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THE SEC AND THE INTERNAL AUDITOR

BY

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I am glad to have the opportunity to participate in this conference on the relationship between the internal auditor, the audit committee of the board of directors and the place of both in furthering corporate accountability.

In the aftermath of Watergate, investigations revealed a very disturbing pattern of misuse of corporate funds for improper or illegal purposes. The Commission initially became involved in this inquiry as a result of its responsibility for corporate disclosure, since these practices, by their very nature, were carefully concealed. As the Commission's enforcement effort, including its program for the voluntary disclosure of questionable or improper payments, developed, we found that at least questionable payments were far more widespread than we had expected. This raised a more fundamental question than the mere existence of improper payments, and that was whether there was a breakdown in corporate accountability, or at least a need to strengthen the procedures for maintaining corporate accountability. The Congress reacted to this concern in the Foreign Corrupt Practices Act of 1977. That statute not only prohibited bribery of foreign officials but also, in new Section 13(b)(2) of the Securities Exchange Act, sought to improve corporate accountability by requiring accurate books and records and a system of internal accounting controls adequate to accomplish specified objectives.

The Commission similarily concluded that it should respond in a broader way than simply bringing enforcement cases. Our staff undertook to reexamine our rules relating to shareholder communications, shareholder participation in the corporate electoral process and corporate governance generally. The results of this examination are contained in the Staff Report on Corporate Accountability which was published by the Senate Committee on Banking, Housing and Urban Affairs in September of this year.

Before attempting to explain what all this has to do with accounting and with the internal auditor, I would like to dispel a perhaps understandable misapprehension as to what the Commission is trying to do and why it is doing it. When the Commission talks about corporate governance, there is a reaction by some in the business community that this is none of the Commission's business, and in the abstract there is something to that. The Commission does not have or claim authority over corporate structure and organization generally. Members of the Commission, like other citizens, may have and express ideas as to how that structure could be improved but

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the Commission is not seeking to regulate corporate structure, except perhaps, with respect to the need for audit committees, which is a matter closely related to our responsibilities in the area of accounting, auditing and internal controls.

But the Commission does have authority, and consequently, responsibility, with respect to some aspects of corporate accountability. The developments I have just referred to have brought these into clearer focus. The Staff Report placed emphasis on the broad rulemaking power of the Commission in the area of proxy solicitation, shareholder voting, tender offers, and institutional investment. In these areas Sections 13 and 14 of the Exchange Act provide that certain activities must be conducted "in accordance with such rules as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." This broad standard is also in various other provisions of the Act.

The Commission, in addition, has certain authority and responsibility with respect to accounting and auditing, which authority was supplemented by the Foreign Corrupt Practices Act which I mentioned. It seems fairly clear that the preparation and distribution of audited financial statements, as well as record keeping and internal controls, are a major aspect of corporate accountability, and as the Metcalf subcommittee of the Senate noted, internal auditors working within corporations "can serve an important function in promoting corporate accountability, as well as efficiency."

Today, I would like to focus on two areas in which I believe the audit committee and the internal auditor should work particularly closely. But before we look at those areas, it is necessary to examine the framework in which these two functions - the audit committee and the internal auditor - operate.

I believe there are two particular ground rules which should be established before one can look at specific responsibilities. First, the audit committee must be made up of independent outside directors. Reporting by internal auditors to a board, or a committee of the board, made up of corporate managers wearing their director's hats does little to strengthen the independence of the internal audit staff. The heightened sense of public responsibility which an independent audit committee brings to the corporate governance process also helps insure that skills of an internal auditor are brought to bear on those problems in which the owners of the business - the public shareholders - have the greatest interest.

Second, the director of internal auditing must be primarily responsible to someone in management with sufficient authority not only to provide independence, but also to insure that cooperation is accorded to the internal audit staff by all elements of the organization subject to audit. The appropriate executive to oversee the work of the internal audit staff will vary from company to company, but should not, except under unusual organizational circumstances, be the chief financial officer or chief accounting officer. It should, nevertheless, be an executive at a level high enough in top management to minimize the risk of pressure to prevent issuance of even the most critical report or to impede access to the board. His authority should also be sufficient so that reports of the internal auditors are accorded appropriate attention by those in a position to take action on their recommendations.

Now that audit committees have become commonplace and have taken on a wider range of functions, the audit committee needs assistance in discharging their oversight functions. Internal auditors can fulfill a vital role in helping to establish and monitor internal control systems, and in providing an independent source of information which audit committees can use in performing their functions.

In aiding the audit committees, it is important that the internal audit director have the ability -- and wherever possible the responsibility -- to communicate directly with the audit committee. Although internal auditors can and should serve management, their vitality and initiative should not be stifled by limitations on access to the audit committee or the full board. In fact, the internal auditors should have a direct reporting relationship with the audit committee, an organizational step that several large companies have successfully taken.

Several responsible organizations, including the AICPA's Cohen Commission, have strongly suggested that the public interest would be served by a requirement for corporate reporting on the adequacy of internal control. Commentators have made various suggestions for implementing these recommendations, such as reports issued by the audit committee, the chief financial officer or the director of internal auditing.

As many of you are aware, in April of 1979 the Commission proposed rules which would have required inclusion of a statement of management on internal accounting control in annual reports. In May of this year, this proposal was withdrawn. 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 Commission intends to give further consideration to rule proposals concerning management reports, and auditor association with them, based upon three years' experience. The Commission intends to continue a monitoring program through the spring of 1982. As a part of that program, the Commission will monitor carefully private-sector initiatives in this area, as well as issuer practice in voluntarily providing management statements on internal accounting control and in engaging independent accountants to report on such statements. Although particular emphasis will be given to management statements on systems of internal accounting control, the Commission will also monitor efforts to implement the broader recommendations of the Commission on Auditors' Responsibilities concerning comprehensive management reports.

Internal accounting control is an area where the depth and breadth of knowledge of the internal auditor should be rivaled by no one, inside or outside the company. Those aspects of internal control which are related to the safeguarding of assets and to the execution of transactions in accordance with management's directives are, it seems to me, areas which internal auditors are particularly well equipped to address. In addition to his on-going role as a monitor of the system, the internal auditor should be called upon to evaluate that system and to make recommendations for modifications and improvements.

Every system of internal control is, of course, subject to the vagaries of human behavior. That is why I believe that a necessary complement to an adequate internal control system is a corporate code of conduct which provides officers and employees with reasonable guidance as to the types of behavior which are considered acceptable in connection with business dealings on behalf of the corporation.

The corporate conduct code should be an important consideration in setting the scope of internal audit. I believe there are two factors which are critical in assuring that such codes serve their intended purposes.

First, top management and the audit committee should insist that employees in responsible positions confirm annually their compliance with the corporation's code of conduct. That affirmation should be in writing and the internal audit staff should review the responses and make any follow-up inquiries which appear to be appropriate. Internal audit should report its findings to the audit committee.

Second, internal auditors should be sensitive to the possible risks of circumvention of the internal control system and should design reasonable and appropriate audit tests to help identify such instances.

Both of these steps should be a part of the routine tasks of the internal audit department in monitoring compliance with the code and in reporting to the audit committee concerning the results of that monitoring process.