Corporate Board Elections
and
Internal Controls

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Panel remarks Alan L. Beller, Director, Division of Corporate Finance, U.S. Securities and Exchange Commission (SEC)

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Well, we've gone from general principles to specific examples, with a lot of opinions thrown in between, but the opinion that matters most, perhaps, is the opinion of the SEC. We have, as our final speaker, a nice clean-up position, Alan Beller, the Director of the Division of Corporate Finance of the Securities and Exchange Commission.

Alan L. Beller: Thank you, Myles. I think that for ten seconds of my allotted ten minutes I have to start with a disclaimer. As a matter of policy, the Commission doesn't take responsibility for what I say, and so I'm speaking only for myself this afternoon and not necessarily for the Commission or any other member of the staff.

I want to jump around a little bit, but I thought I'd start by answering the question Bob Mundheim asked me, which is sort of – you're not an accountant, you're a lawyer, what do you know? Can you tell us what internal controls are? What have we been talking about all afternoon? I think it's actually two-part. I'm going to do this in layman's terms. I think partly because of where internal controls originate from – as John Coffee said, they originally came from the Foreign Corrupt Practices Act (FCPA) and have subsequently developed through groups like the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, the U.K. Turnbull standards, and there are others in other countries – I think they're really about two things. They are what allow you to know what and where your assets and liabilities are, and they are what's in place, other than going out in the field and counting the widgets, that are designed to get the numbers right. I think that, in layman's terms, is what internal controls are. Now they're mostly computer systems, they're mostly electronic, they're mostly bits and bytes, but I really think that's what they are all about. They're used for two things, or had been until Sarbanes-Oxley and its predecessor. It's worth mentioning something John didn't mention; one of the reasons that Sarbanes-Oxley ended up where it was, is that the Senate Banking Committee looked at something called FDICIA [Federal Deposit Insurance Corporation Improvement Act of 1991], which is a statute that dates from the late 80s/early 90s that applies to banks in the United States, and there is an internal-control requirement that goes back that far that applies to banks with, I think it's assets of over $250 million. They were required to do an annual evaluation and report and audit of internal control, which is indistinguishable when you look at the text of the law from that which is in Sarbanes-Oxley.

But, theoretically, internal controls keep you from losing control of your assets so that managers can unscrupulously use them to bribe Defense Ministers and bring down foreign governments, as John described it. They're also there so that the auditors don't have to go to the warehouse and count the widgets. If there's a system to figure out the number of widgets in the warehouse other than going out and counting them, and the system is reliable, you use the system. You save money. So, that's what they are when you talk about financial reporting.

There's been talk this afternoon about why Sarbanes-Oxley and why the Commission and why the Board focus on internal control over financial reporting, rather than the broader spectrum of internal control. I think, one, it is clearly the focus of Sarbanes-Oxley. Almost every sentence in Sarbanes-Oxley is designed to get financial reporting better than it was. That is the theme that runs through the Act. There's a second reason that it's focused on financial reporting, and I'll either take credit or blame for it. When you read the audit requirement or the attest requirement in Sarbanes-Oxley, and you think

about auditors going out and doing evaluations of operational risk, you think AS2 sends shudders down your spine because auditors seem to have gone a little bit overboard in a lot of the internal controls over financial reporting. At least that's the perception; I'm not going to buy into it, but that's the perception. The perception would be a whole lot worse if the spectrum of internal control that was being covered by this requirement went beyond financial reporting. Auditors have, obviously, an incredibly important role in getting the numbers right; they don't have much of a role in getting operational risk management right. So that's where the statute is. That's where we were under the statute.

It doesn't mean the SEC isn't interested in internal control that relates to other risks. We think they're incredibly important. We think the FCPA in certain respects goes to them. More importantly, the bodies around the world who have established best practices to deal with internal control more generally – in the United States, it's COSO; in the U.K., it's Turnbull; there are equivalent groups around the world – they have generally gone beyond financial reporting. That makes absolute perfect sense, and the fact that Sarbanes-Oxley doesn't go there should not be read as the SEC ignoring that or denigrating it or doing anything other than working with the statutory mandate we had and trying to, in effect, not get the audit requirement out beyond where it should have been.

First-year experience, second-year prospects; I know I believe that § 404 has been beneficial. You've heard the 11 percent number. The 11 percent number is an underreported number. The reason is that there were a very significant number of companies and many companies – and I think what we've just heard about Allianz is an example of an extremely well-run company that went through this experience – found and remediated deficiencies in their internal controls as part of that process. So the 11 percent was some number greater than 11 percent when companies and their audit firms dove in for the first time. That kind of number suggests, I think, pretty compellingly that the exercise, just on a benefits basis, was worth it. Was it worth it on a cost-benefit basis? I'm not going to answer that question directly, but I am going to say, and I have no problem saying, it costs too much. I have no trouble saying that. I don't know whether it costs too much by a factor of two, I don't know whether it costs too much by a factor of X, but it costs too much. The efforts of the PCAOB and the Commission since the first round ended, and starting the [SEC] Roundtable and starting with our guidance and continuing through today is, how do we get the benefits without the cost?

If you go back and look at the first year, I agree with what's been said here today, there was a lack of time to plan, there was a lack of time to do an integrated audit, the financial- statement audit was well under way by the time the internal-control audits started. That shouldn't happen this year. I hope our guidance is helpful that we put out in May. I hope the PCAOB guidance that we put out in May is helpful. I really do believe there was some miscommunication by both the Commission and the Board or some misreception by the companies and the audit committees, but the process we saw in the first year did not have the kind of judgment applied to it that I think we really thought, certainly our rule would permit and certainly that we thought even AS2 would permit. Companies started at the bottom and worked their way up, as opposed to starting at the top and working their way down. I absolutely agree with what you said, that entity-level controls should have gotten at least as much attention as they got. Process-level controls should probably have gotten considerably less attention than they got. Paul, I don't know how much reliability you bought for your expenditure on process-level controls. I'm pretty confident you got a lot of reliability bought for your attention on entity-level controls. And that balance is a balance we'd like to see rectified. I think our guidance is an attempt to do that.

I think what we're hearing about the second year suggests it's going to be better in terms of cost. I think it's still not going to be as low as most companies would like it to be. I think this may be more than a two-year learning curve. And so, if we're sitting here at exactly this time next year, I think you will still be getting noises from the corporate community that they are being overaudited and it's costing too much, and I think I will still have some of the same reaction; that the companies are still spending too much time counting grains of sand and not enough time thinking about what the really important controls are.