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THE AUDIT COMMITTEE AND THE INTERNAL AUDITOR: STRENGTHENING CORPORATE ACCOUNTABILITY

ADDRESS BY

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I am pleased to be a participant in this conference on the responsibilities of the internal auditor and the audit committee of the board of directors for assuring corporate accountability. Since the middle of this decade, when the first questionable payments cases were brought by the SEC, the Commission has increased its efforts to facilitate improvement in the means by which corporate officials are held answerable to shareholders for their conduct in managing, overseeing, and operating the corporation. The Commission has not only developed questionable payments enforcement cases and our voluntary program for the disclosure of questionable payments, but has also undertaken a reexamination of rules relating to shareholder communications, shareholder participation in the corporate electoral process and corporate governance generally, has engaged in rule-making to implement the Foreign Corrupt Practices Act of 1977, and has devoted more attention during the last several years to oversight of the public accounting profession.

Articles in the financial press continually highlight the importance of maintaining corporate accountability. Recently it was reported in the Wall Street Journal that under constant pressure to meet production goals some middle managers in major U. S. corporations have resorted, among other things, to misdating invoices, making payments to

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to be returned later in cash, and otherwise falsifying books and records. It was also reported that earlier this month, the former chief financial officer at Firestone Tire and Rubber Co. was paroled from prison after serving 16 months of a four-year sentence for fraud. You may recall that this official pleaded guilty in 1978 to five counts of wire and mail fraud in connection with the misappropriation of $493,000 in company funds. This was achieved by mingling the officer's personal funds with corporate political funds.

Practices such as these undermine our free enterprise capital market system, because if shareholders cannot trust management to properly use and report on corporate assets they will choose alternative investment vehicles. It is the responsibility of the Securities and Exchange Commission, independent accountants, and corporate officials, including directors and internal auditors, to attempt to address and resolve these problems.

The Securities and Exchange Commission administers statutes requiring that public corporations keep appropriate books and records, maintain necessary internal controls, and properly disclose their operations and financial condition to shareholders and the public. The Commission has no special expertise, however, with respect to decisions dealing with day-to-day procedures, meetings, allocation of responsibilities and other questions of implementation that have been suggested for discussion by auditors and directors attending this conference. In my opinion, it should be left to the participants in the process to develop the internal relationships and operations best suited to their particular circumstances, and we at the Commission should limit our involvement to assuring that corporate responsibilities under the federal securities laws are fulfilled.

I would like to focus my remarks this evening on the accounting provisions of the Foreign Corrupt Practices Act of 1977 ("FCPA"). These provisions, which are Section 13(b)(2) of the Securities Exchange Act of 1934, require publicly held companies to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;" and to " devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances . . . " that management is in control of corporate operations, that corporate records permit the proper preparation of financial reports and properly account for corporate assets, and that access to assets is only as authorized by management. Section 13(b)(2) deals with matters essential to the maintenance of corporate accountability and for which both the audit committee of the board of directors and the internal auditor have significant responsibilities.

For a number of years the Commission has stressed the importance of the audit committee as a monitor of management and as an authority higher than management with whom the independent auditor can discuss the terms of the engagement and the results of the audit. It is entirely consonant with these duties that audit committees undertake to review the adequacy of their corporation's compliance with the internal control and books and records provisions of the FCPA.

Similarly, the Standards for the Professional Practice of Internal Auditing ("the IIA Standards"), promulgated by the Institute of Internal Auditors, identify the scope of the internal audit as encompassing an independent and objective examination of the adequacy and effectiveness of the organization's system of internal controls and the quality of performance in carrying out assigned responsibilities. It is fair to say that the IIA Standards give the internal auditor a critical role in assuring a firm's compliance with Section 13(b)(2).

