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SEC Considers 144A to be a Big Step

Whether or not Rule 144A proves to be a popular alternative to a public offering and listing of securities remains to be seen. It is clearly viewed by the SEC, however, as an important development in its efforts to ease the disclosure burden for foreign companies that desire to enter the U.S. capital markets.

SEC PROPOSED RULES ON REPORT OF MANAGEMENT RESPONSIBILITIES: REVIEW AND REACTION

By **Michael D. Akers, PhD, CMA, CPA,** ***Assistant Professor, Marquette University***

[***Editor's Note***: It has been over two years since the SEC proposed the rules discussed in the following article. As the author points out, this is not the first time the SEC has considered a representation on internal control. One of the more difficult aspects of such a requirement is the lack of a common reference point as to the effectiveness of an internal control system. A study is currently being conducted by Coopers & Lybrand sponsored by the Financial Executive Research Foundation (FERF) under the heading "Integrated Guidance on Internal Control" which is intended to establish such reference points. Although there is no direct linkage between the SEC proposal and the aforementioned study both eminate from recommendations by the Treadway Commission.]

In July 1988 the SEC issued for public comment proposed rules that would require registrants to include a management report in their Form 10K and annual reports. The proposal was issued in response to a recommendation that was made by the National Commission on Fraudulent Financial Reporting (Treadway Commission). The purpose of this Article is to examine the proposed rules and the comment letters that were received in response to those rules.

Historical Background

The current proposal is not the first attempt by the SEC to require a management report. On April 30, 1979 the SEC issued for public comment proposed rules that would have required managment to comment on internal accounting control in Forms 10-K and annual reports. The proposed rules required that management's statement on internal accounting control be examined and reported on by an independent accountant.

The 1979 SEC proposal was criticized because of the close correlation of management's representation on internal accounting control with the provisions of the Foreign Corrupt Practices Act (FCPA). Critics felt that such representation indicated compliance with FCPA and that the proposed rules were intended to identify violations of FCPA. The proposed independent accountant's involvement was criticized because of the additional costs involved. The proposed rules were later withdrawn because the SEC felt that the private sector had made significant efforts towards voluntary management reporting.

In October 1987 the Treadway Commission released its report. One of its recommendations was that all public companies be required to include a management report in their annual report. The SEC concluded that the recommendation had merit and issued the 1988 proposed rules.

Objective of Proposed Rules

The proposed rules identified the following major objectives:

1. Increase the investing publics awareness of management's current responsibilities and other information.
2. Improve the public's understanding of the respective roles of management and the independent accountant.
3. Heighten the awareness of senior management of its responsibilities for the company's financial information and internal control system.
4. Disclose managements' response to significant recommendations by its auditors since the response may provide useful information to investors.

Overview of Proposed Rules

Content of the Proposed Management Report. The SEC's proposed requirements set forth the following:

1. A description or statement of management's responsibilities for the preparation of the registrants' financial statements in accordance with GAAP, the determination of the estimates and judgments used therein, and the preparation of other financial information included in a document containing the registrant's financial statements.
2. A description or statement of management's responsibilities for establishing and maintaining a system of internal control directly related to, and designed to provide reasonable assurance as to the integrity and reliability of financial reporting.
3. An assessment of the effectiveness of the registrant's system of internal control that encompasses material matters, as of the registrant's most recent fiscal year end.
4. A statement as to how management has responded to significant recommendations concerning the system of internal control made by its internal auditors and independent accountants.
5. Other information by management that it considered appropriate.
6. The report would be signed by the registrant's principal executive officer or officers, principal financial officer or officers, and its controller or principal accounting officer.

Role of Independent Accountant. The proposed rules only require the independent accountant to read the management report and note any material inconsistencies between the information in the financial statements and the management report.

The SEC believes that compliance with SASs 55 and 60 along with other information obtained during the course of an audit engagement increases the likelihood that the auditor will detect a material misstatement in the management report on internal control. If a material inconsistency between the management report and the financial statements is noted, the proposal indicates that SAS 8 provides authoritative guidance inasmuch as it requires an auditor to take specified action in such instance.

Costs. The proposal points out that the costs of applying the proposed rules will be limited for both registrants and independent accountants. Since registrants are already responsible for establishing, documenting, and maintaining internal control systems, only incremental costs will be incurred as a result of the required representation. Since the independent accountant is not required to explicitly report thereon his costs will relate to the time to read and consider the management report.

