

Internal Control Reporting— 950 Negative Responses*

Although SAS 30 offers guidance for auditors in reporting on internal accounting control, mandatory reporting is not at issue today. Yet the withdrawal of the SEC proposal leaves open many questions on this subject—inconsistencies within the proposal and auditing literature. In this article there is a discussion of flaws in the SEC's claim that reports on material weaknesses will be useful to investors, as well as problems with the SEC's expectations and proposal of monitoring and estimating the cost of private sector initiatives for public reporting on controls.

Indeed, the Commission continues to believe that management disclosure concerning, and auditor involvement with, issuers' systems of internal accounting control have important values that can be achieved without undue cost or other burdens. (SEC, 1980, p. H-11, IV)

These are the concluding remarks of the SEC in the Withdrawal on June 6, 1980 of their April, 1979 proposal to require a Statement of Management on Internal Accounting Control. Despite the staff's acknowledgment that the original proposal provoked more negative responses than any other proposed rule on accounting, the SEC appears to have waived only slightly from its initial stance. The Withdrawal Statement reports that

Approximately 550 commentators viewed the Commission's rule proposals as an attempt to require management to report on its compliance with the FCPA (Foreign Corrupt Practices Act) as distinguished from a medium for meaningful disclosures to investors. (Emphasis added.)

Yet, the SEC persists in stating

The withdrawal of these proposals at this time should not be interpreted as a change in the Commission's views concerning the importance of effective systems

of internal accounting control and of management reporting on and auditor examination of such controls. (Emphasis added.)

What the Withdrawal Statement does is pose an ultimatum. After the SEC monitors

issuer practice in voluntarily providing management statements on internal accounting control and in engaging independent accountants to report on such statements . . . through the spring of 1982 . . . should the Commission's monitoring effort or the comments which it receives identify a specific need for further Commission action, the Commission stands ready to take whatever appropriate regulatory action may be indicated. (Emphasis added.)

In light of this SEC promise to mandate disclosures in the absence of private sector action, it is important that the profession understand what constitutes action in the eyes of the Commission. If reasons exist for questioning the propriety of the SEC's expectations, these reasons should be presented to elicit the Commission's reactions, to direct the profession's development, and to insure against the misinterpretation of private sector disclosure practices.

The purpose of this article is to provide evidence of primary flaws in the SEC's analysis of the value of internal accounting control disclosures and consequent problems with the SEC's expectations and proposed means of monitoring "private-sector initiatives for public reporting

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on internal accounting control." Literature citations, market evidence, and survey findings provide support for the critique.

Reliable Financial Statements in Spite of Inadequate Control

In the SEC's 1979 proposal, the Commission states: "An effective system of internal accounting control has always been necessary to produce reliable financial statements." and the Withdrawal reiterates this assertion.

While difficult to evaluate with such ambiguous language as "effective," "necessary" and "reliable," these statements seem to contradict the accounting and auditing literature. It is widely recognized that a clean audit report can be issued to a company with a poor internal control system.

It should be understood that when an auditor gives a certificate on the financial statements of a company, he is not necessarily endorsing, or completely satisfied with, the system of internal check and control he finds in effect. He has to take it as he finds it for the current examination, and determine how far it should influence the scope and extent thereof.¹

While influencing the risk of the auditor, a poor control system will be compensated for through substantive tests to assure that the auditor has the evidential base required to attest to financial statement reliability.

The ability of auditors to compensate for poor controls is supported by the infrequency of audit opinions which are qualified due to problems involving internal accounting control systems. A review of the *Disclosure Journal* indicates that out of all the filings with the SEC, including disclaimers and qualified opinions by auditors, less than ten companies annually have inadequacies in the internal control system which influence the audit opinion. The SEC Proposal and Withdrawal overstate the "need" for control reports when they claim such controls are essential for reliable financial statements. Further, due to the judgment involved in selecting reporting practices which can significantly affect financial statement reliability, the mere existence of an adequate control system does not preclude the preparation of unreliable financial reporting.

Evidence is Available on Costs and Benefits

The SEC in its Withdrawal refers to the costs and benefits "asserted" by commentators and points to its intention to evaluate voluntary efforts of registrants to engage independent auditors to examine and publicly report on their system of internal accounting control as a basis for evaluating the actual costs of such examinations. The inference that only assertions as to the cost/benefit

tradeoffs exist ignores the ability to measure such cost and benefits by observing the current market equilibrium and the current demand for and related costs of providing internal control reports to commercial lending officers and private placement debt officers.

