SEC COMMENTARY

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SEC Withdraws Proposal To Require Reports on Internal Accounting Controls

In August 1979 this column discussed SEC Release No. 34-15772, which proposed rules that would have required reports by management and independent auditors on systems of internal accounting control. The proposals met substantial opposition. Over 950 individuals and organizations submitted letters in response to the Commission's request for public comments. Most commentators criticized the proposals.

On May 28, 1980, the Commission announced that it was withdrawing the proposed rules. Shortly thereafter, the Commission issued ASR No. 278. Athough ASR No. 278 does not impose any new SEC requirements, it is an important release because it sets forth the Commission's views on the internal accounting control provisions of the Foreign Corrupt Practices Act of 1977, voluntary management statements on internal accounting controls, and independent auditor involvement with such statements.

Reasons for Withdrawal

According to the release, the Commission's decision to withdraw the rule proposals was "based, in part, on a determination that the private sector initiatives for public reporting on internal accounting control have been significant and should be allowed to continue." The private sector initiatives cited by the Commission are:

- Recommendations of the Commission on Auditors' Responsibilities (Cohen Commission) related to management reports;
- Endorsement of the concept of "management reports" by the Financial Executives Institute (FEI) and its issuance of "Guidelines for Preparation of a Statement of Management Responsibility for Financial Statements";
- Report of the AICPA Special Advisory Committee on Reports by Management;
- Voluntary inclusion of management reports on internal accounting controls in annual reports to shareholders;
- Report of the AICPA Special Advisory Committee on Internal Accounting Control; and
- AICPA proposed Statement on Auditing Standards on "Reporting on Internal Accounting Control" (subsequently adopted as SAS No. 30).

The Commission's expressed attitude toward voluntary management reports went beyond merely allowing private sector initiatives to continue. The release states the Commission believes its actions "will encourage further voluntary initiatives and . . . experimenting with various approaches to public reporting on internal accounting control." It is clear that the Commission favors such developments. In addition, the Commission urged experimentation with auditor association with such statements.

Monitoring Program

The Commission intends to "monitor carefully private sector initiatives . . . as well as issuer practice in voluntarily providing management statements on internal accounting control and in engaging independent accountants to report on such statements." It will also monitor efforts to implement the broader recommendations of the Cohen Commission concerning comprehensive management reports.

The monitoring program will continue through the spring of 1982, after which the Commission intends to consider whether it is necessary or

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desirable to require management statements and public reporting by independent accountants on internal accounting control, and to propose requirements for more comprehensive management reports. The release states that the "Commission's determination . . . will depend not only upon the extent to which issuers voluntarily provide such management statements or management reports, but also upon the appropriateness and usefulness of the information included and the procedures used to develop such reports."

No Change in Commission Views

The Commission stated that withdrawal of the rule proposals "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." And to forestall any such impression, the Commission reiterated many of the views it expressed in the withdrawn proposal (Release No. 34-15772). For example, in ASR No. 278 the Commission stated it "continues to believe" that:

- Information "about the effectiveness of an issuer's system of internal accounting control would enable investors to better evaluate the reliability of interim financial statements and other unaudited financial information, as well as management's performance of its responsibilities to control the assets and transactions of the business."
- A "report containing management's assessment of the effectiveness of the issuer's system of internal accounting control would provide information important to investors, and that auditor involvement with such a report may be needed."
- Systems of internal accounting control "are essential to sound business management for reasons wholly apart from legal requirements, and that its [the Commission's] action in proposing management statements on internal accounting control and auditor involvement with such statements should be viewed in that context."
- The determination of whether a system of internal accounting control provides "reasonable assurance" that the broad objectives of internal accounting control are achieved generally will involve the same "conceptual elements" discussed in Release No. 34-15772. Those elements are:

1. Evaluate the overall control environment;
2. Review the system of controls, including identification of specific control objectives and specific control procedures for achieving the objectives;
3. Monitor control procedures to determine whether they are functioning as intended; and
4. Consider the costs and benefits of additional or alternative controls, a conceptual element that, according to the Commission, "might be characterized as determination of reasonable assurance."

The Commission also continues to believe—as originally set forth in Release No. 34-15772—that appropriate documentation is important to an evaluation of internal accounting control. Although the release does not prescribe minimum documentation standards, it emphasizes the importance of documenting: the control environment, specific control objectives and procedures to achieve them, tests of controls, and the bases for management's conclusions with respect to reasonable assurance. Moreover, the release points out that "it is typically only after the fact of systems failure or circumvention that the question of whether the system provided reasonable assurance will most likely come under scrutiny" and that the judgments management had made would stand a better chance of being "afforded some presumption of regularity and reasonableness if the reasoning of its cost-benefit analysis was supported by full information as evidenced by appropriate and persuasive documentation not only of the system of internal accounting control, but also of management's ongoing review and evaluation of it."

