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In Our Opinion...

The Newsletter of the AICPA Auditing Standards Division*

Volume 6 Number 2

April 1990

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CONSIDERATION OF INTERNAL AUDITORS' WORK

by Mark S. Beasley

There's an exposure draft of a proposed statement on auditing standards (SAS) currently being considered by practitioners and others—it's titled, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. The Auditing Standards Board (Board) issued this exposure draft on March 12, 1990 and seeks comments on it by June 15, 1990. The Board developed this proposed SAS with the assistance of representatives of the Institute of Internal Auditors (IIA). As a matter of fact, an IIA representative, Vic Jarvis of Bell South Corporation, participated as one of the task force members. Here's an overview of what the proposed SAS contains.

Scope of Proposed SAS

In conducting an audit in accordance with generally accepted auditing standards, the auditor considers many factors in determining the nature, timing, and extent of auditing procedures to be performed. One of those factors is the existence of an internal audit function. An internal audit function is frequently one of an entity's most important means of monitoring performance of other controls. Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and board of directors or others with equivalent authority and responsibility. Many of those activities are relevant to the audit because they provide evidence about the design and effectiveness of internal control structure policies and procedures, or direct evidence about misstatements of financial data contained in financial statements. This proposed SAS contains guidance to assist the auditor in considering the work performed by internal auditors.

How It Affects Existing Standards

Existing authoritative literature for considering the work of internal auditors in an audit is contained in SAS No. 9, *The*

Effect of an Internal Audit Function on the Scope of the Independent Audit. The guidance in this exposure draft, if adopted, would supersede the guidance in SAS No. 9.

Why Revise SAS No. 9?

The Board believes that the current guidance in SAS No. 9 should be revised to provide practitioners with *expanded* guidance when considering work performed by internal auditors. Here's a summary of why the Board decided to proceed with this proposed revision of SAS No. 9.

Audit Risk Concepts—The Board issued SAS No. 9 in December 1975. Since that time, the Board has issued SASs that have made significant changes in the audit process and terminology. These changes include the introduction of the audit risk concepts described in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, and the new terminology and concepts of SAS Nos. 53 through 61 issued in April 1988, particularly SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. The Board believes that the guidance in SAS No. 9 needs revision to reflect how audit risk affects the auditor's consideration of internal auditors' work. For example, in the proposed SAS, the Board describes how factors, such as inherent risk, affect the auditor's evaluation of internal auditors' work.

Gaining An Understanding of the Internal Audit Function and Assessing Control Risk—SAS No. 55 requires the auditor—in every audit—to obtain an understanding of the internal control structure policies and procedures. SAS No. 55 goes on to indicate that one of the elements of the entity's internal control structure is the control environment, which includes the internal audit function. The Board brought this SAS No. 55 concept forward to the proposed SAS. The proposed SAS requires the auditor, when obtaining an understanding of the internal control structure as required by SAS No. 55, to obtain an understanding of the internal

*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.

CONSIDERATION OF INTERNAL AUDITORS' WORK (continued from page 1)

audit function. That understanding should be sufficient to identify those internal audit activities that are relevant to planning the audit. The proposed SAS contains guidance to assist the auditor when obtaining that understanding of the relevance of internal auditors' work to the audit. Once the auditor determines that the work of internal auditors is relevant to the audit, he or she can look to guidance in the proposed SAS to determine how the work of internal auditors affects the audit. Specifically, the proposed SAS describes how the work of internal auditors may affect the audit procedures the auditor performs when obtaining an understanding of the entity's internal control structure and assessing control risk as required by SAS No. 55. It also describes how the work of internal auditors may affect substantive procedures the auditor performs.

Evaluating The Extent Of The Effect of Internal Auditors' Work—Another reason why the Board believes SAS No. 9 should be revised is to provide guidelines for considering the extent of the effect of internal auditors' work on the audit. In other words, the Board believes guidance is needed to help practitioners avoid placing too much reliance on the work performed by internal auditors. Groups like the Securities and Exchange Commission and the AICPA Quality Control Inquiry Committee have noted situations where they believe the auditor over-relied on the work performed by internal auditors. Thus, the Board has attempted to provide

expanded guidance in the proposed SAS to address this over-reliance concern. For example, the proposed SAS indicates that if the inherent risk of material misstatements for an assertion is high, the combination of the auditor's assessment of control risk and the work performed by internal auditors cannot alone reduce audit risk to an acceptable level. In those instances, the proposed SAS requires the auditor to perform sufficient procedures for those assertions.

"How To" Guidance That Expands SAS No. 9 Terminology—For certain issues, the proposed SAS expands the guidance in SAS No. 9 by providing "how to" implementation information. For example, the proposed SAS retains the requirement for the auditor to assess the competence and objectivity of the internal auditors and builds on that requirement by providing examples of factors that might affect the auditor's assessment. Additionally, like SAS No. 9, the proposed SAS contains guidance for circumstances where the auditor requests direct assistance from the internal auditors in performing an audit.

