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# Outlook for Public Internal Control Reports

Should reports on audit clients' internal controls be made to the public? What will be the guidelines for auditors to follow in assessing adequacy of systems?

REPORTS on audit clients' internal controls are not a new phenomenon. For years, accounting firms have voluntarily submitted informal reports to their clients' top management concerning recommended improvements to the accounting procedures and internal controls. Effective for examinations of financial statements for periods ending on or after December 24, 1977, the auditor is *required*, under generally accepted auditing standards, to communicate to senior management and the board of directors material internal control weaknesses.

However, reports *to the public* on audit clients' internal controls are infrequent, and whether they should be required is an emerging issue in the accounting profession. The purposes of this paper are (1) to present the current viewpoints of the AICPA, the SEC, and the Commission on Auditors' Responsibilities with respect to such public reports; and (2) to offer the writer's predictions concerning future requirements for these reports.

## AICPA's Position

The AICPA's position with respect to reports to the public on audit clients' internal controls is contained in Section 640 of *Statement on Auditing Standards No.1*. The issue date of the original pronouncement, *Statement on Auditing Procedure No. 49*, was November, 1971.

In *SAS No. 1*, the AICPA declared that the usefulness of such reports to the general public is questionable. Any possible action that could be taken by investors, creditors, customers and other members of the general public would be confined to decision making about either a company's financial statements or its management. With regard to audited financial statements, the AICPA said that an auditor's report on his evaluation of internal accounting control would not provide any additional credibility to the statements. With regard to decisions on a company's management, the AICPA pointed out that reports on internal accounting control could be useful, but that such reports alone could result in distorted appraisals of management performance. The Institute concluded that the decision about whether such public reports would be useful in particular cases is the responsibility of management and/or any regulatory agencies having jurisdiction.

Through *SAS No. 20*, issued in August 1977, the AICPA established a requirement that the auditor communicate to senior management and the board of directors or its audit committee, material weaknesses in internal accounting control that come to his attention during an examination of financial statements made in accordance with generally accepted auditing standards. It is noteworthy that *SAS No. 20* also modified the form of the report contained in *SAS No. 1* that could be used by auditors in reporting to the public on internal control. The Auditing Standards Executive Committee further stated in *SAS No. 20* that it is continuing its consideration of the significant underlying issues of other forms of reporting to the public on a system of internal accounting control.

For several years, J. P. Morgan & Co. has followed the practice of including in its annual report to stockholders the report of its independent auditors on the internal accounting controls. In Exhibit 1, the internal control reports for 1977 are presented. The report by Price Waterhouse & Co. closely parallels the language suggested by *SAS No. 20* in *connection with an examination of the financial statements* made in accordance with generally accepted auditing standards. The report by Haskins & Sells illustrates the language that is appropriate for an engagement *limited to the evaluation of the internal control system*.

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**EXHIBIT 1**
**Internal Control Reports for J. P. Morgan & Co.**

*To the Directors and Stockholders of J. P. Morgan & Co. Incorporated:*

We have examined the consolidated financial statements of J. P. Morgan & Co. Incorporated and subsidiaries for the year ended December 31, 1977 and have issued our report thereon dated January 11, 1978. We have also assisted the Banking Examining Committee of the Board of Directors of Morgan Guaranty Trust Company of New York during the year in making the annual surprise examination of the banking departments of the Bank as required by the New York Banking Law. As a part of our examination, we reviewed and tested the Bank's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards the purpose of such evaluation is to establish a basis for reliance thereon in determining the nature, timing and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements.

A Statement describing the objective and limitations of any system of internal accounting control, which is a part of this report, appears below.

Our study and evaluation of the Bank's system of internal accounting control for the year ended December 31, 1977, which was made for the purpose set forth in the first paragraph above, was not designed for the purpose of expressing an opinion on internal accounting control and it would not necessarily disclose all weaknesses in the system. However, such study and evaluation disclosed no conditions that we believe to be material weaknesses.

Price Waterhouse & Co.

*New York, N.Y. January 11, 1978*

*To the Directors and Stockholders of J. P. Morgan & Co. Incorporated:*

We made a study in 1977 of the system of internal accounting control in those domestic departments of Morgan Guaranty Trust Company of New York (the "Bank") controlling nonbank assets held for others in trust, investment advisory, and custody accounts for the purpose of reporting on our evaluation of the system. In making our study, we reviewed and tested the system (including the procedures employed as they affect internal control, the extent of the segregation of duties within and among the various departments, and the scope of the internal audit program) to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Our study included inspection and confirmation, on a test basis, of nonbank assets held for others in trust, investment advisory, and custody accounts as of August 17, 1977, test of administration of selected accounts and observation and review of the procedures followed by the Auditing Department.

A Statement describing the objective and limitations of any system of internal accounting control, which is a part of this report, appears below.

Our study and evaluation of the system of internal accounting control in those domestic departments of the Bank controlling nonbank assets held for others in trust, investment advisory, and custody accounts, which was made for the purpose set forth in the first paragraph above, would not necessarily disclose all weaknesses in the system. However, such study and evaluation disclosed no conditions that we believe to be material weaknesses.