It is an empirical fact that market forces have led to accountants' reports on internal control in only two companies' annual reports: J.P. Morgan & Co., Incorporated, and Bankers Trust New York Corporation. This indicates that auditors can furnish these reports but there is little market demand for them. The existence of only two such public disclosures reflects consumers' cost-based valuation of internal control reports.

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Even stronger support for the low valuation of auditors' reports on internal control is provided by the fact that commercial lending officers and private placement analysts, in a position to demand internal control reports without the inclusion of such information in annual reports, rarely require them (based on interview and survey evidence collected by the author). Even management letters, normally available to managers and potentially available to such third parties at nominal or no cost to the borrowers, are rarely requested. Based on discussions with loan officers, they are only requested from small to medium-sized companies considered high-risk investment prospects, and the reports are then only useful in raising the right questions. Most officers state that the report would be meaningless without direct access to management to discuss the issues addressed in the management letters.

A direct measure of demand for internal control related information is available from the examination of bonding indentures and covenants. Since companies are rewarded for contracting to supply information for monitoring bonding covenants at the times of entering into covenants, i.e., by being able to sell the securities at higher prices with the covenants than without them, the companies have incentives to fill information requests by third parties and to provide the most useful means of monitoring their performance to third parties. Yet, the required types of reports specified in bond covenants do not include management letters or other internal accounting control reports.

SEC's Proposed Basis for Calculating Costs of Auditor Examination of Controls

In light of the current market equilibrium and disclosure practices in the private placement markets, if an increased number of voluntary reports on internal account-

¹ Walter A. Staub, "Auditing Developments During the Present Century," Harvard University Press, 1942.

ing control with auditor examinations are observed, the underlying demand for such disclosures is properly attributed to the SEC and its regulatees' desire to deter future rule-making by the Commission. Investors' "need" for such reports will remain unsupported. It can be predicted that those companies which voluntarily opt for such reports will be highly regulated ones: like banking institutions that believe that without such voluntary action, the reports are likely to be mandated; or companies that have low marginal costs related to such reports. Hence, the data reviewed by the SEC as a basis for assessing the actual cost of its withdrawn proposal will be systematically understating the costs of imposing the disclosure on all SEC registrants.

The voluntary issuers' cost data will provide only a least cost or minimum floor from which to evaluate the incremental costs of auditors' examination of control reports. Those companies for which control reports are deemed not to be cost beneficial (even in light of the possible benefit of deterring regulation) will not be included in the data base. Yet, subsequent regulation from the SEC would be likely to encompass all registrants.

A mandatory CPA examination of controls would fall with the greatest severity on smaller registrants. Not only does the traditional "little GAAP" argument apply, but the quality of controls is typically less for smaller companies because of the scale of operations. The business itself does not require sophisticated controls to conduct normal business, and frequently owner-managers are considered reasonable replacements for numerous controls typically found in larger companies. Subjective attributes like loyal employees are also likely to play a role in assessing control adequacy. Bankers who lend to small businesses state that personal acquaintance with the owner/manager is the primary information used in the lending decision. In light of current control practices and credit relations of small businesses, there are two central problems with applying a regulation similar to the SEC 1979 proposal.

First, auditors are likely to be unwilling to rely on subjective support for system adequacy, e.g., employee loyalty, or to accept the owner/manager's presence as an "adequate" control. Hence, smaller companies will be forced to implement more objective, though unnecessary, control measures; based on the status quo, these controls will not be cost justified. *Second*, if creditors have direct access to small businesses, it is unlikely that a report by a CPA on general control adequacy will be of any use whatsoever. Further, since other small business investors are frequently knowledgeable of the operations and personally acquainted with management, the same argument applies.

These problems with regulation also exist with voluntary issuance of auditors' reports on control. It is unreasonable for the SEC to expect the majority of businesses, particularly small businesses, to undergo auditors' examination of internal control in the absence of creditors' or investors' demand for such information, given the substantial costs related to such an audit extension.

