

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
(202) 272-2650

FOR RELEASE: 10:00 A.M., WEDNESDAY, MAY 28, 1980

OPENING STATEMENT OF THE

HONORABLE HAROLD M. WILLIAMS, CHAIRMAN
SECURITIES AND EXCHANGE COMMISSION

AT THE

COMMISSION'S CONSIDERATION OF PROPOSED RULES TO
REQUIRE A MANAGEMENT STATEMENT ON INTERNAL ACCOUNTING CONTROL

ANNOUNCED IN

SECURITIES EXCHANGE ACT RELEASE NO. 15772, APRIL 30, 1979

WASHINGTON, D. C.
MAY 28, 1980

THE COMMISSION WILL CONSIDER THIS MORNING WHAT FURTHER ACTION TO TAKE WITH RESPECT TO THE RULE PROPOSALS WHICH IT PUBLISHED LAST SPRING TO REQUIRE THAT ISSUERS PREPARE AND FILE WITH THE COMMISSION MANAGEMENT STATEMENTS CONCERNING INTERNAL ACCOUNTING CONTROL. THESE PROPOSALS, WHICH RESPOND IN PART TO THE ACCOUNTING PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT, HAVE GENERATED EXTENSIVE COMMENT. THE DIFFICULT AND FAR-REACHING QUESTIONS RAISED HAVE NECESSITATED AN EXTENDED PERIOD OF STAFF ANALYSIS.

THE STAFF IS NOW RECOMMENDING THAT THE COMMISSION WITHDRAW THE PENDING RULE PROPOSALS AND LOOK INSTEAD TO THE CORPORATE COMMUNITY AND ACCOUNTING PROFESSION VOLUNTARILY TO DEVELOP MANAGEMENT REPORTING AND AUDITOR REVIEW TECHNIQUES IN THIS AREA. UNDER THE STAFF'S RECOMMENDATION, THE COMMISSION WOULD CONTINUE TO MONITOR PRIVATE SECTOR INITIATIVES AND, ASSUMING THAT CONSTRUCTIVE PROGRESS IS MADE IN THE INTERIM, FURTHER CONSIDER THE NEED FOR RULEMAKING CONCERNING MANAGEMENT REPORTS ON INTERNAL CONTROL, AND AUDITOR ASSOCIATION WITH THOSE REPORTS, IN THREE YEARS.

I AM PLEASED WITH THE RESPONSIVENESS OF THE PRIVATE SECTOR IN THIS AREA,
AND, BASED ON THE EXISTING INITIATIVES, I AM PREPARED TO SUPPORT THE STAFF'S
RECOMMENDATION. MUCH THOUGHTFUL AND CONSTRUCTIVE ACTIVITY HAS TAKEN PLACE
IN RESPONSE TO THE ACT ON THE PART OF COMPANIES, THE ACCOUNTING PROFESSION, AND
ACADEMICIANS. A NUMBER OF FINE ARTICLES HAVE BEEN WRITTEN ABOUT COMPLIANCE.
AT THE SAME TIME, A CERTAIN AMOUNT OF SENSATIONALISM HAS OCCURRED ON THE PART
OF THOSE WHO WOULD RATHER IMAGINE DANGERS IN THE DARK THAN RESPOND TO
REALITY IN THE LIGHT.

BECAUSE THE ACCOUNTING PROVISIONS AND THE COMMISSION'S IMPLEMENTATION
OF THEM RAISE SIGNIFICANT LEGAL AND POLICY ISSUES CONCERNING THE INTERPLAY
BETWEEN FEDERAL LAW AND THE MANAGEMENT AND CONTROL OF PUBLIC CORPORATIONS,
I WANT TO PREFACE OUR DISCUSSION OF THE RULE PROPOSALS WITH A PERSPECTIVE ON
THIS NEW STATUTORY REQUIREMENT. IN MY VIEW, THE ACT EMBODIES ACCOUNTABILITY
PRINCIPLES WHICH ARE CRUCIAL TO EFFECTIVE MANAGEMENT OF A BUSINESS ENTERPRISE.
IF THE ACCOUNTING PROVISIONS ARE APPROACHED WITH THAT POINT IN MIND, THEY WILL
CONSTITUTE A MAJOR CONTRIBUTION TO STRENGTHENING BOTH CORPORATE MANAGEMENT

AND PUBLIC CONFIDENCE IN THE INTEGRITY OF CORPORATE RECORDKEEPING AND CONTROL.

