

**Interpretation No. 7, “Reporting on the Design of Internal Control”
of AT Section 101: *Attest Engagements***

December 2008

Interpretations of Section 101
AT Section 9101: *Attest Engagements*

7. Reporting on the Design of Internal Control

.59 Question—A practitioner may be asked to report on the suitability^{fn25} of the design of an entity’s internal control over financial reporting (internal control) for preventing or detecting and correcting material misstatements of the entity’s financial statements on a timely basis. Such requests may be made by, for example,

- an entity applying for a government grant or contract that is required to submit a written preaward survey by management about the suitability of the design of the entity’s internal control or a portion of the entity’s internal control, together with a practitioner’s report thereon.
- a new casino applying for a license to operate that is required by a regulatory agency to submit a practitioner’s report on whether the entity’s internal control *that it plans to implement* is suitably designed to provide reasonable assurance that the control objectives specified in the regulatory agency’s regulations would be achieved. (In this situation the casino would not yet have begun operations, and audited financial statements or financial data relevant to the period covered by the engagement may not exist.)

May a practitioner report on the suitability of the design of an entity’s internal control based on the risk assessment procedures the auditor performs to obtain a sufficient understanding of the entity and its environment, including its internal control, in an audit of the entity’s financial statements?

.60 Interpretation—No. In a financial statement audit, the purpose of the auditor’s understanding of the entity and its environment, including its internal control, is to enable the auditor to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The understanding obtained in a financial statement audit does not provide the practitioner with a sufficient basis to report on the suitability of the design of an entity’s internal control or any portion thereof.

.61 Question—How may a practitioner report on the suitability of the design of an entity’s internal control or a portion thereof?

.62 Interpretation—The practitioner may perform an examination under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1) or apply agreed-upon procedures under AT section 201, *Agreed Upon Procedures* (AICPA, *Professional Standards*, vol. 1) to management’s written assertion about the suitability of the design of the entity’s internal control.

^{fn25} In this interpretation, the *suitability of the design of internal control* means the same thing as the *design effectiveness of an entity’s internal control*.

Footnote 4 of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1) states that although AT section 501 does not directly apply when an auditor is engaged to examine the suitability of design of an entity's internal control, it may be useful in planning and performing such engagements. Paragraphs 57-59 of AT section 501 discuss how the auditor evaluates the design effectiveness of controls.

.63 When the engagement involves the application of agreed-upon procedures to a written assertion about the suitability of the design of an entity's internal control over compliance with specified requirements, the practitioner should also follow the provisions of paragraphs .09 and .11–.29 of AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1).

.64 The following is an illustrative report a practitioner may issue when reporting on the suitability of the design of an entity's internal control that has been implemented. The report may be modified, as appropriate, to fit the particular circumstances.

Independent Accountant's Report

[Introductory paragraph]

We have examined the suitability of the design of W Company's internal control over financial reporting to prevent or detect and correct material misstatements in its financial statements on a timely basis as of December 31, 20XX, based on *[identify criteria]*^{fn26}. W Company's management is responsible for the suitable design of internal control over financial reporting. Our responsibility is to express an opinion on the design of internal control based on our examination.

[Scope paragraph]

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, evaluating the design of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. We were not engaged to examine and report on the operating effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, and, accordingly, we express no opinion on operating effectiveness.

[Inherent limitations paragraph]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Opinion paragraph]

^{fn26} This report assumes that the control criteria are both suitable and available to users as discussed in AT section 101 paragraphs .23–.33. Therefore, the use of this report is not restricted.

In our opinion, W Company's internal control over financial reporting was suitably designed, in all material respects, to prevent or detect and correct material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*].

[*Signature*]

[*Date*]

.65 When reporting on the suitability of the design of an entity's internal control that has not yet been implemented, the practitioner would be unable to confirm that the controls have been implemented and should disclose that information in the practitioner's report. In those circumstances, the practitioner should modify (1) the scope paragraph of the illustrative report in paragraph .64 to inform readers that the controls identified in the report have not yet been implemented and (2) the inherent limitations paragraph to reflect the related risk. Following are modified illustrative report paragraphs for use when controls have not yet been implemented. (New language is shown in boldface italics. Deleted language is shown in strikethrough.)

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, evaluating the design of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. ***Because operations had not begun as of December 31, 20XX, we could not confirm that the specified controls were implemented. Accordingly, our report solely addresses the suitability of the design of the Company's internal control and does not address whether the controls were implemented. Furthermore, because the specified controls have not yet been implemented, we were unable to test, and did not test,*** the operating effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, and, accordingly, we express no opinion on operating effectiveness.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls ***may not be implemented as intended when operations begin or*** may become inadequate because of changes in conditions, ~~or that the degree of compliance with the policies or procedures may deteriorate.~~

.66 Question—A practitioner may be asked to sign a prescribed form developed by the party to whom the form is to be submitted regarding the design of an entity's internal control. What are the practitioner's responsibilities when requested to sign such a form if it includes language that is not consistent with the practitioner's function or responsibility or with the reporting requirements of professional standards?

.67 Interpretation—Paragraphs .32–.33 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1) address such situations in the context of an audit of financial statements and indicate that the auditor should either revise the prescribed form or attach a separate report that conforms with the auditor's function or responsibility and professional standards. When reporting on the suitability of the design of an entity's internal control under AT section 101, the practitioner's report should contain all of the elements in either paragraphs .85

or .86, as applicable, which can be accomplished by either revising the prescribed form or attaching a separate report in place of the prescribed form.

.68 Question—An entity may be required to submit a practitioner's report about an entity's *ability* to establish suitably designed internal control (or its assertion thereon). May a practitioner issue such a report based on (a) the risk assessment procedures related to existing internal control that the auditor performs in an audit of an entity's financial statements or (b) the performance of an attest engagement?

.69 Interpretation—No. Neither the risk assessment procedures the auditor performs in an audit of an entity's financial statements nor the performance of an attest engagement provide the practitioner with a basis for issuing a report on the *ability* of an entity to establish suitably designed internal control. There are no suitable criteria for evaluating an entity's ability to establish suitably designed internal control. The requesting party may be willing to accept a report of the practitioner on a consulting service. The practitioner may include in the consulting service report

- a. a statement that the practitioner is unable to perform an attest engagement that addresses the entity's ability to establish suitably designed internal control because there are no suitable criteria for evaluating the entity's ability to do so;
- b. a description of the nature and scope of the practitioner's services; and
- c. the practitioner's findings.

The practitioner may refer to the guidance in CS section 100, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2).