Haskins & Sells

*New York, N.Y. November 14, 1977*

*Statement by the independent accountants on the objective and limitations of any system of internal accounting control in form prescribed by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants:*

The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

At the time *SAS No. 20* was released, Thomas Kelley, former Director of the Auditing Standards Division, stated that the AICPA has appointed a broad-based special advisory committee, comprised principally of financial and internal audit executives, to develop criteria for determining the adequacy of a system of internal control. He added that the committee may take up the basic question of whether reports on internal controls should be issued to the public, and, if so, how. At the writing of this article, an exposure draft of the committee's report was expected by mid-September (1978).

"Reporting on the System of Internal Accounting Control" is one of the projects currently under active consideration by the Institute's Auditing Standards Executive Committee. The project will attempt to determine whether or not it will be possible for an auditor to give an opinion on the adequacy of an internal control system, as opposed to merely giving negative assurance as to the existence of material weaknesses, as is presently the case. This project may attempt to define the material weaknesses in internal control systems and devise a reporting mechanism for making these weaknesses known in a formal report. The direction which the AudSEC takes will be determined, in part, by the forthcoming recommendations of the special advisory committee. AudSEC hopes to issue an exposure draft of a Statement on Auditing Standards on this topic by Spring 1979.

## SEC's Position

For several years, the SEC has been concerned with the issue of the adequacy of registrants' internal accounting controls. The Commission formally proposed that corporations under its jurisdiction maintain accurate books and records and an adequate system of internal control; the comment period ended in April 1977. Adoption of the proposal was delayed pending the outcome of congressional legislation in this area.

In December 1977, President Carter signed into law the Foreign Corrupt Practices Act. It embodies the salient provisions of the SEC's proposal, as the Act requires corporations to maintain accounting records and internal controls designed to help corporate management detect illegal payments. As described in the May 1978 issue of *The CPA Journal*, the law specifically requires issuers to devise and maintain an internal accounting control system "sufficient to provide reasonable assurances" that (1) transactions are executed in accordance with management's general or specific authorization, and (2) transactions are recorded in such a way as to permit preparation of financial statements in conformity with generally accepted accounting principles and to maintain accountability for assets. A consequence of the Foreign Corrupt Practices Act is that corporate managements may request their independent auditors to render an opinion on whether or not their internal control systems meet the legal requirements.

***'. . . to define the material weaknesses in internal control systems and devise a reporting mechanism for making these weaknesses known in a formal report.'***

Still on the SEC's active agenda is a possible amendment to the securities statutes requiring *public* reporting by independent accountants on the adequacy of a registrant's internal control system. However, the SEC may delay action in this area pending the completion of the project, described earlier in this paper, under active consideration by the Auditing Standards Executive Committee of the AICPA. Such was the case in 1976 when the SEC delayed the enactment of a regulation concerning auditors' reports on a limited review of interim financial information pending adoption by the AICPA of requirements contained in *SAS No. 13*.

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## Position of the Commission on Auditors' Responsibilities

In its *Report, Conclusions, and Recommendations* issued in early 1978, the Commission on Auditors' Responsibilities (CAR) urged immediate adoption by the accounting profession of a requirement for the independent auditor to expand his study and evaluation of the controls over the accounting system. The objective of such an in-depth evaluation would be the formation of a conclusion on the functioning of the internal accounting control system. According to the CAR, the auditor should be able to reach a decision on "whether controls over each significant part of the accounting system provide reasonable, though not absolute, assurance that the system is free of material weaknesses."

The CAR went on to say that "users of financial information have a legitimate interest in the condition of the controls over the accounting system, and management's response to the suggestions of the auditor for correction of weaknesses." The Commission advocated that each corporate board of directors require the company's chief financial officer to present, with the financial statements, a report acknowledging the responsibility of management for the representations in those statements. Such a report would contain, as well, management's assessment of the company's accounting system and controls over it, including a description of the inherent limitations of the controls. It is here that management would describe the company's response to material weaknesses identified by the independent auditor. Finally, to assure the credibility of the report by management, the independent auditor would report on whether or not he agrees with management's description of the company's accounting controls, and would describe material uncorrected weaknesses not disclosed in management's report. The Commission's proposal would,in effect, require a report to the public on the adequacy of the internal controls for all engagements involving an examination of financial statements made in accordance with generally accepted auditing standards.

In its 1978 *Report*, the CAR presented the following illustration of a statement by management with respect to the internal accounting controls:

> The Company maintains an accounting system and related controls to provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition and that financial records are reliable for preparing financial statements and maintaining accountability for assets. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. The concept of reasonable assurance is based on the recognition that the cost of a system of internal control should not exceed the benefits derived and that the evaluation of those factors requires estimates and judgments by management. The company's system provides such reasonable assurance. We have corrected all material weaknesses of the accounting and control systems identified by our independent auditors, Test Check & Co., Certified Public Accountants (or, We are in the process of correcting all material weaknesses . . . ) (or, We have corrected some of the material weaknesses but have not corrected others because . . . ).