One possible alternative for the SEC would be to ex-

empt smaller registrants from both the SEC's expectations of voluntary reporting and subsequent regulation, as offered in the 1979 Proposal. Yet, "most of the problems related to internal control systems are concerned with medium-sized and smaller companies just entering the public market." (*Financial Analysts Journal*, May-June 1980, p. 79). If an internal control report is to be required (or expected through voluntary actions), there is no clear rationale for exempting smaller companies.

SEC's Focus in Estimating Actual Costs too Narrow

Not only is there a predictable bias in the data base proposed by the SEC as useful in evaluating the cost of regulation similar to the 1979 Proposal, but there is a predictable exclusion of relevant cost factors.

The concept of describing uncorrected material weaknesses in the annual report assumes:

- Management should be placed in a defensive position when not correcting material weaknesses, i.e., it is desirable to pressure management to implement controls to correct cited "material weaknesses";
- Some benefit is derived from the implied "bad information" that material weaknesses exist in the internal control system;
- A description of a material weakness can be understood without thorough knowledge of the internal accounting control system of the entity;
- Users will comprehend that a material weakness does not translate to a probable loss;
- Such reported weaknesses cannot be utilized to "rip-off" resources;
- Significant competitive disadvantages will not result;
- Users comprehend auditors' current responsibility, particularly the absence of a cost/benefit analysis of controls; and
- There is a significant problem with weaknesses in the control systems of corporations and this information is of value.

If any one of these assumptions is in error, extensive "misinformation" will be communicated through public reporting of material weaknesses. The third and fourth points may well be the most critical.

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The risk exposure due to a given control weakness is a judgment which may differ across business managers and across auditors. There are even cases where a material weakness is also a material strength to a control system. The classic example is in the owner-managed com-

pany where owner participation replaces numerous controls involving segregation of duties in larger entities. Yet from a creditor's perspective, the dependence primarily on the owner can be an extremely risky proposition. In the auditing literature, decisions that are matters of judgment are rarely described because of the professional expertise and information required to evaluate the circumstances. Ordinarily, an opinion is "better left unexplained." For instance, when an auditor lacks independence, he simply states that fact, not explaining, for example, that the lack of independence is based on his wife's ownership of five percent of the client's stock. Such an explanation could confuse the user, implying that he should reassess whether the auditor is indeed lacking independence. A measure of overall system adequacy or risk exposure appears to be a superior means of discussing internal controls when compared with the proposed alternative of listing material weaknesses, which implies users have some basis for evaluating the importance of the individual weaknesses.

A survey by the author in 1979 indicates there is substantial diversity in the interpretation of the effect of internal control points on report users' assessment of management. This observed diversity suggests that the report form of a management letter or a listing of material weaknesses alone is inadequate to provide a basis for evaluation of a company's management. The respondents noted that it was impossible to evaluate the internal control points without knowing more about the company and the context of the control suggestion.

Similarly, description of the means of evaluating internal accounting controls implies that the user of the report can meaningfully incorporate such information in an investment decision. Yet, without in-depth knowledge of an entity, evaluating the appropriateness of a review technique is extremely difficult. The disclosure of the basis for the management opinion, suggested in the original SEC proposal and in the Withdrawal statement, will likely be uninformative and its effect will be much like an advertising marketing reaction: what "sounds" best. For example, if one company has a periodic inventory system with six spot-checks a year, while another firm has a perpetual inventory system but poor control over the accessibility of inventory, which firm's description of the approach to controlling inventory is preferred? If one firm follows "common industry practices" while another "unlike, other companies in this industry . . ." adopts a unique control or approach to controls, how can this be evaluated? To give an adequate description of internal control, the length of disclosures would be excessive. To give less, particularly with some description, is misleading in the inference that "information" is being made available; data, perhaps, but certainly not information.

The questionable information content of proposed disclosures is supported empirically by a survey (reported in the *Financial Analysts Journal*, May-June, 1980) of 112 Chartered Financial Analysts, 60 to 70 percent of whom believed that a report on internal accounting controls could not lead

to valid inferences about the quality of management, the likelihood of embezzlement or other impropriety, the reliability of audited financial statements (in addition to the auditor's opinion), the reliability of unaudited financial information or compliance with the FCPA (p. 79—Survey by Holzmann).

In light of such questionable benefits the costs related to internal control regulation of registrants would be expected to affect the capital formation process by encouraging more private debt placements.

