date or during a specified period of time.
- Reporting on all or part of an internal control structure, for restricted use of management or other specified regulatory agencies, based on the regulatory agencies' pre-established criteria.
- Issuing other special-purpose reports on all or part of the internal control structure for the restricted use of management, specified regulatory agencies, or other specified third parties.

Reporting on internal control as described above is addressed in portions of SAS No. 30, *Reporting on Internal Control*, that SAS No. 60 did not supersede. However events such as the recent issuance of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, the recommendation of the Treadway Commission regarding auditor's responsibility for management's report on the internal control structure, and the issuance in March 1986 of the Statement on Standards for Attestation Engagements have caused the ASB to consider the need for revising the remnants of SAS No. 30.

### EFFECT OF SAS NO. 55 ON THE NEED FOR NEW GUIDANCE

One reason the ASB issued SAS No. 55 was to broaden the concept of internal control to include the control environment, accounting system and control procedures, now termed "internal control structure." This broader concept recognizes that the policies and procedures a company establishes within each of the three components of the internal control structure are forms of control

that might have an important effect on many major audit planning matters. Other concepts and terminology that existed under AU section 320, *The Auditor's Study and Evaluation of Internal Control*, have been superseded by SAS No. 55.

Because guidance about reporting on internal control structures should parallel existing guidance on internal control structures, SAS No. 30 should be revised to correlate discussion of reporting on internal control structures with the concepts and terminology of SAS No. 55.

### EFFECT OF TREADWAY RECOMMENDATION ON THE NEED FOR NEW GUIDANCE

One of the recommendations of the National Commission on Fraudulent Financial Reporting (Treadway Commission) in its report dated October 1987, was that management be required to report on its responsibility for the company's internal control structure, how that responsibility was fulfilled, and provide its assessment of the effectiveness of the company's internal control structure.

The Treadway Commission followed with a recommendation to independent public accountants that auditing standards explicitly address the auditor's responsibility for management's report on its internal control structure. Specifically, the Treadway Commission recommends that auditing standards provide detailed guidance to accountants if the knowledge gained about the company's internal accounting controls causes them to disagree with management's assessment of controls in its report.

However, the Treadway Commission indicated that it did not propose changing existing standards to increase the extent to which accountants obtain information about the internal control structure. Instead, the auditor's standard report should include disclosure of the extent of knowledge obtained about the internal control structure in connection with the audit of financial statements.

New guidance relevant to appropriate disclosures about management's report will be necessary in the event that the recommendation that management report on its internal control structure is implemented.

## REPORTING ON INTERNAL CONTROL STRUCTURES

(continued from page 1)

### EFFECT OF THE STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS ON THE NEED FOR NEW GUIDANCE

Since SAS No. 30 was issued, the ASB and the Accounting and Review Services Committee established the attestation standards, a broad framework for independent accountants engaged to provide assurance on representations other than financial statements, and in forms other than the expression of an opinion. There are inconsistencies between SAS No. 30 and the attestation standards in that SAS No. 30 provides attest reports where there is no reference to a separate presentation of assertions by the responsible party. For example, SAS No. 30 refers to an engagement to express an opinion on an entity's system of internal accounting control rather than on management's description of such a system. Furthermore, the standard report provided in SAS No. 30 gives the accountant's opinion directly on the entity's internal control structure, not on management's assertion about the internal control structure. There is, however, an attempt in SAS No. 30 to more appropriately place responsibility for the internal control structure where it lies. The report requirements include some explanatory paragraphs that describe management's responsibility and the inherent limitations of internal controls.

Given the need for revising SAS No. 30 for other factors, the opportunity presents itself to reconcile the standard with the attestation standards.

## ASB ACTION TO PROVIDE THE NEW GUIDANCE

In the spring of 1988 the ASB established a task force with the charge of considering alternative models for reporting on internal control for general distribution, determine the circumstances in which each model is appropriate, and develop or amend performance and reporting guidance under each of the appropriate models.

To correlate the guidance of SAS No. 55 with guidance about reporting on internal control structures, the task force will determine if the minimum study of the internal control structures required by SAS No. 55 provides the auditor with a sufficient basis for reporting on internal control structures.

