



Corporate Board Elections and Internal Controls



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Panel remarks by Charles W. Gerdtz, III, General Counsel, PricewaterhouseCoopers LLP

Moderator: Myles V. Lynk, Peter Kiewit Foundation Professor of Law and the Legal Profession, Arizona State University

Our next speaker will provide some empirical data on the experience of American companies complying with § 404, and that's Charles Gerdtz, the General Counsel of PricewaterhouseCoopers LLP.

Charles W. Gerdtz: Thank you. What I'd like to do this afternoon is to cover two things: one, as Myles says, to give you some better feel for what the experience was in the financial reporting on internal controls during the first year and then, two, to give you a sense of what we think may occur in year two, which I think, for the policymakers in the room, would help inform the question of, if one is trying to evaluate the costs and benefits of a § 404-type regimen, what is the date that you should select in order to measure those costs and benefits? Let me underline essentially – and this will not surprise, I'm sure, this audience – when Professor Coffee gave you the statistics in the round that he did earlier, that our data – and as you might imagine, we monitor this relatively closely – lines up very closely with what he reported. We have data as of August 31 that shows that there have been, in that period, a total of 3082 10-Ks filed that include § 404 opinions. Of those, 442 include an adverse opinion, i.e., a disclosure of a material weakness. One of the things that's interesting about that information is that in many circumstances, when the company and/or the auditor have identified one material weakness, they have often found multiple material weaknesses, and the total number of material weaknesses as of August 31 that has been identified is 1955. I can think of one situation, which I'm unfortunately familiar with, that included at least 10 material weaknesses. I think that's our in-house winner for the year.

In terms of the consistency across the profession, there is relatively little statistical difference between the incidences of material-control adverse reporting among the Big Four. The numbers range, I think, from about 12 percent to just under 15 percent of each of the Big Four firms. There is a difference for the relatively small number of accelerated filers that have as their independent accountants firms other than the Big Four. There seems to be a statistically significant increase to roughly more than 20 percent of those firms' reports including adverse opinions. That may correlate to some information when you look at the size of the entities. There is a perceptible correlation that shows that within the boundary of accelerated filers, typically, as a general rule, the larger the segment of filer, the smaller the number of reported material weaknesses. And so the material weaknesses tend to be, not in any terribly significant way, focused more on the smaller size of what obviously is a large group of companies.

Let me turn to year two, because I think, in some respects, this whole issue of costs needs to be looked at from the standpoint of what occurred in year one versus what, at least generally speaking, we anticipate in year two. To understand year two, I think it's important to look and say, how did this process actually evolve in year one? Professor Coffee has pointed out that really in mid-year, in mid-audit year, the PCAOB [Public Company Accounting Oversight Board] standard came out. The timing of that had an effect on the efficiency with which this could all get done in the first year. One, because it was new; two, because it was complicated; but, three, because that timing, through no fault of anyone, really limited the opportunity for the independent accountant to integrate what was already through the planning stages of the financial-statement audit and at the same time getting under way the planning for the internal-control piece of the audit. Because, again, as Professor Coffee has pointed out, ultimately the independent accountant is going to issue two very separate

reports. So, in the first year, you had, in effect, one audit having already been started and the other one trying very quickly to catch up because by the time the standard came out, we were dealing with some very difficult time constraints.

The other thing, from a practical standpoint, in terms of the testing of internal controls over financial reporting, is that they cannot be tested every day. Many of the controls that are actually being tested can only be tested at the month-end or quarter-end. Now what we saw in the first year, which we do not expect to see nearly at the levels going forward with those companies that have already been through the process, is the notion that you could go in the first quarter and you could identify an issue. You would not necessarily have concluded on its severity, but you would identify an issue and consult with the company over the fact that the issue existed. In other situations, the company itself might come to the independent accountant and say, "We think that there is an issue of a potential deficiency at this quarter." What was involved in the first year was then a remediation effort during the time period until that could be retested, and coming back to that control, a retesting of that control, a new assessment, and then moving on. So that you had, very often, the testing and redocumentation of respectively the same control, bearing in mind at the first year what was essentially going on was the creation of a baseline for both the auditor and, more importantly, for the registrant.

As we look out over year two, obviously we are going into the process with three or four things that tell us that the cost, both internal and external, in year two should be reduced compared to year one. First, we do have the ability to plan an integrated audit, because we have both the standard, and obviously the PCAOB standards around a professional audit, that we can integrate in the process. Secondly, we assume that we will have – and our early look at this confirms it – a reduction in the amount of time spent in this process I just described. And three, we've gotten guidance from both the SEC and the PCAOB this year that will further enable us to reduce the amount of time, at least from an external-auditor standpoint, that needs to be spent in the § 404 area because of our ability to rely on the work of others and to use judgment in assessing which controls become key controls. So therefore, I would say that, as we look forward, I would anticipate that we will see a reduction in costs in year two.