SECTION 13(B)(2) OF THE SECURITIES EXCHANGE ACT OF 1934 IS THE ONLY COMPONENT OF THE FEDERAL SECURITIES LAWS WHICH SPEAKS DIRECTLY TO INTERNAL CORPORATE PRACTICES UNRELATED TO DISCLOSURE AND TRADING IN SECURITIES. IT REQUIRES PUBLIC COMPANIES TO MAKE AND KEEP ACCURATE BOOKS AND RECORDS AND TO DEVISE AND MAINTAIN A SYSTEM OF INTERNAL ACCOUNTING CONTROLS SUFFICIENT TO PROVIDE REASONABLE ASSURANCES THAT ASSETS ARE SAFEGUARDED FROM UNAUTHORIZED USE, THAT CORPORATE TRANSACTIONS CONFORM TO MANAGERIAL AUTHORIZATION, AND THAT CORPORATE RECORDS PERMIT THE PREPARATION OF FINANCIAL STATEMENTS IN ACCORD WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES. THE IMPLICATIONS OF A FEDERAL STATUTORY MANDATE OF THIS NATURE ARE COMPLEX. FROM A MANAGEMENT STANDPOINT, HOWEVER, THE LAW SIMPLY RECITES A BUSINESS TRUISM. OBVIOUSLY, IT WOULD BE IMPOSSIBLE TO CONDUCT AN ENTERPRISE OF ANY SIZE WITHOUT KEEPING REASONABLY ACCURATE RECORDS, AND WITHOUT MAKING PROVISIONS TO ENSURE THAT ASSETS ARE NOT MISAPPROPRIATED AND THAT THE VENTURE OPERATES IN

ACCORDANCE WITH MANAGEMENT'S INSTRUCTIONS. FOR THAT REASON, INTERNAL ACCOUNTING CONTROLS ARE THE BEDROCK ELEMENT OF AN EFFECTIVE MANAGEMENT SYSTEM. MOREOVER, INTERNAL ACCOUNTING CONTROLS ARE ESSENTIAL TO THE ACCURACY OF FINANCIAL AND OPERATING DATA ON WHICH THE COMPANY RELIES IN DISCHARGING ITS REPORTING OBLIGATIONS UNDER THE FEDERAL SECURITIES LAWS AND ENGAGING IN INFORMED INTERNAL DECISION-MAKING.

WHILE CONTROLS ARE A BASIC BUSINESS TOOL, THE ENACTMENT OF THE ACCOUNTING PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT SHOULD HAVE SEVERAL IMPORTANT EFFECTS ON THE MANAGEMENT OF PUBLIC CORPORATIONS. FIRST, THE STATUTE PROVIDES AN INCENTIVE FOR MANAGEMENT TO REVIEW SYSTEMATICALLY THE CONTROL PROCEDURES BY WHICH IT AND THE BOARD ENSURE THAT CORPORATE ASSETS ARE EXPENDED IN CONFORMITY WITH THE POLICIES WHICH TOP MANAGEMENT AND DIRECTORS HAVE PROMULGATED AND THAT CORPORATE RECORDS ACCURATELY REFLECT CORPORATE ACTIVITIES. SYSTEMATIC EVALUATIONS OF THE ADEQUACY OF INTERNAL ACCOUNTING CONTROLS HAVE NOT BEEN TRADITIONAL, AND STANDARDS OF REASONABLENESS MUST, OF COURSE, GOVERN. HOWEVER, THE IDEA THAT BUSINESS

VENTURES FUNDED BY THE INVESTING PUBLIC SHOULD, IN THE EXERCISE OF GOOD JUDGMENT, EVALUATE THE EFFECTIVENESS OF CONTROL MECHANISMS -- AS A MATTER OF EFFECTIVE MANAGEMENT, LET ALONE LEGAL REQUIREMENT -- HARDLY SEEMS RADICAL.

SECOND, THE ACCOUNTING PROVISIONS SHOULD ENCOURAGE MANAGEMENT TO ANALYZE THE INSTITUTIONAL DYNAMICS WITHIN WHICH THE ISSUER'S RECORDKEEPING AND INTERNAL CONTROL MECHANISMS OPERATE. THE KEY IS AN APPROACH ON THE PART OF TOP MANAGEMENT WHICH MAKES CLEAR WHAT CONDUCT IS EXPECTED OF CORPORATE EMPLOYEES AND THAT CONFORMITY TO THOSE EXPECTATIONS WILL BE REWARDED WHILE BREACHES WILL BE PUNISHED. THE DEVELOPMENT OF THIS KIND OF A POSITIVE "CONTROL ENVIRONMENT" IS PERHAPS THE SINGLE MOST IMPORTANT STEP WHICH CAN BE TAKEN TO PREVENT THE ABUSES WHICH MOTIVATED CONGRESS IN ENACTING THE LEGISLATION.