What Happens Next?

The comment period on the exposure draft ends June 15, 1990. At that point, the Board will consider comments received. Copies are available by writing the AICPA order department (product no. G00575). Address is listed on the last page. Persons interested in commenting on the exposure draft should send written comments to the Auditing Standards Division, File 4560. Please refer to specific paragraphs and include supporting reasons for each suggestion or comment that you make.

AFTER PLAIN PAPER

by Judith Sherinsky

As reported in the article "ARSC Revisits the Plain-Paper Issue"—see the January 1990 issue of *In Our Opinion*—the Accounting and Review Services Committee (ARSC) held a public hearing in September 1989 to discuss a proposal that would have allowed CPAs to submit interim financial information to nonpublic clients without issuing a compilation, review, or other report—commonly referred to as "plain-paper reporting." Although ARSC concluded that the proposed service should not be developed, many of the issues discussed at the public hearing indicated that CPAs sometimes find it difficult to determine whether the services they are providing are subject to the performance and reporting requirements of *Statements on Standards for Accounting and Review Services (SSARS)*. That article reported that ARSC would attempt to create "how to" guidance to clarify the applicability of SSARS. Here's an update on what ARSC has done to develop that guidance.

What's Been Done?

In January 1990, ARSC members and invited participants conducted a special meeting to develop "how to" guidance for practitioners about the applicability of SSARS. Participants prepared case studies that described situations in which the applicability of SSARS was in question. In addition, ARSC invited state society accounting and review services committees to describe situations in which the applicability of SSARS is in question. Also, a request for practitioners to provide similar descriptions was announced in the AICPA's *The CPA Letter*.

What Will Be Done?

Based on a discussion of the case studies and a review of letters from state societies and practitioners, ARSC decided that interpretations of SSARS No. 1 that answer the three questions discussed below would help to minimize misunderstanding of the applicability of SSARS.

1. *How can an accountant differentiate a financial statement presentation from a trial balance?*

When an accountant has been engaged to compile or review financial statements, he or she should report on those statements in accordance with the requirements of SSARS. SSARS No. 1 notes that when an accountant prepares a trial balance, he or she is not subject to the provisions of SSARS. ARSC plans to describe, in a proposed interpretation, attributes that differentiate a financial statement presentation from a trial balance so that practitioners will be able to determine if SSARS is applicable to the accounting services performed. The interpretation will also note that when an accountant has not been engaged to perform services in accordance with SSARS, he or she should avoid performing services that result in financial presentations that are not easily identifiable as either a financial statement or a trial balance.

2. *Has the accountant "submitted" financial statements even when he or she has not been engaged to compile or review financial statements?*

Accountants are subject to the requirements of SSARS when they "submit" financial statements to their clients

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(continued from page 2)

or others. Because there is a wide diversity of opinion as to what actions performed by the accountant result in submitting financial statements, ARSC plans to include in a proposed interpretation a definition of submission. That definition will note that submission is presenting financial statements that the accountant has:

- a) generated, either manually or through the use of computer software, or
- b) modified by materially changing account classifications, amounts, or disclosures directly on client-prepared financial statements.

The interpretation will also include a listing of services that do not constitute submitting financial statements.

3. *May a practitioner submit draft financial statements without reporting on them?*

Accountants frequently submit draft financial statements

to clients (1) because information needed to complete a compilation of the financial statements is not available until a later date, or (2) to provide the client with the opportunity to read and analyze financial statements prior to their final issuance. ARSC plans to state in an interpretation that accountants may not issue draft financial statements without reporting on them in accordance with the provisions of SSARS No. 1 unless they:

- a) label each page of the draft financial statements with words such as "draft" or "preliminary draft," and
- b) intend to submit financial statements in final form accompanied by an appropriate compilation or review report.

On April 19 and 20, 1990, ARSC met to review drafts of the proposed interpretations. At that meeting, committee members made recommendations that are currently being incorporated into the draft interpretations. The revised interpretations will be sent to the committee for "fatal flaw" review in May 1990 and are expected to be published in the July or August 1990 issue of the *Journal of Accountancy*.

TECHNICAL PLAN HIGHLIGHTS

Audit Sampling (AICPA Staff: DOUG SAUTER). The *Audit Sampling* audit guide will be updated to conform the guide to the terminology in several recently issued SASs and to provide better "how to" guidance for applying SAS No. 39, *Audit Sampling*. **Schedule:** The task force will present an issues paper to the Board in June 1990.

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 performing 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*, respectively, 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 will be available in the third quarter of 1990.

