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In Our Opinion...

The Newsletter of the AICPA Auditing Standards Division*

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REPORTING UNDER SAS NO. 63 WHEN SAS NO. 55 HAS NOT YET BEEN ADOPTED

by Patrick McNamee

Government Auditing Standards, issued by the Comptroller General of the United States, (the Yellow Book) set certain requirements for auditors' reports on the internal control structure that differ from those contained in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*. Most of these different requirements are discussed in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*.

One of the Yellow Book's provisions calls for auditors to describe in the internal control report the scope of their internal control work. SAS No. 63 states that auditors may satisfy this requirement by stating that they (a) obtained an understanding of relevant internal control structure policies and procedures and whether those policies and procedures have been placed in operation and (b) have assessed control risk. This description of the scope of the auditor's consideration of the internal control structure is based on the provisions of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*.

Thus, using SAS No. 63's suggested wording implies that auditors did internal control work in accordance with SAS No. 55, which is not effective until audits of financial statements for periods beginning on or after January 1, 1990.

If the auditor has not yet implemented SAS No. 55, he or she should not use the reporting language illustrated in SAS No. 63. Rather, the description of the scope of the auditor's work should be based on the provisions of SAS No. 1, AU section 320, "The Auditor's Study and Evaluation of Internal Control." Following is an example of such a description.

Our consideration of the internal control structure included all of the control categories listed above except that we did not evaluate the internal control structure over (identify any category not evaluated) because (state reasons for excluding any category from the evaluation). The purpose of our consideration of the internal control structure was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the entity's financial statements.

If the auditor has not made a study and evaluation of any significant category of the internal control structure beyond the preliminary review phase described in AU section 320.53—55, a description of the scope of the auditor's work such as the following should be used.

Solely to assist us in planning and performing our audit, we made a study and evaluation of the internal control structure of City of Example, Any State. That study and evaluation was limited to a preliminary review of the structure to obtain an understanding of the control environment and the flow of transactions through the accounting system. Because (state reason), our study and evaluation did not extend beyond this preliminary review phase.

This updated report language, as well as revisions to the reports illustrated in the AICPA audit and accounting guide *Audits of State and Local Governmental Units*, are presented in SOP 89-6, *Auditors' Reports in Audits of State and Local Governmental Units*. This new SOP (product no. 014836) can be obtained by calling or writing to the AICPA order department.

*The views expressed herein are those of the authors and do not necessarily reflect the views of the American Institute of CPAs. Official positions of the AICPA are determined through certain specific committee procedures, due process, and deliberation.

INTERNAL CONTROL IN A COMPUTER ENVIRONMENT

by Jane Mancino

By the end of 1989, the Computer Auditing Subcommittee plans to issue an auditing procedure study (APS) on considering the internal control structure in a computer environment. This APS, developed by a task force of the Computer Auditing Subcommittee, provides guidance on applying SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, for clients that have a relatively complex data processing environment. This article previews the APS.

The auditor is likely to try to assess control risk as low, at least for some assertions, since that would be the most cost-effective audit strategy in the circumstances. The APS recognizes, however, that other audit approaches would also be feasible.

Guidance is presented in the form of an illustrative case study of an audit client, Fawn Health Products, Inc. (Fawn). Fawn markets exercise equipment, such as weight machines, treadmills, and stationary bicycles, to wholesalers and major retailers throughout the United States. Revenues, which have grown steadily since the company's inception, amounted to \$450 million for the most recent fiscal year. Despite the fact that market share has decreased in the last year because of increased competition, revenues have continued their upward trend. Although Fawn does not manufacture any of the products it sells, it does hold long-term purchase contracts with its suppliers, most of which are located in the Caribbean basin.

The case study focuses primarily on the aspects of Fawn's internal control structure that relate to the revenue cycle, with an emphasis on data processing. Fawn has an integrated

data base system with the following modules: order entry, sales invoice processing, shipping, and accounts receivable. A flowchart outlines these modules of the accounting system and relevant control procedures. This information, obtained in prior year audits, was updated in the current year primarily through inquiry and observation.

The auditor, as part of his or her consideration of the internal control structure, has chosen to obtain knowledge about Fawn's general computer control procedures. For purposes of this APS, those controls have been placed into the four following categories: (1) controls over development of new programs and systems, (2) controls over changes to programs and systems, (3) controls over access to programs and data, and (4) computer operations controls.

The auditor decided that the following general computer control procedures relate to the assertions of completeness and valuation: controls over development of new programs and systems, controls over changes to programs and systems, and computer operations controls. The case study describes specific tests of controls that the auditor performed to obtain support for the assessed level of control risk. These tests will provide evidence as to whether relevant control procedures are operating effectively.