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An investigation of financial disclosure in a competitive economy, indicates that disclosures interfering with management's legitimate right to make decisions (in this case, the selection of internal control policies), should be viewed as "dysfunctional" and as having a harmful effect on capital formation. In addition, the disclosure of material weaknesses in control systems can have a competitive impact. Despite the problems with such reports in terms of information content, some users will evaluate such disclosures as "bad news" and reallocate resources. Further, there is some possibility that the information will be used to "beat the control system" of the entity, and thereby "rip-off" assets of a company which otherwise were adequately safeguarded. Some "trade secrets" may be disseminated in control related disclosures.

The application of the ruling to all companies will clearly alter the relative wealth positions of small and large ones as well as those in industries with differing control practices. Business conditions can be expected to lead to adequate controls for large companies, with those businesses with very liquid assets necessarily having more extensive control systems. Hence, the relative costs of conforming with regulations are not uniform across companies. Competitive disadvantages from financial disclosure are possible when the costs of disclosure fall unevenly on competing companies. Consideration should be given to the cumulative costs to the company (of disclosure as well as to the effects of disclosure on hardship cases which may be so severe as to imperil some companies' survival.

Lifting Limitation on Materiality Would be Cost Prohibitive

In its Withdrawal of the 1979 Proposal, the Commission reemphasizes

the fact that the internal accounting control provisions of the FCPA (Foreign Corrupt Practices Act) are not limited by a standard of materiality. Those provisions require the design and maintenance of a

system of internal accounting control which provides reasonable assurance of achievement of the objectives of internal accounting control. However, the Commission does recognize that certain weaknesses in internal accounting control are more significant than others. Therefore, the Commission believes that, for disclosure purposes, the focus of such a management statement should encompass, at a minimum, the adequacy of the issuer's controls over matters about which shareholders reasonably should be informed.

Despite this invitation to invoke a materiality guideline, a footnote in the Withdrawal suggests that, in light of the federal securities laws, some otherwise immaterial control difficulties may have to be disclosed, for example, if related to a significant inventory adjustment. Further, the message is clear that the concept of reasonable assurance, with the application of cost/benefit criteria, is being promoted in preference to any materiality limit.

Not only will an audit directed by concern for financial statement materiality fail to uncover all immaterial inadequacies, but it is also likely that auditors will deem certain system flaws to be material despite cost/benefit justification for exclusion of the control as sanctioned in the SEC proposal. Further, in light of the absence of cost/benefit analyses in the current performance of audits, it is not entirely clear that CPAs can make such an analysis in meaningful terms, despite the SEC's proposal to charge CPAs with such responsibility. There is some doubt that any advantage accrues from having the auditor redundantly assess cost/benefit tradeoffs. In fact, the trend of other government agencies is to avoid redundancy when possible, for example, "The comptroller now cautiously admits that . . . bankers may be just as capable of recognizing good and bad credits as the examiners are! The examiner is now allowed possible reliance upon internal loan review if [certain] . . . criteria are met."² Since auditors may very well not be "just as capable" as management in evaluating costs and benefits, a separate evaluation requirement seems senseless.

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If the SEC persists in its preference for a report and related auditor's examination on internal control without materiality limitations, the reporting process would be cost prohibitive with respect to the auditor's role. It would alter

the entire auditing process and, by definition, is impossible to justify in cost/benefit terms. If a control is of no consequence in determining the overall fairness of financial statements, of what use is information concerning that control? Even the SEC's Regulation SX, Rule 1.02 states

The term "material," when used to qualify a requirement for furnishing information . . . limits the information required to those matters to which an average prudent investor ought reasonably to be informed . . .

At the very least the statement infers the unreasonableness of requiring immaterial disclosures.

Continued Lack of Clarity Poses Reporting and Cost Concerns

The SEC 1979 proposal and Withdrawal, just as the Foreign Corrupt Practices Act, utilize the accounting and auditing literature extensively. In describing the objectives of internal accounting control, it is cited that reasonable assurances should be provided that "The recorded accountability for assets was compared with the existing assets at reasonable intervals and appropriate action was taken with respect to any difference." While the above requirements are generally understood by CPAs in private practice, it appears that the regulators enforcing the FCPA have a different perception of "reasonable intervals." Most review techniques are performed annually and traditionally have been considered sufficient. Yet, the SEC's questioning of all large fourth quarter adjustments as possible violations of the FCPA implies that periodic inventory systems may be inadequate. If such interpretations are anticipated by regulators, more clarification of the internal accounting control objectives is essential for effective implementation of the proposal or some similar reporting practice. There is evidence that the SEC is making

unrestrained use of Section 15 (c) (4) in contested proceedings, particularly coupled with far-reaching provisions of the Foreign Corrupt Practices Act . . . whether Congress intended that the Commission be so armed, and whether such an administrative weapon is in the public interest, . . . become issues for judicial or legislative resolution.³

