

SEC COMMENTARY

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Proposed Rules on Statement of Management on Internal Accounting Control: Implications for Auditors

The SEC recently proposed rules that would require a management statement on internal accounting control in annual reports. The proposed rules would also require management's statement to be examined and reported on by an independent auditor. Although this column generally comments only on final rules, these proposals deserve special attention in light of their potential impact on independent auditors and their clients. This article summarizes the proposed rules, highlights certain matters of particular interest to independent auditors and suggests some actions that CPAs should take in the event the rules are adopted.

Basis for Proposal

The SEC release (No. 34-15772) is a direct result of the enactment of the Foreign Corrupt Practices Act of 1977 (FCPA). As discussed in this column in the May 1978 issue, the FCPA requires issuers to devise and maintain a system of internal accounting control "sufficient to provide reasonable assurances" that specified objectives are met. The proposed management statement would be directed toward those objectives, and thus appears to be aimed at assuring that registrants comply with the FCPA. However, the SEC takes the position that:

Information regarding the effectiveness of an issuer's system of internal accounting control may be necessary to enable investors to better evaluate management's performance of its stewardship responsibilities and the reliability

of interim financial statements and other unaudited financial information generated from the accounting system, and that, therefore, the proposed rules may be necessary to the interests of investors and other users of financial information.

Implementation Stages

The proposed management statement would be required both in Form 10K annual reports and in annual reports to shareholders. The requirements would be implemented in two stages. For fiscal periods ending after December 15, 1979 (but prior to December 16, 1980) for which audited balance sheets are required, the management statement would have to include an opinion as to whether, as of the balance sheet date, the systems of internal accounting controls of the registrant and its subsidiaries provided reasonable assurances that the objectives of internal accounting controls specified in the FCPA were achieved. The statement would also have to describe any uncorrected material weaknesses in internal accounting controls that had been communicated by the company's independent auditor, and "the reasons why they have not been corrected." There are no requirements for independent auditor involvement in this stage. However, the SEC believes that SAS No. 8 would require that an independent auditor's report on financial statements include an explanatory paragraph if management does not "appropriately disclose" uncorrected material weaknesses.

The second implementation stage applies to periods ending after December 15, 1980 for which audited statements of income are required. The management statement would then have to include an opin-

ion as to whether, for such periods, the systems of internal accounting controls provided reasonable assurances that the specified objectives of internal accounting controls were achieved. In this stage, the rules would require that an independent auditor examine and report on the management statement.

Management Evaluation

The SEC expects management to evaluate its company's internal accounting controls as a basis for the required statement. The proposed rules do not specify the method or procedures for evaluating controls, but the release describes certain "conceptual elements" the SEC believes management's evaluation should include. Those elements are:

- Evaluate the overall control environment;
- Review the system of controls, including identification of specific

control objectives and specific control procedures for achieving the objectives;

- Monitor control procedures to determine whether they are functioning as intended; and

- Consider the costs and benefits of additional or alternative controls.

The release states that "appropriate documentation" is important to each aspect of management's evaluation. Except for the need to consider the costs and benefits of additional or alternative controls, the SEC's "elements" are consistent with the approach recommended in the report of the AICPA Special Advisory Committee on Internal Accounting Control. The additional guidance in that report will be useful to management in performing its evaluation.

Reasonable Assurance

The SEC's proposed rules would require management to report whether its systems of internal accounting controls provided "reasonable assurances" that the control objectives in the FCPA were met. The SEC believes that changes in control procedures "necessitated by changing circumstances" and "made on a timely basis" do not indicate that a system did not provide "reasonable assurances" prior to the changes. On the other hand, the SEC believes that weaknesses that existed but were not identified on a timely basis "would indicate that the system did not provide reasonable assurances" and "would preclude an unqualified management opinion." Further, "any weaknesses which have been identified but not appropriately corrected" also would preclude an unqualified management opinion. While the concept of reasonable assurance recognizes that costs of controls should not exceed expected benefits, in the SEC's view such assurance should be provided "without regard to materiality of amounts."