The task force will address the recommendation of the Treadway Commission by developing appropriate guidance for accountants on disclosures about management's report on internal control structures.

In providing new guidance, the task force will evaluate whether a distinction in the guidance on reporting on internal control can be made to consider situations when (1) the accountant is engaged to express an opinion on a written assertion of management in accordance with the attestation standards or (2) when the accountant is engaged to report in one of the formats prescribed in SAS No. 30.

### CONCLUSION

The ASB continues to respond to concerns about the responsibilities of accountants. A task force was recently formed to tackle the issues surrounding reporting on internal control structures. Final guidance cannot be completed until the recommendation of the Treadway Commission about management's report on internal control structures has been implemented. However, the task force is developing guidance in other areas that affect reporting on internal control.

## PROSPECTIVE FINANCIAL INFORMATION: ISSUES FACING THE PRACTITIONER

by Mimi Blanco-Best

Because of the increased demand for accountant association with prospective financial information in recent years, the Auditing Standards Division of the AICPA published the Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections*, in 1985 and the *Guide for Prospective Financial Statements* (the Guide) in 1986. These documents provide guidance on the preparation and presentation of prospective financial information and assistance to the accountant performing and reporting on professional services rendered in connection with such information.

Some practitioners, however, have asked for more guidance on some troublesome areas of practice not addressed in existing literature. Therefore, the Auditing Standards Board established the Forecasts and Projections Task Force in 1987 to identify problems in implementing these pronouncements and to determine whether additional guidance is needed. This article discusses some of the issues the task force is working on.

### Two Views on Independence

Prospective financial statements and assumptions underlying them are the responsibility of the "responsible party"—usually management. However, Section 220.02 of the AICPA Guide states:

"The responsible party may enlist the assistance of outside parties in preparing prospective financial statements. For example, an accountant may provide such assistance by helping

the responsible party identify key factors, develop assumptions, gather information, or assemble the statements.

... Such activities ordinarily would not affect the accountant's objectivity in examining the prospective financial statements."

The Guide considers the accountant to be independent, regardless of the work he performs, as long as the responsible party evaluates the assumptions, makes key decisions, and adopts and presents as its own the assumptions on which the forecast is based.

The SEC staff's position on an accountant's independence with respect to prospective financial statements, however, differs significantly from that of the Guide. In correspondence to a practitioner, the SEC staff indicated that an accountant who prepares or assists in preparing a financial projection for a public company is not considered independent and may not report on that projection [see correspondence from the SEC's Office of the Chief Accountant dated April 14, 1987 (Amper, Politzner, and Mattia, *SEC Accounting Rules*, Commerce Clearing House, Inc.)]. SEC Release Nos. 33-5992 and 34-15305, "Disclosure of Projections of Future Economic Performance," state that, for prospective financial statements filed with the Commission, "a person should not be named as outside reviewer if he actively assisted in the preparation of the projection." An accountant's participation in the preparation of a projection, in the SEC staff's opinion, creates a "mutuality of interest" with the client. In other words, the accountant is deemed to have an interest in the outcome of the financial projection since

## PROSPECTIVE FINANCIAL INFORMATION: ISSUES FACING THE PRACTITIONER (continued from page 2)

he participated in preparing it; therefore, he may not examine and report on that projection. The concept of "mutuality of interest" may also affect the accountant's independence in the subsequent audit of historical financial statements covering one or more of the same periods as a financial projection when the accountant assisted in the preparation of that projection.

Practitioners should be aware of the SEC staff's views on accountants' independence when planning and performing services on prospective financial statements of a public entity or a non-public entity reasonably expected to become a public entity in the near future.

### Clarification of the Term "Reasonably Objective Basis"

In considering whether there is a reasonably objective basis to present a financial forecast, the responsible party considers whether it can develop sufficiently objective assumptions for each key factor. Many of the issues the task force is addressing are affected by the responsible party's and the accountant's understanding of the "reasonably objective basis" concept included in section 400.04 of the Guide. For example, what factors should be considered in evaluating:

- the appropriate length of a forecast period?
- the basis for refinancing assumptions during the forecast period?
- the basis for an assumption that an entity will raise more than the minimum level of funds needed to go ahead with an offering?