There appears to be some confusion, however, as to exactly what responsibilities these accounting provisions impose on the managers, internal auditors, and audit committees of publicly held corporations. In addition, there is a high degree of concern in the business community as to how the Commission is going to enforce the accounting provisions and the extent to which the Commission will implement the statute through rule-making. Because I was involved in proposing that these provisions be included in legislation, and because the Commission is responsible for their administration, perhaps I can help provide some clarification regarding the Commission's interpretation of the Act and how we intend to administer the accounting provisions. Although I can only give you the views of one Commissioner, I hope that you will conclude that the Commission intends to act in a reasonable and judicious way and that we are not trying to undermine or disrupt business operations but are attempting to assist the corporate system to function better.

The impetus for enactment of this statute was the misuse of corporate assets revealed through the corporate questionable payments cases. In response to those cases, the Commission issued a "Report on Questionable and Illegal Corporate Payments and Practices," recommending legislation to the Senate Committee on Banking, Housing and Urban Affairs. Our report stated that "the almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which had been designed to assure that there is proper accounting of the use of corporate funds and that documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts."[1/]

Two of the primary elements of this problem which the statute was enacted to address were a lack of adequate internal controls, and a failure to keep adequate books and records. As the Report accompanying the Senate bill stated:

> The establishment and maintenance of a system of internal controls and accurate books and records are fundamental responsibilities of management. The expected benefits to be derived from the conscientious discharge of these

> responsibilities are of basic importance to investors and the maintenance of the integrity of our capital market system. 2/

It is essential to understand that the accounting provisions of the FCPA are intended to address both disclosure deficiencies and the failure to safeguard and properly account for the use of corporate assets. Some of the commentary on the Act focuses only on disclosure deficiencies and the result is an overly narrow interpretation of the application of Section 13(b)(2).

I can illustate my point by turning to a specific provision. Section 13(b)(2)(A) requires companies to "make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." I have read one interpretation which suggests that authoritative auditing and accounting literature provides the reference for determining compliance with this provision and that books and records need be accurate only to the extent necessary to prepare financial statements in accordance with generally accepted accounting principles. 3/ Such an interpretation overlooks a major purpose of this provision.

I think it is clear that Congress was concerned not only about the preparation of financial statements to be included in disclosure documents for investors, but also about appropriate corporate accountability for assets and Congress believed that such accountability would require that the books and records provision cover a broader range of documentation than that used for the preparation of financial statements. Among other things, the books and records provision was intended to address the off-the-books or disguised slush fund. Under the narrow view such a fund arguably would not have to be recorded accurately if the record was not necessary for the preparation of financial statements. This is plainly inconsistent with the Act. A reporting company may have books and records concerning the safeguarding of assets or the execution of transactions that are subject to Section 13(b)(2) but which are not ultimately used in the process of preparing or auditing financial statements.

For example, Section 320.37, of Statement of Auditing Standards No. 1, provides that "reasonable assurance that * * * transactions are executed in accordance with management's general or specific authorization" requires that there be "independent evidence that authorizations are issued by persons acting within the scope of their authority and that transactions conform to the terms of the authorizations." Additional records which might be required could include memoranda from senior officials to subordinates reflecting management's authorization for employees to effect transactions on behalf of the corporation or to have access to specified assets.

The concern for corporate accountability was also the basis for the Congressional decision that there be no materiality standard in the recordkeeping provision of the statute, even though some who testified on the bill urged that such a standard be included. A materiality standard would imply that some corporate assets could appropriately be outside the accountability framework. This would be inconsistent with the principle incorporated in the Act that all of the funds belonging to the corporation and thus to its shareholders, must be within the system of financial accountability.

It should not be concluded, however, that because there is not a materiality standard, the Act requires absolute completeness and accuracy. Congress included the "in reasonable detail" language so that management could exercise its judgment as to the degree of detail and accuracy required by the Act. In this regard, the Conference Committee expressed its intention "that the issuer's records should reflect transactions in conformity with accepted methods of recording economic events."[4/] Moreover, the Senate Report indicates that "standards of reasonableness must apply".[5/]

Thus, you and your corporate associates are responsible to determine the appropriate detail in a given set of circumstances. Those decisions, however, must result in documentation which presents a reliable, accurate presentation of the maintenance of accountability for assets as required by the Act. Obviously it would be inconsistent to record an illegal payment or a bribe in such a manner that an auditor or a director could not so identify it.