Communications About Interim Financial Information (MARK BEASLEY). The Board is currently considering whether to issue an exposure draft of a SAS that would establish requirements for the auditor to communicate certain matters affecting interim financial information filed or to be filed with specified regulatory agencies. **Schedule:** If the Board votes to issue the exposure draft, such draft would be available by late June 1990.

Computer Auditing (JANE MANCINO). The Computer Auditing Subcommittee is currently drafting three auditing procedure studies. One discusses how SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, may be implemented in a computer environment. The second will update the guidance in the audit and accounting guide, *Computer Assisted Audit Techniques*. The third will address the possible effects of advanced EDP on the auditor's consideration of an entity's internal control structure. **Schedule:** The first procedure

study is expected to be published in the third quarter of 1990. The other procedure studies are expected to be published in 1991.

Consideration of Internal Auditors' Work (JUDITH SHERINSKY). On March 12, 1990, the Board issued an exposure draft of an SAS titled *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. This proposed statement would supersede SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*. **Schedule:** The comment deadline is June 15, 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*. The Board discussed comments received from practitioners at its December meeting. **Schedule:** The final guide is expected to be issued in May 1990.

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 Accountant's Services on Prospective Financial Information. **Schedule:** An exposure draft of a statement of position (SOP) titled *Questions and Answers on Reasonably Objective Basis and Other Questions Affecting Prospective Financial Statements* was issued in February 1990. The SOP would provide guidance to practitioners on the meaning of the term "reasonably objective basis" as used in the *Guide for Prospective Financial Statements*. The comment period ends June 5, 1990.

GAAP Hierarchy (DOUG SAUTER). The Board created a task force to consider recommendations of the Financial Accounting Foundation to revise the hierarchy of GAAP as described in SAS No. 5, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"*

TECHNICAL PLAN HIGHLIGHTS

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in the Independent Auditor's Report. Schedule: The Board plans to revise SAS No. 5 as a part of an Omnibus SAS. An exposure draft should be issued in the fall of 1990

Letters for Underwriters (JANE MANCINO). The Board's project on revising SAS No. 49, *Letters for Underwriters*, will not be discussed by the Board until the negative assurance project is completed (see below). Guidance on letters to non-underwriters will be presented concurrently with proposed revisions to SAS No. 49 at the Board's August meeting.

Negative Assurance (JANE MANCINO). The Board is considering whether it is appropriate to provide negative assurance based on agreed-upon procedures. **Schedule:** The Board will consider an issues paper at its June 1990 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 June meeting, the Board will discuss issues related to providing assurance about an entity's internal control structure.

Review of Interim Financial Information (JANE MANCINO). The Board created this task force to consider whether the guidance in SAS No. 36, *Reviews of Interim Financial Information*, should be revised to contain guidance about how the accountant obtains an understanding of

internal control structure policies and procedures when there is no prior audit base. **Schedule:** The Board will consider an issues paper at its June 1990 meeting.

Service-Center-Produced Records (JUDITH SHERINSKY). At its April meeting, the Board reviewed a draft proposed revision of SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*. The Board directed the task force to incorporate into the draft the concept of "suitability of design" of control policies and procedures to meet control objectives. **Schedule:** The Board will discuss a proposed SAS at its June meeting.

Updated Audit Reports (GERRY YARNALL). 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*, SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, and SAS No. 62, *Special Reports*.

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 developed a revised standard bank confirmation form that will be accompanied by a notice to practitioners that explains the revisions. The revised bank confirmation form is to be used for confirmations mailed on or after March 31, 1991. **Schedule:** The Board plans to consider a revised draft of proposed guidance on the use of other types of confirmations at its August 1990 meeting. The revised form will be available from the AICPA order department in the fall of 1990.

RECENT DIVISION PUBLICATIONS

Four Statements of Positions (SOPs) were issued:

SOP 90-1—*Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations*—was issued in March 1990. The comment deadline is June 15, 1990. Product no. 014837. Price \$4.75

SOP 90-2—*Report on the Internal Control Structure in Audits of Futures Commission Merchants*—was issued in February 1990. Product no. 014839. Price \$4.75

SOP 90-3—*Definition of "Substantially the Same" for Holders of Debt Instruments as Used in Certain Audit Guides and a Statement of Position*. Product no. 014840. Price \$4.75

SOP 90-4—*Auditors' Reports Under U.S. Department of Housing and Urban Developments' "Audit Guide for Mortgagees Having HUD Insured or Secretary Held Multifamily Mortgagees"*—was issued in February 1990. Product no. 014841. Price \$4.75

Two exposure drafts were issued:

Questions and Answers on Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements—was issued in February 1990. Product no. G00309.

The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements—was issued in March 1990. Product no. G00575

Exposure drafts (product numbers that begin with a "G") can be obtained free of charge (up to 5 copies—\$0.50 each copy thereafter) by writing to the AICPA order department (see address below).

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