
From: Curt Verschoor [cverscho@condor.depaul.edu]
Sent: Friday, November 21, 2003 4:34 PM
To: Comments
Subject: Docket 008

General Comments:

1. In Paragraphs 13 and 14, the Exposure Draft (ED) sets forth the COSO Framework as suitable for use in developing management's assertion and presumably, the auditor's attestation. The ED also refers to COSO's important place in the auditing literature regarding internal control in AU 319. In spite of this, however, the ED deviates from the established standard of internal control effectiveness contained in COSO, the presence and effective functioning of all five internal control components. By adopting a new effectiveness standard based on absence of identified material weaknesses, the ED focuses too much context on only one COSO component, control activities.

Granted, the need to consider all five components has been inserted in various paragraphs, including 43, 80, 101. Nevertheless, the overall thrust of the document concerns specific controls concerning assertions that relate to: 1) significant accounts and disclosures (¶ 41, 43, 45, 74, 75), 2) significant processes (¶ 69, 79). There is insufficient reference to the auditor's need to assess the strength of overall controls.

Because of emphasis on specific transaction-based controls, rather than company-wide and more general controls, the internal control evaluation process risks becoming merely an automated box-checking process. Excessive costs and efforts may thereby be spent on the documentation and testing of routine transactions, and insufficient efforts on the controls resulting from operation of the control environment and risk assessment. The Board is no doubt aware of the marketing efforts of consultants and software developers who promise easy compliance with repetitive aspects of controls identified with specific transactions.

2. Because of its importance and the fact that it has a pervasive effect on internal control, an expanded several paragraph discussion of the control environment, including integrity and ethical values, should be set forth at the beginning of the ED, perhaps before ¶ 24. Thereafter, the ED should guide the auditor to consider controls that result from the control environment in each aspect of the audit.

As stated in the AICPA Audit Guide on internal control: *"The effectiveness of internal control 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 components."*

Section 301 of The Sarbanes-Oxley Act of 2002 requires public company audit committees to establish procedures for employees to confidentially submit complaints about internal controls. In addition, the recently enacted listing standards of the stock exchanges require companies to have a code of conduct and effective compliance measures. Consequently, inadequacies in either of these two areas should be included in ¶ 126 as a strong indicator of a material weakness. (See below).

3. The subject of risk assessment also requires expanded coverage in the ED. Otherwise, unnecessary efforts may be expended in evaluating the design, functioning, and monitoring of controls (for example, over routine recurring transactions) where there is a limited risk of material misstatement. The auditor should concentrate his/her efforts where risks are highest. Therefore, the auditor's evaluation of the client's risk assessment should precede the auditor's understanding of existing internal controls in Paragraph 48. A listing of factors that would alter risks relevant to financial reporting would be helpful:

- Changes in operating environment
- Changes in management structure, acquisition or divestiture
- New personnel or personnel reductions
- New or revamped information systems
- Rapid growth, new products or production processes
- Developments in foreign operations
- New accounting pronouncements

Specific Comments:

1. In ¶ 19, a reference to ¶ 50 may be helpful.
2. Factors contained in ¶ 24 transcend fraud considerations and should not be identified as necessarily fraud-related. A listing of the red flags from AU 316 would be helpful in alerting the auditor.
3. In ¶ 50, the reference should state 'the design of control resulting from the operation of all five control components.'
4. Some references (¶ 80, 101) to the five components of internal control describe the need to consider 'the controls for all components.' The five components are not control objectives. Rather these references should state a need to consider 'the controls resulting from the operation of all five control components.'
5. "Ineffective procedures to ensure compliance with either the entity's code of conduct or with procedures designed to enable employee complaints on internal controls over financial reporting" should be added to ¶ 126.

Answers to questions:

1. Yes, so long as there is reference to the fact that it is an attestation of management's assertions.
2. Yes
3. No, this does not appear to be economically feasible.
5. If expressed in the positive, ie, the qualities necessary for effective auditing, then OK.
6. Yes
7. Yes
8. Yes
9. Some walkthroughs are helpful and necessary, but the ED should not imply or even hint they are required for every significant account or process every year. The ED should clarify this point.
10. No, as some authorities believe walkthroughs are helpful in pointing out only the most egregious control weaknesses.
11. Audit evidence gathered in previous years may be used if the auditor is satisfied that no changes have occurred.
14. Not enough, if the auditor is able to satisfy him/herself of the quality of the internal audit

activity.

19. Yes

20. Yes

21. No, see addition at Specific Comment No. 5 above.

22. Not as an end in itself, however, the auditor must include an evaluation of the strength of the controls added by the audit committee in his/her overall assessment of controls over financial reporting.

23. Yes, if they follow present and future (expanded) ethical guidelines.

24. No

28. Yes, and clarify and restate the guidance already given through FAQ's.

29. Yes, and they have already been stated, but apparently not in sufficient clarity.

Respectfully submitted,

Curtis C. Verschoor

Research Professor, School of Accountancy and MIS

DePaul University