Benefits. The intended primary benefits of the proposed rules are:

1. The management report should improve communications to financial statement users about the processes that surround the preparation and presentation of the financial statements.
2. The proposed rules would allow the auditor to make public significant concerns about the reported status of the registrant's internal control system.

Solicitation of Public Comment. The SEC invited comments on the proposed rules and specifically on the content of the proposed management report, the role of the independent accountant, the costs and benefits of the proposed rules, and a number of specific items. The cutoff date for the comment letters was October 24, 1988.

Comment Letters

Copies of the comment letters received by the SEC were obtained and analyzed. Seven important issues were identified during that analysis.

1. Support of the Basic Concept. Although investors and creditors have not demanded information regarding internal controls, the examination of the comment letters revealed that there was general support for the basic concept.

Further evidence of support of the basic concept is that approximately 40% of all 115 respondents were already including a management report on internal control in their annual report. Most of these companies, however, felt their current report achieved the objectives identified by the SEC and therefore opposed certain features of the proposal.

2. Assessment of the Effectiveness of the Internal Control Systems. Approximately 80% of the respondents that commented on this aspect of the proposal indicated that management should not be required to assess the effectiveness of the internal control system. The primary concern was that the proposal did not provide definite criteria to be used in the assessment. Consequently, the respondents felt that two possible outcomes could occur. First, the management report would not provide useful information to financial statement users because "boilerplate" comments would result. Second, the management report could actually be misleading or confusing since the financial statement users will not be aware of the criteria used.

3. Response to Significant Recommendations Made by Internal Auditors and Independent Accountants. This aspect of the proposed rules was commented on more than any other item. Approximately 90% of the respondents who commented on this issue indicated that management should not be required to respond to significant recommendations made by auditors. Three primary problems were noted with this aspect of the proposal.

First, the proposal does not contain a clear and concise definition of significant recommendations. Although the proposal pointed out that reportable conditions, as defined in SAS 60, should be considered significant recommendations, the respondents, noted that the determination of a reportable condition requires a subjective evaluation by the auditor.

Second, disclosure of responses to significant recommendations could actually mislead or confuse financial statement users. Consequently, the expectation gap would be widened. Third, disclosure of this information could inhibit dialogue between management, independent and internal auditors, and the audit committee.

4. Role of the Independent Accountant. While some respondents felt that the responsibilities of the independent accountant should be clearly defined, the majority indicated any expanded role of the independent accountant should be eliminated from the final requirements. The respondents felt that additional involvement was not cost-beneficial.

Although the proposal indicated that the independent accountant would not have to perform any additional procedures to corroborate the information in the management report, the majority of the respondents disagreed. Most of the respondents felt that SAS 8 was not appropriate and the additional procedures would have to be performed to determine if the information in the management report was materially inconsistent with the information in the financial statements. Such procedures would be necessary to minimize potential legal liability.

The respondents also indicated that compliance with SASs 55 and 60 might not provide sufficient evidence to determine if the management report contained a material misstatement of fact. Since adherence to SAS 55 and SAS 60 might not provide sufficient evidence to evaluate the management report, the respondents were concerned that financial statement users would incorrectly interpret the auditor's involvement or the degree of assurance. Consequently, the expectation gap could be widened.

5. Materiality. The majority of the respondents agreed with the SEC regarding the establishment of a materiality threshold. This finding is also consistent with the finding that the respondents felt that clear and concise criteria should be established.

6. Point-in-Time Reporting. The majority of the respondents noted that they supported the issuance of the report as a specified date, although limited justification provided for this position. It appears that the respondents support the SEC's rationale that point-in-time reporting enhances the likelihood that significant recommendations made by the auditors throughout the fiscal period will actually be implemented prior to year end.

Required Signatures. The majority of the respondents felt that the signature requirement was not necessary, because the individuals required to sign the management report also sign the Form 10K.

Conclusion

The results of the analysis of the comment letters received by the SEC show that there is support for the basic concept included in the proposal but that most respondents disagreed with certain of its aspects. Most of the objections to the proposed rules pertain to the assessment of the effectiveness of the internal control system, the identification of significant recommendations, and the role of the independent accountant. The SEC at this time has not issued the final requirements.

The delay in issuing such requirements may be an indication that the SEC is struggling with the issues addressed in the comment letters or that the SEC is waiting to see how the private sector will react to the proposed requirements. Notwithstanding a final ruling by the SEC, the increase in the number of firms presenting a management report, including a reference on internal control, indicates that the concept is here to stay. Ω