### Reporting on Partial Presentation

Section 1000.1 of the AICPA's Guide states that "a partial presentation, as used in the Guide, is a presentation that excludes one

or more of the items required for prospective financial statements (see section 400.6)." Examples include sales forecasts and projections that present operating income but not net income or significant changes in financial position. Accountants provide a spectrum of services on partial presentations including attestation services such as an examination or the application of agreed-upon procedures; a compilation; and various internal-use-only services. Some practitioners believe that Section 1000 of the Guide does not provide sufficient preparation, presentation, and reporting guidance for partial presentations and the accountant's services thereon.

### Financial Projections in General Use Documents

On occasion, a responsible party may decide to include a financial projection in a general use document. Section 500.12P states that an accountant should not submit or report on or consent to the use of his name in conjunction with a financial projection intended for general use. However, practitioners have requested guidance on their responsibility when a financial projection is included in a client-prepared general use document where historical financial statements and their report thereon are included in the same document.

An exposure draft of a proposed Statement of Position titled *Questions Concerning Accountant's Services on Prospective Financial Information* will be released in the summer of 1988.

Practitioners with questions or concerns on other matters related to financial forecasts and projections should send written comments to the task force at the following address: Auditing Standards Division, File Ref. 2660, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY, 10036.

## TECHNICAL PLAN HIGHLIGHTS

### PROJECTS RELATED TO IMPLEMENTATION OF EXPECTATION GAP SASs

**Special Reports (SAS 14)** (AICPA Staff: MIMI BLANCO-BEST). The Board approved exposure of a proposed statement on auditing standards that revises SAS No. 14, *Special Reports*, to prescribe changes to special reports that reflect the new requirements of SAS No. 58, *Reports on Audited Financial Statements*, and to clarify requirements for issuing a special purpose report on special or incomplete presentations. *Schedule*: The proposed exposure draft will be available in the third quarter 1988.

**Control Risk Audit Guide** (RAY JOHNSON). The Board is developing an audit guide to assist auditors in implementing the new requirements of SAS No. 55, *Consideration of Internal Control Structure in a Financial Statement Audit*. *Schedule*: The Board plans to expose the proposed audit guide in 1989 prior to the effective date for SAS No. 55.

**Updated Audit Reports** (PAT McNAMEE). The Auditing Standards Division is developing guidance that will update existing audit guides to reflect the new reporting requirements of SAS No. 58, *Reports on Audited Financial Statements*, and SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*. *Schedule*: Guidance to be issued by fourth quarter 1988.

**Understanding Audits and the Auditor's Report, A Guide for Financial Statement Users** (RAY JOHNSON). The Auditing Standards Division is updating its booklet that gives financial statement users a nontechnical explanation of the meaning of the revised auditor's standard report. *Schedule*: The booklet will be available in the third quarter 1988.

### Auditing Procedure Study: Audits of Small Businesses

(RAY JOHNSON). The auditing procedure study *Audits of Small Businesses* is being revised to reflect the new SASs (52-61). The chapters on evaluating internal controls and on analytical review will be revised to discuss the implementation of SAS Nos. 55 and 56, *Consideration of the Internal Control Structure in a Financial Statement Audit* and *Analytical Procedures*, in the small business audit. Other changes will be made throughout the study to provide guidance that is consistent with the new standards. *Schedule*: The revised auditing procedure study will be available in the third quarter 1988.

### OTHER PROJECTS OF THE AUDITING STANDARDS DIVISION

**Management's Discussion and Analysis** (MIMI BLANCO-BEST). At the April meeting the Board voted to defer discussion of the exposure draft of the proposed statement for standards for attestation engagements titled *Examination of Management's Discussion and Analysis* until there is sufficient support for issuance among preparers, users, and regulators.

**Reporting on Pro Forma Financial Information** (JANE MANCINO). The Board is balloting on an attestation standard that provides guidance in reporting on pro forma financial information. *Schedule*: Standard to be issued third quarter 1988.

