112-19

INFORMATION MEMORANDUM

TO: The Commission

FROM: Office of the Chief Accountant Sampson

DATE: December 28, 1979

SUBJECT: Reports by Accountants on Internal Accounting Control

RESPONSIBLE STAFF: Clarence Sampson (272-2050)
James Doyle (272-2130)

The AICPA's Auditing Standards Board ("ASB") has approved the issuance, for comment, of a proposed Statement on Auditing Standards on "Reporting on Internal Accounting Control" ("the proposed SAS"). Although the proposed SAS will not be published for a week or two, we have reviewed the prepublication draft.

The major focus of the proposed SAS is to provide standards, and the form of reporting, for an expression of an opinion by an accountant on an entity's overall system of internal accounting control. In addition, the proposed SAS addresses reporting based solely on a study and evaluation of internal accounting control made as part of an audit of financial statements; reporting on all or part of a system based on preestablished criteria of regulatory agencies; and issuance of other special purpose reports on all or a part of a system for the restricted use of management, regulatory agencies or other specified third parties.

Expression of Opinion on Overall System of Internal Accounting Control

The proposed SAS prescribes the study and evaluation and the form of the accountant's report for expression of an opinion on an entity's system of internal accounting control when an accountant is engaged to perform such an evaluation. */ Such a report, which would be available for public distribution, would, in substance, contain the

*/ It should be emphasized that the proposed SAS does not require accountants to evaluate the overall system as a part of an audit of financial statements. Such an overall evaluation would be a distinct service for which the accountant would be engaged.

accountant's opinion as to whether or not there were any "material weaknesses" in the system of internal accounting control as of a specified date. "Material weakness" is defined as:

> A condition in which the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a specific control objective--that is, errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. A weakness is material if the condition results in more than a relatively low risk of such errors or irregularities in amounts that would be material in relation to financial statements.

The proposed SAS makes clear that the definition, and therefore the scope of the accountant's study and evaluation, covers each of the broad objectives of internal accounting control (which are included in the FCPA) and that the objective of preparation of reliable financial statements includes interim as well as annual financial statements.

However, in addition to the materiality limitation (which we agree with the ASB is necessary to limit costs if engagements of this kind are to be accepted on a voluntary basis) and the fact that the report would cover conditions existing as of a point in time, the accountant's opinion would depart from the FCPA in a potentially significant way: it goes beyond a standard of "reasonable assurance" (i.e., cost-effectiveness of controls).

A condition which "results in more than a relatively low risk of errors or irregularities in amounts that would be material in relation to financial statements" could, at least potentially, be one for which the costs of correction exceeded the benefits and, thus, not be a violation of the FCPA. The accountant, nevertheless, would report this as a "material weakness."

The ASB has taken this approach to remove the accountant from judging management's cost-benefit decisions on the basis of its belief that the highly subjective nature of such cost-benefit decisions could often put the accountant in a difficult position if he believed a material weakness existed but management maintained that correction was not cost-effective.

We understand the ASB's concern on this issue and we are not significantly troubled by the substance of the decision,

since it would result in no less, and potentially more, situations which will be reported as "material weaknesses" than would be the case if a cost-benefit criterion were used. However, we are concerned that this reporting structure may be viewed unfavorably by registrants and, therefore, result in less voluntary engagements of accountants to perform a study and evaluation of the overall system of internal accounting control and report publicly thereon. A better assessment of this may be made as a result of the comments on the proposed SAS, and we plan to monitor closely the comment process.

Reporting Based Solely on Audit of Financial Statements

The proposed SAS would not change the accountant's existing responsibilities, under SAS No. 20, to report to management and the board of directors or audit committee "material weaknesses" of which he is aware as a result of the audit. However, it would amend the definition of "material weakness," which is presently based on "reasonable assurance" to one based on "more than a relatively low risk." That is, for purposes of SAS No. 20, cost-benefit considerations would be similarly removed.

The ASB considered providing for public reporting of whether or not the accountant was aware of any material weaknesses as a result of the audit of financial statements. However, it concluded, and we concur, that such public reports could be potentially misleading since there may be significant differences, from audit to audit, in the extent of review and testing of internal accounting controls and it does not seem practicable to communicate the extent of such differences in a report. Therefore, the proposed SAS would prohibit public reporting based solely on the audit of financial statements.

Other than revising the definition of "material weakness" for purposes of SAS No. 20, as discussed above, the proposed SAS would not affect auditors' existing responsibilities under SAS No.'s 8, 17 and 20.