Compliance with the books and records provision is an integral part of the implementation and maintenance of an effective system of internal accounting controls which is required by the second of the accounting provisions of the FCPA, Section 13(b)(2)(B). As an article last spring in the New York Times stated, this section is:

> aimed at management, boards of directors and audit committees. Its aim, much broader than the integrity of financial statements, is to insure a responsible level of corporate governance and an effective discharge of managements' stewardship responsibility. This requires a more intensive study of internal controls and a far greater involvement by management in order to establish that a system of internal control exists, that it is well documented, that it is adequately maintained and regularly reviewed and modified to meet changing requirements. 6/

The section itself does not specify the particular controls which must be adopted. That is left to the firm to determine. The legislative history suggests that the size of the business, the diversity of operations, and the degree of centralization of management are among the factors which must be considered in establishing a control system.

In structuring compliance with Section 13(b)(2)(B), it is important to note that although the statutory requirements were taken from Statement of Auditing Standards No. 1, existing auditing literature is not the sole determinant of compliance with the statute. The auditing literature only requires the independent accountant to evaluate the system of internal controls as a basis for setting the scope of the audit. This is more limited than an evaluation to provide "reasonable assurance" of an adequate system of internal controls to assure corporate accountability. The evaluation must be directed at achieving each of the statutory objectives, not just the preparation of financial statements.

It should be remembered also that Section 13(b)(2)(B) is not limited by the concept of materiality. It has been suggested by some commentators that the system of internal controls must only be adequate to protect against material irregularities or errors. The Act and its legislative history make clear that this is not the case. The Act defines the objectives which must be met in terms of "reasonable assurances," not in terms of materiality. Again, Congress was attempting to provide for appropriate safeguarding of assets which necessarily encompasses amounts which the accounting literature may not characterize as material with respect to financial statements.

This does not mean that accountability must be maintained down to the last penny. The Act requires "reasonable assurances," in recognition that a standard of reasonableness must apply and that a cost-benefit analysis is appropriate. In our release proposing a management report on internal controls the Commission stated that "reasonable assurance will necessarily depend in part on estimates and judgments by management which . . . [must be] reasonable under the circumstances."

In determining whether a system does provide such reasonable assurances it may be helpful to look at our April release proposing a management report on internal controls, Securities Exchange Act Release No. 15772. In that release we identified some conceptual elements which should be part of an evaluation of internal control systems:

> First, evaluation of the overall control environment;
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> Second, translation of the broad objectives of internal accounting control into specific control objectives applicable to the particular business, organizational and other characteristics of the individual company;
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> Third, consideration of the specific control procedures and individual environmental factors which should contribute to achievement of the specific control objectives;
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> Fourth, monitoring of control procedures and consideration of whether they are functioning as intended; and
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> Finally, consideration of the benefits (consisting of reductions in the risk of failing to achieve the objectives) and costs of additional or alternative controls.

We also suggested that documentation is a critical aspect of the evaluation of internal accounting control. This encompasses not only written policies and procedures, formalized reporting responsibilities, specified control objectives, and results of tests of the systems, but also a record of the basis upon which management concluded that it has "reasonable assurances."

Finally, we stressed the importance of viewing the internal controls system as dynamic, and thus requiring ongoing reevaluations and monitoring. In determing the need to take enforcement action pursuant to this provision, one of the factors the Commission will consider is the nature of the weaknesses and the efforts undertaken to identify and correct such weaknesses.