**Compliance Auditing** (PATRICK McNAMEE). The Board has issued an exposure draft of a proposed SAS on compliance auditing. This proposed statement provides guidance on the auditor's responsibility in an engagement to report on compliance with laws and regulatory requirements of government financial assistance programs. (See "Recent Division Publications") *Schedule*: Comment deadline is August 15, 1988.

## TECHNICAL PLAN HIGHLIGHTS (continued from page 3)

**Recodification Framework** (JANE MANCINO). The Board is discussing a revision to the framework of the *Codification of Statements on Auditing Standards* that will make the *Codification* more relevant and useful to practitioners and that will permit the effective integration of future auditing standards. *Schedule*: An issues paper will be discussed at the July 1988 Board meeting.

**Reporting on Internal Control** (PEG FAGAN). The Board is considering alternative models for general distribution reporting on an entity's internal control structures, determining the circumstances in which each of those models is appropriate for such reporting, and developing performance and reporting guidance under each of the appropriate models. (See article on page 1.) *Schedule*: The Board will continue discussion of an issues paper at the July Board meeting.

**Reliance on Internal Audit** (MIMI BLANCO-BEST). The Board is considering revising SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*, to reflect the audit risk concept, the new "expectation gap" standards, and current practice. *Schedule*: The Board will discuss an issues paper at its July meeting.

**Internal Auditor Procedures Study** (ALAN WINTERS). The Auditing Standards Division, in conjunction with the Canadian Institute of Chartered Accountants, is preparing an auditing procedure study on the use of internal auditors. *Schedule*: This procedure study will be published in the third quarter 1988.

**Use of Confirmations** (PEG FAGAN). The Board created a task force to develop guidance on the use of confirmation procedures in audit engagements. The Board deferred issuance of the proposed guidance and revision to the standard bank confirmation form until general guidance is developed by the task force. *Schedule*: The Board will discuss this project at its July meeting.

**Financial Forecast and Projections** (MIMI BLANCO-BEST). The Board created the Forecasts and Projections Task Force to deal with problems encountered in implementing the guidance in the Statement on Standards for Accountant's Services on Prospective Financial Statements. Persons with questions or problems in this area are encouraged to write to the task force. The address is: AICPA, Auditing Standards Division, File 2660, 1211 Avenue of the Americas, New York, NY 10036-8775. (See article on page 2) *Schedule*: An exposure draft of a proposed Statement of Position titled *Questions Concerning Accountant's Services on Prospective Financial Information* will be released in the third quarter 1988.

**Computer Auditing** (MARK BEASLEY). The Computer Audit Subcommittee and related task forces are responsible for developing guidance for auditors about the effects computers have on the audit process and advising the Board and other senior technical committees and the membership on computer-related matters. The Subcommittee currently is drafting guidance in the form of auditing procedures studies on the audit impact of microcomputers, minicomputers, and mainframe computer systems. *Schedule*: Proposed drafts of the procedures studies will be discussed at the Subcommittee's next meeting scheduled for July 25-26, 1988.

## RECENT DIVISION PUBLICATIONS

In April the Division published ten new Statements on Auditing Standards: SAS Nos. 52, *Omnibus Statement on Auditing Standards-1987* (product number 060529); 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (060533); 54, *Illegal Acts by Clients* (060548); 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (060552); 56, *Analytical Procedures* (060567); 57, *Auditing Accounting Estimates* (060571); 58, *Reports on Audited Financial Statements* (060586); 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (060590); 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (060603); and 61, *Communication With Audit Committees* (060618).

In May the Division published an exposure draft of a proposed SAS "Compliance Auditing: The Auditor's Responsibility for Testing Compliance With Laws, Regulations, and Contractual Terms Governing Financial Assistance Certain Entities Receive From Government" (product number G00474). The Division has also published *Codification of Statements on Standards for Accounting and Review Services* (057155).

Each of these publications can be obtained by writing the AICPA's order department at 1211 Avenue of the Americas, New York, NY 10036.

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