Several large U.S. corporations have recently included, within the financial sections of their annual reports to stockholders, statements by management with regard to the systems of internal control. These management statements appear to embody the spirit of the corresponding recommendation of the CAR. For example, Ford Motor Company issued the following statement in 1977:

> The Company maintains a system of internal controls to ensure that its records reflect the transactions of its operations in all material respects and to provide protection against significant misuse or loss of Company assets. The internal control system is supported by a staff of internal auditors, by thorough auditing programs, by careful selection and training of financial management personnel, and by written procedures that communicate the details of the control system to the Company's worldwide activities.

The following statement was signed by the Chairman and by the Chief Financial Officer of General Motors Corporation in its 1977 annual report:

> The system of internal controls of General Motors Corporation and its subsidiaries is designed to assure that the books and records reflect the transactions of the companies and that its established policies and procedures are carefully followed. This system is augmented by written policies and guidelines, a strong program of internal audit, and the careful selection and training of qualified personnel.

Finally, Monsanto Company included this statement under the heading "Responsibilities for Integrity of Financial Data" in its 1977 annual report:

> To gather and control financial data, Monsanto establishes and maintains accounting systems adequately supported by internal controls. Management believes a high level of internal control is maintained by the selection and training of qualified personnel, by the establishment and communication of accounting and business policies and by internal audits. In establishing internal controls, management weighs the cost of such systems against the benefits derived. Management believes the internal control systems in use are sufficient to provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition and that the financial records are reliable for preparing financial statements and maintaining accountability for assets.

As far as the auditor's involvement is concerned, the CAR recommended that the CPA include the following paragraph in his standard audit report in order to lend credibility to management's statement of responsibility for the accounting controls:

> Based on our study and evaluation of the accounting system and related controls, we concur with the description of the system and controls in the report by management (or, Based on our study and evaluation of the accounting system and controls over it, we believe the system and controls have the following uncorrected material weaknesses not described in the report by management . . . ) (or, other disagreements with the description of the system and controls in the report by management) (or a description of uncorrected material weaknesses found if there is no report by management). Nevertheless, in the performance of most control procedures, errors can result from personal factors, and also, control procedures can be circumvented by collusion or overridden. Projection of any evaluation of internal accounting control to future periods is subject to the risk that changes in conditions may cause procedures to become inadequate and the degree of compliance with them to deteriorate.

In this way, the auditor would explicitly, although indirectly, express an opinion on the adequacy of the reporting company's internal control system. Therefore, investors and other members of the general public would be informed periodically as to the absence or existence of material weaknesses in the accounting controls of companies in which they are interested.

Relative to the demand for internal control reports, Marilyn Brown, in the September 1977 issue of *The CPA Journal*, pointed out that commercial bankers and private placement investors have, on occasion, required corporations to provide them with specific information on their internal controls. These requests have been satisfied either in the form of the auditor's management letter or through direct conversations with the auditor. Ms. Brown also cited evidence that financial analysts desire information on corporate internal controls, preferably in the form of a statement from the auditors similar to the one recommended in *SAS No. 1*, described earlier in this paper. Apparently a market for internal control reports does exist in that sophisticated readers of financial statements find the information on the controls useful in their decision processes.

## Conclusion

Reports to the public on the adequacy of companies' internal controls may become mandatory in one of two ways: (1) They may become a legal requirement via congressional legislation or by regulations adopted by the SEC; and/or (2) they may become a requirement in connection with audit examinations via the promulgation of a Statement on Auditing Standards by the AICPA's Auditing Standards Executive Committee. Although the SEC has included the subject of such internal control reports on its active agenda, the agency is not currently pressing for a requirement in this area. In the writer's opinion, the SEC is prepared to wait until the matter is formally considered by the AICPA.

The impetus for the AICPA's project involving internal control reports to the public currently stems from the strong recommendation in this regard made by the Commission on Auditors' Responsibilities. The AICPA has already demonstrated its responsiveness to one recommendation of the CAR: In October 1977, the Auditing Standards Executive Committee issued an exposure draft which would have suspended the use of the "subject to" qualified audit report in cases involving material uncertainties. (The exposure draft was withdrawn in July 1978, however, pending deliberation by a new AICPA task force of a number of issues related to the standard short-form audit report.) Since

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the AICPA has assigned a high priority to the internal control report project, the writer believes that within a period of perhaps two years, the issuance of such reports to the public will be a requirement of all audit engagements.

The immediate concern which must be addressed, prior to the promulgation of a new Statement on Auditing Standards, is the development of criteria for assessing the adequacy of internal control systems. Before public reports on internal controls become widespread, auditors must have access to guidelines for determining whether their clients' controls provide reasonable assurance that assets are safeguarded from loss and that financial records are reliable for preparing financial statements. It would appear that the development of such guidelines will be a challenging undertaking. The fact that the AICPA has created a special advisory committee to explore the basic issues underlying the concept of internal control adequacy provides evidence as to the Institute's degree of concern in this area. The project is underway; public reports on internal controls will soon become a commonplace reality. Ω