I can understand the concern that exists within the business community about structuring compliance, because the Commission and its staff are also searching for the best method to implement these provisions. As I have indicated, last April the Commission proposed for comment a requirement that management report on internal controls. We proposed that initially commencing as of dates after December 15, 1979, management report its opinion as to whether as of the date of the balance sheet, the systems of internal accounting control of the registrant and its subsidiaries provided reasonable assurances that specified objectives of internal accounting control were achieved. We also proposed that management describe any material weaknesses in internal accounting control communicated by the independent accountants which had not been corrected, and provide a statement of reasons why not.

In the second stage, which would be for periods ending after December 15, 1980, the management report would have been required to include management's opinion as to whether <u>during such periods</u> (as opposed to as of the date of the balance sheet) the internal control system provided reasonable assurances that the specified objectives of internal control were achieved and the management statement would have had to be examined and reported on by an independent public accountant.

The Commission received over 900 letters of comment on the proposals. Although some commentators supported the concept of a required management report, most commentators criticized the proposals on a number of grounds. The most controversial aspect of the proposals was the correlation of the requirements of the proposed report with the provisions of the FCPA. Commentators argued that the proposals, as drafted, required a statement of compliance with the law. The proposals were also criticized, even by most commentators who supported a Commission requirement for a management statement, for requiring disclosure of weaknesses in internal control which had been corrected and for not being limited to material information. There was also almost unanimous opposition to the requirement that independent accountants examine and report on the statement of management. More than 500 respondents argued that the costs of such a requirement would substantially outweigh the benefits because a duplicative review of management's controls would be costly and would not add significantly to the auditor's knowledge of the systems of internal controls based on existing responsibilities under Statements of Auditing Standards Nos. 8 and 20. The cost estimates with respect to the proposed examination and report varied substantially--ranging from one percent of the current audit fee to three times the audit fee, with an average falling within the range of 5 to 25 percent of the current audit fee. Finally, many commentators suggested that the Commission wait until the profession develops standards, an undertaking that has already been accepted by the AICPA's Auditing Standards Board.

The overwhelming opposition to our proposals has triggered a reevaluation at both the staff and Commission level as to what form reporting requirements should take.

The Commission's April rule proposal was intended to carry forward the work of the Cohen Commission, the Financial Executives Institute and the Special Advisory Committee on Reports by Management of the American Institute of Certified Public Accountants, all of which endorsed the concept of a management report to shareholders assessing, among other things, the company's internal control system. The Cohen Comission also stated that the independent auditor "should report on whether he agrees with management's description of the company's accounting controls and should describe material uncorrected weaknesses not disclosed in that report."[7/] These were thought to be valuable disclosures to financial statement users. We viewed our proposal as implementing these recommendations, and not in any way as a report on the extent of compliance with the FCPA. In fact, our proposal was an effort to give management flexibility in complying with the Act.

Initially, there was consideration given to adopting internal control standards but this was rejected as being too rigid and not practicable. The management report appeared to represent a more moderate disclosure approach that would give investors meaningful information upon which to base an evaluation of the internal controls in their company. In view of the negative commentary on the proposal, however, I am confident that the Commission will not adopt the rule as proposed. Although we have not yet received a recommendation from the staff, there are several alternatives under consideration.

First, it is possible, although not likely, that we will withdraw the rule and do nothing at this time. Over 250 commentators suggested that because voluntary initiatives in the private sector have been substantial since the enactment of the FCPA, the private sector should be given time to experiment and develop a meaningful management report on internal controls. We could follow this recommendation.

We could also consider whether to adopt a rule for a temporary period of time in order to maintain some momentum toward the development of more comprehensive reporting requirements on internal controls, while giving the Commission time to evaluate what an appropriate next step should be. This proposal would require that management disclose significant efforts, if any, that the company has made during the past year to enhance the effectiveness of its system of internal controls. Some staff members believe that such a requirement might give shareholders a sense of what companies are, or are not, doing in response to the FCPA, and would recognize that compliance with the Act includes an on-going monitoring process to reflect the dynamic nature of internal controls. As currently being considered, this alternative would not require management to express an opinion as to whether its system of internal accounting controls complies with standards of the Act, although such an assessment might be encouraged on a voluntary basis.