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Content of Management Statements

The release presents the Commission's views on the content of management statements on internal accounting controls. These include:

• A management report should contain management's *assessment* of the effectiveness of the system of internal accounting control.

• Although, in the Commission's view, the internal accounting control provisions of the Foreign Corrupt Practices Act are not limited by a standard of materiality, it does recognize that certain weaknesses are more significant than others. Therefore, the Commission believes that, for disclosure purposes, the focus of a management statement on internal accounting control "should encompass, at a minimum, the adequacy of the issuer's controls over matters about which shareholders reasonably should be informed."

• The Commission believes that each of the objectives of internal accounting control should be addressed in management statements because each is important under the Foreign Corrupt Practices Act of 1977.

• The Commission believes that for disclosure purposes there is value in providing management statements that address the effectiveness of internal accounting control systems at a "point in time" rather than for a period of time, such as a fiscal year.

• The Commission encourages registrants to provide management reports which include, in addition to an assessment of the effectiveness of internal accounting control, whatever discussion of related matters they believe will make such an assessment "most informative." The Commission also encourages issuers to provide "comprehensive management reports" that deal with management responsibilities for accounting, control, and financial reporting in general; the respective responsibilities of management and independent accountants; and "the role which independent accountants play or have played in the internal accounting control system of the issuer."

Involvement of Independent Accountants

The release indicates that the Commission's decision to withdraw the proposal for required independent auditor reporting was "based in part on the extent of auditors' present involvement with internal accounting control in connection with audits of financial statements" and "on the Commission's expectation of enhanced voluntary or private sector initiated auditor association with internal accounting control in the near future." Further, the Commission continues to believe in the importance of

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"significant involvement of independent accountants in the process of evaluating and reporting on internal accounting control systems."

The release indicates auditors' present involvement is based on the requirements of SAS No. 20 to communicate "material weaknesses" that come to their attention in the course of an audit and the requirements of SAS No. 8. SAS No. 8 requires the auditor to read other information in certain annual reports that contain audited financial statements (including annual reports to shareholders and Form 10-K) and consider whether such information, or the matter of its presentation, is "materially inconsistent" with information, or the manner of its presentation, appearing in the audited financial statements. SAS No. 8 also requires the auditor to discuss with the client any other "material misstatements of fact" that the auditor becomes aware of as a result of reading the other information in the annual report, even though the misstatement is not inconsistent with the financial statements.

In discussing the Commission's views of auditors' responsibilities under SAS No. 8 the release states:

> Where a management statement includes an assessment of the effectiveness of internal accounting control, the auditor is required to inform the registrant of any information of which he is aware—including weaknesses in internal accounting control—which would render such information in the management statement materially misstated. Similarly, when a management statement includes a discussion of matters in support of or in addition to management's assessment of the effectiveness of internal accounting controls, the auditor is again required to inform the registrant of any material inconsistencies or material misstatements of fact contained therein. [If] the issuer fails to correct such misstatements when informed of them, SAS No. 8 requires the auditor to take appropriate steps to ensure disclosure, or, failing that, to consider other action, including withdrawing from the engagement.

Some commentators suggested to the Commission that it is not clear whether SAS No. 8 applies to *omissions* (as opposed to misstatements) of disclosure of internal accounting control weaknesses in a management statement. The Commission has encouraged the AICPA's Auditing Standards Board "to take whatever action is necessary to make clear that the provisions of the Statement are applicable to such omissions."

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Commentators "were almost unanimously opposed" to the proposed requirement for an auditor examination of the management statement. Many held that such involvement would entail substantial costs. The Commission, therefore, intends to assess the costs and benefits, as well as the need, for auditor reporting as part of its efforts to monitor private sector initiatives and voluntary auditor engagements to report on internal accounting control systems under SAS No. 30, "Reporting on Internal Accounting Control." The release states the Commission can be expected to reevaluate its decision concerning independent auditor involvement in light of the extent to which private sector initiatives and voluntary auditor engagements "have satisfied those Commission concerns which presently exist or which may exist at that time."

Request for Further Comment

The Commission has invited additional public comment on the issues discussed in ASR No. 278. Although the release does not specify a due date for submission of comments, it does say that the Commission "intends to formally revisit these questions by the spring of 1982." Ω

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