While ambiguity may be desirable from the regulators' perspective, the regulated companies require clarification as to the expectations and planned enforcement activities of the SEC regarding the FCPA and future reports by management and auditors on internal accounting control.

³ Dennis J. Block and Nancy E. Barton, "Administrative Proceedings to Enforce the Foreign Corrupt Practices Act," *Securities Regulation Law Journal*, 1979.

² Bruce Adamson, "Current Examination Procedures," *The Journal of Commercial Bank Lending*, January 1979.

In its proposal the SEC recognizes management's *unique* position in assessing the adequacy of the internal controls in cost/benefit terms and the importance of evaluating such controls in the *specific context* of the single entity. Yet, as suggested earlier in this article under "misinformation" communication, the SEC still expects the public to appropriately evaluate the material weaknesses

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of a company as well as management's explanations regarding its lack of action. If the SEC admits the peculiarity of each decision to a given entity, and assigns responsibility for that decision to management, why encourage financial statement users to "second-guess" management with insufficient information on the entity's circumstances?

Overstatement of Existing Auditor Involvement

The Withdrawal focuses on SAS No. 20 and SAS No. 8—as well as the proposed SAS on Reporting on Internal Accounting Control, now SAS No. 30, 1980—as evidence of substantial auditor involvement in the examination of internal accounting controls. The Withdrawal does acknowledge that the auditor is required to inform the registrant of any information of *which he is aware* including weaknesses in internal accounting. However, the SEC does not acknowledge that the auditing process now permits a review of controls with no testing of those controls that are not relied upon by the auditor. Hence, an inference that the auditor already essentially has control examination responsibilities constitutes an overstatement.

Further, a footnote in the Withdrawal acknowledges

Certain commentators suggested that it is not clear that Statement on Auditing Standards No. 8 would apply to an *omission* (as opposed to a misstatement) of disclosure of an internal accounting control weakness in a statement of management on internal ac-

counting control. The Commission encourages the Auditing Standards Board to take whatever action is necessary to make clear that the provisions of the Statement are applicable to such omissions.

This "back-door" attempt to require public reporting of material weaknesses by auditors is extremely questionable. How does the auditor discern "Where a management statement includes an assessment of the effectiveness of internal accounting control"? Does a simple description of the logic of the control system suffice? And, what if management qualifies its statement with the reasonable assurance, cost/benefit based language of the SEC?

In an article in the May 1980 *Journal of Accountancy*, Douglas Carmichael explains

the reasonable assurance standard would allow management to avoid disclosing weaknesses if it could justify the costs of correction as exceeding the benefits of reducing the risk of an error or irregularity. In other words, a material amount of assets could theoretically be at risk, but the risk would not be disclosed if cost of correction exceeded the potential monetary effect.

Finally, the SEC seems to interpret the proposed SAS on internal control reports as suggesting that future voluntary auditing engagements to evaluate and publicly report on systems of internal accounting control can be expected to become common. *First*, the SEC fails to acknowledge that the proposed SAS (now SAS No. 30) provides guidelines not only for reports on Internal Accounting Control based on a separate engagement, but also for reports based solely on a study and evaluation made as part of an audit. In the Withdrawal Statement, the SEC provides no information as to whether such limited reports would fulfill the SEC's expectations of voluntary initiatives. Further, the SEC refers to the proposed SAS as capable of providing a framework for assessing the costs of such examinations. It is, of course, imperative that the SEC distinguishes between the report types outlined in the SAS in order that the SEC avoid the further understatement of the costs of past proposals (already predicted in this article). *Second*, the mere presence of a pronouncement says nothing of companies' demand for control review. In fact, as demonstrated by J.P. Morgan and Bankers Trust, there have been no barriers to public reports and official guidelines for reports have long been a part of generally accepted auditing standards. It is an overstatement by the SEC to infer future demand for control reports merely due to the availability of another SAS. □