I also expect to see a change in the proposed nature of the independent accountant's involvement with the management report. Alternatives being considered, include dropping this aspect altogether or providing for more limited auditor participation than originally proposed. For example, some staff members are considering recommending to the Commission that the independent auditor be required to give a brief report on whether in the course of his audit, anything came to his attention that was inconsistent with management's report. Under this approach the auditor would not need to extend the scope of his audit.

Other staff members have tentatively concluded that the Commission should adopt a requirement providing for full auditor review of the system of internal accounting controls and report the auditor's opinion as to its adequacy and whether it is being properly implemented. Such a report would not be required for several years in order to give reporting companies additional time to design and implement their control systems.

As you can see, a number of alternatives are being considered and although I have discussed the subject with the Chief Accountant and senior members of interested divisions, before finally determining which alternative I will support, I would like to get the final staff recommendations and discuss them with my fellow commissioners.

I can tell you, however, that no matter what we do with the April proposals, the Commission will be revisiting the subject of the management report on internal controls as experience in implementing and maintaining such systems is gained, as the AICPA's Auditing Standards Board develops standards for reports on internal accounting controls, and as we see from our monitoring of progress in this area whether more rigorous requirements are appropriate.

Secondly, I do not expect to see a positive response in any Commission action at this time to the recommendation of some 349 commentators that a materiality standard should be incorporated into the rule proposal for disclosure purposes. Congress determined not to include the materiality concept in the FCPA, and for the Commission to engraft it now through a management report requirement could obfuscate that point. Moreover, it might lessen the sensitivity of all of us to what the Act requires.

Finally, with regard to the date any action we might take would become effective, the Commission realizes that it is getting late in the year to adopt a requirement that would be effective for reports covering fiscal years ending next month. In fairness, we must give companies enough lead time to comply with whatever rule we adopt. Therefore, I do not expect any rule to be effective before early next year.

In conclusion, I would emphasize that all members of the Commission are committed to a judicious use of the authority granted to us by the Foreign Corrupt Practices Act. This applies not just to our management report proposals and other rule-making activities pursuant to Section 13(b)(2) but also to the actions we bring to enforce the accounting provisions. Although Section 13(b)(2) has been in effect for almost two years, the Commission has filed only four complaints alleging its violations and I believe that anyone who objectively reads the complaints for those cases would agree that the Commission had a sound basis for bringing them.

Perhaps some of the concern over the accounting provisions of the Act could be alleviated if the Commission provided more guidance as to its interpretation of what compliance with the Act requires. In this regard, I have strongly supported the issuance of either a release by the Commission or by our top legal staff providing an interpretation and such a release is being seriously considered.

I am sure that the management of many corporations is just as interested as the SEC is in developing and maintaining internal controls adequate to assure that corporate operations are in accordance with management authorization and policies, that corporate records are such that financial statements may be properly prepared, and that accountability for assets is maintained. Indeed, I believe that many corporations were in compliance with Section 13(b)(2) long before it was enacted. To operate a public corporation on any other basis is irresponsible.

FOOTNOTES

1/Senate Committee on Banking, Housing and Urban Affairs, Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, 95th Cong., 1st Sess. at a (1976).

2/S. Rep. No. 95-114, 95th Cong., 1st Sess. (1977).

3/See, "A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934," 34 Bus. Law. 307, 313 (1978).

4/H.R. Rep. No. 95-831, 95th Cong., 1st Sess. 10 (1977).

5/S. Rep. 95-114, supra, note 2, at 8.

6/Schiff & Sorter, "An Accountant Is Not a Chairman," New York Times (April 1, 1979).

7/The Commission on Auditors' Responsibilities, Report, Conclusions and Recommendations 62 (1978)