THIRD, THE ACCOUNTING PROVISIONS SHOULD ENCOURAGE MANAGEMENT TO DOCUMENT ITS CONTROL SYSTEM AND ITS REVIEW OF THAT SYSTEM. WITHOUT THE DISCIPLINE OF DOCUMENTATION, IT IS DIFFICULT TO UNDERSTAND HOW ANY MANAGEMENT COULD SATISFACTORILY ASSESS, LET ALONE DEMONSTRATE, ITS COMPLIANCE. YET, SYSTEM ADEQUACY WILL TYPICALLY BECOME A LEGAL ISSUE ONLY AFTER THERE HAS BEEN

A SYSTEM FAILURE. THE ABILITY TO SHOW THAT THE BREAKDOWN IS AN ISOLATED LAPSE IN AN EFFECTIVE CONTROL SYSTEM -- RATHER THAN EVIDENCE OF MANAGEMENT'S FAILURE TO MAINTAIN AN ADEQUATE SYSTEM -- WILL, IN MY JUDGMENT, BE INFLUENCED STRONGLY BY THE QUALITY OF THE PRE-EXISTING DOCUMENTATION.

THIS PROCESS OF REVIEWING, AND, IF NECESSARY, STRENGTHENING CONTROLS WILL ALMOST NECESSARILY INVOLVE THE PARTICIPATION OF THE OUTSIDE AUDITOR AND OF AN EFFECTIVE, INDEPENDENT AUDIT COMMITTEE. IF MANAGERMENTS, BOARDS, AND AUDITORS DISCHARGE THEIR RESPONSIBILITIES DILIGENTLY AND IN GOOD FAITH, IT WILL ENABLE THE CORPORATION AND THE BUSINESS COMMUNITY TO SEPARATE MORE CLEARLY THOSE INCIDENTS WHICH REFLECT UPON THE ACCOUNTABILITY ETHIC AND THE MORALITY OF THE PRIVATE SECTOR FROM MORE ISOLATED INSTANCES OF SYSTEM SUBVERSION OR HUMAN FRAILTY. FURTHER, THE STRENGTHENING OF CONTROLS WILL MEAN THAT THE TYPE OF QUESTIONABLE CORPORATE CONDUCT WHICH PERIODICALLY FUELS THE MOVEMENT FOR DIRECT FEDERAL LEGISLATION AFFECTING CORPORATE DECISION-MAKING WILL BE LESS LIKELY TO RECUR.

THESE THREE STEPS -- A REVIEW AND STRENGTHENING OF CONTROLS, THE FOSTERING OF A POSITIVE CONTROL ENVIRONMENT, AND SYSTEM DOCUMENTATION -- ARE THE ESSENCE OF COMPLIANCE WITH SECTION 13(B)(2). THEY WOULD ALSO, IN MY JUDGMENT, BE THE ESSENCE OF A MANAGEMENT REPORTING PROCESS, AND IT WAS IN THIS CONTEXT WHICH THE COMMISSION PROPOSED THE PENDING RULES. THE COMMISSION'S OBJECTIVE WAS NOT -- CONTRARY TO THE SUGGESTIONS OF SOME COMMENTATORS -- TO OPEN THE DOOR TO A PROGRAM OF COMPLIANCE REPORTING APPLICABLE TO THE FULL RANGE OF FEDERAL LAW OR TO LAY THE GROUNDWORK FOR AN ENFORCEMENT EFFORT AIMED AT FERRETING OUT TRIVIAL ARITHMETIC OR OTHER BOOKKEEPING INACCURACIES. ON THE CONTRARY, THE OBJECTIVE OF OUR PROPOSAL -- AND, IN MY VIEW, THE OBJECTIVE OF THE STATUTE -- IS TO MAKE CLEAR THAT PRIMARY RESPONSIBILITY FOR THE INTEGRITY OF CORPORATE CONTROLS RESTS ON MANAGEMENT. IF THAT OBJECTIVE CAN BE ACCOMPLISHED WITHOUT MANDATORY INTERNAL CONTROL REPORTING -- INDEED, IF IT CAN BE ACCOMPLISHED WITHOUT REGARD TO THE ACCOUNTING PROVISIONS THEMSELVES -

- SO MUCH THE BETTER.

GIVING MEANINGFUL CONTENT TO THE ACCOUNTING PROVISIONS WILL NOT BE EASY -- AS THE COMMENT FILE WHICH THE COMMISSION HAS AMASSED IN THIS PROCEEDING DEMONSTRATES. DESPITE THOSE DIFFICULTIES, HOWEVER, THESE PROVISIONS HAVE THE POTENTIAL TO PROVIDE AN IMPORTANT AND CONSTRUCTIVE LINK IN THE EVOLVING PHILOSOPHY OF ACCOUNTABILITY. THAT LINK IS ONE WHICH, IN MY JUDGMENT, CAN DO MUCH TO DEMONSTRATE THE EFFECTIVENESS OF CORPORATE SELF-DISCIPLINE -- ADMINISTERED NOT PRIMARILY BY GOVERNMENT, BUT BY EACH CORPORATION IN CONJUNCTION WITH ITS OUTSIDE ACCOUNTANTS AND COUNSEL.

WITH THOSE OBSERVATIONS IN MIND, I WOULD LIKE TO TURN NOW TO A DISCUSSION OF THE SPECIFIC RULE PROPOSALS WHICH ARE BEFORE US THIS MORNING.