Independent Auditor's Report

As previously stated, for periods ending after December 15, 1980 registrants would be required to have their statement on internal accounting control examined and reported on by an independent auditor. The proposed rules would require that the

examination be sufficient to enable the auditor to express an opinion on two aspects of management's representation: First, whether it is consistent with the results of management's evaluation of the control systems and, second, whether it is "reasonable with respect to transactions and assets in amounts which would be material when measured in relation to the registrant's financial statements."

With regard to the first aspect of management's representation, the release proposes that the auditor determine whether management's procedures for reviewing, monitoring and evaluating controls were "not insufficient" to provide a basis for its representation. Although the auditor "would not necessarily be required to perform independent tests" to express such an opinion, the opinion would have to reflect "any other knowledge" that he might have acquired from his examination of financial statements or from other means.

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In order to express an opinion on the second aspect of management's representation, the auditor would be required to "independently evaluate and test the underlying bases for management's conclusions."

The SEC recognizes that the proposed rules would result in an expansion of the independent auditor's work with respect to internal accounting control, but believes that the resulting additional audit costs would likely be "in large part of an initial rather than a continuing nature." On the other hand, the SEC also believes that in many instances audit costs for examining financial statements would decrease since auditors, having done additional work with respect to internal accounting controls, would be able to place more reliance on them. Although this might be true for companies that improve their controls significantly because of the proposed rules, it is not likely to be true for companies that already have good systems.

The SEC recognizes that the AICPA needs to develop appropriate professional standards in response to the requirements of the proposed rules. The AICPA's Auditing Standards Board is presently considering a *Statement on Auditing Standards* for reports on a system of internal accounting controls, and hopes to issue an exposure draft this fall. However, the Auditing Standards Board's efforts are directed to reports ex-

pressing an opinion on a system of internal accounting control. Such reports would not be required in an examination of financial statements, but the SAS would provide standards for separate engagements to report on systems. Although this work is relevant to the proposed SEC requirements, if the proposals are adopted as they are now set forth, additional standards would have to be developed, particularly with respect to the opinion that management's representation is consistent with the results (and sufficiency) of its evaluation.

Suggested Action

Many CPAs may wish to respond to the SEC's request for comments on the proposed rules. The comment period ended July 31, 1979, but the SEC will probably consider comments submitted within a few weeks after the deadline. Generally accepted auditing standards require independent auditors to communicate material weaknesses in internal accounting controls to senior management and the board of directors or its audit committee (SAS No. 20). Clients should be advised that if the proposed rules are adopted effective for years ending after December 15, 1979, such material weaknesses will need to be disclosed unless corrected prior to the end of their fiscal year. If independent auditors become aware of material weaknesses during

current examinations, they should be promptly communicated to clients so that they can be corrected prior to the end of the fiscal year.

CPAs should also act now to advise their clients on the need to plan immediately the steps that would be necessary to evaluate and document their systems of internal accounting controls in the event the rules are adopted as proposed. Substantial lead time may be needed to complete the evaluation and documentation by the end of 1979 (for calendar year companies). Independent auditors can assist their clients in many "elements" of the evaluation, such as in identifying specific control objectives and evaluating procedures.

As noted, the SEC has proposed that independent auditors express an opinion as to whether the representations of management are consistent with the results of its evaluation of internal accounting controls. Although the AICPA has not yet developed professional standards for such an opinion, if this aspect of the SEC proposal is adopted, client documentation of their evaluation and monitoring of the system will be essential to enable the independent auditor to express such an opinion. Accordingly, management should be urged to provide detailed documentation of its evaluation in the event such an independent auditor review is required in 1980. Ω

Human Values

The business executive, in his efforts to maximize, to computerize, to energize, can never forget that his most important job is to humanize.—
Excerpt from a speech by David P. Reynolds, Chairman of the Board and Chief Executive Officer, Reynolds Metals Company.