A matrix identifies specific application control procedures and relates them to control objectives and management's assertions for accounts receivable, sales, and related accounts. The APS concludes with a description of how the auditor's assessment of control risk with respect to each assertion affects the nature, timing, and extent of substantive tests.

TECHNICAL PLAN HIGHLIGHTS

Letters for Underwriters (AICPA Staff: JANE MANCINO). The Auditing Standards Board (the Board) is considering revisions to SAS No. 49, *Letters for Underwriters*, to reconcile that SAS with services that can be performed under the attestation standards. *Schedule*: The Board will consider revised guidance at its December meeting.

Service Center Produced Records (JUDITH SHERINSKY). The Board is considering revision to SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, to meet the needs of auditors of organizations using service centers and to conform that SAS with SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. *Schedule*: The Board considered proposed guidance at its September meeting.

Audit Sampling (RAY WHITTINGTON). The *Audit Sampling* audit guide will be updated to conform the guide to the terminology in several recent SASs to provide better "how to" guidance for applying SAS No. 39, *Audit Sampling*. *Schedule*: The revised audit guide is expected to be available in the third quarter, 1990.

Control Risk Audit Guide (MIMI BLANCO-BEST). The Board has developed a proposed audit guide to assist auditors in implementing the new requirements of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. *Schedule*: An exposure draft of

the proposed audit guide titled *Consideration of the Internal Control Structure in a Financial Statement Audit* (product no. G00520) was issued in August, 1989. The comment period ends November 10, 1989.

Updated Audit Reports (PATRICK MCNAMEE). The Auditing Standards Division, working with various AICPA committees, 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*: A statement of position amending the audit guide for state and local governments was issued in the third quarter, 1989. (See "Recent Division Publications," on page 3).

Auditing Procedure Study: Audits of Small Businesses (DOUG SAUTER). The auditing procedure study *Audits of Small Businesses* is being revised to reflect SAS Nos. 53-62. The chapters on evaluating internal controls and on analytical procedures 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 standards. *Schedule*: The revised auditing procedure study is expected to be available in the spring of 1990.

TECHNICAL PLAN HIGHLIGHTS (continued from page 2)

Codification 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 useful to practitioners. *Schedule*: The Board will discuss further development of a proposed framework at its November meeting.

Reporting on Internal Control (MIMI BLANCO-BEST). The Board is considering alternative models for general purpose reporting on an entity's internal control structure, 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. *Schedule*: At its September meeting, the Board discussed issues related to providing limited assurance about an entity's internal control structure.

Reliance on Internal Audit (JUDITH SHERINSKY). The Board is considering revisions to SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*, to reflect the audit risk model, SAS No. 55, and current practice. *Schedule*: The Board discussed a revised draft of a proposed SAS at its September meeting.

Internal Auditor Procedure Study (RAY WHITTINGTON). 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 is expected to be published in the fourth quarter, 1989.

Use of Confirmations (DOUG SAUTER). The Board created a task force to develop guidance on the use of all types of confirmation procedures in audit engagements. The task force has proposed changes to the standard bank confirmation form and a notice to practitioners that explains the revisions. At its June 1989 meeting, the Board directed the task force to draft guidance on the use of confirmations in obtaining evidential matter in an audit. *Schedule*: The projected issuance of the revised bank confirmation form is pending approval by committees of the banking industry. The Board considered the proposed guidance on the use of other types of confirmations at its September meeting.

Financial Forecasts 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 Accountants' Services on Prospective Financial Information. An exposure draft of a proposed statement of position titled *Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations*, was issued in April, 1989, and the comment period ended July 25, 1989. *Schedule*: The final statement of position is scheduled to be issued in November, 1989.

Computer Auditing (JANE MANCINO). The Computer Auditing Subcommittee is currently drafting guidance in the form of an auditing procedure study that presents a case study illustrating how SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, may be implemented in a computer environment. (See article on page 1.) *Schedule*: The procedure study is expected to be published in the fourth quarter, 1989.

RECENT DIVISION PUBLICATIONS

An exposure draft of a proposed audit guide titled *Consideration of the Internal Control Structure in a Financial Statement Audit* (product no. G00520) was issued in August, 1989. The comment period ends November 10, 1989. A copy of this exposure draft can be obtained by writing to the AICPA order department.

Statement of Position 89-6, *Auditors' Reports in Audits of State and Local Governmental Units* (product no. 014836), was issued in August, 1989. A copy of this SOP can be obtained by calling or writing to the AICPA order department.

The division has also published "Implementing the Expectation Gap Auditing Standards," a collection of articles on SAS Nos. 53 through 61, which appeared in the *Journal of Accountancy* over the last year (product no. 060680). A copy of these articles can be obtained by calling or writing to the AICPA order department.

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